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## FEDERAL CORPORATE LAW: LESSONS FROM HISTORY

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FEDERAL CORPORATE LAW:  
LESSONS FROM HISTORY

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Abstract

This paper analyzes the history of federal intervention in corporate law and draws from it lessons for the future. We show that the replacement of state law arrangements by federal ones has not been sometimes in favor of investors and sometimes in favor of corporate insiders. Rather, the federal government has systematically replaced state law arrangements with ones imposing tighter constraints on insiders. Without federal intervention, state law would have produced a corporate system that provides substantially weaker investor protection than the U.S. enjoys today. We also show that federal interventions have systematically taken advantage of additional tools (including public enforcement, criminal sanctions, gatekeeper liability, and agency-based regulations) beyond those that state law has chosen or been able to use. Thus, unless one views existing levels of investor protection as substantially excessive, past patterns suggest that state competition is unlikely to produce by itself an adequate level of investor protection. Furthermore, the recurring need for federal officials to rectify state law failures in order to provide investors with adequate protection suggests that, going forward, federal lawmaking should be proactive rather than reactive. We thus recommend that Congress appoint a National Corporate Law Commission that will review all corporate law issues governed by state law to identify those that should be partly or fully federalized either because tighter restrictions on insiders are needed or because the additional tools available to federal law would be useful.

Keywords: State competition, regulatory competition, Delaware regulations, incorporations, Corporate Charters, corporate law, corporate governance, securities regulations, SEC.

JEL Classifications: G30, G38, H70, K22.

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## I. INTRODUCTION

One of the fundamental questions facing corporate law scholarship concerns regulatory competition. Does the competition for corporate charters induce states to offer arrangements that enhance shareholder value?<sup>1</sup> What role if any should federal law play in the regulation of corporate affairs? With these questions in mind, we examine the history of federal intervention in corporate law over the past seven decades. We draw from this history lessons about the past performance of regulatory competition and the desirable scope of state law in the corporate law area. History, we conclude, suggests that competition for corporate charters is unlikely to produce sufficient protection for investors. Rather than continue to respond only to clearly visible failures of state law by incremental federalization, federal officials should systematically review all corporate law areas governed by state law to determine which ones should be fully or partly federalized.

Early literature on the merits of regulatory competition has assumed that Delaware is mostly influenced by competition for incorporations with other states. However, our recent study,<sup>2</sup> as well as a contemporaneous study by Marcel Kahan and Ehud Kamar,<sup>3</sup> provide evidence that the competition among states for out-of-state incorporations is much less vigorous than had been previously assumed. It turns out that Delaware is a virtual monopoly in the market for out-of-state incorporations. While many public companies incorporate in the state of their headquarters, very few companies incorporate out of state in a state other than Delaware. States' failure to mount a meaningful challenge to Delaware's dominant position implies that the main threat that Delaware faces is federal intervention.

Indeed, federal intervention has not been a mere threat. It has taken place at various points during the past seven decades.<sup>4</sup> In a recent Article, Mark Roe provided a vivid and comprehensive account of the history of federal intervention since the

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<sup>1</sup> For the view that state competition results in a "race to the top," see, e.g., Roberta Romano, *The Genius of American Corporate Law* (1993); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251 (1977). For the opposite view, see, e.g., William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *Yale L. J.* 663 (1974); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1435 (1992).

<sup>2</sup> See generally Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 *Yale L. J.* 553 (2002).

<sup>3</sup> See generally Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 *Stan. L. Rev.* 679 (2002).

<sup>4</sup> See Joel Seligman, *The New Corporate Law*, 59 *Brook. L. Rev.* 1, 1 (1993) ("[I]n the twentieth century state corporate law norms for the large publicly held corporation have been progressively supplanted by federal standards.")

New Deal.<sup>5</sup> Roe argued that this history precludes any assessment of the merits of regulatory competition over corporate charters.<sup>6</sup> Actual federal incursions and the omnipresent threat of such interventions, so the argument goes, make it impossible to determine whether regulatory competition works well or badly or to derive conclusions from recent empirical evidence.<sup>7</sup>

We share the view that past federal interventions are highly relevant for assessing both the evolution of investor protection in the United States and the performance of state competition. In our view, however, the mere fact that the existing regime of U.S. investor protection is partly a product of federal interventions need not impede any assessment of the performance of state competition. Rather, the history of federal intervention lends support to the view that regulatory competition tends to produce insufficient investor protection. This history also has implications for the course that federal officials should pursue going forward.

*Assessing the Performance of State Competition:* Supporters of state competition believe that (1) state competition does not favor insiders' over shareholders;<sup>8</sup> (2) even if it does, there is no reason to expect insiders to have less influence at the federal level to tilt corporate rules in their favor;<sup>9</sup> and (3) state law—and especially Delaware's—is capable of providing the arrangements that would maximize shareholder value. We argue that, for anyone who does not view current investor protection in the United States as substantially excessive, history provides a good basis for questioning these three claims.

Consider first whether state law excessively favors management. A key pattern that emerges from the past is that federal lawmaking nearly always imposed greater constraints on corporate insiders. *A priori* one expects intervention to be in both directions. If the feds act when they believe that state lawmakers adopted undesirable arrangements, then intervention should sometimes impose greater restrictions on insiders and sometimes relax existing restrictions. But that is not the case. Rather, the federal government has consistently intervened to restrict insiders. Thus, anyone who does not view the current system as providing considerably excessive protection to investors should conclude that competition tends to produce arrangements that excessively favor insiders. For it is clear that, left to its own forces, competition would have produced a regime that is much more lax toward insiders than the current one. Note that this paper does not seek to contribute to the literature analyzing the

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<sup>5</sup> See Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003).

<sup>6</sup> See *id.* at 592-593.

<sup>7</sup> See *id.* at 592.

<sup>8</sup> See Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913, 921 (1982).

<sup>9</sup> See sources cited *infra* note 159.

mechanisms that might lead state law to favor insiders.<sup>10</sup> Rather, it provides evidence that, whatever the underlying mechanism turns out to be, state law does display such a tendency.

History also provides a basis for rejecting the claim that insiders would be at least as powerful at the federal level as they are at the state level. While there are good theoretical grounds for rejecting this claim,<sup>11</sup> this paper provides empirical support for doing so. If insiders were as powerful at the federal level as they are at the state level, we again would expect intervention to go in both directions, both in favor of and against insiders. But the fact that this is not the case is telling. Whatever power insiders may have at the federal level, it has proved to be weaker than their power at the state level. Insiders have failed to block federal pro-investor reforms that they successfully blocked at the state level, and they have generally failed to gain sufficient support for federal interventions that would replace state law restrictions on insiders with laxer federal rules.

History further leads us to reject the claim that state law, and especially Delaware law, is fully capable of providing optimal corporate arrangements. The federal government has repeatedly used additional instruments beyond those that states have been willing or able to employ.<sup>12</sup> While state law has largely relied on judge-made standards to govern corporate affairs, federal law has used both judge-made standards and agency-made regulations. While state law has limited itself to imposing direct duties on company directors and officers, federal law has directly regulated not only directors and officers but also outsiders, such as gatekeepers, bidders for corporate control, and controlling shareholders. While state law has relied on enforcement by private parties, federal law has used both private *and* public enforcement. Finally, while state law has limited itself to civil sanctions, federal law has used both civil and criminal sanctions. Agency-based regulations, regulation of gatekeepers and other outsiders, public enforcement, and criminal sanctions are now commonly viewed as critical elements in an effective system of investor protection. The inability or unwillingness of state law to use them thus undermines the view that state competition can provide adequate investor protection.

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<sup>10</sup> For explanations, see Oren Bar-Gil, Micahl Barzuza & Lucian A. Bebchuk, *The Market for Corporate Law*, 162 J. Inst. Th. Econ. 134, 135-138 (2006).

<sup>11</sup> See, e.g., Bebchuk & Hamdani, *supra* note 2, at 609-10 (a federal regulator would not face the market incentives that encourage Delaware to favor management); Lucian Arye Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 Va. L. Rev. 993, 1002-1004 (2001) (explaining why federal government is more likely than states to produce corporate laws that enhance shareholder value).

<sup>12</sup> For an insightful analysis of differences in the tools employed by federal law and Delaware's law, see Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 Vand. L. Rev. 1573, 1604-1607 (2005).

Federal interventions thus have not hopelessly muddled the evidence, making it difficult or even impossible to assess the merits of regulatory competition which never got a chance to operate by itself. To the contrary, the pattern of past interventions provides useful evidence for assessing the performance of state competition. For the past seven decades, regulatory competition has consistently failed to provide adequate investor protection with respect to many issues. The proposition that, by itself, competition among states can produce sufficient investor protection has failed to pass the test of history.

*Going Forward:* History indicates that it would be a mistake to roll the clock back and return to state law the areas that have already been federalized. But should federal officials proceed in the future differently than they have thus far? Given that a wide range of corporate issues is still left to state law, should federal officials continue to rely on the familiar combination of the threat of federal intervention and occasional incursions? We argue that they should not. It is time for federal officials to abandon the presumption that corporate arrangements are best left to the states unless a crisis or other visible failure requires federal officials to intervene.

To begin, while it exerts some influence on state law officials, the threat of federal intervention is generally insufficient to induce states—and Delaware in particular—to adopt the arrangements that federal officials prefer. Adopting such arrangements might expose Delaware to competition from other states, whereas the failure to do so would not necessarily trigger federal intervention. Delaware’s optimal strategy is thus hardly that of trying to imitate what federal officials would have done. Indeed, history clearly illustrates the insufficiency of the mere threat of federal intervention. Despite this threat, the feds repeatedly had to intervene and federalize substantial parts of corporate law.

We also argue that the past approach of federalizing pieces of corporate law in reaction to a crisis or visible and substantial state law shortcomings is problematic. Reacting to a crisis might produce arrangements that are designed in a hurry and without careful consideration, as some have argued happened when Congress rushed to adopt the Sarbanes-Oxley Act.<sup>13</sup> Furthermore, some pieces of state corporate law may be inadequate, but not to an extent that is sufficiently salient and alarming to overcome the prevailing presumption in favor of state law solutions. Federal policymakers should thus recognize the structural shortcomings of state competition and abandon the presumption that corporate affairs should normally be left to the states. Instead of federalizing a corporate law area when a crisis occurs,<sup>14</sup> the federal

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<sup>13</sup> Public Accounting Reform and Investor Protection Act of 2002, Pub.L. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C.A and 18 U.S.C.A).

<sup>14</sup> Reforms of securities regulation, for example, tend to follow crashes. See Stuart Banner, What Causes New Securities Regulation? 300 Years of Evidence, 75 Wash. U. L.Q. 849, 850 (1997) (‘[M]ost of the major instances of new securities regulation in the past three

government should consider which areas should be federalized in a systematic, deliberate, and comprehensive fashion.

To this end, we recommend that Congress appoint a National Corporate Law Commission charged with conducting a comprehensive review of corporate law. The Commission should examine whether there are issues currently governed by state law that (i) should be governed by arrangements that are less lax toward insiders, or (ii) could be more effectively regulated with the help of the additional tools that federal law uses, such as agency-based regulations, outsider regulation, public enforcements, and criminal sanctions. The Commission should recommend to Congress which additional corporate law issues should be federalized fully (by replacing state law arrangements with federal ones) or partly (by establishing federal minimum standards or supplementing state law with federal arrangements or enforcement devices). Because it would conduct a systematic and comprehensive examination of corporate law, the Commission may also be used to draft a proposed corporate law code for a federal incorporation option.

Our analysis is organized as follows. Parts II and III identify and discuss key patterns in the federal intervention over the past seven decades. Part II shows that federal intervention has systematically replaced state law arrangements with ones that are more restrictive vis-à-vis insiders. Part III compares the various mechanisms through which corporate arrangements are produced and enforced at the state and federal level. Part IV discusses the implications of our analysis for the debate on state competition.

## II. THE PATTERNS OF PAST INTERVENTIONS

In this Part, we provide an overview of the history of federal regulation of corporate affairs in recent decades. As we shall demonstrate, federal lawmaking in this area has generally followed a uniform pattern: regardless of the branch taking action—Congress, the Securities and Exchange Commission or courts—federal intervention generally has been in the direction of restricting corporate insiders. Whether by adopting substantive rules or by tightening the enforcement of existing ones, the federal government has consistently displayed greater willingness than the states to act against insider interests.

Before proceeding, we would like to address two potential objections. First, one might argue that this pattern is not a unique feature of federal lawmaking. After all, government intervention normally limits the freedom of private actors. When it decides to regulate a certain area, the government is expected to impose various restrictions on all parties involved. This, however, is not the case here. Federal

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hundred years of English and American history have come right after crashes.”); Larry E. Ribstein, *Bubble Laws*, 40 *Hous. L. Rev.* 77, 79-83 (2003).



intervention should not be assessed against hypothetical “free market” arrangements. Rather, it should be evaluated against the state law regime it displaces or modifies, or the regime that would have been adopted by states had the federal government not preempted the field. Compared to the restrictions set by state law, therefore, federal regulation could be either more restrictive or less restrictive of management.

Second, it is not the case that the federal government took action before states had the opportunity to do so. Indeed, once Congress preempted certain corporate issues, states would lack the authority to devise their own arrangements. But this Part shows that there were many areas—such as insider trading and disclosure obligations—concerning which the states had ample opportunity to adopt their own restrictive arrangements before the federal government took action.

In section A, we discuss federal lawmaking limiting insiders’ ability to preserve their control of public corporations. In section B, we examine federal action limiting the extent to which insiders can use their position to extract private benefits. Section C considers the role of federal law in regulating disclosure and its implications for the governance of public corporations. We will not provide a comprehensive analysis of the extensive body of federal law regulating, directly or indirectly, public corporations. Neither will we review in detail the historical background underlying each federal intervention. Rather, our goal in this Part is to uncover the consistent pattern of federal intervention.

#### A. *Insider Control and Insulation*

This section considers federal action that has impacted the extent to which incumbents are protected from insurgents aspiring to take control of the corporation or from shareholders wishing to have greater say in its affairs. As we shall demonstrate, states and the federal government have adopted different approaches to insider insulation. Whereas states generally seek to bolster insider ability to protect their controlling position, the federal government has acted to hinder insider entrenchment.

##### 1. *Hostile Takeovers*

One of the important constraints on managerial behavior is an effective market for corporate control. Indeed, takeover law has been one of the most important areas of U.S. corporate law in the last three decades. During this period, state lawmakers have been more eager than their federal counterparts to impose restrictions on takeovers.

At first sight, one may argue that the federal regulation of takeovers demonstrates that federal officials can sometime cater to managerial interests. Prior

to the enactment of the Williams Act in 1968,<sup>15</sup> cash tender offers were essentially unregulated.<sup>16</sup> In the Williams Act, Congress imposed extensive disclosure obligations and other requirements on bidders contemplating a tender offer.<sup>17</sup> By making hostile bids more difficult to implement than they would have been under the then-existing state law, this statute undoubtedly assists incumbents seeking to entrench their position. Thus, the argument goes, the Williams Act demonstrates that federal intervention can—and has—operated not only to restrict insiders, but also to assist them.<sup>18</sup>

But this initial impression is out of historical context. Upon closer inspection, it becomes clear that while the Williams Act did make hostile bids somewhat more burdensome to implement, it did not enable insiders to block indiscriminately any offers that shareholders found attractive. Rather, it allowed shareholders to decide whether to accept a tender offer without being subject to improper pressure. Indeed, it seems that Congress made a deliberate effort to protect shareholders without completely blocking takeovers.<sup>19</sup> Moreover, with the benefit of hindsight, it is evident that whatever impediments the Williams Act created, they were minor compared to the major effort undertaken by the states to block hostile bids regardless of their potential value for shareholders. The Williams Act merely attempted to create an auction between bidders when a corporation is up for sale. State takeover law, in contrast, has repeatedly attempted to block unwanted bidders.<sup>20</sup>

Consider the record of state law in the area of takeover regulation. State law impeding hostile takeover has developed in several waves, with state legislators going back to the drawing board multiple times to bolster insider protection. The first wave commenced with the first state takeover statute enacted by Virginia in 1968,<sup>21</sup> with over thirty-six states adopting similar statutes by 1981.<sup>22</sup> These statutes typically

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<sup>15</sup> Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. 78m(d)-(e), 78n(d)-(f) (2000)).

<sup>16</sup> See Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 896 (2d ed. 1995).

<sup>17</sup> For a review of the Williams Act and the SEC rules promulgated thereunder, see *id.* at 895-1008.

<sup>18</sup> See, e.g., Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 *Theoretical Inquiries L.* 387, 537-38 (2001) (relying on the Williams Act to argue that federal intervention is unlikely to increase shareholder value).

<sup>19</sup> See Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 *Mich. L. Rev.* 1862, 1896 (1989) (noting that in the Williams Act Congress refused “to take sides in the controversial debate over whether takeovers should be discouraged or encouraged.”)

<sup>20</sup> Indeed, the opponents of state antitakeover legislation relied on the Williams Act in their constitutional objections to the entrenchment measures that states adopted. *Id.* at 1868-1889.

<sup>21</sup> *Takeover Bid Disclosure Act*, Va. Code §§ 13.1-528 to -541 (1978) (repealed 1983).

<sup>22</sup> See Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 *J. L. Econ. & Org.* 225, 234 (1985).

imposed disclosure requirements on bidders intending to pursue a tender offer, and often required an administrative approval for a bid to proceed. This first wave ended with the Supreme Court's decision in *Edger v. Mite Corp.*<sup>23</sup> which invalidated the Illinois antitakeover statute.

States, however, did not acknowledge defeat, and a "second generation" of takeover statutes quickly followed. Trying to avoid constitutional challenges, the so-called second-generation statutes adopted measures that were limited to the issues traditionally regulated by state corporate laws. Some states adopted so-called "fair price" statutes, which prohibit a merger between the bidder and the target company unless a supermajority shareholder vote approves the merger or the bidder provides a "fair price" for the remaining shares. Other states enacted "control share acquisition" statutes, which require a shareholder vote approving an acquisition of control by a party. States also enacted "business combination" statutes, which prohibit mergers between bidder and target for a period of time, usually three years from the bidder's acquisition of a significant ownership position.

State efforts to impede hostile bids intensified in the aftermath of the Supreme Court's decision in *CTS Corp.*,<sup>24</sup> which essentially granted a constitutional pass to second generation statutes. Overall, 23 states adopted "fair price" statutes, 25 states adopted "control share" statutes, and 23 states adopted "business combination" statutes.<sup>25</sup>

Other examples illustrate the substantial difference in attitude concerning hostile takeovers.<sup>26</sup> In 1983, for instance, the SEC Advisory Committee on Takeovers devised recommendations that were much more restrictive of managers' ability to use defensive tactics than what state law has subsequently permitted.<sup>27</sup> The SEC also got on a collision course with state antitakeover law with its promulgation of the so-called "all-holders" rule. One of the formidable defenses against takeovers is a discriminatory tender offer—a (typically generous) tender offer by the company to its shareholders that excludes a bidder who managed to secure a toehold position. In the *Unocal* case, the Supreme Court of Delaware approved the deployment of this defense by management.<sup>28</sup> The *Unocal* decision played a key role in motivating the

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<sup>23</sup> 457 U.S. 624, 630 (1982) (Illinois takeover statute violates the Commerce Clause).

<sup>24</sup> *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 88 (1987) (upholding Indiana's second generation antitakeover statute against a dormant commerce clause challenge).

<sup>25</sup> See William J. Carney, *The Production of Corporate Law*, 71 S. Cal. L. Rev. 715, 735-736 (1998).

<sup>26</sup> It is also noteworthy that in 1987, corporate management failed in their attempt to pass restrictive federal takeover legislation. See Stephen Bainbridge, *The Politics of Corporate Governance*, 18 Harv. J.L. & Pub. Pol'y 671, 705-709 (1995).

<sup>27</sup> See SEC Advisory Committee on Tender Offers, *Report of Recommendations* (1983), reprinted in [Extra Ed. No. 1028] Fed. Sec. L. Rep. (CCH) (July 15, 1983).

<sup>28</sup> See *Unocal Corporation v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985).

SEC to adopt Rule 14d-10, which provides that no bidder shall make a tender offer unless the offer is open to all security holders of the class that is the subject of the tender offer.<sup>29</sup>

But what the SEC tried to prohibit through the all-holders rule, states in effect allowed by granting management the power to adopt a poison pill.<sup>30</sup> Like the discriminatory tender offer, the poison pill grants management the power to defeat hostile acquisitions and penalize bidders regardless of the merits of their offer.<sup>31</sup> Since poison pills do not involve the purchase of securities, the SEC could not regulate them in the absence of an authorization from Congress.

To summarize, throughout the past thirty years, state law has been far ahead of federal law in rescuing incumbents from unwanted bidders. The Williams Act does increase the cost of acquiring control, but its insulating effect pales in comparison to the various impediments that states eagerly adopted to prevent hostile bids. Furthermore, while the Williams Act was designed to protect shareholders against coercive offers, no parallel justification can be found for the blunt measures adopted or endorsed by states. It is also noteworthy that state efforts have persisted for a long period of time and with unprecedented zeal, responding promptly to any judicial intervention in favor of hostile bids.<sup>32</sup>

## 2. *Defensive Recapitalization*

One of the most effective defenses against hostile acquisitions is granting management voting control of the company.<sup>33</sup> In the 1980s, management of many public corporations attempted to gain voting control of their companies by a dual

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<sup>29</sup> Rule 14d-10, 17 C.F.R. § 240.14d-10. Rule 14d-10 applies to bidders in general. Rule 13-4 reiterates that rule in the context of tender offers by the issuer. See Rule 13e-4(f)(8), 17 C.F.R. § 240.13e-4(f)(8) (regulating outside offers). The SEC acknowledged that the all holders rule was in response to the Unocal decision. See Proposed Amendments to SEC Tender Offer Rules, 17 Sec. Reg. L. Rep. (BNA) 1320, 1321 n.5 (1985).

<sup>30</sup> The Delaware Supreme Court upheld the pill in *Moran v. Household Int'l*, 500 A.2d 1346 (1985).

<sup>31</sup> For a description of how the pill works, see John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 *Tex. L. Rev.* 271, 287 n. 62 (2000).

<sup>32</sup> When several courts ruled that boards lacked the power to adopt a pill unilaterally, state lawmakers quickly amended the statutes to explicitly provide boards with such power. See Lucian A. Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 *Nw. U. L. Rev.* 489, 514 (2002). Moreover, as Roe acknowledges, the threat of pro-takeover federal intervention has apparently led Delaware to adopt a relatively mild approach against hostile takeovers. See Roe, *supra* note 5, at 630-32

<sup>33</sup> See Jeffrey N. Gordon, *Ties that Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 *Cal. L. Rev.* 1, 4 (1988) (“If management and its allies hold the voting stock necessary to elect directors, a hostile bid becomes practically impossible”).

class stock recapitalization in which management (or an existing dominant shareholder group) received a class of stock that conferred voting control while public shareholders received a class of stock with no voting rights (or reduced voting rights).<sup>34</sup> State corporate law imposed virtually no limits on the ability of firms to separate ownership from control through the use of dual class structures.<sup>35</sup> Although controversial and potentially coercive,<sup>36</sup> such recapitalization of *existing* companies was also allowed under state law.<sup>37</sup>

The federal government, in contrast, did attempt to constrain management power to follow this practice. In 1988, the SEC adopted Rule 19c-4, which prohibited the stock exchanges from listing the securities of an issuer who engaged in mid-stream dual-class stock recapitalization.<sup>38</sup> Shortly after Rule 19c-4 was adopted, however, the D.C. Circuit invalidated it as an improper incursion into matters of state corporate law.<sup>39</sup> Despite the defeat of its initial effort in court, the SEC continued in its attempts to prohibit dual-class stock recapitalizations.<sup>40</sup> Finally, in 1994, the stock exchanges gave in to the pressure from the SEC and adopted anti-dual-class listing standards.<sup>41</sup>

The SEC's persistent effort to prohibit dual class stock recapitalizations demonstrates that the federal government is willing to step in and constrain insiders when states decline to take the initiative. The prohibition on defensive recapitalizations denies management the ability to regain, without the expense of purchasing a sufficient amount of outstanding stock, voting control of the corporation after it went public. This rule therefore makes public companies more susceptible to hostile bids and thus is clearly unfavorable to managers of existing corporations.

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<sup>34</sup> For a description of the techniques used by management to achieve voting control, see Gilson & Black, *supra* note 16, at 749.

<sup>35</sup> See, e.g., *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 124 (Del. 1977) (original charter can allow differential voting rights).

<sup>36</sup> Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807 (1987); Gordon, *supra* note 33.; Louis Lowenstein, *Shareholders Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 Colum. L. Rev. 979 (1989).

<sup>37</sup> *Williams v. Geier*, 671 A.2d 1368, 1371 (Del. 1996) (midstream recapitalizations can change voting allocation).

<sup>38</sup> See Exchange Act Release No. 34-25891, *Voting Rights Listing Standards—Disenfranchisement Rule* (July 7, 1988).

<sup>39</sup> See *Business Roundtable v. SEC*, 905 F.2d 406, 408 (D.C. Cir. 1990).

<sup>40</sup> See Report: *Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 Bus. Law. 1487, 1506-1507 (2002) (reviewing SEC's effort on this issue following the court's invalidation of Rule 19c-4).

<sup>41</sup> See, e.g., *New York Stock Exchange Listed Company Manual* § 313(A). See also SEC Release No. 34-35121, 59 FR 66570 (Dec. 19, 1994).

### 3. *Voting*

Shareholders of publicly-traded companies with dispersed ownership are largely passive and have little input concerning corporate affairs. In a large part, this is the outcome of a fundamental collective action problem: with stock ownership divided among many owners, shareholders have little incentive to exert effort to monitor management and actively intervene in corporate decision-making. Shareholder passivity, however, is also the result of the background legal rules, which often make it difficult for shareholders to intervene.<sup>42</sup>

Although state law sets the basic allocation of power between management and shareholders, federal law has intervened on many occasions in issues relating to shareholder voting. Federal intrusions have generally aimed at facilitating shareholder participation or granting shareholders more voice. In this section, we consider some of the key issues with respect to which the federal government took action to bolster shareholder voting power.

(a) *Access to the Company's Proxy.* State law generally prevents shareholders from intervening in corporate affairs other than through the election of directors and voting on certain fundamental issues. Against this backdrop, the SEC has acted to boost shareholder voice through the proxy rules. Specifically, the SEC promulgated Rule 14a-8, which provides shareholders with the right to include their proposals in the company's proxy materials.<sup>43</sup>

In the first decades after the promulgation of Rule 14a-8, the SEC had generally respected the allocation of powers under state law and allowed management to exclude shareholder proposals relating to corporate governance. In the 1990s, however, the SEC shifted its position and required management to give access to shareholders' "precatory" proposals relating to corporate governance matters.<sup>44</sup>

In 2003, the SEC proposed a rule that would require companies under certain circumstances to include shareholder nominees to the board in the company's proxy materials.<sup>45</sup> Although it now appears that the SEC is unlikely to adopt this rule in the near future, it is notable that the SEC has come close to passing this measure, while state law has never seriously considered such a reform.

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<sup>42</sup> See generally Lucian A. Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005) (arguing for increasing shareholder power to intervene in certain corporate affairs); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L. Rev. 520 (1990) (providing comprehensive overview of various legal obstacles to shareholder action, especially in context of institutional investors).

<sup>43</sup> 17 C.F.R. § 240.14a-8 (2003).

<sup>44</sup> See *Waste Management, Inc.*, SEC No-Action Letter, 1991 WL 178585, at \*18 (Mar. 8, 1991).

<sup>45</sup> See Proposed Rule: Security Holder Director Nominations, Exchange Act Release 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003).

One may argue that these measures do not significantly alter the balance of power within public corporations. After all, the proposed rule concerning shareholder nominations does not purport to grant shareholders the right to nominate directors when the applicable state law does not recognize such a right,<sup>46</sup> and the SEC will allow shareholder proposals on corporate governance matters under Rule 14a-8 only if the proposals have no binding effect. This argument, however, fails to appreciate the full impact of these reforms. Although not formally binding, precatory shareholder resolutions on governance matters can exert substantial pressure on management.<sup>47</sup> Under this rule, shareholders have been passing, for example, precatory resolutions to dismantle staggered boards.<sup>48</sup> In addition, by requiring companies to include shareholder nominees in their proxy, the SEC alleviates the difficulty associated with shareholder nomination of directors, making contested elections more likely.<sup>49</sup>

*(b) Proxy Solicitation by Challengers.* In 1956, the SEC overhauled its proxy rules and expanded the registration and review requirement to all forms of communication to shareholders “under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy.”<sup>50</sup> This reform made it more difficult for challengers to disseminate information to shareholders.<sup>51</sup>

One might thus argue that the 1956 proxy reform shows that the SEC may act to shield incumbents from challenges. We believe, however, that this is not the case. The expansion of the proxy rules did make challenges to management more difficult and was thus widely supported by managers of public corporations.<sup>52</sup> The reform, however, was also perceived at the time as a proper response to the genuine concern for protecting investors from large corporate raiders, who did not always provide shareholders with all the relevant information necessary to decide how to vote in a

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<sup>46</sup> Id.

<sup>47</sup> See Roe, *supra* note 5, at 622 (describing precatory shareholder proposals as “means to power”).

<sup>48</sup> See Georgeson Shareholder, *Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests* (noting increase in shareholder support for precatory resolutions in favor of dismantling staggered boards in 2002).

<sup>49</sup> It is also important to note that the proposed rule concerning director nominations has been considered by the SEC on several occasions in the past, starting as early as 1943. See Proposed Rule: Security Holder Director Nominations, Exchange Act Release 48,626, 68 Fed. Reg. 60,784 (Oct. 23, 2003).

<sup>50</sup> See SEC Exchange Act Release 5276 (Jan. 17, 1956).

<sup>51</sup> See John Pound, *Proxy Voting and the SEC: Investor Protection versus Market Efficiency*, 29 J. Fin. Econ. 241, 265 (1991).

<sup>52</sup> See, e.g., Roe, *supra* note 5, at 613 (noting that the 1956 proxy reform was perceived at the time as responding to managerial pressure).

proxy fight.<sup>53</sup> Indeed, the rules were designed to enable shareholders to receive a clear presentation of full, accurate information necessary for casting their vote.

Most importantly, when it became clear that the proxy rules impeded communication among institutional shareholders, the SEC significantly modified the proxy rules.<sup>54</sup> Prior to this change, institutional investors were limited in their ability to influence corporate management due to the concern that oral or written communication among shareholders would amount to proxy solicitation subject to the proxy rules.<sup>55</sup> It is thus not surprising that managers of public corporations viewed this modification of the proxy rules as a restriction of their power. The Business Roundtable, for example, argued that the proposed change would “further the disturbing trend toward the determination of the outcome of shareholder voting by secret back-room lobbying of and negotiations with institutional investors.”<sup>56</sup>

But the 1992 proxy reforms did not stop at lifting restrictions that had been originally put in place by the SEC in 1956. Until 1992, the proxy rules followed state law and allowed management to submit to a single shareholder vote a “group of related matters.” As part of the 1992 proxy reform, however, the SEC required that the form of proxy provide for a separate vote for each matter presented to shareholders.<sup>57</sup> Although it does not prevent management from conditioning the effectiveness of one proposal on the approval of another, this unbundling rule makes it impossible for management to avoid shareholder opposition to certain proposals simply by bundling them with other issues for a single shareholder vote.<sup>58</sup>

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<sup>53</sup> See Pound, *supra* note 51, at 263-64.

<sup>54</sup> See Regulation of Communications Among Shareholders, Exchange Act Release No. 30,849, 57 Fed. Reg. 29,564 (July 2, 1992).

<sup>55</sup> See Black, *supra* note 42, at 536 (1990) (the proxy rules “impose costs, delays, and legal risks on shareholder efforts to communicate with each other, if the communication is even loosely tied to the prospect of a shareholder vote.”)

<sup>56</sup> See Thomas L. Briggs, Shareholder Activism and Insurgency under the New Proxy Rules, 50 Bus. Law. 99, 100 (1994). See also Roe, *supra* note 5, at 622 (noting that the reform was perceived as counterbalancing state antitakeover laws).

<sup>57</sup> See Rule 14a-4, 17 C.F.R. § 240.14a-4(a)(3).

<sup>58</sup> The SEC also promulgated Rule 14a-7, which sets forth the so-called list-or-mail rule. See 17 C.F.R. § 240.14a-7 (2003). Under this rule, a company must, upon request by a dissident shareholder, either provide a shareholders’ list or agree to mail the dissident’s proxy statement and solicitation materials. This Rule was adopted in light of the perceived inadequacy of the arrangement supplied by state law concerning access to the shareholder list. See Proposed Rule: Regulation of Securityholder Communications, Exchange Act Release No. 29,315, 49 SEC Docket 147, 159 (the purpose of Rule 14a-7 is “to facilitate dissemination of material information to securityholders by reducing the expense and delay requestors typically encounter in obtaining a securityholder list”).



#### 4. *Board Composition*

Although the value of independent directors is widely recognized as a key component of good corporate governance,<sup>59</sup> states generally granted companies freedom in choosing the composition of their boards, and did not require them to appoint independent directors.<sup>60</sup> Through judicial interpretations of fiduciary duties in certain contexts, state corporate law did provide incentive for corporations to have independent directors.<sup>61</sup> However, even in the limited cases in which they did recognize the value of independent directors, states adopted a broad definition of independence.<sup>62</sup>

In 2002, Congress decided to intervene in the area of board composition. The Sarbanes-Oxley Act requires the SEC to issue rules that prohibit the stock exchanges from listing securities of an issuer unless the members of its audit committee are independent.<sup>63</sup> Congress also intervened in board structure by strongly encouraging public companies to have at least one “financial expert” on their audit committee.<sup>64</sup>

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<sup>59</sup> See, e.g., Ira M. Milstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of Large Actively Traded Corporations*, 98 *Colum. L. Rev.* 1283 (1998) (arguing that independent directors enhance corporate performance). Cf. Sanjai Bhagat & Bernard Black, *The Non-Correlation between Board Independence and Long-Term Firm Performance*, 27 *J. Corp. L.* 231 (2002) (finding no empirical support for the hypothesis that firms with independent directors perform better).

<sup>60</sup> See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) (norms of good corporate governance “are not required by the corporation law and do not define standards of liability.”)

<sup>61</sup> See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, n.7 (a committee of independent directors negotiating a cash-out merger could indicate that the transaction satisfied the entire fairness test); *Aronson v. Lewis*, 473 A.2d 805 (Del. 1984) (a committee of independent directors can overcome “demand futility” in the context of derivative actions).

<sup>62</sup> See, e.g., *In re The Walt Disney Co. Derivative Litigation*, 731 A.2d 342, 354-56 (Del. Ch. 1998) (a director will be considered independent concerning a derivative action only when the director has a financial interest in the outcome of such litigation). See also Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 *J. Corp. L.* 1625 (2004) (arguing that the standards for director independence adopted by the Delaware courts is “notoriously low”).

<sup>63</sup> See Section 301 of the Act, adding Section 10A(m)(1) of the Exchange Act (requiring the SEC to issue rules that prohibit the stock exchanges from listing securities of an issuer unless the members of its audit committee are independent). See also SEC Release No. 33-8220 (Apr. 9, 2003) promulgating new 17 C.F.R. § 240.10A-3, *Listing Standards Relating to Audit Committees*.

<sup>64</sup> See Section 407 of the Act (requiring the SEC to issue rules requiring issuers to disclose whether their audit committee includes at least one “financial expert,” and if not, why not); *Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, Exchange Act Release No. 33-8177 (Jan. 24, 2003).

The most far-reaching reforms concerning director independence, however, were introduced through the listing standards of the stock exchanges. Under these new listing requirements,<sup>65</sup> the majority of a listed company's directors must be independent under an enhanced independence standard, and the independent directors must hold regular sessions without management present. The New York Stock Exchange listing standards, for example, require that two board committees (in addition to the audit committee)—the compensation and nominating-governance committees—consist only of independent directors. While Nasdaq and the American Stock Exchange do not mandate that companies form independent nomination or compensation committees, the listing standards of both exchanges require that executive compensation and director nomination issues be considered by a majority of independent directors or by committees consisting solely of independent directors.<sup>66</sup>

One may question the wisdom of mandatory independence requirements.<sup>67</sup> For our purpose, however, the important point is that, from management's perspective, mandating director independence is undesirable. In other words, the reforms concerning director independence follow the consistent pattern of federal willingness to restrict insiders when the states refrain from doing so.

#### *B. Insiders' Benefit of Control*

The previous section surveyed federal lawmaking that limits the extent to which insiders are insulated from challenges to their control of public corporations. In this section, we show that federal intervention has also reduced the extent to which those in control of public companies can use their position to extract private benefits.

##### *1. Executive Compensation*

One of the direct means through which insiders can extract benefits from public corporations is arranging for generous compensation packages.<sup>68</sup> With the

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<sup>65</sup> See SEC SRO Release No. 34-48745 (November 4, 2003), NASD and NYSE Rulemaking: Order Approving Proposed Rule Changes; SEC SRO Release No. 34-4863 (December 1, 2003), Order Granting Approval for Proposed Rule Change by the American Stock Exchange.

<sup>66</sup> Like in other areas, however, the full impact of the federal reforms concerning board composition is not limited to federal law. The federal focus on director independence may put a pressure on Delaware courts to scrutinize director independence issues more carefully. See Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 *Bus. Law.* 1371, 1374-85 (2002).

<sup>67</sup> See, e.g., Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 *Sec. Reg. L.J.* 370 (2002).

<sup>68</sup> See generally Lucian Arye Bebchuk, Jesse Fried & David Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 *U. Chi. L. Rev.* 751 (2002).

exception of certain minimal process requirements, state corporate law has effectively granted insiders unlimited freedom to shape their compensation schemes.<sup>69</sup>

Federal foray into the area of executive compensation has been rather subtle at first. Yet, notwithstanding its limited scope, federal intervention has repeatedly demonstrated willingness to take a position against excessive arrangement of executive compensation.

Because it viewed this matter as a corporate internal affair subject to state law, Congress initially attempted to discourage excessive compensation indirectly, by modifying its treatment for federal income tax purposes. Federal law thus imposed an excise tax and limited the deduction on certain golden parachutes payments—made to senior executives when they unexpectedly leave the firm.<sup>70</sup> Congress also made executive compensation above \$1 million non-deductible to the corporation unless the compensation was tied to the company's earnings or stock price.<sup>71</sup> Although they do not impose any mandatory restrictions on pay arrangements, these amendments to the tax Code demonstrate that the federal government has been more willing than the states to impose substantive limits on executive compensation.

Federal authorities, however, have since then adopted a more direct approach against abusive compensation practices. In the Sarbanes-Oxley Act, Congress expressly prohibited loans made by a company to its executives,<sup>72</sup> and required the CEO and CFO of a public corporation to disgorge certain bonuses, equity-based compensation and gains on the sale of the company's stock if the company restates its financial statements as a result of material non-compliance with the SEC's financial reporting requirements.<sup>73</sup> The stock exchanges have also moved to require greater scrutiny of executive compensation arrangements. In 2003, the SEC approved Nasdaq and NYSE listing rules that require shareholder approval of equity compensation plans.<sup>74</sup>

To be sure, the array of new requirements concerning executive compensation, and especially the flat prohibition on loans to executives, may be overly broad. For our purposes, however, what is important is that this prohibition again displays a

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<sup>69</sup> See, e.g., Melvin A. Eisenberg, *Corporations and Other Business Organizations* 651 (8<sup>th</sup> ed. Unabridged 2000) (“Courts only seldom overturn the compensation of senior executives in publicly held corporations if the compensation has been approved by disinterested directors.”)

<sup>70</sup> Internal Revenue Code, Sections 280G and 4999.

<sup>71</sup> Internal Revenue Code, Section 162(m).

<sup>72</sup> Sarbanes-Oxley § 402 (codified at 15 U.S.C.A. § 78m(k)). State corporate law generally allows companies to make loans to their executives.. See e.g., Del. Code Ann., tit. 8, § 143 (2001) (authorizing loans to employees and officers of a corporation).

<sup>73</sup> See Section 304 of the Sarbanes-Oxley Act.

<sup>74</sup> See Order Approving NYSE and Nasdaq Proposed Rule Changes Relating to Equity Compensation Plans, Exchange Act Release No. 34-48108 (June 30, 2003).

much greater willingness on the part of the federal government to intervene in a manner that limits insiders' discretion.

## 2. *Insider Trading*

Prior to the federal regulation of insider trading, only state law governed the extent to which management and other insiders could trade the stock of public corporations on the basis of their inside information. States did not enact statutes to regulate insider trading. Addressing the issue under the common law of deceit and general principles of corporate law,<sup>75</sup> state courts typically refused to rule against insiders who traded based on information not available to shareholders.<sup>76</sup> Managers, therefore, were generally free to trade the stock of their corporations on the basis of inside information.<sup>77</sup>

The federal prohibition on insider trading had evolved gradually by different branches of the federal government. First, Congress enacted Section 16 of the Exchange Act, which requires certain corporate insiders to file public reports of any transactions in the corporation's securities, and to disgorge to the corporation any profits they realize from so-called "short-swing" transactions.<sup>78</sup> At a later stage, federal courts began to apply the general, open-ended antifraud provisions of Section 10(b) of the Exchange Act and Rule 10b-5 to prohibit the trading by insiders on the basis of nonpublic information, culminating in a mandatory ban of insider trading.<sup>79</sup>

The rationale underlying the mandatory prohibition on insider trading is a matter for a lively scholarly debate.<sup>80</sup> There is little doubt, however, that the federal rule against insider trading is more restrictive of management than the permissive approach under state law. The reporting requirements under Section 16 of the Exchange Act impose an administrative burden on any insider who trades in the corporation's shares, and the disgorgement provisions under this section limit the

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<sup>75</sup> See Robert C. Clark, *Corporate Law* 310-11 (1986).

<sup>76</sup> See, e.g., *Goodwin v. Agassiz*, 186 N.E. 659 (Mass. 1933). For a general overview of the common law rule and the circumstances under which it did prohibit insider trading, see Eisenberg, *supra* note 69, at 772-74.

<sup>77</sup> Moreover, corporations rarely attempted to prohibit trading by managers in possession of nonpublic information. See Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 265 (1991).

<sup>78</sup> For an overview of Section 16 of the Exchange Act, see William T. Allen & Reinier Kraakman, *Commentaries and Cases on the Law of Business Organizations* 587-89 (2003).

<sup>79</sup> The seminal decision was *In the Matter of Cady, Roberts & Co.*, 40 S.E.C. 907 (1961). See also *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (1968) (en banc), cert. denied 394 U.S. 976 (1969). For an overview of the evolution of the federal prohibition on insider trading, see Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 *Colum. L. Rev.* 1491, 1499-1506 (1999).

<sup>80</sup> See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 *Stan. L. Rev.* 857 (1983).

liquidity of corporate insiders' stock ownership. More importantly, by limiting insiders' ability to benefit from the nonpublic information available to them in their managerial capacity, the rule against insider trading limits the monetary rewards associated with the management of a public corporation.<sup>81</sup> Finally, the federal prohibition against insider trading turns this practice into a criminal offense with severe penalties.

### 3. *Freezeout Mergers*

The existing federal regulation of “freezeouts” transactions is rather limited in scope. But a closer look at the evolution of federal law governing these transactions and its impact on state law provides a powerful demonstration of how various federal authorities displayed greater willingness than Delaware to constrain improper attempts by controlling shareholders to extract benefits at the expense of minority shareholders.

In the 1960s and 1970s, there was a wave of public companies undergoing freezeout transactions—whereby the controlling shareholder cashes out the minority shareholders in order to take the corporation private.<sup>82</sup> Taking a public company private may have a variety of legitimate business reasons, such as avoiding the burden of SEC reporting. But these transactions also provide controlling shareholders an opportunity to abuse their power in order to deny the minority the option of sharing in the future profits of the company. Thus, the proper treatment of freezeout transaction was a controversial issue during the 1970s.<sup>83</sup> Initially, Delaware's courts held that minority shareholders' exclusive remedy was their appraisal right,<sup>84</sup> a remedy that many view as inadequate.<sup>85</sup>

Federal authorities were clearly discontent with Delaware's position. In 1976, the SEC proposed to adopt Rule 13e-3, which would have imposed substantive

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<sup>81</sup> To be sure, insiders can demand larger compensation in an amount equal to the forgone rewards from insider trading. Unlike other forms of executive compensation, however, insider trading does not require continual renegotiations and is less susceptible to “outrage” constraints. See generally Bebchuk et al., *supra* note 68 (analyzing the role of the outrage constraint on the design of executive compensation arrangements).

<sup>82</sup> For a review of the mechanics of implementing freezeout transactions, see Gilson & Black, *supra* note 16, at 1253-1254.

<sup>83</sup> See generally Arthur M. Borehn, *Going Private—Old Tort, New Tort or No Tort?*, 49 *N.Y.U. L. Rev.* 987 (1974); Mark K Kessler, *Elimination of Minority Interests by Cash Mergers: Two Recent Cases*, 30 *Bus. Law.* 699 (1975); Victor Brudney & Marvin Chirelstein, *A Restatement of Corporate Freeze-Outs*, 87 *Yale L.J.* 1354 (1978).

<sup>84</sup> See, e.g., *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).

<sup>85</sup> On the problems associated with the appraisal remedy, see, e.g., Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, in *Concentrated Corporate Ownership*, 247 (Randal I K. Morck, ed. 2000).

limitations on the terms under which controllers could take companies private.<sup>86</sup> And, for a brief period, it seemed that federal courts would expand the antifraud provisions of Rule 10b-5 to include oppressive freezeouts.<sup>87</sup>

Ultimately, however, the federal incursion into this domain of state law turned out to be quite limited in scope. The Supreme Court held that, in the absence of fraud, Rule 10b-5 does not apply to controlling shareholders in freezeout mergers.<sup>88</sup> And, responding to comments that it lacked the authority to regulate the substance of going private transactions, the SEC limited the final Rule 13e-3, promulgated in 1979, to disclosure issues.<sup>89</sup> Today, this rule subjects controlling shareholders in going private transactions to extensive disclosure requirements that include the true purpose of the going private transaction and the reasons for both the timing and the structuring of the transaction.

The threat of federal intervention, however, appears to have led to a dramatic change in the attitude of the Delaware courts.<sup>90</sup> In a landmark decision, the Supreme Court of Delaware held that controlling shareholders must show both a corporate business purpose for the merger and the merger's "entire fairness."<sup>91</sup> Delaware, therefore, abandoned its position that the appraisal remedy was the only one available to dissenting minority shareholders in a going private transaction.<sup>92</sup>

Moreover, although Rule 13e-3 appears to be technical in nature, its impact transcends the administrative burden of complying with its disclosure requirements. Rather, as Robert Clark explains,<sup>93</sup> its intrusive disclosure requirements put insiders who wish to squeeze out minority shareholders primarily to make profits for themselves into a dilemma. On the one hand, they can hide their true motives and face liability for violating Rule 13e-3. On the other hand, if they fully disclose their

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<sup>86</sup> See Notice Of Public Fact-Finding Investigation and Rulemaking Proceeding in the Matter of "Going Private" Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 11231 (Feb. 6, 1975) (proposing a rule under which, among other, the consideration in a freezeout shall be no lower than the consideration recommended jointly by two qualified independent persons).

<sup>87</sup> The minority shareholders of Santa Fe sued in a federal court alleging that a freezeout merger without a business purpose is fraudulent under Rule 10b-5, and the Second Circuit accepted the plaintiffs' application of Rule 10b-5 to freezeouts. See *Green vs. Santa Fe Industries*, 533 F.2d 1283, 1287 (2d Cir. 1976).

<sup>88</sup> See *Santa Fe Industries vs. Green*, 430 U.S. 462, 471 (1977) (without misrepresentation or nondisclosure, a freezeout merger will not amount to a violation of Rule 10b-5).

<sup>89</sup> See *Gilson & Black*, supra note 16, at 1307.

<sup>90</sup> See *Fischel*, supra note 8, at 915 (linking the reversal in the position of Delaware to the adoption of Rule 13e-3 by the SEC); *Clark*, supra note 75, at 520-522 (same).

<sup>91</sup> See *Singer vs. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1976).

<sup>92</sup> On the developments in Delaware law subsequent to the *Singer* decision, see *Clark*, supra note 75, at 521-522 & 525-528.

<sup>93</sup> See *Clark*, supra note 75, at 524.

true purpose they may provide minority shareholders with the evidence they need to challenge the transaction in state courts.

### C. *Insiders' Disclosure*

The area in which federal regulation of corporate affairs has been most salient is mandatory disclosure by public companies. This section considers the corporate governance implications of the disclosure requirements under federal law, as well as those of the key mechanisms that were put in place to better implement these requirements. As we shall explain, federal regulation of corporate disclosure produces significant restrictions on corporate insiders.

#### 1. *Disclosure as a Key Constraint on Insiders*

Until the enactment of the Securities Act of 1933, the extent to which managers were required to disclose information to shareholders was a matter of state corporate law.<sup>94</sup> States generally did not compel managers to disclose information to shareholders,<sup>95</sup> and little information was indeed disseminated.<sup>96</sup> In the wake of the 1929 stock market crash and the great depression that followed, Congress intervened to fill this perceived gap in investor protection by enacting the Securities Act of 1933 and the Securities Exchange Act of 1934—requiring management of public corporations to disclose information to shareholders.<sup>97</sup> This federal foray has evolved into the extant body of statutes, regulations, and case law currently governing the disclosure of information to shareholders.

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<sup>94</sup> Prior to the enactment of the 1933 Act, there were several attempts by the exchanges to regulate corporate disclosure. See, e.g., Robert B. Thompson, Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation, 38 Wake Forest L. Rev. 961, 970 (2003) (in 1923, the NYSE required listed companies to disclose their quarterly earnings).

<sup>95</sup> See Allen & Kraakman, *supra* note 78, at 210. To this date, Delaware law imposes very limited disclosure obligations on management. See Robert B. Thompson & Hillary A. Sale, Securities Fraud as Corporate Governance: Reflections upon Federalism, 56 Vand. L. Rev. 859, 868 (2003) (Delaware law “does not require disclosure, except in the sporadic circumstances in which shareholders are asked to vote”). For a comprehensive review of disclosure duties under state law, see generally Lawrence A. Hamermesh, Calling off the Lynch Mob: The Corporate Director’s Fiduciary Disclosure Duty, 49 Vand. L. Rev. 1087 (1996).

<sup>96</sup> See also David F. Hawkins, The Development of Modern Financial Reporting Practices among American Manufacturing Corporations, Bus. Hist. Rev. 135, 140 (Winter 1963) (describing the management of many turn-of-the-century public corporations as “notoriously secretive,” providing little or no financial disclosure to shareholders).

<sup>97</sup> On the history of this intervention, see Joel Seligman, *The Transformation of Wall Street*, 1-72 (3<sup>rd</sup> ed. 2003).

Whether the federal regime of mandatory disclosure is justified is beyond the scope of this Essay.<sup>98</sup> For our purposes, it is important to note that, compared to the then prevailing norms under state law, this major federal intrusion substantially expanded the scope of duties imposed on managers of public corporations.

Mandatory disclosure affects management in several ways. To begin, the duty to disclose information on a regular basis obviously imposes a significant administrative burden on management and increases its exposure to liability. Moreover, the disclosure requirements under the securities laws extend to many issues, including areas especially vulnerable to insider abuse, such as going private transactions, executive compensation, and self-dealing transactions.<sup>99</sup> As most practitioners can testify, this sweeping disclosure regime often has a chilling effect on abuses by management or controlling shareholders, because it presents these insiders with a dilemma. They can hide the true nature of the arrangement at stake and face liability, including criminal liability, for violating the securities laws. However, if they fully disclose their all the relevant facts, they may provide shareholders with the evidence they need to challenge the transaction in state courts. An extensive regime of mandatory disclosure and continuous reporting thus increases management accountability and impedes its ability to siphon wealth to itself at the expense of shareholders.<sup>100</sup>

Finally, as we will discuss in more detail in the next Part, federal disclosure obligations have served as a vehicle for introducing powerful enforcement mechanisms, such as public enforcement by the SEC and criminal liability. In addition, by creating express and implied private rights of action,<sup>101</sup> federal securities laws have significantly empowered shareholders and plaintiff attorneys to bring suits against management. Indeed, some argue that federal securities laws have become more important than state law in preventing abuses by corporate insiders,<sup>102</sup> and

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<sup>98</sup> On the justification for mandatory disclosure, see, e.g., John C. Coffee, Jr., *Market Failure and the Economic Case for Mandatory Disclosure*, 70 Va. L. Rev. 717 (1984); Paul G. Mahoney, *Mandatory Disclosure as a Solution to Agency Problems*, 62 U. Chi. L. Rev. 1047 (1995).

<sup>99</sup> See Thompson & Sale, *supra* note 95, at 875 (the SEC has adopted “various mandatory disclosure items that arguably regulate the duty of loyalty.”)

<sup>100</sup> See, e.g., Donald C. Langevoort, *Seeking Sunlight in Santa Fe’s Shadow: The SEC’s Pursuit of Managerial Accountability*, 79 Wash. U. L. Q. 449 (2001).

<sup>101</sup> See, e.g., Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k (2000) (imposing liability to investors on issuers and certain outsiders when a registration statement contains a material misrepresentation); Section 18(a) of the Securities Exchange Act of 1934, 15 U.S.C. § 78r(a) (2000) (creating express right of action for misleading reports filed with the SEC).

<sup>102</sup> See Thompson & Sale, *supra* note 94, at 861 (“Disclosure has become the most important method to regulate corporate managers”).



recent empirical evidence shows that securities class actions are being used mostly in areas that relate to management's operation of the corporation's business.<sup>103</sup>

## 2. *Mandatory Auditing and Its Regulation*

The securities laws do not stop at prescribing what information corporations must disseminate. They also impose a detailed set of supplementary rules designed to improve the quality of corporate disclosure. The principal example is the mandatory requirement for auditor certification of financial statements. This requirement restricts managerial freedom of action by subjecting the affairs of the corporation to an (ideally) independent scrutiny by an accounting firm.

Federal action in this area, however, has transcended the basic requirement for auditor certification. For many years, management was responsible for retaining the accounting firm providing the required certification. In recent years, however, federal law has intervened in the relationship between public companies and their auditors, leaving management with very little say concerning the company's auditors. Thus, federal law currently requires mandatory rotation of auditing partners and limits the scope of non-auditing services that accounting firms can provide to their auditing clients.<sup>104</sup> Most importantly, the Sarbanes-Oxley Act requires that the audit committee (which must consist of independent directors only) approve all auditing and non-auditing services provided to an issuer by its auditor.<sup>105</sup> The various requirements concerning auditor independence take power away from management, and limit its ability to improperly influence auditor scrutiny of the company.

### III. THE FEDS' EXTRA TOOLS

Our discussion thus far has largely focused on the substantive body of federal law governing corporate affairs. In this Part, we compare the structural features of state versus federal lawmaking and enforcement. State corporate law has deployed a significantly narrower range of devices than has the federal government to regulate corporate affairs. To begin, while state law primarily relies on judge-made standards to provide arrangements for many corporate issues, federal law uses *both* judge-made law and detailed agency-made regulations. Secondly, whereas state law imposes duties and restrictions only on company insiders—most notably directors and officers—federal law regulates both insiders and outsiders, such as gatekeepers, bidders for corporate control, and controlling shareholders. Thirdly, while state law exclusively relies on enforcement by private parties, federal law has used both public

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<sup>103</sup> Id. at 863.

<sup>104</sup> See Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence, Release No. 33-8183 (Jan. 28, 2003).

<sup>105</sup> See Sections 201(b) and 202 of the Act.

and private enforcement. Finally, while state law limits itself to civil sanctions, federal law uses both civil and criminal sanctions.

State law's use of a narrower set of tools might be the outcome of states' preference not to use other tools or their inability to do so. For our purposes, however, identifying the precise reason is not the most pressing question. What matters is that, like the consistent pattern of federal intervention to restrict insiders, the extra instruments that federal officials have consistently employed have implications for the proper role of the federal government. Will some of these tools be desirable also for issues that are still governed by state law due to the inclination of Congress to leave corporate issues to state law absent a crisis or some acute problem providing a compelling reason for intervention?<sup>106</sup>

#### A. *Agency-based Regulations and Judge-made Standards*

One of the noteworthy features of Delaware law is its heavy reliance on judge-made standards to regulate corporate affairs. Delaware extensively relies on its judiciary to promulgate the arrangements governing important corporate law issues,<sup>107</sup> including director liability,<sup>108</sup> duties of controlling shareholders,<sup>109</sup> and the regulation of self-dealing transactions.<sup>110</sup> Delaware judges, in turn, tend to produce flexible and highly fact-intensive standards rather than bright-line rules.<sup>111</sup> Prominent examples for such loose—some say indeterminate—standards include those governing the permissible scope of takeover defenses,<sup>112</sup> and the corporate opportunity doctrine.<sup>113</sup>

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<sup>106</sup> Kahan & Rock, *supra* note 12, view the federal use of additional tools as a positive aspect of the existing state of affairs. While we also view these tools as an advantage produced by past federal interventions, our focus is on the implications that the feds' extra tools have for leaving to state law and regulatory competition issues not yet targeted by federal incursions.

<sup>107</sup> See e.g., Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. Cin. L. Rev. 1061, 1064 (2000).

<sup>108</sup> See, e.g., *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052-53 (Del. Ch. 1996) (applying the common-law business judgment rule to find no director liability).

<sup>109</sup> See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (explaining when the intrinsic fairness test applies to parent-subsidiary dealings).

<sup>110</sup> See, e.g., *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987) (establishing a legal standard for evaluating a transaction when company directors are on both sides).

<sup>111</sup> See, e.g., William T. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894, 900 (1997) (Delaware cases are fact-specific applications of principles that are difficult to generalize); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009, 1024 (1997).

<sup>112</sup> See generally Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 Bus. Law. 247 (1989).

<sup>113</sup> See Clark, *supra* note 75, at 244-46 (proposing a clearer test).

The federal government, in contrast, often uses elaborate, bright-line rules to regulate public corporations. Prominent examples of such federal practice include the rules governing auditor independence and the disclosure of executive compensation. The sharp contrast between the Delaware and the federal approach is perhaps best illustrated by the rules governing director independence. In the limited circumstances in which Delaware law attaches significance to director independence, courts have refused to adopt rigid definitions to determine who qualifies as an independent director.<sup>114</sup> Instead, Delaware courts decide questions of director independence on a case-by-case basis taking into account the specific issue at stake.<sup>115</sup> In contrast, federal law—through the exchange listing requirements—relies on detailed rules to provide guidance on the issue of director independence.<sup>116</sup> For example, the national exchange listing requirements include a lengthy list of relationships that preclude a director from being independent.<sup>117</sup>

Note, however, that federal law does not rely exclusively on rules to regulate corporate affairs. Many important issues are regulated at the federal level through judge-made standards. For example, courts applying the general anti-fraud provisions under Rule 10b-5 are those who have largely defined both the range of conduct prohibited as insider trading and the scope of disclosure duties imposed on companies and their management.<sup>118</sup>

Competing theories purport to explain Delaware’s heavy reliance on judge-made standards. In the past, we have argued that this reliance reduces the likelihood of federal intervention by camouflaging the extent to which Delaware law favors insiders.<sup>119</sup> In a recent Article, Kahan and Rock posit that this feature of Delaware law provides Delaware with political legitimacy.<sup>120</sup> At least in some cases, states may

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<sup>114</sup> Lisa Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 *Ohio N.U. L. Rev.* 381, 395 (2005) (“Delaware courts have not identified any specific categories of relationships that would presumptively prohibit a director from being independent.”)

<sup>115</sup> See E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 *U. Pa. L. Rev.* 2179, 2182 (2001).

<sup>116</sup> See sources cited *supra* note 65.

<sup>117</sup> For a review, see Note, *And Now, the Independent Director! Have Congress, the NYSE, and Nasdaq Finally Figured Out How to Make the Independent Director Actually Work?*, 117 *Harv. L. Rev.* 2181, 2187-94 (2004).

<sup>118</sup> See generally Donald C. Langevoort & G. Mitu Gulaty, *The Muddled Duty to Disclose under Rule 10b-5*, 57 *Vand. L. Rev.* 1639 (2004); Thomas Lee Hazen, 3 *Law of Securities Regulation* § 12.17 (5<sup>th</sup> ed. 2006) (“There is no statutory definition to precisely identify which types of insider trading are permissible and which are not.”)

<sup>119</sup> See Bebchuk & Hamdani, *supra* note 2.

<sup>120</sup> See also Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 *Tex. L. Rev.* 469, 472 (1987) (this feature increases litigation and thus fees paid to Delaware’s attorneys); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 *Colum. L. Rev.* 1908, 1929-32 (1998) (Delaware’s

simply find it economically wasteful to invest in the complex process of producing elaborate rule-based regulations. A regime of bright-line rules would normally require states to establish a regulatory agency and provide it with adequate funding. The agency would then have to invest considerable resources in researching the issues, drafting proposed rules, analyzing the public's comments, and finalizing the rules. Consider the recent initiative to modify the disclosure rules concerning executive compensation. The SEC release with the proposed rules is roughly 370 pages long, including a detailed analysis of the proposed rules and their underlying rationale and requests for comments.<sup>121</sup> Needless to say, states might find this regulatory process to be prohibitively costly.

For our present purposes, however, the motivation for this feature of Delaware law is unimportant. As the next Part explains, regardless of the real reason underlying it, the heavy reliance on judge-made standards significantly constrains the manner through which states can produce their corporate law arrangements.

#### *B. Regulation of Outsiders and Insiders*

Rules of personal jurisdiction and conflict of laws impose considerable limits on the range of matters and actors that state corporate law can effectively regulate. Under the prevailing legal regime, the law of the state of incorporation governs the internal affairs of the corporation.<sup>122</sup> State corporate law is thus significantly limited in the scope of actors that it can govern, as states normally lack jurisdiction over important participants at the corporate sphere, such as creditors, bidders for control, and sometimes even controlling shareholders.<sup>123</sup> For example, since controlling a Delaware corporation is not a sufficient nexus for personal jurisdiction, Delaware has only indirect ways to regulate controlling shareholders. Likewise, Delaware does not impose any duties on bidders for corporate control. Federal law, in contrast, does impose certain requirements on bidders with respect to structuring their tender offers.<sup>124</sup>

Most notably, federal law extensively regulates corporate gatekeepers. Business corporations and their management interact with a wide range of advisors, including lawyers, accountants, and investment banks. State corporate law has generally refrained from intervening in the relationship between public companies

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reliance on open-ended standards excludes rival states from the network benefits offered by Delaware).

<sup>121</sup> See SEC Release No. 33-8655, Executive Compensation and Related Party Disclosure, (Jan. 27, 2006).

<sup>122</sup> See Note, The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy, 115 Harv. L. Rev. 1480 (2002).

<sup>123</sup> See Kahan & Rock, *supra* note 12.

<sup>124</sup> See Securities Exchange Act of 1934, § § 13(d), 14(d), 15 U.S.C. § § 78m(d), 78n(d) (2005)

and their advisors. Federal law, in contrast, has regulated, directly and indirectly, the relationship of companies with their so-called gatekeepers.<sup>125</sup> Although this interference does not directly modify state corporate laws, it does have substantial implications for the governance of public corporations. Providing a full account of the extensive regulation of gatekeepers by the federal government is beyond the scope of this Article. For illustration purposes only, we will consider two specific forms of federal intervention—subjecting gatekeepers to liability and the professional conduct rules for attorneys of public corporations promulgated by the SEC.

Federal securities laws subject a variety of gatekeepers to liability for failure to prevent issuer fraud.<sup>126</sup> Under Section 11 of the Securities Act of 1933,<sup>127</sup> multiple parties may be subject to liability for the company’s fraud at the capital raising stage. Gatekeeper liability also applies to fraud committed by public companies not in connection with an offering of securities to the public. After the Supreme Court’s decision in *Central Bank* abolished aiding and abetting liability to private parties under Rule 10b-5,<sup>128</sup> Congress explicitly authorized the SEC in the Private Securities Litigation Reform Act of 1995 to impose civil liability for auditing and abetting securities fraud.<sup>129</sup> Moreover, some courts, including in the Enron case,<sup>130</sup> have interpreted the *Central Bank* decision very narrowly.<sup>131</sup>

Under certain circumstances, attorneys representing issuers have been subject to liability even prior to the Sarbanes-Oxley Act.<sup>132</sup> But the alleged involvement of attorneys in many of the recent corporate debacles induced the federal government to

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<sup>125</sup> The term “gatekeepers” refers to “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers”). See Reinier Kraakman, Gatekeepers: The Anatomy of a Third Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 53 (1986).

<sup>126</sup> For an analysis of the strategy of imposing gatekeeper liability, see generally Kraakman, id.; Assaf Hamdani, Gatekeeper Liability, 77 S. Cal. L. Rev. 53 (2003).

<sup>127</sup> 15 U.S.C. § 77(k)(a) (2000).

<sup>128</sup> See *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994) (holding that civil liability under Section 10(b) does not extend to aiding and abetting).

<sup>129</sup> See 15 U.S.C. § 78b, d, t(f) (2000).

<sup>130</sup> *In Re Enron Corp. Secs., Derivative & Erisa Litig.*, 235 F.Supp 2d 549 (S.D. Tex. 2002); Kurt Eichenwald, Ruling Leaves Most Players Exposed to Suits on Enron, N.Y. Times, Dec. 21, 2002, at C3.

<sup>131</sup> Courts may hold gatekeepers liable by finding them to be “primary wrongdoers.” On the elusive distinction between primary and secondary liability for securities fraud, see generally Jill E. Fisch, The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants, 99 Colum. L. Rev. 1293 (1999).

<sup>132</sup> See, e.g., Lewis D. Lowenfels & Alan R. Bromberg, Liabilities of Lawyers and Accountants under Rule 10b-5, 53 Bus. Law. 1157 (1998).

directly intervene in the relationship between issuers and their counsel.<sup>133</sup> Section 307 of the Sarbanes-Oxley Act thus directs the SEC to issue rules requiring attorneys representing issuers to report evidence of certain material misconduct, including “breach of fiduciary duties” to the company’s chief legal officer or CEO. If the latter does not respond appropriately, the attorney is required to bring the matter to the attention of the audit committee, to another committee consisting of independent directors or to the entire board.<sup>134</sup>

### C. *Public Enforcement and Private Enforcement*

Federal authorities enforce corporate law norms through an elaborate system—using private, public, and criminal enforcement mechanisms. Under state law, in contrast, the sole mechanism for enforcing the rules of corporate law is private litigation in state courts. States’ narrower range of devices leads to two salient differences between states and the federal government: First, states normally lack the apparatus for scrutinizing compliance with corporate law on a routine basis. Second, states do not rely on public enforcement *ex post*.

The federal government engages in a wide variety of proactive measures designed to enhance investor protection even in the absence of any indication of wrongdoing. This includes not only the promulgation of a variety of prophylactic rules, but also ongoing inspection of public companies. The Division of Corporation Finance at the SEC, for example, scrutinizes prospectuses and other disclosure documents, provides administrative interpretation of securities legislation, and issues no-action letters to companies seeking assurances.<sup>135</sup> Similarly, the Public Company Accounting Oversight Board regularly inspects audit firms to determine their compliance with auditing standards.<sup>136</sup>

No state has a comparable function of inspecting public companies’ compliance with applicable corporate laws. In fact, it is likely that no state would find

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<sup>133</sup> See, e.g., Roger C. Cramton, *Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues*, 58 *Bus. Law.* 143 (2002) (reviewing the multiple ways in which lawyers were implicated in the Enron affair).

<sup>134</sup> See also Final Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8185 (Jan. 29, 2003). The SEC’s originally proposed a rule that included a “noisy withdrawal” obligation. See Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8150 (Nov. 21, 2002). Given widespread opposition, the SEC has extended the comment period concerning this portion of the rule. See Proposed Rule: Implementation of Standards of Professional Conduct for Attorneys, Exchange Act Release No. 33-8186 (Jan. 29, 2002).

<sup>135</sup> See SEC 2005 Performance and Accountability Report 11 (2005), available at <http://www.sec.gov/about/secpar/secpar2005.pdf>

<sup>136</sup> See Public Company Accounting Oversight Board 2004 Annual Report, 10-12, available at [http://www.pcaobus.org/About\\_the\\_PCAOB/Annual\\_Reports/2004.pdf](http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2004.pdf)

it economically worthwhile to make such considerable investment in the regulatory infrastructure necessary for fulfilling this function.<sup>137</sup>

Federal law also implements a wide array of public enforcement devices to facilitate the enforcement of corporate norms, especially those stemming from securities laws. The SEC carries out a variety of enforcement functions, including investigating cases of financial fraud, bringing civil actions in federal courts or imposing administrative and disciplinary penalties.<sup>138</sup> In severe cases (such as Enron and Adelphia), the Department of Justice brings criminal indictments. States, in contrast, rely almost exclusively on private enforcement of corporate norms. No state has established a state agency to investigate corporate matters or to bring actions against insiders that breached their fiduciary duties.<sup>139</sup> The enforcement system available to federal authorities thus goes far beyond that of state law in controlling insiders.

#### *D. Criminal and Civil Sanctions*

Criminal liability occupies a key role in the federal government's enforcement arsenal. Federal authorities have used criminal law to enforce disclosure duties and the prohibition on insider trading under the federal securities laws.<sup>140</sup> In certain cases, moreover, federal criminal law has been extended to cover breach of fiduciary duties by corporate officers.<sup>141</sup> Indeed, most recent scandals ended with criminal charges brought against the allegedly responsible corporate insiders in federal courts.<sup>142</sup> Finally, responding to perceived deterrence failure underlying the recent corporate

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<sup>137</sup> In fiscal year 2005, for example, the Corporation Finance Division at the SEC reviewed the financial statements of over 6,000 reporting companies. See SEC 2005 Performance and Accountability Report 61 (2005, available at <http://www.sec.gov/about/secpar/secpar2005.pdf>)

<sup>138</sup> For an overview, see James D. Cox & Randall S. Thomas, SEC Enforcement Heuristics: An Empirical Inquiry, 53 Duke L. J. 737 (2004).

<sup>139</sup> See, e.g., Carlton & Fischel, *supra* note 80, at 891 (states have not enacted public enforcement schemes directed against insider trading).

<sup>140</sup> See Carlton & Fischel, *supra* note 80, at 889 (the federal government can bring criminal charges to enforce the ban on insider trading).

<sup>141</sup> See John C. Coffee, Jr., Does “Unlawful” Means “Criminal”? Reflection on the Disappearing Tort/Crime Distinction in American Law, 71 B.U. L. Rev. 193, 204 (1991) (for a certain period in the 1980s, “defendants have been convicted of a federal felony on facts that would have been unlikely to support civil liability in a derivative suit”). For an overview of the federal offenses that may apply to insiders' fraud, see Geraldine Szott Moohr, An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime, 55 Fla. L. Rev. 937 (2003)

<sup>142</sup> See Kathleen F. Brickey, In Enron's Wake: Corporate Executives on Trial, 96 J. Crim. Law & Criminology, 397 (2006).

debacles, Congress introduced even harsher penalties on corporate insiders in the Sarbanes-Oxley Act.<sup>143</sup>

In contrast, states normally do not rely on criminal law to enforce corporate law norms. The motivation underlying states' reluctance to rely on criminal law is unclear. One might argue that this reluctance has changed in recent years, with the New York Attorney General, Elliot Spitzer, bringing criminal charges against investment banks and mutual funds, and other states' authorities indicting corporate officers for their involvement in corporate scandals. Yet, states that bring criminal charges are often not the states of incorporation and they do not rely on the corporation statute.<sup>144</sup> Elliot Spitzer, for example, used New York's blue sky statutes—also known as the Martin Act—to bring charges against corporate wrongdoers.<sup>145</sup> Finally, while other states have occasionally prosecuted corporate insiders, we are not aware of any criminal action by Delaware.<sup>146</sup>

#### IV. LESSONS FOR THE FUTURE

In this Part, we consider the implications of our analysis thus far. Section A evaluates the performance of state competition. Persistent federal interventions, we argue, do not hinder the assessment of state competition. To the contrary, the pattern of federal intervention provides evidence to support the view that a pure regime of state competition cannot produce adequate investor protection.

Section B considers whether federal intervention should take the same form in the future as in the past. We argue that the mere threat of federal intervention is insufficient to induce states to adopt desirable arrangements. We also highlight the shortcomings of the existing regime of federal lawmaking through occasional interventions in reaction to scandals or manifest problems.

Section C argues that the federal government should take a more proactive approach to regulating corporate affairs. Federal officials should abandon the presumption that corporate issues should normally be left to state law. Rather, the

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<sup>143</sup> For an overview, see Michael A. Perino, *Enron's Legislative Aftermath: Some Reflection on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 *St. John's L. Rev.* 671 (2002).

<sup>144</sup> See Kahan & Rock, *supra* note 12, at 1606 ("some states publicly prosecute corporate misconduct, albeit under the guise of their criminal, rather than their corporate, law.")

<sup>145</sup> For an overview, see Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 *Conn. Ins. L.J.* 107, 115-121 (2004).; Johnathan Mathiesen, Note: *Survey: Dr. Spitzlove Or: How I Learned To Stop Worrying And Love "Balkanization"*, 2006 *Colum. Bus. L. Rev.* 311, 316-325 (2006).

<sup>146</sup> See also Kahan & Rock, *supra* note 12, at 1607 ("we are not aware of any instances in which Delaware prosecutors have investigated or charged corporate officials.")



federal government should undertake a systematic and comprehensive examination of the need for full or partial federalization of corporate law issues.

A. *The Race Debate*

1. *Do Past Interventions Make it Impossible to Assess State Competition?*

In a recent article, Mark Roe has argued that the state competition debate is inherently inconclusive given the extensive federal intervention and the omnipresent threat of such intervention.<sup>147</sup> On his view, because Delaware's corporate lawmaking has been influenced by both state competition and the federal threat, it is impossible to isolate the competition effect.<sup>148</sup> In other words, because the premise of a “pure” race among states is a counterfactual one, corporate law scholars face a fundamental problem of observability when trying to assess whether competition pushes states in a positive or a negative direction.

We believe this agnosticism is unwarranted. Analytically, the fact that an outcome is the product of two distinct forces does not necessarily make it impossible to identify the separate effect of each force. To be sure, this cannot be done merely by evaluating the relevant outcome. In our case, however, it is possible to isolate the effect of state competition and obtain evidence about its direction.

For simplicity, assume that we can rank the quality of corporate law rules on a scale of one to ten. Suppose that Delaware is at five. Delaware is influenced by both the federal threat and the desire to compete with other states over incorporations. According to Roe, we cannot determine in which direction state competition pulls Delaware. State competition might have pulled it to lower the quality of its corporate arrangements, but the federal threat made it settle at five. It might also be that state competition pulled it up towards the top but the federal threat pulled it down to settle at five.

But there is a way to identify the direction in which competition pulls states. The force of state competition is the desire to increase incorporations. Thus, as long as states vary in the quality of their corporate law rules, one can examine whether states with superior rules attracted more incorporations. For example, if Delaware (with a quality score of five) does worse in attracting companies from states that have a score of six or more than from states with a score of five or less, then the motive of attracting incorporations is pulling to the top; improving quality would increase incorporations.

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<sup>147</sup> See Roe, *supra* note 5.

<sup>148</sup> See Roe, *supra* note 5, at 635 (“The state race analysis must be inconclusive because we live in a federal system.”)

We can thus evaluate the effect of state competition notwithstanding the presence of federal lawmakers by examining cases of cross-state variations to determine whether states do better in terms of incorporations inflow by providing rules that help shareholders. This test is not only analytically feasible, but it has also been partly pursued.

There is substantial agreement among academics that state takeover law provides excessive protections against takeovers.<sup>149</sup> Even some prominent supporters of state competition view state antitakeover statutes as undesirable.<sup>150</sup> The empirical evidence supports this view. The overwhelming majority of event studies found either no price or negative price reactions to the adoption of state antitakeover statutes.<sup>151</sup> Researchers have also found evidence that state antitakeover statutes increase agency costs.<sup>152</sup>

While consistent with the view that state competition produces adverse incentives concerning issues with a substantial effect on managers' private benefits,<sup>153</sup> the proliferation of antitakeover statutes presents a challenge for advocates of state competition. Supporters of regulatory competition thus sought to reconcile it with their belief that state antitakeover statutes do not serve shareholders by arguing that

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<sup>149</sup> Some believe that takeover defenses are desirable. See, e.g., Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers*, 55 *Stan. L. Rev.* 791, 808 (2002) (arguing that eliminating antitakeover defenses will reduce the amount of premium shareholders will receive upon an acquisition). But see Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 *Yale L. J.* 621 (2003) (finding no evidence that strong antitakeover defenses increase the premium shareholders receive in negotiated acquisitions).

<sup>150</sup> See, e.g., Winter, Jr., *supra* note 1, at 288 (stating that a regime that facilitates takeovers maximizes shareholders' profits); Frank Easterbrook & Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161 (1981) (arguing against the use of defensive tactics by targets' boards); Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation*, 9 *Yale J. on Reg.* 119 (1992) (almost all state antitakeover law is unwarranted and harmful); Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 *Fordham L. Rev.* 843, 859 (1993) (acknowledging the "dismal track record of most states in takeover regulation.")

<sup>151</sup> See, e.g., Jonathan Karpoff & Paul Malatesta, *The Wealth Effects of Second-Generation Takeover Legislation*, 25 *J. Fin. Econ.* 291 (1989). For surveys of these many studies, see Romano, *supra* note 1.

<sup>152</sup> See, e.g., Marianne Bertrand & Mullainathan Sendhil, *Executive Compensation and Incentives: The Impact of Takeover Legislation*, NBER Working Paper No. 6830 (1998) (the adoption of state antitakeover statutes resulted in increased extraction of rents through executive compensation); Marianne Bertrand & Mullainathan Sendhil, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 *Rand J. Econ.* 535 (1999) (the adoption of antitakeover statutes reduced managers' incentives to minimize labor costs).

<sup>153</sup> See Bebchuk, *supra* note 1; Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: the Race to Protect Managers from Takeovers*, 99 *Colum. L. Rev.* 1168 (1999); Oren Bar-Gill, et. al., *supra* note 10.

state competition does not encourage, and is thus not responsible for, the adoption of antitakeover statutes.<sup>154</sup> Most of these statutes were adopted, so the argument goes, by states that could not resist the lobbying or political pressure of some managers concerned about the threat of a takeover. State competition arguably has operated not to encourage the adoption of antitakeover statutes, but to discourage and moderate it.

Under this view, therefore, amassing strong antitakeover statutes is likely to decrease rather than increase the number of incorporations. However, a recent research conducted by Alma Cohen and one of us shows otherwise.<sup>155</sup> For all states other than Delaware,<sup>156</sup> adopting all the standard antitakeover statutes enabled the state to more than double the percentage of local firms incorporating in the state.<sup>157</sup> Moreover, the study found no evidence that the incorporation market has penalized the three states that adopted the most far-reaching antitakeover statutes.

Thus the recurring federal interventions and their influence on state lawmakers do not preclude an assessment of the effect of competition among states on such lawmaking. Moreover, the existing evidence suggests that state competition provides states with incentives to protect insiders.

## 2. *Does State Competition Induce States to Favor Insiders?*

We have rejected the claim that the extensive federal presence renders unhelpful the existing evidence on the performance state competition. We now turn to explain that past federal interventions in fact provide additional evidence concerning this question.

A key question underlying the state competition debate is whether competition pushes states in a positive direction. Supporters of state competition argue that it generally leads states to adopt corporate law rules that enhance shareholder value. Examining past interventions, however, casts a doubt on this claim. The systematic pattern of federal action, we argue, suggests that competition pushes states to produce arrangements that excessively favor insiders. This view follows from history unless one is prepared to take the position that the existing regime of investor protection in the United States provides investors with greatly excessive protection.

Indeed, the United States is believed to offer a good system of investor protection. To be sure, there are those—including perhaps some supporters of state

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<sup>154</sup> See Easterbrook & Fischel, *supra* note 77 at 222-23; Romano, *supra* note 18, at 533-34 (2001).

<sup>155</sup> See Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 *J.L. & Econ.* 383 (2003).

<sup>156</sup> The study did not include Delaware because its takeover law is in large part provided by its judiciary. See *id.*, at 405-406.

<sup>157</sup> *Id.* at 412. See also Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 *U. Pa. L. Rev.* 1795 (2002) (finding that managers generally migrate to states offering antitakeover statutes).

competition—who believe that the U.S. rules concerning investor protection are not lax enough. But it seems fair to say that the majority of corporate law scholars and policymakers—while not necessarily endorsing all the existing federal rules concerning corporate issues—would not wish to roll back the times to a massive more *laisse faire* system. And there is a significant body of empirical evidence suggesting that the system of investor protection has contributed to the success of the U.S. stock market.<sup>158</sup>

With the above in mind, let us turn to the question whether state competition produces arrangements that are too lax on corporate insiders. The pattern of intervention, we argue, suggests that it does.

As demonstrated in Part II, federal intervention has not been sometimes in favor of insiders and sometimes against them. Rather, it has consistently established arrangements restricting insiders when state law was not willing to adopt such arrangements. Moreover, states did not fail to act because federal law had acted faster to produce corporate law arrangements. If that were the case, our inference would be invalid. Rather, history shows that federal officials typically act after they reach the conclusion that state law failed to provide adequate arrangements. In other words, but for federal intervention, the corporate law regime would have been much more favorable to insiders—and thus significantly less protective of investors—than the current regime. Indeed, the system without federal intervention might have been even worse than what you would get by simply excluding the existing federal arrangements. Without the omnipresent threat of intervention, state law arrangements might have been even more lax toward insiders than the current ones. After all, as Mark Roe so convincingly describes, the current state law rules have often been adopted against an omnipresent threat of intervention.

Federal lawmakers presumably share the view that the existing investor protection regime—much of it the product of federal interventions—is not greatly excessive. Otherwise, the right thing for them to do would be to dismantle the protections that they have adopted in the past. Our analysis suggests that this view should lead to the conclusion that state competition tends to be too lax with respect to insiders.

### 3. *Do Insiders Have as Much Influence on Federal Law as on State Law?*

The pattern of federal lawmaking suggests that state competition produces arrangements that favor insiders. This, however, does not necessarily imply that a federal regime that displaced state competition would be superior. After all, federal law could be worse in catering to management. In this section, we show that the history of federal intervention undermines this argument as well.

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<sup>158</sup> See, e.g., Rafael La Porta et. al., *Law and Finance*, 106 *J. Pol. Econ.* 1113 (1998).

State competition supporters contend that the federal government is unlikely to offer corporate laws that would maximize shareholder value.<sup>159</sup> The federal government, they point out, has its own political dynamic and is influenced by various interest groups. Managers, perhaps aligned with labor interests, would have enough political clout to influence national legislation to the ultimate detriment of shareholders. Choi and Guzman, for example, argue that managerial lobbying will be especially intense at the federal level since federal rules would be relevant for every firm in the nation.<sup>160</sup> Since this is one of the principal objections to having mandatory federal rules, it is important to comment on whether political economy concerns indeed caution against federal intervention.

Would federal lawmaking be as (or even more) favorable to insiders? Before discussing the evidence, let us explain why federal officials would be more likely than state officials to provide pro-investor arrangements. At both the state and federal level, lobbying and pressure by interest groups are likely. But regulatory competition creates an important force pushing states to cater to managerial interests that would not exit at the federal level.

In an earlier work,<sup>161</sup> we showed how the desire to influence managers' reincorporation decisions induces states to provide corporate law arrangements that are favorable to managers. Even if managers invested no resources in lobbying, state lawmakers would likely be attuned to their interests. Put differently, beyond whatever lobbying by interest groups occurs, charter competition pushes states to favor managerial interests. This pressure would not apply to federal lawmakers.

To be sure, lobbying by managerial interests might be strong at the federal level, but such lobbying can occur at both the state and the federal levels. At the national level, however, lobbying by financial interests and institutional investors would be more likely to counter managerial lobbying.<sup>162</sup> Moreover, with the rise of the shareholder class, the political dynamics at the federal level might induce federal

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<sup>159</sup> See Jonathan R. Macey, *Displacing Delaware: Can the Feds Do a Better Job Than the States in Regulating Takeovers?*, 57 *Bus. Law.* 1025, 1027-28 (2002); Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 *U. Chi. L. Rev.* 1103, 1160-61 (2002) (a federal statute regulating takeovers is likely to be worse than the current regime under state law); Romano, *supra* note 18, at 537 (it is highly unlikely that Congress would adopt takeover legislation that would be superior to Delaware's); Bainbridge, *supra* note 26, at 671-75 (Congress is institutionally incapable of corporate governance reforms); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 *U. Cin. L. Rev.* 457, 468-85 (1987).

<sup>160</sup> See Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 *Va. L. Rev.* 961, 975-76 (2001).

<sup>161</sup> See Bebchuk & Hamdani, *supra* note 2.

<sup>162</sup> Cf. Mark Roe, *Delaware's Politics*, 118 *Harv. L. Rev.* 2491, 2530 (2005) (arguing that shareholders and managers are likely to be most influential at the state level).

authorities to modify corporate law arrangement so as to further restrict corporate insiders even without organized lobbying.<sup>163</sup>

The pattern of federal interventions lends further support to this analysis. If pro-insider lobbying were as or even more effective at the federal level as at the state level, then a considerable share of federal interventions would favor insiders. But that has not been the case. Whatever forces operate at the federal level, the consistent pattern of the past indicates that they tend not to be as pro-insider as those operating at the state level.

One might argue that the history of federal lawmaking provides a misleading snapshot of the balance of powers under a system of federal corporate law. Since it has thus far taken place against the backdrop of the prevailing norm under which states regulate companies' internal affairs, federal intervention was typically limited to periods of financial crisis. Given the strong populist sentiment underscoring federal action during these crisis periods, it is not surprising that the arrangements produced by the federal government disfavored insiders. Things would be different, however, were the federal government to engage in corporate lawmaking on a regular basis. Under such a regime, managers would have greater opportunity to influence lawmakers, especially when the general public is not too occupied with corporate law topics.

This potential objection is not only speculative, but also paints an overly simplistic picture of the circumstances underlying past federal interventions. As Part I indicates, not all federal interventions took place during periods of national crisis. To be sure, some of the most extensive federal incursions were sparked by the collapse of the stock market or some other national crisis. This description applies mostly to the extensive reforms undertaken by Congress to federalize what had previously been matters regulated exclusively under state law. However, many reforms or threatened reforms adopted by the SEC or federal courts did not take place during periods of national crisis. For example, while it contrasted sharply with the approach of state lawmakers at the time, the SEC's persistent attempt to prohibit dual class stock recapitalizations cannot be attributed to any particular crisis or a populist demand. The same applies to the federal courts' decisions that extended Rule 10b-5 to apply to insider trading. Even Congress intervened on several occasions without any national crisis--for example, when it adopted the tax reforms designed to curb excessive executive compensation.

#### 4. *Does State Law Have all the Necessary Tools?*

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<sup>163</sup> See William B. Bratton & Joseph A. McCahery, *The Equilibrium Content of Corporate Federalism* (Working Paper, 2005) 50, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=606481](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=606481) (political demand for certain Congressional interventions stemmed from the general public rather than organized interest groups).

Our analysis highlights another reason why state law alone cannot be relied upon to produce an adequate regime of investor protection. Beyond whatever problems exist as a matter of substantive law, states also use a much narrower arsenal of instruments to govern corporate affairs. In this section, we consider the implications of the limited toolkit that state law uses. As we explain, there likely are cases in which the devices that only the federal government has been willing or able to use are optimal. The limited tools that states deploy thus significantly question the ability of a state competition regime to provide desirable arrangements.

*Judge-made Standards.* Delaware rarely adopts rules to regulate corporate affairs. The academic literature, however, shows that rules may sometime be superior to standards.<sup>164</sup> Consider, for example, public companies' duty to disclose information concerning executive compensation. Given the complexity of compensation arrangements and the need for a uniform disclosure format across issuers, bright-line rules are presumably superior to open-ended standards. Indeed, the SEC has adopted an extensive scheme of disclosure rules concerning executive compensation.<sup>165</sup>

Furthermore, courts' central role (and the reliance on private enforcement) substantially limits the nature of corporate lawmaking. The reliance on courts substantially undermines Delaware's ability to respond to exigent circumstances without fundamentally altering the balance of power between the legislator and the judiciary.<sup>166</sup> Unlike legislators or other agencies with rulemaking power, courts need to wait for the proper dispute to reach them in order to modify existing rules. Even when the proper occasion arrives, however, they typically cannot simply overrule prior precedents. A legal system that heavily relies on judge-made law is normally bounded to make only gradual changes to existing rules.

The gradual evolution of state corporate law stands in sharp contrast to the federal response in the aftermath of Enron and other debacles. This response included quick legislative action by Congress, followed by extensive rulemaking by the SEC and the stock exchanges. Delaware, on the other hand, did not respond so quickly.<sup>167</sup>

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<sup>164</sup> See generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L. J.* 557 (1992).

<sup>165</sup> See SEC Release No. 33-8732, *Executive Compensation and Related Party Disclosure*, (Aug. 11, 2006).

<sup>166</sup> See Kahan & Rock, *supra* note 12, at 617-619.

<sup>167</sup> We do not argue that Delaware's legislator is slow to respond to rapidly changing business conditions. Indeed, some believe that Delaware's lawmakers promptly amend corporate laws when the need arises. See, e.g., Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough: A Response to Kahan & Kamar's Price Discrimination in the Market for Corporate Law*, 86 *Cornell L. Rev.* 1257, 1268 (2001). However, when case law governs an important issues, legislators are limited in their ability to respond, unless they are willing to adopt legislation that would displace the case law on the issue.

Again, we do not argue that the federal response to the recent crisis was optimal. In fact, some argue that the federal response was too hasty, and that some of the reforms lack merits.<sup>168</sup> Rather, our point is that Delaware simply cannot respond in such a prompt manner to rapidly changing circumstances.<sup>169</sup>

*Private Enforcement.* The virtually exclusive reliance of states on private litigation may be justified from the economic perspective of each individual state. However, the failure to provide for public enforcement may lead to under-enforcement of corporate norms.<sup>170</sup> There are some issues for which public enforcement may outperform private litigation. The same applies with respect to routine inspections of the extent to which companies comply with corporate law norms.

*Criminal Law.* A similar analysis applies to states' exclusive reliance on civil remedies. As is well established by the theory of enforcement, monetary penalties may sometime produce under-deterrence. When the probability of detecting wrongdoing is smaller than one (i.e., when there is some probability that the wrongdoer will not be caught), the optimal penalty should equal the social harm divided by the probability of detection.<sup>171</sup> In those cases, optimal enforcement requires that at least punitive damages be imposed.<sup>172</sup> But punitive damages, or any other form of monetary sanction, may be insufficient when the wrongdoer is of limited wealth and thus cannot pay the damages amount. Under these circumstances, the use of criminal law allows the state to overcome the judgment-proof problem.<sup>173</sup>

#### B. *The Feds' Desirable Role*

The analysis thus far leaves open the question whether the federal government should continue to occupy the same role that it has occupied thus far. In this section, we argue that federal officials should take a more proactive approach to regulating public corporations.

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<sup>168</sup> See generally Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *Yale L.J.* 1425 (2005).

<sup>169</sup> In a recent article, Justice Steele and Professor Griffith argue that its reliance on standards provides Delaware with the ability to alternate between lax and stringent regulation. See generally Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 *Bus. Law.* 1 (2005). This analysis, however, overlooks two important points. First, as we explained above, federal law also relies on judge-made standards. Second, judge-made law may be a poor device for regulating areas in which a detail-intensive rules are optimal.

<sup>170</sup> See generally Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 *J. Law & Econ.* 255 (1993).

<sup>171</sup> See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169 (1968).

<sup>172</sup> See Shavell *supra* note 170.

<sup>173</sup> See Shavell *supra* note 170.



### 1. *Is the Federal Threat Sufficient?*

We have showed that, if left alone without the threat of federal action, state competition would likely not be optimal. We have also explained why federal intervention is likely to be less biased in favor of insiders. This still leaves open the possibility that the existing regime of state competition, coupled with the mere threat of federal intervention, may be sufficient. Under this view, which is supported by a growing number of commentators,<sup>174</sup> if states go too far in the direction of favoring insiders, federal officials might intervene and extend the scope of federal rules governing corporations (or, in the worst-case scenario, displace state corporate law altogether). The threat of such hypothetical intervention, so the argument goes, will discourage states from adopting undesirable arrangements. For the reasons we explain immediately below, however, we believe that the sheer threat of federal intervention is insufficient. Put differently, the constraint produced by the threat of federal intervention is hardly a tight one.

To begin, for states other than Delaware, the federal threat has no deterrent effect. Since its corporate law affects only a small fraction of U.S. public companies, each such state does not expect its actions to have a significant impact on the likelihood of federal intervention. These states can thus adopt laws catering to insiders' interests without meaningfully increasing the likelihood of intervention.

Delaware, in contrast, cannot take its effect on the likelihood of intervention to be negligible. To the extent that deviating from shareholder interests may trigger federal intervention, Delaware would have an incentive to restrict insiders. Still, the fear of intervention would not lead it to act optimally.

First, Delaware's dominance is a two-edged sword in this context. On the one hand, its dominant position might induce Delaware to be more attuned to shareholders than other states. Given its visibility, it will not be the leading state in terms of insider protection.<sup>175</sup> On the other hand, the desire to preserve its dominance also prevents Delaware from going too far from other states in restricting management or else it will lose favor in insiders' eyes.

Second, the triggers of federal intervention are such that being excessively favorable to insiders does not necessarily spark intervention. Failure by Delaware to serve shareholder interests might trigger federal intervention only if it is sufficiently substantial and salient so as to move the relevant federal officials to take action. Although Congress has the power to regulate all corporate issues, the internal affairs norm means that Congress is unlikely to act unless there is sufficient political payoff associated with doing so. The SEC, on the other hand, *is* legally constrained from

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<sup>174</sup> See, e.g., Jones, *supra* note 62 (arguing that “vertical” competition between the federal government and Delaware produces a sufficient disciplining effect).

<sup>175</sup> For example, Delaware has adopted fewer and milder antitakeover statutes than many other states. See, e.g., Romano, *supra* note 18, at 533-34.

regulating the internal affairs of public corporations in the absence of explicit statutory authorization.<sup>176</sup> In addition, Delaware need not remain passive in the face of the threat of federal intervention. Rather, it has ample room for camouflage and other measures designed to secure legitimacy and reduce the risk of intervention—such as greater reliance on courts to regulate corporate affairs.

Finally, whereas the threat of entirely displacing the existing system of regulatory competition with a mandatory regime of federal law has a clear deterrent power, it is far from clear how strong is the threat of federalizing specific issues. After all, states continue to compete for incorporations and derive tax revenues even when a specific issue is federalized. As long as it knows that the most that can happen is a limited intervention, Delaware is less likely to act in a manner that maximizes shareholder value.

In other words, while placing some limits, the threat of federal intervention clearly provides Delaware with a substantial slack to stray away from shareholder wealth-maximization without triggering federal action. The optimal strategy for Delaware might thus be to take a calculated risk of intervention and hope for the best.

Indeed, the patterns of the past convincingly demonstrate that the sheer threat of federal action is hardly sufficient. If the mere threat were sufficient, there would never—or rarely—be actual interventions, as states would do whatever was required to avoid federal action. The evidence, however, is inconsistent with this view. Intervention has not occurred once—it has been repeated in various forms throughout the last seven decades. History thus suggests that the factors that we discussed above prevent the sheer threat of federal intervention from producing a tight constraint on state law.

## 2. *Is Reactive Federal Lawmaking Sufficient?*

Having concluded that the disciplining impact of the federal intervention threat is insufficient, we now turn to *actual* federal interventions. We believe that the existing practice of occasional interventions suffers from several drawbacks.

First, federal officials follow a reactive approach under which the “inadequacy threshold” needs to be quite high in order to trigger federal action. Federal lawmakers normally decide to intervene in corporate law issues that appear especially bad and saliently so. Arrangements that are merely suboptimal but are not crying for repair are unlikely to trigger the federal government to act. To be sure, the paucity of federal incursions is not always the outcome of legal restrictions. Congress undoubtedly has the power to make laws in whatever areas of corporate law it wishes.<sup>177</sup> Yet, the

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<sup>176</sup> See also Seligman, *The SEC at 70: A Modest Revolution in Corporate Governance*, 80 *Notre Dame L. Rev.* 1159, 1169 (2005) (the federalism norm is one of the impediments explaining the relatively sporadic involvement of the SEC in corporate governance issues).

<sup>177</sup> See Kahan & Rock, *supra* note 12, at 1574 (Congress has the power under the commerce clause to enact national corporate laws that would displace state law).

federalism discourse produces a substantial political impediment to federal intervention.<sup>178</sup> Moreover, federal courts and SEC *are* legally prohibited from preempting state corporate law arrangements, and, even when they do have the authority to intervene, are subject to political pressures to focus on their "core responsibilities."<sup>179</sup>

The upshot is that federal interventions—at least those that require Congress to act—often take place only as a response to a financial or other crisis providing lawmakers with compelling reasons to respond to the public outcry and restore confidence.<sup>180</sup> The political environment in which such federal intervention takes place has implications. First, given the need to restore public confidence, lawmakers typically act quickly, and the legislative process often lacks deliberation and thorough consideration of the issues at stake. Consider, for example, Roberta Romano's critique of the legislative process leading to the enactment of the Sarbanes-Oxley Act as being rushed.<sup>181</sup> This critique might be warranted, but its lesson is not to shun federal intervention. Rather, federal lawmakers should start thinking about the issues in a proactive way without waiting for a crisis atmosphere.<sup>182</sup> In other words, the problematic nature of federal intervention is to a large extent not the outcome of some inherent failure of the federal system. Rather, it's the outcome of the existing federalism norm under which Congress normally does not seek to regulate corporate affairs.

Second, limited interventions that focus on the concrete problems crying for repair are inherently problematic. The corporate area is complex, with many interrelations and interconnections that are often hidden. Unlike occasional interventions, a proactive approach would allow federal officials to develop a comprehensive assessment of corporate reforms and carefully study any hidden interrelations between arrangements in various fields.

Finally, because the threshold for Congressional intervention is high, the SEC and federal courts are significantly constrained in the tools that they can use when they decide to intervene. This means that the SEC and federal courts might adopt strategies that are not necessarily optimal. The SEC, for example, has often addressed perceived state law failures through enhanced disclosure requirements. Perhaps disclosure requirements were indeed the right instrument, but one cannot escape the

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<sup>178</sup> See Kahan & Rock, *supra* note 12, at 1578 (although not necessarily binding legally, the underlying themes of "corporate federalism" states' rights have significant political salience).

<sup>179</sup> See Seligman, *supra* note 176, at 1169.

<sup>180</sup> See, e.g., Mark Roe, *Delaware's Politics*, 118 *Harv. L. Rev.* 2491, 2530 (2005) (Congress intervenes in corporate law primarily when "constituents scream, fire alarms go off, and the media spots a big issue.")

<sup>181</sup> See Roberta Romano, *supra* note 168.

<sup>182</sup> Constant evaluation of the need to revise corporate law rules is considered to be one of the advantages of Delaware over the federal government. Strine, Jr., *supra* note 167, at 1268.

concern that the SEC adopted this strategy only because it was clearly within its authority. In other words, the SEC might have acted differently if it could choose from a broader menu of instruments.

Note that this section focuses on the occasional interventions that resulted in the federalization of an issue, and not on the evolution of federal law governing an issue after it has been federalized. While federalization often has been sparked by scandals or other patent problems, federal officials in charge of an issue that had been federalized can base their actions on a more systematic and comprehensive review of the issues governed by state corporate law.

### *C. Going Forward*

The federal government should therefore adopt a proactive approach to corporate law. It should go back to the drawing board and review, without the pressure caused by a scandal or other pressing problem, all the issues now governed by state law. For each issue, the federal government needs to examine (i) whether the existing state law arrangement is optimal, and (ii) whether any of the tools that are now unavailable at the state level—rules, agency involvement, public enforcement, criminalization, duties on agents not subject to the jurisdiction of the state of incorporation—would be superior. Such a review may conclude, for example, that self-dealing transactions should be governed by different arrangements or regulated with different instruments. Most importantly, this review should not proceed under the powerful prevailing presumption that corporate affairs should normally be left to state lawmakers absent some compelling reasons to intervene.

Such a systematic review would not suffer from the drawbacks of the existing approach of reactive, occasional interventions. To begin, whereas Congress in the past expanded federal law only when it perceived the state law treatment of a certain subject to be especially bad and thus presenting a compelling reason for intervention, a systematic review could result in the expansion of federal law to many issues whose treatment by state law is "merely suboptimal."

Second, while the current reactive approach often leads to Congressional interventions that are done quickly and without sufficient deliberation, a systematic review process would be immune to such a problem. Because the review process would not be conducted against the background of a crisis and perceived need to act quickly to restore confidence, decisions could be made with appropriate deliberation and examination. Thus, those who criticized the passage of SOX for being too hurried<sup>183</sup> would not be able to attribute similar flaws to the outcome of the proposed review. Federal law has thus far taken an "emergency-room" attitude of addressing only acute problems calling for immediate treatment. The review we have in mind

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<sup>183</sup> See Roberta Romano, *supra* note \_\_.

would also seek to provide solutions that could have significant long-term benefits even if the problems are not ones that demand immediate treatment.

Thirdly, the comprehensive review that we propose would enable federal officials to examine in an integrated and unconstrained fashion the optimal design of all corporate law arrangements to be specified by federal law. As we explained, some of the existing elements of federal law were adopted by the SEC or the federal courts which sought to address perceived state law failures by using disclosure requirements. Because the proposed review would allow for Congressional legislation, it could rely on a wide range of instruments beyond disclosure requirements. It would thus reconsider the strategies pursued by the SEC and the courts. For example, the proposed review would examine whether federal law would do better to address problems of self-dealing through substantive rules rather than disclosure requirements.

To conduct this review, we recommend that Congress appoint a National Corporate Law Commission to study in a comprehensive manner the arrangements that should govern public companies.<sup>184</sup> This Commission would prepare for Congressional consideration a proposed revision of all the Congressional legislation concerning public companies--a federal public companies code--which could include application of federal law to areas of corporate law thus far regulated only by state law as well as revision of existing elements of federal law.

Of course, public companies live in a dynamic and ever-changing world and the task of adjusting optimally the body of federal corporate law will never end. Delaware has a process that produces periodic revisions of its Corporate Code. We similarly believe that Congress should engage in periodic adjustment of its public companies code. To this end, the national Corporate Law Commission should be a standing commission which would continue to monitor and review the subject after the completion of its initial comprehensive set of recommendations.

The most important role of the Commission and the Congressional legislation following its work would be to determine the full range of corporate issues which should be regulated by federal law rather than state law. With respect to some issues, the federal rule might simply provide a minimum requirement to which states could add or even a default arrangement from which states could opt out to a specified extent. Because some of the rules governing a public company would continue to be supplied by its state of incorporation, we believe that the National Review Commission should also develop (or at least consider developing) a supplemental code to govern those companies that would choose a federal incorporation option.

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<sup>184</sup> The model we have in mind is the National Bankruptcy Review Commission. See <http://library.findlaw.com/1997/Nov/1/130505.html>.

We already made a detailed case for a federal incorporation option in our earlier work.<sup>185</sup> Even the strongest supporters of regulatory competition cannot and should not oppose a federal incorporation option. A federal incorporation option does not impose any rules on public companies but merely expands the menu of choices available to them. Furthermore, because the incentives and tools of federal lawmakers are different from those of state lawmakers, the federal incorporation option could well provide a meaningful expansion in this menu of choices given that states offer codes that are rather similar.

Because it will be engaged in a comprehensive and continuous review of the optimal design of all the elements of corporate regulation, the National Corporate Law Commission might be naturally positioned to develop and adjust over time the supplemental code for the federal incorporation option. Alternatively, and that is one of the issues that the Commission should consider, the task of developing and adjusting over time this supplemental code could be given to a separate standing commission whose job would then largely parallel the work done by the state committees developing recommendations for changes in state law corporate codes.

As we argued earlier, one advantage of federal regulation is the ability to make significant use of rule-making and enforcement by regulatory agencies. To the extent that the comprehensive review we recommend would conclude that expansion of federal law is desirable, the role and responsibility of the SEC could expand as well. Furthermore, developers of the supplemental federal incorporation code might also conclude that an agency involvement might be desirable for enforcing some of the code's provisions or for developing rules that provide detailed specification to implement some of the code's general provisions.

Given our discussion of the federal bodies that should play a role in the future development of federal corporate law, we wish to note that one important subject the National Corporate Law Commission should consider is the establishment of a federal corporate law court. Critics of federal corporate law have stressed the benefits of having a judge-made law developed by Delaware's court of chancery which has a great deal of expertise in corporate matters. As we pointed out in earlier work, however, not having a specialized corporate court is not an *inherent* disadvantage of federal corporate law.<sup>186</sup> A federal court specialized in corporate law--or a number of such courts--could be established and staffed with judges with great expertise in the corporate area. Such a court could be charged with jurisdiction over disputes arising from the elements of the mandatory federal public companies code, from the elements of supplementary code that might be adopted for companies choosing a federal

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<sup>185</sup> See Bebchuk & Hamdani, *supra* note 2.

<sup>186</sup> Bebchuk and Hamdani, *supra* note \_\_, at \_\_. See also Bebchuk and Ferrell, *supra* note \_\_, at \_\_ (proposing a specialized federal court to apply a body of optional federal takeover law into which shareholders could opt).

incorporation option, or both. Whether the establishment of such a court(s) is overall desirable is one significant issue that could be examined in the comprehensive review of corporate law we recommend.

In any event, while students of corporate law might reasonably differ in the recommendations they'll make to federal officials engaged in a comprehensive review of the law governing public corporations, we hope that many will come to recognize the value of such a review, and our hope is that this work will help in bringing about this recognition.

## V. CONCLUSION

The persistent federal interventions throughout the past decades do not prevent scholars and policymakers from assessing the performance of state competition. To the contrary, the clear path of federal interventions that we have identified provides important evidence that sheds light on the performance of state competition. This evidence cuts against the claims of state competition supporters. For those who are not prepared to view current levels of investor protection as far too excessive, history shows that state competition produces arrangements that are excessively lax toward insiders and that insiders' political influence at the federal level is not as strong as at the state level. And for those who believe that an adequate investor protection regime should sometime use the tools that only the federal government has used—agency-made regulations, regulation of outsiders, public enforcement, and criminal sanctions, history shows that state law is lacking.

Past interventions help us not only to identify the shortcomings of state competition but also to address them better in the future. History indicates that the mere threat of federal intervention is not sufficient to induce states to provide adequate investor protection. It further suggests that federal officials should abandon their presumption against intervening unless and until they feel compelled to do so. While such occasional interventions are better than nothing, the federal government should take a more systematic approach.

Such a systematic examination can lead to the design of arrangements without the rush that characterized the Sarbanes-Oxley legislation. It can also produce improved arrangements not only with respect to issues whose regulation by state law is alarmingly inadequate but also with respect to ones whose regulation by state law is merely inadequate. Such an examination can also ensure that different federal arrangements are designed in a coordinated way, taking care of inter-relationships and interactions among various arrangements.

We therefore recommend that Congress appoint a National Corporate Law Commission to examine all the issues now governed by state law and determine whether any of them should be fully or partially federalized. The optimal path for federal intervention in the future should be different from the one that it has taken in

the past seven decades. History suggests that state competition cannot be relied on to produce adequate investor protection. Devising a regime under which federal intervention would be done in a systematic and comprehensive way is long due.