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Corporate Law's Race to Nowhere in Particular

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Competition among the American states for corporate charters is discussed from two divergent points of view – a 'race to the bottom' versus a 'race to the top.' Under the former view, most prominently articulated by William L. Cary,[1] the states compete to provide managers with special benefits. The competition causes state law to adhere less and less strongly to the norm of shareholder wealth maximization, and a federal corporate law regime should be imposed to remedy the problem. Under the latter view, most prominently articulated by Ralph Winter,[2] market controls assure that efficient governance structures result as the states respond to managers' demands. This obviates any need for federal intervention.[3]

The two views, thus juxtaposed, make for a clear statement of the issues raised by state charter competition. But, unfortunately, the oppositional formulation no longer describes the substance of the debate. It has been a number of years since either view – 'race to the top' or 'race to the bottom' – has had any vocal adherents. Discussion of state charter competition now occupies a middle ground. On the middle ground, many desirable results of state competition are recognized. But negative effects on shareholder value also are identified, especially in respect of regulation of takeovers.[4]

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† A review of *The Genius of American Corporate Law* by Roberta Romano (Washington: The AEI Press 1993) pp. xvii, 161, US$24.75.
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1 W. Cary 'Federalism and Corporate Law: Reflections upon Delaware' (1974) 83 *Yale LJ* 663.

2 R. Winter 'State Law, Shareholder Protection, and the Theory of the Corporation' (1977) 6 *J. Leg. Stud.* 251.

3 For a useful summary of this discussion, see R. Daniels 'Should Provinces Compete? The Case for a Competitive Corporate Law Market' (1991) 36 *McGill LJ* 130, 170–9.

4 See, e.g., R. Winter 'The Race for the Top Revisited: A Comment on Eisenberg' (1989) 89 *Colum. LR* 1526, 1528 (expressing more confidence in the view that Cary was wrong than that state competition results in a race to the top); F. Easterbrook and D. Fischel *The Economic Structure of Corporate Law* (Cambridge: Harvard University Press 1991) 222 (race to the top stands as refuted, but the proposition that competition creates a 'powerful tendency' to enact shareholder beneficial laws remains vital); M. Eisenberg 'The Structure of Corporation Law' (1989) 89 *Colum. LR* 1461, 1509 (position between Winter's and Cary's but closer to Cary's).

Professor Roberta Romano first staked out the middle ground in an article published in 1985.[5] That article and her subsequent work on the subject make hers the leading voice on corporate regulatory competition in the United States. Two elements distinguish Romano's contribution. First, her model of incorporation as product competition driven by transaction-cost concerns has the capacity to simplify the description of the process of corporate law creation even as it explains most of the institutional details. Second, she observes the distinction between fact and value more scrupulously than any other corporate law academic. Her projects search in the first instance for answers to fact questions: Does reincorporation in Delaware in fact decrease shareholder value?[6] Why do legislatures enact anti-takeover statutes?[7] She does the hard, empirical work required to propose answers. Her enterprise reproaches those of us who tend to remain content to ruminate in a world of descriptive and normative theory, testing propositions in the limited and uncertain framework of personal experience and confirming them with anecdotal evidence from periodicals. In a discourse where reference to the empirical work of others is routine, Romano does her own.

Romano has restated her work on corporate regulatory competition in a book, *The Genius of American Corporate Law*.[8] It is a pleasure to report that the book is not a collection of chapters that separately condense each of her many articles.[9] Instead, it sets out her principal points in a new and concise essay, and adds some new material. It is welcome for these reasons alone.

The book also is timely. Romano builds on three positions. Two of these are descriptive – an explanation of reincorporation in terms of transaction costs, and an explanation of Delaware's position as the

5 R. Romano 'Law as Product: Some Pieces of the Incorporation Puzzle' (1985) 1 *J. of Law, Econ. & Org.* 225.

6 Romano's event study of the stock prices of corporations moving to Delaware transformed the normative direction taken by the state competition discussion. See supra note 5.

7 R. Romano 'The Political Economy of Takeover Statutes' (1987) 73 *Va LR* 111.

8 Supra note †.

9 These include the articles cited supra notes 5 and 7; 'A Guide to Takeovers: Theory, Evidence and Regulation' (1992) 9 *Yale J. Reg.* 119; 'State Competition for Close Corporation Charters: A Commentary' (1992) 70 *Wash. U. LQ* 409; 'The Shareholder Suit: Litigation without Foundation' (1991) 7 *J. of Law, Econ. & Org.* 55; 'Corporate Governance in the Aftermath of the Insurance Crisis' (1990) 39 *Emory LJ* 1155; 'Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws' (1989) 89 *Colum. LR* 1599; 'The Future of Hostile Takeovers: Legislation and Public Opinion' (1988) 57 *U. Cin. LR* 457; 'The State Competition Debate in Corporate Law' (1987) 8 *Cardozo LR* 709.

preferred state of incorporation of large American firms in terms of relational contracting. The third position is normative – a firm opposition to any form of federal intervention, derived from a view of the benefits and detriments of competition close to that of Winter on the range of opinion between Winter's and Cary's.[10] Each of these positions has been controverted, and the controversy has been intensifying.

The controversy proceeds on the middle ground, and the middle ground leaves open room for contrasting descriptions of the competitive system and different normative conclusions respecting some of its consequences.[11] Many on the middle ground remain closer to Cary than to Winter, and stand ready to isolate some state law provisions for federal pre-emption. The flow of reform suggestions has quickened lately, partly as a response to widespread enactment of anti-takeover legislation by the states in the 1980s,[12] and partly as a response to the trend towards active participation in corporate decision-making by institutional investors.[13] Romano takes the opportunity to confront these differing views in her book. The book, in turn, invites a review of the state of the debate at this unstable moment in American corporate politics.

This commentary undertakes such a review. It takes the position that Romano's product competition model, while sound in most respects, needs to be unpacked to allow us to confront barriers to shareholder input in corporate contracting processes. The exercise of unpacking shows that the product competition analogy, taken alone, does not fully describe the creation of corporate law. A pattern of political mediation partially corrects the system in response to the shareholders' voice problem and shares a place in the description. Nor does the product competition analogy, taken alone, provide a basis for projecting a satisfactory solution to the voice problem itself.

Part I considers Romano's explanations of state competition and Delaware's position in the light of her responses to those who supple-

10 Romano 'State Competition Debate' supra note 9, 753.

11 Ibid. 753.

12 See L. Bebchuk 'Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law' (1992) 105 *Harv. LR* 1435; D. Charny 'Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities' (1991) 32 *Harv. Int. LJ* 423; J. Seligman 'The New Corporate Law (1993) 59 *Brooklyn LR* 1; J. Seligman 'The Case for Minimum Corporate Law Standards' (1990) 49 *Maryland LR* 947.

13 See R. Karmel 'Is It Time for a Federal Corporation Law?' (1991) 57 *Brooklyn LR* 55. Congressman Markey recently introduced federal legislation that would increase shareholder power respecting director nominations by mandating inclusion of shareholder nominees on the issuer's proxy ballot. See 25 *BNA Secs. Reg. & L. Rep.* (29 October 1993) 1464.

ment or modify her model. Here her principal interlocutors are Bernard Black,[14] John Coffee,[15] Melvin Eisenberg,[16] and Jonathan Macey and Geoffrey Miller.[17] Drawing on Coffee and Eisenberg, the discussion suggests that reference must be made to the threat of federal intervention as we explain Delaware's status and ongoing behaviour. Part II considers the case for federal intervention. Here Romano's principal interlocutors are Lucian Bebchuk[18] and David Charny.[19] The discussion questions Romano's view that the regulatory responsiveness attending jurisdictional competition results in the best available mix of corporate law rules. It suggests that Romano – inadvertently – is a leading voice for federal intervention.

I *Charter competition as cost economy and relational contract*

A. THE MODEL

1. *Charter competition in the United States*

Romano's model assumes that state corporation codes may be viewed as products consumed by corporations[20] (p. 6). In her story, firms operate in dynamic conditions, and competition for their legal business forces the states to adapt the law to these changing circumstances. State lawmaking emerges as a trial-and-error process suited to the accurate identification of optimal corporate arrangements. Delaware, the leading state,[21] excels in this market (p. 9).

14 B. Black 'Is Corporate Law Trivial? A Political and Economic Analysis' (1990) 84 *Nw. U. LR* 542.
15 J. Coffee 'The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards' (1987) 8 *Cardozo LR* 759.
16 Eisenberg, supra note 4.
17 J. Macey and G. Miller 'Toward an Interest-Group Theory of Delaware Corporate Law' (1987) 65 *Texas LR* 469.
18 Bebchuk, supra note 12.
19 Charny, supra note 12.
20 On the question as to the existence of charter competition, Romano does not have to make an assumption. She has support in her own empirical work (p. 16). Her study of the spread of innovation in corporations codes found that innovations spread rapidly in a pattern resembling the S-shaped diffusion curve of technological innovations. Supra note 5, 225. Her study of state responsiveness, ibid. 237–8, found that states that are more responsive gain more and lose fewer incorporations, and that state responsiveness is significantly positively correlated to the proportion of state revenues derived from franchise taxes. Ibid.
21 Delaware is home to one-half of the largest American corporations, and the new domicile of 80 per cent of reincorporating firms. Supra note 5, 244.

The state lawmaking process, in Romano's view, benefits the shareholders on the whole. She admits that state competition would be undesirable if it resulted in codes that so favoured management preferences as to impair shareholder interests. But she does not find that characterization to be accurate, citing her famous empirical rebuttal of Cary's 'race to the bottom' position. Event studies by her (and others) consistently show that reincorporating firms do not experience stock price declines (pp. 16–18).

In Romano's account, reincorporating firms are the marginal consumers in the charter market. They seek a legal regime that reduces their costs, and a guaranty that the new state of domicile will maintain the desirability of its code (p. 32). She backs the cost-reduction assertion with her study of public corporation domicile changes between 1960 and 1982. The study shows that corporations tend to change domiciles in advance of either a public offering, an acquisitions program, or the promulgation of anti-takeover measures[22] (p. 33). They incur substantial costs in so doing, including the one-time costs of the move, the possibility of appraisal claims, and, in the case of corporations moving to Delaware, the present negative value of an additional layer of high franchise taxes (pp. 34–5). The benefits mostly stem from the threat of litigation – all three of the identified transactional occasions for changes of domicile entail litigation risks. The reincorporating firms look to the target state for a predictable legal regime. Delaware provides this with its comprehensive case law, well-specified indemnification rules, and expert judiciary (pp. 33-4, 39 n20).

Romano's account of Delaware's leading position rests on one further point. The reincorporating firm and the target jurisdiction enter into a relational contract that entails a risk of opportunistic breach. Even as the firm invests to gain access to the target's favourable legal regime, the target remains free to change its politics and transform itself into an unresponsive jurisdiction.[23] The competitive jurisdiction has to reduce this possibility by offering a credible commitment (pp. 36–7). Delaware's commitment stems from its dependence on franchise tax revenues.[24] These revenues are an 'intangible asset'[25] that

22 Ibid.

23 New Jersey did this early in the twentieth century, precipitating a mass movement of corporations across the river to Delaware.

24 These amounted to 17.7 per cent of Delaware's total tax revenues in 1990 (p. 10).

25 Romano offers some new empirical work to bolster this point. She surveys the costs and franchise tax returns of Delaware's chartering business between 1960 and 1990 (pp. 7–8), and sets out franchise revenue as a proportion of tax collections for the fifty states, 1960–1990 (pp. 10–11).

emerges from the combination of a large number of incorporations and a small population. Delaware also invests in real assets specific to its incorporation business – its case law and judicial and administrative expertise. These, together with Delaware's code, constitute a reputational capital. Delaware has devised legal devices to protect this capital against political disruption. These include its direction of corporate matters to a specialized chancery court, its practice of appointing rather than electing its judges and limiting them to twelve-year terms, and its requirement of two-thirds majorities of both houses of its legislature for the approval of corporation code amendments (pp. 38–42). The storehouse of capital, thus well guarded, bolsters the state's market position in two ways. First, it fosters reciprocal dependencies between Delaware and its customers. The lawyers who recommend reincorporation to client corporations invest in Delaware expertise, and thus have incentives to recommend it as a destination. Their clients need to economize on legal costs, and thus tend to stay in place (pp. 43–4). Second, other states cannot credibly precommit to offer superior service, and thus are deterred from incurring the necessary start-up costs. A first-mover advantage in Delaware results[26] (pp. 40–1, 44).

2. Canada and Europe compared

Romano complements her discussion of charter competition in the United States with a comparison of corporate law systems in Canada

26 Romano reviews the competing explanations of R. Posner and K. Scott *Economics of Corporation Law and Securities Regulation* (Boston: Little Brown 1980) and B. Baysinger and H. Butler 'The Role of Corporate Law in the Theory of the Firm' (1985) 28 *J. of Law & Econ.* 179. Posner and Scott suggested that large firms go to Delaware. Romano notes in response that only 50 per cent of the large firms go to Delaware. This creates a puzzle for solution, given the assumption that legal regimes are costly in differing degrees and in the presence of competition. Romano solves the puzzle with her transactional explanation of reincorporation motivations – the cost picture only indicates a move to Delaware when the firm envisages one of the described transactions.

Baysinger and Butler distinguished Delaware and non-Delaware firms based on concentration of ownership. In their study, firms with holders of large blocks of stock tend towards strict states because the large holders lack easy exit and depend more on legal monitoring mechanisms. Romano dislikes this product-differentiation story because she is not convinced of the existence of meaningfully strict regimes; competition causes state codes to converge in their basic sets of provisions. She accounts for Baysinger and Butler's empirical results by noting that concentrated ownership diminishes the need to migrate to Delaware in the first instance. Since the blockholders exercise control, the legal regime matters little, unless new activities are to be undertaken (pp. 45–7).

Romano has the better of this discussion.

and Western Europe. This new material takes her model to the task of explaining the absence of American-style jurisdictional competition elsewhere.

The Canadian discussion centres on leading articles by Ronald Daniels and Jeffrey MacIntosh.[27] Daniels explained the diffusion among the provinces of the reform provisions of the Canada Business Corporations Act after its 1975 enactment as a form of charter competition.[28] MacIntosh has countered that the federal innovations should be treated either as a random event or a function of bureaucratic preferences. Romano, bringing components of her American model to bear, tends towards MacIntosh's view. She questions whether the Canadian federal government has significant incentives to compete for charters. Unlike Delaware, it does not look to franchise taxes to make up a significant proportion of total revenues[29] (pp. 120–1). In accounting for the absence of vigorous provincial charter competition, she joins with both Daniels and MacIntosh in citing authority-sharing arrangements among the provinces and between the provinces and the federal government, in particular the corporate governance authority of provincial securities administrators and the Supreme Court of Canada's jurisdictional authority over the provinces (pp. 122–3). She adds a reference to concentration of ownership of larger Canadian firms,[30] noting that

27 Daniels, supra note 3; Jeffrey MacIntosh 'The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law: A Second Look' University of Toronto Law and Economics Working Paper 18 (Toronto 1993).

28 Daniels, supra note 3, 151–6. Daniels's empirical studies also uncovered some shifts in incorporation patterns. The largest number of federal incorporations has consistently come from Quebec firms, but the percentage of federal incorporations from Quebec declined after 1980. For an explanation, Daniels looks to the inclusion of CBCA reform provisions in the Quebec Companies Act in 1979 and 1980 as well as political factors. Ibid. 166–7. He also notes an acceleration of the trend after an increase in the federal incorporation fee in 1985. Ibid. 168–9.

MacIntosh counters with a regression analysis of data on total federal and provincial incorporations from 1979 to 1988 to test the hypotheses that each of a significant provincial code reform along the lines of the CBCA and an increase in federal incorporation fees relative to provincial fees will result in an increase in provincial incorporations relative to federal incorporations. He finds support for the latter proposition but not for the former.

29 Thus Romano construes the 1985 increase in the federal franchise fee as a signal that the federal government cannot be expected to invest in a reputation for responsiveness to corporate concerns. This account follows from her explanation of Delaware and dovetails with her negative view of the desirability of federal intervention in the United States.

30 Here again Romano draws on Daniels and MacIntosh. See R. Daniels and J. MacIntosh 'Capital Markets and the Law: The Particular Case of Canada' (1990) 3 *Can. Investment Rev.* 77, 80–1.

controlling shareholders have the voting power to opt out of default rules and therefore less incentive to pay a premium for a responsive regime[31] (pp. 124–5).

With Europe, the fact for explanation is the virtual absence of any lawmaking behaviour that even arguably resembles American charter competition. Romano sets out a long list of legal and institutional barriers. First, reincorporation costs more in Europe. Since European choice-of-law rules apply the law of the corporation's real rather than nominal domicile, changing domiciles entails new capital investment and the costs of transferring human capital (pp. 132–3). Also, European reincorporations trigger taxes on hidden reserves (p. 133). Second, European patterns of corporate regulation and equity capitalization do not open up market opportunities for a revenue-seeking jurisdiction. European systems have not allowed for much shareholder litigation, and some restrict shareholder voting rights. This dampens demand for responsive lawmaking along American lines (pp. 133–6). Scant demand also results from the fact that the percentage of corporate capital embodied in publicly traded equity remains small. Outside of Britain, capital still tends to be raised privately from banks and equity ownership tends to be concentrated (pp. 136–8). Third, Europe's normative landscape is more complex. Labour codetermination in Germany and statutory worker participation structures elsewhere create a barrier to a regulatory system directed to the preferences of managers and shareholders. In Romano's view, such schemes are unlikely to enhance shareholder value (p. 130), and give rise to incentives on the part of nations adopting them to prevent the emergence of active charter competition (p. 132). Romano takes a similarly negative view of the corporate and securities law harmonization project of the European Union. This too dampens competition by mandating a floor and reducing returns from innovation[32] (p. 132).

31 This explanation also shows up in Romano's description of American practices.

32 Romano, having done the comparative exercise, closes her book by addressing claims that the competitive success of European and Japanese firms during the past twenty years can be tied to their superior governance structures, in particular their concentrated ownership and the practice of greater participation by financial institutions. Romano responds, rightly in my view, that the claim is unproven. In the absence of empirical studies tying governance structures to productivity, the claim rests on the relative decline of American productivity growth. Romano ascribes this to international convergence (pp. 140–1). While she does not oppose the removal of legal constraints on active equity investment by American institutions, she, again rightly in my view, makes no prediction about the scope of institutional involvement that would follow from deregulation (pp. 144–7).

Romano's direct comparison and joint disposition of Europe's codetermination models and harmonization movement[33] has a parallel in American discussions of worker participation and corporate law. Participants in the American constituency rights debate have noted[34] that competition directed to the satisfaction of management preferences prevents the states from mandating employee inclusion in their domiciliary corporations, whether as beneficiaries of fiduciary duties or holders of rights to be heard. The American case for worker rights thus is tied to the case for federal intervention.[35]

Calls for harmonization do not tend to figure into these American discussions as an independent factor, however. Harmonization for its own sake remains a relatively undeveloped theme in American corporate law,[36] even though a single, national set of rules arguably would lower information and compliance costs. But the lack of concern for harmony does not follow from a consensus agreement on the proposition that competitive diversity redounds in overwhelming benefits. The consensus, instead, centres on the smaller point that the system has evolved so that diversity, taken alone, costs little.[37] Delaware law functions as the national corporations code on a de facto basis.[38] As a result, most of the advantages of standardization are available to those firms

33 Romano's association of European codetermination and harmonization, while apt, misses one point. Differing policies on codetermination among European nations have created a major stumbling block to efforts to integrate corporate law. See Richard M. Buxbaum and Klaus J. Hopt *Legal Harmonization and the Business Enterprise: Corporate and Capital Market Law Harmonization Policy in Europe and the U.S.A.* (New York: Walter de Gruyter 1988) 259–62.

34 See Bebchuk, supra note 12, 1491–4; W. Bratton 'The Ethical Case Against the Ethical Case for Constituency Rights' (1993) 50 *Wash. & Lee LR* 1449.

35 Romano is hostile to both propositions, given her basic assumption that both shareholder primacy and jurisdictional competition have wealth-creating effects.

36 The practical exception is the Model Business Corporation Act, to which a majority of the states adhere in one form or another, but which the larger states avoid. Academic commentary on corporate law harmonization tends to be limited to the comparative law context. See, e.g., Buxbaum and Hopt, supra note 33; Charny, supra note 12.

37 Opinion does differ on externalities and the normative product of the competitive system. If we characterize rule shopping that leads to suboptimal corporate regulation as a cost of diversity, then there is no consensus favouring American diversity. For a discussion of harmonization in which different types of legal rules are distinguished as more or less well suited for harmonization or diversity, see Charny, supra note 12, 436–51.

38 See B. Manning 'State Competition: Panel Response' (1987) 8 *Cardozo LR* 779, 783.

that opt to accept them by incorporating in Delaware.[39] Competition with Delaware, in turn, reduces substantive diversity among the codes of other states.[40] The Canadian experience of the past two decades, at least in Daniels's story, presents a variation on this theme.

B. COSTS AND LAWYERS

Romano's transaction-cost account of American charter competition has been challenged. It has been suggested she errs on the high side in her estimate of the costs of reincorporation and on the low side in her estimate of the costs of Delaware domicile. She responds to these challenges in the book, and, but for a few adjustments, her model emerges intact.

1. Costs

Bernard Black has argued that Romano overemphasizes the importance of both reincorporation costs and Delaware's revenue-centred commitment to respond to managers. In Black's story, reincorporation is cheap and Delaware's advantage over other states is not that great. Any other state can replicate cheaply the substantive provisions of Delaware law simply by copying its code and directing its judges to follow its case law.[41] Companies stay in Delaware not because of cost barriers to exit, but because it offers them what they want. Its 'modest' advantage is ascribed to its expert judiciary and quick decision-time.[42]

Romano responds that Black's numbers on the out-of-pocket costs of reincorporation are too low, and points to her empirical finding that only 5 per cent of reincorporating firms did so more than once in a two-decade period. She also takes issue with Black's refusal to factor in the discounted value of the higher franchise taxes and higher attorneys' fees incurred by Delaware-bound firms in the years following their moves, along with the concomitant opportunity costs (pp. 34–5 and

39 Some costs of duplicative regulation are incurred to the extent that individual states, within the envelope left open by the commerce clause of the United States constitution, choose to add layers of regulation on the internal affairs of foreign corporations. California, and to a lesser extent New York, are the two states noted for this activity.

40 Thus, putting all normative problems to one side, most agree that the benefits of diversity do outweigh the costs. See Bebchuk, supra note 12, 1493–4.

41 This point derives from Coffee, supra note 15, 769.

42 Black, supra note 14, 551, 574, 586–90. This discussion appears in support of a larger argument that corporate law is trivial. I disagree. Corporate law is not very important in the broad scale of things, but it is not trivial.

n11). In Black's view these latter costs should not be taken into account, because they are tied to the particular destination of Delaware and imply that a firm can incur negative transaction costs by moving out of Delaware. That, he says, 'makes no sense.'[43]

Further, says Black, Romano overstates the importance of Delaware's credible commitment to responsiveness. According to Black, corporations stay in Delaware because they like the service, and not because Delaware's dependence on charter revenues makes it a hostage to their interests. A contracting party needs a hostage, he says, only when the counterparty's one-time gains from midstream opportunism could outweigh its future losses from diminished reputation; if reincorporation costs little, midstream opportunism produces few gains, and the hostage is superfluous.[44]

Romano's account withstands this critique, but with a few modifications. Black makes a good point about the out-of-pocket costs of reincorporation. Even with Romano's numbers, we are not talking about much more than $500,000 per firm per move.[45] Given a large firm, these charges would not seem excessive as against a concrete advantage perceived to stem from a reincorporation. But Black is less persuasive when he excludes the discounted value of higher costs attending Delaware incorporation. The positive financial return on migration from Delaware implied by Black's low out-of-pocket cost figures does make sense. If firms stay in Delaware despite the possibility of an immediate increase in net cash flows elsewhere, then their managers must highly value the less easily quantified benefits of a Delaware domicile.[46] Romano's more capacious cost calculation better describes this phenomenon.

Nor does Black quite succeed in trivializing the importance of Delaware's credible commitment. First, the commitment still matters to Delaware-bound firms at the time they decide to reincorporate. The projected move entails both a one-time investment and a significant increase in ongoing costs. Although exit protects the reincorporating firm against subsequent policy changes in Delaware, it does not guarantee a return on the firm's antecedent investment in a Delaware domicile; the shorter the interval between reincorporation and exit, the

43 Black, supra note 14, 587.

44 Ibid. 588–9.

45 Romano, supra note 5, 246–9 (direct costs for largest firms of around $1 milion). See Black, supra note 14, 588–91.

46 This in turn has negative implications for Black's triviality hypothesis.

lower that investment's return. Delaware's commitment assures that return at the time the firm invests its first dollar. Second, Black makes the hostage superfluous by pointing out that the low cost of reincorporation makes it difficult for Delaware opportunistically to step up its rents. But this covers only a part of the hostage story. The circumstantial guaranty stemming from Delaware's dependence on franchise tax revenues protects less against the possibility of midstream rent extraction than against the possibility of political change in the direction of shareholder- or constituent-protective policies that disregard management preferences. To the extent that Delaware stays management responsive, it still can step up its rents so long as other states are discouraged from investing in a competitive corporate law infrastructure. Of course, in Black's view, such an infrastructure could be put in place with a single package of legislation.[47] The problem is that, given Black's picture of low-cost reincorporation, even that investment would be risky – the competing jurisdiction has no assurance that others will not duplicate its efforts or that its new customers will stay.[48] Delaware thus retains a structural advantage.

But there remains a point for explanation. The bottom line of Black's critique is that migration into Delaware is expensive, while migration out is cheap. Recognition of the disparity provides some support for his point about the fragility of Delaware's advantage. If reincorporation, viewed in the broad scale of things, is cheap, then a new element of uncertainty appears on the demand side of this product competition picture. The question goes to the relative importance to corporate consumers of good service in the near term and long-term relational commitment. To the extent that Black is right and Delaware's customers view the relationship as terminable at will, Delaware's continuance in first place in the event of incidental infirmities in its service depends more on barriers to other states' entry than on its position as hostage. Turning to the supply side of the picture,

47 The competing legislature would declare a policy of responsiveness, incorporate some of Delaware's case law by reference, designate a special corporate court, limit the tenure of its judges, and appoint some experienced corporate lawyers to it. It would also, presumably, set about amending the state constitution to require a supermajority legislative vote to amend the corporations code, and, in time, raise franchise taxes and lower income taxes.

48 See Daniels, supra note 3, 182. Black, in contrast, argues that active competition is unlikely, given high reincorporation costs, because the returns the competitor must provide are that much higher. Black, supra note 14, 588. It is safe to conclude that barriers to entry exist whatever the costs of reincorporation.

this implies more insecurity in Delaware's position than we see described in Romano's account.

But how insecure is Delaware? On the surface it has little cause for concern. Although it gained its lead as an accident of political history, no state has succeeded in wresting the lead away in the subsequent succession of political contexts. However awkward Delaware's confrontation with the most recent round of management-shareholder conflicts – those that grew out of the takeover battles of the 1980s – it appears to have retained its place.[49] This continued success implies support for Romano's emphasis on the importance of its long-term commitment to its customers.

Furthermore, the isolation of an additional element of structural insecurity only serves to underscore Romano's story of Delaware's ongoing incentives to stay responsive. That very responsiveness in turn discourages active competition. Even so, nothing embeds the system so as to assure Delaware that its special long-term commitment will retain relative importance as political contexts change in the future. Since the precise extent of Delaware's competitive advantage is unknown and risk aversion can be assumed on the part of the Delaware lawyers and lawmakers who have most at stake, insecurity of competitive position can safely be emphasized as a variable that explains their ongoing behaviour.

2. Lawyers

Delaware's litigation rules are the great anomaly in the charter competition discussion. Delaware differs from many jurisdictions in not requiring plaintiffs in shareholder derivative actions to post security for expenses.[50] It facilitates service of process on non-resident directors with a broad consent to service statute.[51] It also is liberal in its fee awards to derivative plaintiffs' lawyers: Under its non-pecuniary settlement practice, defending managers can trade a high fee for a small overall recovery.[52] Thus, Delaware facilitates derivative litigation. Having done so, it makes sure that the local bar gets a share of the action by requiring that Delaware lawyers make appearances and filings.[53] It also makes some concessions to managers. It ameliorates the litiga-

49 This assertion assumes that the reincorporation patterns described in Romano, supra note 5, persisted without material alteration during the ensuing decade.

50 Del. R. Civ. Proc. 23.1 (1991).

51 Del. Code Ann. tit. 10 sec. 3114 (1993).

52 Coffee, supra note 15, 761–2.

53 See Del. Sup. Ct. Rule 12, Del. Ch. Ct. Rule 170.

tion rules' immediate impact on them by allowing for liberal indemnification. Its courts also have been inventive in recent years in placing procedural barriers in the way of trial on the merits of derivative claims,[54] and these defendant-friendly procedures do discourage litigation. But, because these process rules generate new legal disputes as they discourage plaintiffs, they by no means counter Delaware's reputation as a fee-generating centre for corporate lawyers.

Cary, who favoured strict fiduciary law control of management conduct, acknowledged that Delaware's litigation rules did not synchronize with the rest of his 'race to the bottom' description. He explained them as a special exception keyed to the interests of the Delaware bar.[55] The litigation rules are equally problematic for a strict 'race to the top' theory, since they expand the zone of legal control of corporate actors at cost for the benefit of lawyers and therefore arguably derogate from shareholder interests.[56] Similarly, it has been suggested that the rules should be treated as an exception to Romano's product-based description of Delaware's responsiveness. John Coffee commented that revenue maximization for the bar amounts to a force shaping Delaware law distinct from a desire to maximize its desirability to consumers, leading to a product more indeterminate than that predicted by a simple revenue maximization model.[57] Jonathan Macey and Geoffrey Miller expanded on that point, supplementing Romano's demand-side model with a supply-side account of the role of interest-group politics in the production of Delaware law.[58]

Macey and Miller question whether Delaware can be modelled as an entity without further inquiry into the distribution of rents among interest groups within the state. Although all groups within the state have a common interest in producing a desirable legal regime, they differ on the relative proportions of costs imposed and revenues earned. The taxpayers have an interest in higher direct costs (franchise tax revenues) and lower indirect costs (legal fees). The lawyers' interest in fees would be served by lower direct costs leading to a greater number of incorporations, and higher indirect legal costs even at the sacrifice of some incorporations to the extent that the legal fees paid exceed those lost. Macey and Miller assert that, unlike Delaware, a state acting purely

54 See *Aronson* v. *Lewis* 473 A.2d 805 (Del. 1984); *Zapata Corp.* v. *Maldonado* 430 A.2d 779 (Del. 1981). For criticism of these and subsequent cases see Seligman 'New Corporate Law' supra note 12, 23–6.
55 Cary, supra note 1, 686–8.
56 Macey and Miller, supra note 17, 510–11.
57 Coffee, supra note 15, 764.
58 Macey and Miller, supra note 17, 471–2.

as a profit maximizer would limit indirect costs so as to maximize direct costs.[59] To account for Delaware's failure to conform to the product model's predictions, they draw on interest group theory. Under the public choice model, when groups in the state bid for regulations, the legislature tends to benefit small, cohesive groups at the expense of the general public. In Delaware, the organized bar has this advantage.[60]

Macey and Miller add a second component to this market imperfection story. They draw on Romano's finding that lawyers (and to a lesser extent investment bankers) play key roles in reincorporation decisions and favour Delaware.[61] Romano accounts for this by looking to the lawyers' interest in lowering the cost of doing business by protecting and maximizing returns from their capital investment in expertise in Delaware law (pp. 43–4). Macey and Miller add that information problems on the clients' part may present a barrier to competition among the lawyers. If the clients have an information problem, then we can account for Delaware's litigation rules as a shrewd marketing move – a boon to those responsible for making reincorporation decisions.[62]

Romano, responding to Macey and Miller, acknowledges that the Delaware bar has a special ability to influence legislation. But she remains sceptical of their view that Delaware's litigation rules reflect a significant agency problem between corporations and lawyers (p. 28). She makes reference to a study of the results of derivative litigation in which she found common practice patterns among federal courts, Delaware courts, and other state courts, and minimal dollar returns to shareholders across the board. She conjectures that Delaware may not be more favourable to lawyers than other jurisdictions and that litigation practice may be unrelated to state competition[63] (p. 29). She concludes with a return to the middle ground. The competitive system is effective but not perfect: While Delaware's dominant market position enables its bar to siphon off a share of the state's revenues and the law facilitating this rent extraction decreases firm value, the trade-off will not reach a point where a reincorporating firm is indifferent between staying put and moving to Delaware (p. 30).

59 Ibid. 472–3, 498, 503–4.

60 Ibid. 504–8.

61 Romano, supra note 5, 273, 275 n2.

62 Macey and Miller, supra note 17, 486–7. They also cite the movement in Delaware fiduciary law towards process scrutiny creating incentives for solicitation of investment banker opinions. Ibid. 487.

63 Romano also sees significant common interests between lawyers and shareholders in most circumstances, and looks to competition among lawyers to provide a floor on lawyers' ability to use legal codes to benefit themselves (p. 30).

This is a cogent response to Macey and Miller. A few points can be added, however. First, shareholder interests can be aligned more closely with those of litigating lawyers so as to diminish the magnitude of the imperfection. Romano judges the value of derivative actions as a monitoring device by comparing the bottom-line dollar returns to shareholders and lawyers. But figures in court records do not present a complete picture. Rules that facilitate derivative litigation increase the incentive of managers to comply with fiduciary rules against self-dealing by increasing the costs of non-compliance. They make it more likely that risk-averse managers will consult with counsel for assessment of legal risks before engaging in questionable transactions. Thus the rules' value lies mostly in increased shareholder returns, net of those legal fees, on capital that would be diverted to questionable projects if litigation were a less active possibility.[64]

Second, rules that encourage litigation in Delaware play a secondary role in production. Delaware's case law and judges figure prominently in its substantive law product line.[65] Its code's advantages are less distinct than those of its cases, given statutory convergence among the states. But Delaware does not completely control the production of case law. The first option on the choice of the forum for new disputes tends to lie with the plaintiff, and in many instances Delaware law questions can be litigated in other states or in federal courts. This gives Delaware a reason to offer incentives to plaintiffs. Their cooperation gives Delaware the opportunity to apply its own law, preserving the first-mover advantage and generating a flow of cases. These, in turn, are products sold in the charter market.[66] Happily, the resulting business generates incomes for Delaware's citizens.

64 W. Bratton 'The Economic Structure of the Post-Contractual Corporation' (1992) 87 *Nw. U. LR* 180, 206–7; C. Yablon 'Overcompensating: The Corporate Lawyer and Executive Pay' (1992) 92 *Colum. LR* 1867, 1896–906. Delaware's non-pecuniary settlement practice very well may be an ineffective means to the end of constraining management at the planning stage, however. Management presumably will anticipate that probable litigation includes the prospect of non-pecuniary settlement and incorporate terms to be traded off in the settlement into the transaction.

65 In addition to a large collection of past decisions, Delaware sells a unique, technically qualified judiciary and speedy determination of new disputes. Manning, supra note 38, 784–5, identified the judiciary as the prime attraction, comparing Delaware to the medieval law merchant.

66 This argument admittedly makes little sense to an observer sceptical of the value of derivative litigation to shareholders. Under that view, Delaware here injures its customers (both managers and shareholders) in the process of creating both its product and the demand for it.

Finally, there is evidence that the conflict between Delaware's taxpayers and attorneys is either more nascent than actual or more settled than active. Delaware's bar and legislature have a long-standing 'understanding' – amendments to the corporations code must first be drafted and approved by the bar association's corporate law section and the bar association itself.[67] Active drafting and discussion is largely limited to the corporate law section.[68] The legislature rubber-stamps the bar's recommendations; the executive branch's role is limited to representation at bar association meetings on invitation.[69] These arrangements do confirm Macey and Miller's emphasis on the organized bar's political power. But they also reinforce Romano's picture of responsiveness. By delegating corporate matters to the bar, Delaware removes them from its larger political life in order to keep corporate law directed to the interests of corporate actors. The lawyers' expertise, sensitivity to corporate politics, and financial interest make them obvious delegees. An implicit deal certainly has been cut between the lawyers and the rest of the state, and no doubt the lawyers had an advantage at the table. But that deal was cut long ago, seems to work well, and no one in Delaware seems inclined to disturb it. The practice implies extraordinary cooperation due to shared interests.

Romano's figures on Delaware's franchise revenues support this assertion. The franchise draw increased every year from 1977 to 1990, from $57.9 million to $200.2 million. During that period, the percentage of total tax revenues contributed by the franchise tax remained relatively stable, ranging between 12.5 per cent and 17.7 per cent[70] (pp. 7–8). At least right now, there seems to be plenty for everybody.

In sum, Romano justifiably treats Delaware as a unit for most purposes in the discussion.

67 A. Moore 'State Competition: Panel Response' (1987) 8 *Cardozo LR* 779, 780–81.

68 C. Alva 'Delaware and the Market for Corporate Charters: History and Agency' (1990) 15 *Delaware J. of Corp. Law* 885, 888–92. The section itself performs the legislative function of sifting the comments of interested parties. Each of the three largest corporate servicing firms have representatives to the section. Ibid. 888–92, 910.

69 Ibid. 988–92. See also D. Shaffer 'Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law' (1987) 10 *Harv. J. Law & Pub. Pol.* 665, 682–4.

70 Both measures show more volatility during the period 1960–1976. The high 17.7 percentage obtained in 1990, a recession year in the which legal fees probably diminished.

C. THE THREAT OF FEDERAL INTERVENTION

Cary's account of Delaware's litigation rules attributed a constraining influence to the threat of federal intervention. Possible adverse political consequences, he suggested, might disable Delaware from closing the door to monitoring by shareholder plaintiffs, despite management preferences.[71] His point, applied more broadly, adds a political factor to the list of forces that shape Delaware law: If Delaware's activities as the leading state have the potential to excite political action at the national level, then the preservation of its lead requires sensitivity to the responses of the actors and groups that influence federal law as well as to management preferences. Two questions follow for the state competition discussion: First, whether the federal threat should be recognized as a special influence on Delaware lawmaking, and second, whether such recognition, with its addition of political demands to customer demands, enervates the product competition model.

Factoring potential federal intervention into the model situates Delaware between two threats – first, corporate migration out of the state and entry into competition by other states, and, second, pre-emptive federal intervention. Given two threats, Delaware becomes a hostage to two potentially competing centres of interest. Managers constrain it with charter revenues on one side; the federal government, which depends on the proceeds of national income tax collections and therefore favours optimal corporate rules, constrains it on the other as a proxy for the shareholder interest.[72] The two threats may call for different responses, complicating the position of Delaware's lawmakers and creating possibilities for competition by other states. The effect, according to Eisenberg, is to give Delaware an incentive to avoid taking the lead in the adoption of rules favouring managers at the shareholders' expense. Other states have a different incentive. If they offer innovative management-side payments they may siphon business from Delaware; if the federal government intervenes to stop them, they lose little. So long as a given state has a small market share, its actions attract little attention. Delaware, in contrast, cannot take any significant steps without close scrutiny nationwide.[73] It remains under pres-

71 Cary, supra note 1, 688.

72 Eisenberg, supra note 4, 1512. Of course, the federal tax maximization incentive is significantly more diluted than is Delaware's.

73 Ibid. 1512–3. See also Bebchuk, supra note 12, 1455, pointing out that there remains a range on which states can manoeuvre without fear of federal intervention.

sure to follow new developments elsewhere, but emerges in a mediative role.

The federal threat undeniably exists – it inheres in the constitutional structure of the United States. But since it could be more hypothetical than real, the magnitude of its influence on Delaware lawmaking is open to empirical dispute.[74] Certainly, its form and intensity varies from period to period. Federal intervention was a present prospect in the late 1970s.[75] But calls for blanket intervention by academics and federal politicians fell off after 1980.[76] An active federal politics on takeovers followed – proposals to constrain either takeovers or takeover defences were on the congressional agenda throughout the 1980s.[77] But this activity did not markedly threaten Delaware. Enactments were rare and incidental in scope. Furthermore, political actors with agendas hostile to Delaware did not play a leading role. Romano shows this with surveys both of the content of federal takeover legislation proposed during the period 1969–87 and of interest group representation in the accompanying legislative processes (pp. 76–81). She finds that the overwhelming majority of bills had an anti-bidder aspect and that management voices appeared much more frequently than shareholder or labour voices.[78] Employing the federal threat in accounting for Delaware law developments after the early 1980s, then, depends heavily on an assumption of extreme risk aversion in Delaware's lawyers and judges. But the assumption is plausible. These actors have large stakes in the status quo, and can be expected to be mindful of the reactions of federal actors even during quiet intervals.

The best evidence of the federal threat's influence lies in the pattern of the law itself. The Delaware judiciary abruptly changed its habit of monolithic fidelity to management's interests in 1977 with *Singer* v. *Magnavox Co.*[79] Cary's 1975 article has been accorded a role in the

74 Macey and Miller noted that no existing theory provides a complete account of Delaware law; we can identify relevant variables and specify their interactions, but falsification is difficult. Macey and Miller, supra note 17, 509–10.

75 See notes 79–81 infra.

76 They did not entirely disappear, however. See D. Schwartz 'Federalism and Corporate Governance' (1984) 45 *Ohio State LJ* 545.

77 Romano offers a succinct account of these events (pp. 75–81).

78 Bureaucratic, political, and academic voices were heard in quantity, however (p. 77).

79 380 A.2d 969 (Del. 1977). That case imposed strict fiduciary standards on parent firms in cash-out mergers. The *Singer* rule was in turn rejected for a looser, process-based approach in *Weinberger* v. *UOP, Inc.* 457 A.2d 701 (Del. 1983). Oddly, *Singer* came down after the immediate threat of federal pre-emption of state fiduciary rules under the anti-fraud rules of the securities laws had been removed by the

break.[80] Although the article did not result in federal intervention, many believe that it crystallized the threat. In turn, that development impressed upon the Delaware courts the practical importance of solicitude to shareholder interests.[81] This post-Cary behaviour pattern continued and still yields headlines. Famous cases like *Unocal*,[82] *Revlon*,[83] *Smith* v. *Van Gorkom*,[84] and the more recent *Cede & Co.* v. *Technicolor*[85] and *Paramount Communications, Inc.* v. *QVC Network Inc.*,[86] each articulate surprising new shareholder-protective applications of basic fiduciary rules. But the pattern has been volatile, and shareholder-protective intervention has been a more intermittent than constant theme. Equally famous cases such as *Weinberger*,[87] *Moran* v. *Household International*,[88] and *Time-Warner*[89] restrict the application of the new rules. The legislature, prompted as always by the corporate committee of the state bar, entered on management's side in one famous instance. After *Smith* v. *Van Gorkum*'s application of the duty of care caused nervousness in

Supreme Court in *Santa Fe Industries* v. *Green* 430 US 462 (1977). The story told at the time was that the brush with pre-emption at the hands of the federal judiciary and the wider critical atmosphere provoked by Cary and others had prompted the Delaware Supreme Court to reverse its direction and become more accommodating of the interests of investors so as to diminish the threat of intervention.

80 The federal threat, and Cary's association with it, shows up in accounts of these events, most notably those of Coffee, supra note 15, 764–6, and Eisenberg, supra note 4, 1511–3.

81 Prior to *Santa Fe Industries* supra note 79, there was a cognizable chance that much conduct covered by state fiduciary law would be found to be 'manipulative' or 'fraudulent' conduct violative of section 10(b) of the Securities Exchange Act of 1934 and rule 10b-5 thereunder. The anti-managerial political climate of the time also resulted in the introduction of pre-emptive legislation in Congress. See Metzenbaum Bill of 1980, S. 2567, 96th Cong., 2d Sess. (1980).

82 *Unocal Corp.* v. *Mesa Petroleum Co.* 493 A.2d 946 (Del. 1985)(expanded review of tender-offer defensive tactics under proportionality test).

83 *Revlon, Inc.* v. *MacAndrews & Forbes Holdings, Inc.* 506 A.2d 173 (Del. 1985) (duty of management defending tender offer to auction company in limited circumstances).

84 488 A.2d 858 (Del. 1985) (sudden expansive application of duty of care to board approval of arm's-length merger).

85 634 A.2d 345 (Del. 1993) (strengthened duty of care applied to boardroom merger decision with suggestion of expanded remedial concept inclusive of post-merger gain).

86 637 A.2d 34 (Del. 1994) (obligation to achieve best value reasonably available for shareholders).

87 Supra note 79 (overruling Singer in favour of less restrictive process scrutiny of cash-out mergers).

88 500 A.2d 1346 (Del. 1985) (sustaining poison-pill defence under Unocal).

89 *Paramount Communications, Inc.* v. *Time Inc.* 571 A.2d 1140 (Del. 1989) (limiting application of Unocal and Revlon).

boardrooms and a substantial increase in insurance premiums, the legislature amended the code to permit firms to opt out of the duty of care by charter amendment.[90]

Delaware lawmakers confirm that the federal threat influences this erratic back-and-forth shift between management and shareholder interests. Cary accused the Delaware judiciary of being the agents of a corrupt sovereign – integrity was wanting in their fiduciary decisions, he said; there was no 'public policy' left in their law other than the objective of raising revenue.[91] They have responded to the accusation with public representations of role integrity.[92] They describe themselves as mediators between management and shareholders – protectors of market risk-taking who nevertheless impose ethical constraints.[93] Delaware, in their description, seeks middle ground, pressured by the federal government on one side and management incorporation decisions on the other.[94] The Delaware bar's concern about federal responses is confirmed in accounts of its deliberations on new legislation.[95]

It thus can safely be said that Delaware actors remain sensitive to federal pre-emptive power and averse to the prospect of intervention. But, like the role of interest-group conflict, the precise role of the federal threat in their activities is hard to measure. Worse, it is easily overstated. There are a number of problems. First, the gravity of the threat varies with the particular form of intervention proposed. A discrete provision, such as the all-holders rule[96] or the special tax on greenmail profits,[97] only incidentally impairs Delaware's position. Such

90 Del. Code Ann. tit. 8, sec. 102(b)(7) (1991) (permitting opting out of personal liability for directors for duty-of-care violations). For an excellent discussion, see Romano 'Aftermath of Insurance Crisis' supra note 9.

91 Cary, supra note 1, 684, 696–8.

92 The term comes from Coffee, supra note 15, 764–5.

93 Moore, supra note 67, 779–800 (Justice of the Delaware Supreme Court).

94 W. Quillen 'The Federal-State Corporate Law Relationship – A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law' (1993) 59 *Brooklyn LR* 107, 129 (former Delaware Chancellor and Supreme Court Justice, now Secretary of State).

95 When the bar first considered (and rejected) an anti-takeover statute, it received comment letters from Martin Lipton and Joseph Flom warning that enactment might excite federal intervention. Such worries were expressed at the committee meeting on the proposal. Alva, supra note 68, 906–8.

96 Rule 14d–10 under section 14(d) of the Securities Exchange Act of 1934, 17 CFR 240.14d–10 (1993), provides that any tender offer must be open to all holders of the subject class of securities, pre-empting the defensive tactic sustained in *Unocal*.

97 Internal Revenue Code, section 5881 (1991), enacted in 1987, imposes a 50 per cent excise tax on profit realized in a greenmail transaction.

provisions block a particular management accommodation, but apply the block to all fifty states. Delaware no longer can take a competitive lead on the subject matter regulated, but neither can any other state. The overall field of subject matter for competition shrinks slightly, but not enough cognizably to impair Delaware's position. Furthermore, a federal provision might even result in a short-term enhancement of Delaware's position. Consider the national control-share-acquisition statute proposed during the 1980s (p. 78). During the mid-1980s, the federal threat contributed to Delaware's hesitancy to initiate takeover defence legislation. Federal intervention on either side would have settled the matter, removing a threat of competition from other states. It would take a more far-reaching federal intervention, such as federal chartering or fiduciary standards, to cause immediate structural change in the state market.[98] The more sweeping the intervention, the lower its probability.

Second, developments that invite ascription to the federal threat admit of multiple explanations. Most of the significant developments in corporate law during the past fifteen years concern corporate-control transactions. During that time, Delaware's lawmakers had no widely accepted policy blueprint to resolve the resulting disputes. The background political and economic noise[99] makes it plausible to turn to Romano's model and conclude that Delaware simply tried its best to maintain its advantages in the eyes of managers and stay responsive to shareholders at a time when it was impossible to do both.[100] More particularly, Romano explains Delaware's failure to follow the more zealous anti-takeover states in terms of balanced power among interest groups. She sees three factors at work: Delaware's large population of corporations makes it home to potential bidders as well as potential defenders; the large population makes it difficult for a subclass of defending managers to seize control of the legislative process; and, the practice of bar association approval of new legislation assures balance in interest-group representation in the legislative process (pp. 59–60).

98 Federal fiduciary standards for public corporations could cause an outbreak of price competition. Statutory convergence and the proliferation of enabling rules make state codes almost fungible. Federalization of the most heavily litigated areas of subject matter would denude Delaware of a primary product component and remove a justification for its premium price.

99 For political discussions of the takeover cases, see L. Johnson 'The Delaware Judiciary and the Meaning of Corporate Life and Law' (1990) 68 *Texas LR* 865; J. Gordon 'Corporations, Markets, and Courts' (1991) 91 *Colum. LR* 1931.

100 Macey and Miller, in contrast, interpret many of these events in terms of their favourable impact on the flow of legal fees. Macey and Miller, supra note 17.

Finally, the impact of Delaware's cluster of leading shareholder-favourable cases may have been overemphasized. On this reading, which originates from a position very close to Cary on the Winter-Cary scale, Delaware dresses the windows to defuse the federal threat and then goes on with business as usual. In highly publicized cases the Delaware courts take the opportunity to announce vague rules that hold out the prospect of enhancement of shareholder value. But in the less well-publicized cases that follow, the courts take the opportunities held out by complex facts to refrain from applying the vague rules in management-constraining ways.[101] Concrete results count for more than public statements, and the lawyers who make reincorporation decisions keep score.

Despite these objections, the federal threat adds plausibility to accounts of Delaware's volatile lawmaking. As Delaware responded to events in the corporate control market, it kept open its options by employing equivocal judicial rules in preference to clear-cut legislation. It did so at apparent cost to its reputation for certainty, predictability, and management responsiveness. The insertion of a political variable rationalizes the pattern. Moreover, the political middle ground on which Delaware's lawmakers see themselves overlaps with the normative middle ground described by Romano.

But the overlap does not import identity. The political model's explanatory advantages lie largely on the supply side. From the demand side, it presents a puzzle. Delaware's mediative output can be explained in terms of the interests of managers as a group – well-timed interventions to protect shareholders serve to defuse the federal threat and to make Delaware a buffer state that protects corporations from federal intervention.[102] But the benefits of a mediative jurisprudence are more questionable from the point of view of individual managers seeking an optimal environment. They have an apparent incentive to cause their firms to migrate to states adopting less equivocal anti-takeover policies, riding free on the firms that stay.[103]

101 For a reading of the cases after *Unocal* along these lines, see V. Brudney and W. Bratton *Brudney & Chirelstein's Cases and Materials on Corporate Finance* 4th ed. (Westbury: Foundation Press 1993) 1087–95, 1129–30.

102 Federal corporate law holds open the prospect of not only stricter fiduciary rules but inclusion of interest group agendas, such as labour codetermination, blocked under the state competition system.

103 Note that if a large number of firms surmounted this collective-action barrier and successfully shopped for a more responsive jurisdiction, federal intervention becomes more likely. The same thing might happen if a large number of firms left Delaware, starting a new race to the bottom.

If this collective-action problem exists, then Delaware should have seen some erosion of its market share, given the low cost of departure. But Romano's figures on Delaware's franchise tax revenues, which continue to increase both in absolute amounts and as a share of total state revenues, imply that Delaware has not lost significant market share (pp. 7–11). A number of explanations can be offered. First, the opinions of lawyers and investment bankers may still carry great weight. These actors may bring political sensitivity to their recommendations – an experienced astuteness that happily coincides with an interest in protecting their own investments in human capital. Second, no full-service alternative domicile exists. As we have seen, no other jurisdiction has particularly strong incentives to incur the start-up costs to market a full-service operation. Third, the self-protective capacity of shareholders may now be strong enough to deter management reincorporation proposals. Beginning in the late 1980s, incidents of shareholder resistance caused managers to drop the assumption of automatic shareholder approval of anti-takeover proposals requiring charter amendment. Romano contributes some additional evidence of this phenomenon with a report on the behaviour of public corporations subject to the Pennsylvania 1990 takeover statute. The Pennsylvania statute, like most takeover statutes, included a default rule that applied it to all corporations that took no affirmative action to opt out. Despite this, pressure from institutional investors resulted in opting out by the boards of 127 firms; only 72 firms stayed in (pp. 68–9). Presumably, opportunistic reincorporation proposals would excite similar shareholder attention. Thus, departure from Delaware may not be the open option it used to be, however insignificant the out-of-pocket costs entailed.

This review of the demand-side implications of Delaware's responsiveness to federal politics suggests a modified description of Delaware's product. It seems Delaware can sell a more even-handed mediation between management and shareholders, despite enhanced management solicitude in other jurisdictions. In this new equilibrium picture, Delaware must cope with structural insecurity on both the demand side and the political side, but can maintain and perhaps even strengthen its position to the extent it avoids innovations that sharply point in the direction of either shareholder or management interests. We return by indirection to the shop-worn point that firms want stability and certainty. These properties remain a part of Delaware's ideal product, even as events make the ideal's realization difficult. Despite all the noise on the screen, however, Delaware never steps far from the status quo for long.

This integration of the federal threat into the description of Delaware lawmaking has awkward implications for observers with significant normative objections to the legal status quo. Consider first an advocate of full-scale federal intervention. Under the dual-threat model, the federal threat reinforces the shareholder voice, moving Delaware law in the direction of shareholder value enhancement. The stronger the threat, the more pronounced the move. But Delaware miminizes the impact of each such move, defusing the threat of constraint while providing management with maximum feasible protection of its own prerogatives. Now compare an opponent of federal intervention who takes the position that shareholder value is best realized by market constraints and minimal regulation. This observer, while disposed to welcome the shareholder-protective aspects of Delaware's takeover cases, will prefer not to ascribe them to threatened regulation. Incidental benefits from threatened regulation imply substantial benefits from actual regulation, and cast doubt on the efficacy of state competition.

Romano fits the latter profile. She acknowledges the about-face in Delaware's position as management-protective innovator – from leader to laggard on the anti-takeover front (p. 67). But her account does not mention Delaware's awkward posture as lightning-rod for federal intervention.[104] Instead, she takes the position that shareholder-protective federal intervention is unlikely as a practical matter, supporting the point with data on past reform politics that show a management bias at the federal level. As already noted, she then ascribes Delaware's equivocation on takeovers to local factors that affect the play of interest-group politics.[105]

These are important points. But a low-probability assessment on actual federal intervention does not, taken alone, make it implausible to include the federal threat in descriptions of Delaware law. Delaware's stakes are high enough and its juridical position fragile enough to make it sensitive to remote contingencies. And, despite her probability assessment, Romano takes the subject of federal intervention very seriously, as the discussion of her normative views in part II will indicate. An explanation of the omission of politics from Romano's description of Delaware law follows from that discussion.

D. SUMMARY

Romano's product-competition model of corporate law has remarkable resiliency. It either accommodates or provides a base for a plausible counter to each of the additional factors brought to bear against it as

104 The explanation also is omitted from Romano's discussion of the even-handed record of the Delaware courts on takeover related matters (pp. 72–3).

105 See earlier discussion, note 100.

critical supplements – the low cost of reincorporation, interest-group politics, and the federal threat. Romano resists the reincorporation-cost point, but her model can accommodate it without strain. She accepts the possibility that lawyers' rents may be a suboptimal aspect of the system, a concession her model permits. In contrast, she passes over the federal threat, offering a plausible alternative explanation for the law's development without addressing the point expressly. But since federal politics are an acknowledged variable in the state law calculus, they ought to be included in the description absent a strong contrary justification. The product competition we see occurs in a complex juridical framework that has its own path dependencies and that remains subject to political influences. Recognition of Delaware's sensitivity to federal responses does highlight a limitation on the competitive system's operations, but does so without negating the usefulness of the product competition analogy. It ought to be in the description, whatever the observer's ultimate normative judgment.

II *Charter competition and federal intervention*

On Romano's middle ground, the anti-takeover legislation enacted by the states during the last fifteen years is demarked as a zone of charter-market failure. The demarcation implies a case for actual federal intervention. Romano takes up this argument at the core of *The Genius of American Corporate Law*. She offers a succinct and thorough treatment of the problem, along with a strongly stated recommendation against federal intervention (pp. 52–84).

A. ANTI-TAKEOVER LEGISLATION AND THE NEW CASE FOR FEDERAL INTERVENTION

The Genius of American Corporate Law surveys the anti-takeover statutes,[106]

106 The statutes evolved in succeeding generations. The first generation submitted tender offers to substantive review by state securities administrators, and were held unconstitutional under the commerce clause in *Edgar* v. *MITE* 457 US 624 (1982) (Romano pp. 53–5). The second generation limited the subject matter to regulation of internal corporate affairs. These statutes tend to condition the voting right of bidders on the approval of the shareholders as a whole, to impose freeze periods on combinations between bidders and targets, or to require that an equal price be paid in the second stage of a two-tier acquisition. Some statutes combine these elements. These statues have survived constitutional challenge under *CTS Corp.* v. *Dynamics Corp. of America* 481 US 69 (1989). (Romano pp. 55–7). Another variety confirms the legitimacy of board consideration of the interests of constituents other than shareholders in takeover defence situations (pp. 74–5).

their origins as interest-group legislation,[107] and empirical work that confirms their harmful effect on shareholder value.[108] Romano concedes that 'unanimity in the enactment of takeover statutes may represent a disadvantage of federalism,' because the legislation's burdens spill over to citizens of other states. In theory, then, they give rise to a case for national regulation[109] (p. 59).

Others, principally Lucian Bebchuk,[110] have gone on to articulate this theoretical case. Bebchuk argues that the middle-ground[111] result stems from a structural defect in the competitive system that disables the production of a maximizing legal regime. The defect lies in the competing states' concern for management preferences rather than shareholder value itself. The market causes the states to focus on the variables that influence reincorporation decisions,[112] but does not add controls that force the states to exclude policies of management accommodation from the reincorporation package. Specifically, a category of 'insignificantly redistributive' management-favourable rules always escapes the market constraint. Bebchuk hypothesizes a transaction undertaken by a $1 billion firm that reduces shareholder value by $1 million for the purpose of returning $200,000 to management. The transaction is too small to excite a takeover; but so long as state law

107 Romano's case study of the state legislative process here suggests that the statutes are initiated by threatened managers of local corporations and their assistants in the local corporate bar rather than by broad coalitions of business, labour and community leaders (pp. 57–9).

108 This is a complex picture requiring additional reference to negative price effects of contractual anti-takeover provisions such as poison pills. Significant showings of negative price effects do appear. Romano summarizes the large body of work (pp. 60–7).

109 Romano distances herself from commentators who have asserted a causal connection between this legislation and the fall-off in merger activity after 1989. She ascribes the disappearance of takeovers to tight credit and the effect of tighter regulations on institutional portfolios of junk bonds (pp. 70, 72 n37). It should be noted that the literature on the interests of corporate constituents provides groundwork for a theoretical case in favour of some anti-takeover legislation. See, e.g., B. Chapman 'Trust, Economic Rationality, and the Corporate Fiduciary Obligation' (1993) 43 *UTLJ* 547. The discussion here reserves on that question and assumes that shareholder primacy is the end to be obtained.

110 Bebchuk, supra note 12. See also Charny, supra note 12; Coffee, supra note 15, 770–2; Seligman 'New Corporate Law' supra note 12; Seligman 'Federal Minimum Standards' supra note 12.

111 Bebchuk begins his analysis of the problem by stating his assumption that, absent reasons to the contrary, state competition is more likely to produce an efficient rule than federal regulation. Bebchuk, supra note 12, 1457.

112 Ibid. 1452, 1454.

opens the door, management has every incentive to undertake it.[113] In addition, competition can cause the states to use their lawmaking power to impair the strength of market discipline even further, as the proliferation of anti-takeover statutes demonstrates.[114] Bebchuk recommends federal pre-emption of much state takeover regulation and federal fiduciary standards.[115]

Bebchuk engages with Romano in making this case. The engagement begins with the body of event studies that show either an increase in value on reincorporation to Delaware or no significant effect. Bebchuk must confront these results, since the structural defect he identifies lies in the competing states' tendency to focus on reincorporation decisions. He does so, prompting a rebuttal in Romano's book.

Bebchuk brings to bear standard questions about the constraining effect of the shareholder vote on which reincorporation is conditioned. The shareholders may approve a move even though Delaware has value-decreasing rules either because the move on the whole increases shareholder value, the shareholders have inadequate information, or management has tied the move to another corporate action they desire.[116] These problems limit the normative force of the event studies: The stock prices may reflect the market's reaction to the developments signalled by the reincorporation rather than the reincorporation itself, and managers may systematically choose to reincorporate at moments when such information exists.[117] Romano, who has always recognized the former possibility, responds that it is 'improbable' that information tied to the move could swamp an otherwise negative stock price effect; if management were manipulating the process, price-negative rather than price-neutral results should obtain for firms reincorporating for management-favourable purposes (p. 18). Bebchuk, following others,[118]

113 Ibid. 1462–3, 1468, 1488. Bebchuk also argues that suboptimal rules result in cases where the firm inflicts externalities on interest groups other than the shareholders. Ibid. 1485.

114 Ibid. 1467. See also Coffee, supra note 15, 770–2; Macey and Miller, supra note 17, 471, 483.

115 The recommendation for fiduciary standards is the more difficult of the two, given the strong empirical case supporting pre-emption of anti-takeover legislation.

116 Bebchuk, supra note 12, 1460, 1471.

117 Ibid. 1449–50. See also Romano, supra note 5, 267; Coffee, supra note 15, 767–8; Macey and Miller, supra note 17, 482.

118 Coffee, supra note 15, 767–8; Eisenberg, supra note 4, 1508; Macey and Miller, supra note 17, 482–3. Coffee adds two additional points. First, information asymmetry between management and shareholders makes the reincorporation signal noisy; the shareholders only know of the motivations disclosed. Second, the

anticipates this point: Given convergence among the state codes, the absence of negative returns may only mean that the legal rules of the original and destination state are equally harmful. Furthermore, the fact that reincorporation does not decrease value overall does not prove that competition produces desirable results on all corporate issues.[119]

Bebchuk, in sum, argues that the event studies must be seen in temporal perspective. They do contradict Cary's picture of an ever-lowering race to the bottom with Delaware in the lead. But once we accept that point and join Romano on the middle ground, their probative force diminishes. The race, in effect, bottomed out before the studies were undertaken. The prospective question is whether intervention can cause the numbers to improve.

In Romano's view, acknowledgment of disproof of the 'race to the bottom' picture decides the debate over intervention. Given agreement on the beneficial effects of competition, she says, the burden is on advocates of intervention to 'demonstrate empirically which particular code provisions harm shareholders and why national legislation would be more likely to alleviate the problem' (p. 19). This allocation of an empirical burden of proof to the interventionists is the book's principal normative assertion.

B. THE BURDEN OF PROOF

Why, given Bebchuk's identification of a structural infirmity in the competitive system and the powerful empirical backing of studies showing negative price effects of anti-takeover regulation, should the burden of proof be on the advocates of intervention? It would seem that the burden should lie in the other direction as to takeovers and lie evenly with respect to the rest of fiduciary law, clearing the table for consideration of particular reform proposals.

Romano's case to the contrary brings together two theoretical assertions and a practical political observation. First, drawing on a public-choice view of the lawmaking process, she contends that jurisdictional competition almost always works better than central regulation. Second, drawing on the contractual theory of the firm, she projects an ideal corporate law system based on free choice and implies that federal mandates would interfere with the realization of the ideal.

discounted value of transaction-cost savings resulting from a move to Delaware is trivial, leaving the stock price to the influence of transaction-specific inferences.

119 Bebchuk, supra note 12, 1449–50.

Third, she observes that federal lawmaking processes are impaired by the same interest-group influences that impair state lawmaking processes. Accordingly, the chances of benefits from federal intervention are small and the risks of harm are great. These contentions are considered below.

1. The merits of state competition versus the infirmities of federal lawmaking
Romano's position on federal intervention draws in the first instance on a broader description of the benefits of jurisdictional competition. Under this view, competition causes government policies to be matched with diverse citizen preferences (pp. 4–5). Citizens signal their preferences respecting legal goods and services when they migrate from regime to regime. Their ability to exit also disempowers government actors, whose welfare diminishes as citizens depart, taking along votes and revenues.[120] In a federal system, the allocation of lawmaking power to the competing states also protects individuals from the power of the national government.[121] Finally, competition fosters innovation (pp. 4–5). Law production goes forward without time consumed on the task of reconciling competing preferences. This picture imports a correspondingly negative view of the efficacy of centralized lawmaking. Since the revenue-enhancement constraint on the central government is less intense (p. 48), the central lawmaking process will be slower, less responsive to productive concerns, and more susceptible to the influence of organized interest groups. It thus is more likely to make mistakes, is less able to correct them, and should be invoked only when an externality has been demonstrated (p. 5).

Romano complements this theory with a practical projection of the likely direction of any future federal corporate law politics: Since corporate law reform is not at the top of the congressional policy agenda and the voting public is indifferent to it, a federal corporate lawmaking process will be subject to the same management influences that prevail in the states (p. 50). Managers remain concentrated and easily organized, and have powerful financial incentives for political action. Shareholders remain diffuse, are much less easily organized, and have less intense incentives for political action. Thus, movement to

120 Daniels, supra note 3, 142–3.
121 In Romano's view, private organizations provide an additional check by counterbalancing the power of state governments. National regulation of corporations would impair this corporate function and thus detract from individual liberty. Romano 'State Competition Debate,' supra note 9, 753 n97.

the national level does not change the interest-group picture (pp. 75–6). Romano backs up this projection with empirical surveys of past takeover legislation proposed at the federal level and interest-group participation in the accompanying legislative processes (pp. 76–80). She shows that the management voice was much more evident than the shareholder voice. Of course, management's organizational advantages did not precipitate success at the federal level during the 1980s, in contrast to results at the state level. Romano acknowledges this, but ascribes it to the opposition of the Reagan and Bush administrations and the managers' very success in getting what they wanted in the states (p. 80). She concludes that further national legislation is no more likely to foster a free market for corporate control than is state legislation (p. 82), and warns that federal activity could even be counterproductive. She also cites two ameliorating factors in the state law picture: First, Delaware's equivocal position, embodied in less restrictive legislation and a relatively even-handed judicial approach (pp. 59–60, 72–4); and, second, the demonstrated role of institutional investor pressure in forcing opting out by the majority of the firms subject to the most restrictive statute, Pennsylvania's 1990 enactment. This market constraint, she suggests, may amount to a possible floor on deleterious state competition (pp. 68–70). This safety net built into the state system remains absent in the federal[122] (pp. 82–3).

The problem with Romano's practical projection is that it avoids direct confrontation with the theoretical question: Whether federal intervention could improve the results of the state competition system without impairing its productive components. Today's interventionists assert that, in theory, we possess a normative paradigm robust enough to isolate a systemic failure in the charter market's operation and guide us to effective federal remedies. This theoretical case is not rebutted by reference to the overall infirmities of centralized lawmaking. In the case of charter competition, exit from one jurisdiction does not remedy the dissatisfactions of the group of actors disadvantaged by regulation. Due to the peculiarities of the America's constitutional structure, each of the competing jurisdictions has national lawmaking power over the shareholders of its domiciliary corporations. Competition, accordingly, has not sorted out the problem of competing preferences by offering a viable menu of choices. Instead, it resolves the conflicts in only one way. Additional time spent to resolve the problem at the level of the central government presumably would be well invested.

122 See also Easterbrook and Fischel, supra note 4, 218.

Romano's political projection comes to bear at this point to cut off the discussion – time invested in federal corporate law reform is both pointless and dangerous. This preclusive reference to political realities gives rise to two questions. The first goes to the risks of political discussion: Whether, as a structural proposition, federal-level political processes are as management-biased as state-level processes. The second goes to the returns: Whether pressure for federal intervention has beneficent effects taken alone.

As to the risks, federal processes, being central and highly visible, allow for economies in the costs of interest-group participation and incentives for participation by actors disposed to favour shareholders, such as academics. They thus create an opportunity for the weaker shareholder voice to be heard. Romano's statistics on witnesses at congressional hearings on takeover legislation during the period 1963–1987 do not refute this point. They show that the federal government's witnesses participated in 80 per cent of the hearings, target managements' in 60 per cent, academic witnesses in 48 per cent, labour's in 25 per cent, takeover bidders' in 20 per cent, and shareholder groups' in 3 per cent (p. 77). These numbers imply that the inputs were not greatly imbalanced, if we can assume that substantial numbers of government, academic, and bidder witnesses argued from the point of view of shareholder value maximization or expressed positions consistent with it.[123] Moreover, organized shareholder activity has noticeably increased since 1987.[124] As shareholder activists accumulate a record of influence on boardroom decisions, their influence in Washington will grow.

Management influence over state processes remains stronger because charter competition inheres in the structure of state law. This situation will not change so long as management retains agenda control over reincorporation decisions. The federal government's failure to buy management's anti-takeover line – despite twenty years of pushing – corroborates the point.[125] Nor does federal resistance to management influences depend entirely on free market policies peculiar to the Reagan and Bush administrations. The Securities and Exchange

123 Admittedly, Romano's data on the bills proposed show a heavy bias towards management-responsive proposals.

124 This activity has prompted a revision of the SEC's proxy rules to permit greater communication between shareholders.

125 Bebchuk, supra note 12, 1502–4.

Commission builds in a powerful voice motivated by an entrenched interest in shareholder protection and habitual suspicion of management initiatives.

As to the possible returns from political dialogue, it certainly can be conceded that federal legislation is not in prospect. But perhaps intervention should be a constant topic of discussion nevertheless. Just as interventionist talk creates a risk of bad legislation, so an absence of such talk creates a risk of a political shift in management's favour at the state level. Delaware's lawmakers have acknowledged that their recent tendency towards a more even-handed mediation between shareholder and management interests stems from a fear of federal intervention. Were the interventionist voice to fade out of the political landscape, Delaware would be freer to match management-protective innovations elsewhere. Fortunately, the new shareholder voices make it less likely that Delaware's intermediate position will cause it to lose incorporations to these other states. But, absent the federal threat, a more management-responsive posture could be the most risk-averse course for Delaware to follow. Calls for federal intervention support the state safety net to which Romano refers.

This whole discussion plays on the indeterminate connection between academic theory and political practice. Just as Romano's call for unmitigated state competition could play into management's hands if universalized, so academic calls for intervention could result in an active federal process subject to management capture. The solution to the problem lies with a practical appraisal of both risks. Since neither side will likely be silenced by the other anytime soon, and federal intervention is itself a distant prospect, neither risk looms large. The risks counterbalance one another in any event. The theory talk should proceed.

2. *The contractual ideal*

As noted, Romano's theory has an apparent gap – an answer to the question whether federal legislation could be enacted that could move us closer to the optimal side of the middle ground, preserving the responsive benefits of the state system while constraining its susceptibility to management manipulation. Romano addresses this point indirectly by reviewing the debate over the mandatory and enabling terms of corporate law and taking a stand against any mandate, state or federal.

The case against mandatory corporate law follows from an ideal view of the firm. Under this view, firm participants are no different from any other contract parties and should negotiate their own governance rules. The ideal is manifested in a policy prescription – corporate law should replicate the provisions that private parties would have made in a costless environment, and actual bargains made between contracting parties should trump hypothetical bargains made available by law. Thus, corporate law should be enabling and suppletory only;[126] actors should be able to 'opt out.'

Debate over this prescription goes to the appropriate scope of the opting-out permission. The majority view lies against unqualified extension of an opting-out privilege,[127] with the discussion turning on charter amendments that waive application of management fiduciary duties. These present the hard case for opting out, because process defects make the charter amendment process suspect. As with reincorporation decisions, shareholders have a collective-action problem when managers propose charter amendments. Small stakes make it irrational for individual holders to invest in information acquisition.[128] Moreover, managers, by virtue of their agenda control, easily can turn the shareholder's disadvantaged negotiating position to advantage.[129] The upshot, in the majority view, is a classic contract failure: The shareholders rationally vote to approve an amendment that is value-decreasing to them. As a result, the amendment process is deemed reliable as to amendments that are company-specific and transaction-specific – for example, a poison pill or a stock option plan. But as to general, open-ended proposals, contract failure is probable – for example, a broad-brush abolition of director and officer fiduciary duties.[130] Therefore,

126 Terms that permit private contract 'enable'; terms that supply prefabricated terms that the parties would want anyway 'supplement.' Eisenberg, supra note 4, 1461.

127 See W. Bratton 'Self-Regulation, Normative Choice, and the Structure of Corporate Fiduciary Law' (1993) 61 *Geo. Wash. LR* 1084, 1103–4.

128 See, e.g., J. Gordon 'The Mandatory Structure of Corporate Law' (1989) 89 *Colum. LR* 1549, 1575–7; Eisenberg, supra note 4, 1477–80; Coffee 'No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies' (1988) 53 *Brooklyn LR* 919, 934.

129 Gordon, supra note 128, 1577–84. Coffee stresses this problem of 'agenda manipulation' over the rational-apathy story. He points out that shareholders easily can just say no, but that management's ability to manipulate the agenda tilts the whole corporate contracting process. J. Coffee 'The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role' (1989) 89 *Colum. LR* 1618, 1674–5, n234.

130 See Gordon, supra note 128, 1593–7; Coffee, supra note 129, 1664–5; Eisenberg, supra note 4, 1469–70 (close corporations).

according to the majority, charter amendments sometimes should be subject to mandatory regulation.

Lucian Bebchuk happens to be a prominent member of the majority, and has pointed out that those who support mandatory rules cannot consistently advocate leaving mandatory subject matter to state regulation. Since the states are free to offer different rules and corporations are free to choose among the states, the system fails or can be made to fail as to the mandatory subject matter. Only a federal mandate provides the requisite assurance.[131] Significantly, Romano agrees on this point (p. 91). But she turns the point around and restates the case for expanded opting out, apparently having noticed that few members of the mandatory majority seem to be pushing the case for federal intervention.

She does not share the majority's concern for midstream management opportunism. Given a majority of institutional investors, she figures that shareholder information costs respecting voting will be low. Less restrictive alternatives like supermajority voting requirements can ameliorate any problems.[132] Given the historical tendency towards the mandate's erosion and an expectation that most firms would voluntarily adopt some of what now is mandated, such as the duty of loyalty (p. 90), she suggests that we have little to fear in dispensing with it. So little, in her view, that we should go a step further and make both the

131 Bebchuk, supra note 12, 1496–9.

132 Here she joins F. Easterbrook and D. Fischel 'The Corporate Contract' (1989) 89 *Colum. LR* 1416, 1444. Romano also argues that information costs need not be a problem because a rationally uninformed shareholder cognizant of a problem of management opportunism could always vote no or adopt some other arbitrary voting practice (p. 88). The counterarguments here are, first, that the old Wall Street rule stemmed in part from a collective view that holding a stock meant support for the management group on governance matters, and, second, that the absence of a mandatory voting confidentiality precludes such a strategy for many institutions. This does not go to say that Romano's suggestion will not affect future voting practices. See J. Grundfest 'Just Vote No: A Minimalist Strategy for Dealing with Barbarians Inside the Gates' (1993) 45 *Stan. LR* 857.

Finally, Romano argues that if mid-stream opportunism were a systemic problem for investors, we would expect to see ameliorative charter provisions, such as appraisal rights in corporate charters, because promoters would have an incentive to include them (p. 89). The counterargument here is that this point entails an ahistorical jump over to economic theory that ignores corporate contracting practice. Charters have historically been spare documents in part because investors assumed that the state mandate took care of the opportunism problem.

federal securities laws' mandatory disclosure system[133] and their insider trading rules[134] optional as well (pp. 91–108).

We learn something about Romano's unspoken assumptions if we compare her views on federal intervention with her advocacy of universal opting out. She is risk averse in her projections on the former: Interest group machinations make the federal legislative process unreliable; therefore, the downsides loom large. Her allocation of an empirical burden of proof in effect requires that the outcome of any federal process be known in advance, a practical impossibility. Moreover, she does not discuss the possibility that some forms of federal intervention might entail less intrusion and thus less risk of impairment

133 Most commentators today make reference to a public goods justification of the mandatory disclosure system advanced by Easterbrook and Fischel. Easterbrook and Fischel identify a number of situations in which companies, concerned about incidental benefits to third parties, will have incentives to underdisclose. Easterbrook and Fischel, supra note 4, 290–1. Romano is sceptical about this, and notes that a supporting empirical case has not been made (pp. 92–3). More generally, Romano notes that event studies of stock prices at the time of the enactment of the securities laws and the time of certain major amendments do not show that returns to investors increased. This, she says, undermines public goods justifications of the system and gives rise to a question whether the costs outweigh the benefits (pp. 93–101).

I agree that the mandatory disclosure system gives rise to an active cost-benefit question. But I think that simplification and flexibility respecting requirements imposed on foreign issuers would provide a better focus for a reform program than an opting-out privilege. The empirical studies show that the securities laws have caused reductions in market variance (pp. 94–5). This implies that the mandate's benefits come in the form of enhanced confidence in the system as a whole. Under this rationale, attention shifts from transactions between individuals to the individual's relationship to the system as a whole, and the element of trust incident to the empowerment of corporate managers. The legal mandate backstops the regime of empowerment. See N. Luhmann 'Familiarity, Confidence, Trust: Problems and Alternatives' in D. Gambetta (ed.) *Trust: Making and Breaking Cooperative Relations* (New York: Blackwell 1988) 97; B. Barber *The Logic and the Limits of Trust* (New Brunswick: Rutgers Press 1983) 9, 15, 19–20. The identification of a trust element supports allocation of the empirical burden to the advocate of deregulation.

134 Romano applies the contractarian analysis of insider trading in advocating opting out by individual firms, and rests on the proposition that empirical confirmation of benefit to shareholders is thin (pp. 101–6). I agree, but would make reference to outside political instructions in justifying the ban and its criminalization. See W. Bratton 'Public Values, Private Business, and US Corporate Fiduciary Law' in J. McCahery, S. Picciotto, and C. Scott (eds) *Corporate Control and Accountability: Changing Structures and the Dynamics of Regulation* (Oxford: Clarendon Press 1993) 23–40, which argues that fiduciary rules that do not enhance shareholder value can be justified by a social consensus favouring control of management conduct.

of well-functioning state law provisions than others. She proceeds on the assumption that the only regulatory proposition on the table is some form of federal chartering including fiduciary standards, a form of intervention that does indeed invite practical questions about feasibility and perverse effects. When her attention turns to deregulation, her projections become risk prone. We are encouraged to withdraw the mandates across the board, even though we have experienced nothing resembling conventional contracting between shareholders and managers in the past, and the federal disclosure system, although costly, works reasonably well. The careful, practical inquiry that accompanies her discussion of federal intervention in state law now is absent, even though the same questions can be asked about management manipulation of the facilitating legislative process.

In sum, in Romano's normative vision the burden of proof lies intrinsically against regulation, new or old. She envisages a deregulatory shock therapy that thrusts the corporation towards the contractual ideal described in economic theory. The operative assumption must be that investors, having substantial financial stakes, will intervene to assure the subsequent evolution of effective contracting practices – even though such practices have not existed in the past. This is not an implausible projection. But it entails risks and remains controversial.

3. Responsive regulatory alternatives

Romano's absolute opposition to federal intervention may not make complete sense even in the light of her normative vision. Her projected expansion of the opting-out privilege anticipates a world in which shareholder choices determine governance terms. Yet such a regime seems an unlikely outcome under the state system as now constituted. Consider the duty of loyalty as a case for an opting-out privilege. Romano projects, reasonably, that most groups of shareholders would choose to opt in even if the mandate were removed. But, even if most shareholders would so choose, it is questionable whether we can expect the choice to be offered by the state law regime. Under the postwar model of fiduciary mandate, judicial fairness scrutiny obtained in respect of every self-dealing transaction regardless of whether a majority of disinterested directors approved the transaction. That model of fiduciary scrutiny is disappearing. Under the revised Model Business Corporation Act,[135] and repeated dicta of the Delaware Supreme

135 Model Business Corporation Act, sections 8.61, 8.62.

Court,[136] the competing states are substituting a regime in which disinterested director approval results in business judgment scrutiny. If the new rules mean what they say,[137] managers, and hence competing states, have little incentive to offer the shareholders a choice that holds out the possibility of a return to the old regime of fairness scrutiny. Faced with the prospect of a mandate with no bite or a shareholder option to contract into a strict rule, managers probably would prefer the former. More generally, as Romano points out in respect of anti-takeover statutes, the states tend to open doors to shareholder choice on an opting-out basis rather than an opting-in basis. That is, a newly enacted default rule applies subject to an ex post election to opt out; the states almost never condition the application of legislative innovations responsive to management preferences on ex ante shareholder approval. This makes shareholder choice hard to exercise, given the shareholders' collective-action problem and the managers' agenda control.

On this point Romano suggests that, in lieu of the negative price effects of anti-takeover legislation, the statutory defaults should be changed from opting-out to opting-in provisions, which would put the decision in the hands of those who bear the financial consequences. This approach is politically feasible at the state level, she asserts, because it frames the issue in terms of shareholder voting, and franchise extensions are hard to oppose. Moreover, management lobbying against such provisions would not carry much weight – since the lobbying managers would be seeking to strip shareholders of the vote, they would be asking the legislature to 'invert the agency relation' (pp. 83–4).

Romano's suggestion of an 'opting-in' approach is an excellent one. It invites expansive application to any new legislation that impairs existing shareholder rights.[138] But her projection of state-level political feasibility does not resonate similarly. State legislatures do not appear to have been overly concerned with inversions of the management-shareholder agency relationship in recent years.[139] The system's struc-

136 *Cede & Co.* v. *Technicolor, Inc.* 634 A.2d 345, 366 n34 (Del. 1993); *Marciano* v. *Nakash* 535 A.2d 400, 403–5 (Del. 1987).

137 They may not. An imaginative judge with a sense that a transaction is unfair can find ways to attack the process employed by the approving board.

138 Black, supra note 14, 582.

139 In fact, any such concern would be surprising for doctrinal reasons. Simply, American corporate law does not directly place shareholders and managers in a principal-agent framework. Under the doctrine, the managers are agents of the

tural bias towards management makes a political turnabout unlikely. Federal imposition of such a principle at the urging of the newly vocal institutional shareholders seems the more feasible scenario, albeit one unlikely of near-term realization.[140]

Romano dismisses this idea with the comment that the 'optional feature of state takeover statutes is not a characteristic of the national regime' (p. 84). But, true though the point may be, it does not conclude the discussion of relative feasibility. For all the talk about the inherently enabling character of state law, opting-out provisions attached to new rules importing substantial normative changes are recent innovations. Opting-in provisions that hold out the possibility of active shareholder participation in the selection of contract terms are almost unheard-of at any level. Nothing prevents the federal government from taking the leading role in filling in this blank slate. Indeed, the opting-in suggestion has roots in an SEC report circulated in 1983.[141] The long list of proposed but unenacted federal corporate law provisions mentioned the problem of shareholder access as early as 1943.[142]

More broadly, agenda control remains a critical component of management's governance edge over shareholders and a barrier to the realization of the contractual regime Romano envisages. It is enabled by the enabling state regime. It will take a substantial process reform to wrest away management's control. At a minimum, shareholders need

corporation in the first instance. Responsibility to the corporation overlaps with shareholder value maximization in most, but not all, circumstances, giving rise to the appearance of an agency. But 'entity' concerns often interpose themselves to the detriment of shareholders, as occurs throughout the law of takeover defence. The strict agency relationship exists only in economic theory. State charter competition has done little over the last century to bring the law closer into line with the economic model. See Bratton, supra note 34.

140 Black makes this suggestion. In his view, federal rules could require that a majority of independent shareholders of public companies be required to elect to be governed by changes in state law that affect the division of power between management and shareholders. He would permit new publicly offered firms of sufficient size to insure institutional interest to opt out of such 'change governing rules,' but would not extend the privilege to existing public companies. Black, supra note 14, 582.

141 SEC Advisory Committee Report on Tender Offers, Report of Recommendations, CCH Fed. Sec. L. Rep., Special Report No. 1028, pp. 37–40 (15 July 1983) (recommending annual shareholder advisory votes on, among other things, supermajority and disenfranchising charter provisions).

142 SEC Proxy Rules, Hearings Before House Committee on Interstate and Foreign Commerce on HR 1493, HR 1821 and HR 2019, 78th Cong., 1st Sess. pp. 17–9, 34–43 (1943) (proposal to circulate shareholder nominations in proxy statements).

an avenue that facilitates choices on internal rules on voting, fiduciary duty, corporate-control transactions, and state of incorporation. The feasibility of contractual governance can be tested only once that avenue of access to the agenda has been constructed. Federal intervention is the most expeditious means to that end, and shareholder activists are well advised to direct their attention to it. Romano, in staking out the middle ground and identifying the virtues of the state system, has effectively laid the conceptual groundwork for such limited federal intervention directed to the end of expanded shareholder choice.

C. CONCLUSION

The product competition model, used as a normative template, is supposed to keep the field clear of legal artifices that retard the evolution of efficient rules selected by actors with investments at stake. But it is not at all clear that the American institution of corporate charter competition has itself evolved so as to leave a clear field. Movement towards the contractual ideal of corporate law may yet depend on central government intervention. Such intervention need not destroy the benefits of charter competition. Academic discussion can safely go forward on the topic of responsive regulatory strategies. As it does so, discussants on all sides will rely heavily on the work of Roberta Romano. And, despite normative differences, all should agree that her work makes one of the handful of formative contributions to American corporate law of recent decades. One can only look forward to her future interventions.