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DELAWARE LAW AS APPLIED PUBLIC CHOICE THEORY: BILL CARY AND THE BASIC COURSE AFTER TWENTY-FIVE YEARS

*William W. Bratton**

I. CHARTER COMPETITION, CARY, AND THE BASIC COURSE

Twenty-five years ago the late William L. Cary used the pages of the *Yale Law Journal* to serve his famous indictment of Delaware corporate law.[1] His article reviewed Delaware's code and leading opinions of its courts and suggested that Delaware law had "no public policy left . . . except the objective of raising revenue."[2] To Cary, the "public policy" at stake was the integrity of corporate managers.[3] The state's revenue objective, he said, led it to "grant management unilateral control untrammeled by other interests,"[4] thereby sacrificing the national interest. Delaware was, in short, a corrupt sovereign.

Cary's denunciation was soon countered by a commendation of Delaware articulated under the rubric of jurisdictional competition theory.[5] Under this theory, what Cary saw as subject matter for regulation in the public interest instead was seen as appropriately left to decisionmaking within firms—firms choosing among the various states for the best possible legal regime in which to

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[1] William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

[2] *Id.* at 684; *see also* Comment, *Law For Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969) (discussing how selling of Delaware's corporate laws is state business).

[3] *See* Cary, *supra* note 1, at 671-72 (noting that one focus of article was that "necessary high standards of conduct [by management] cannot be maintained by courts shackled to public policy based upon the production of revenue"). The managers' integrity is the competing public policy.

[4] *Id.* at 697-98.

[5] ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 32 (1993).

incorporate or reincorporate.[6] Such firms, said the theory, were seeking a predictable, cost-reductive legal regime.[7] Delaware was said to provide this regime with comprehensive case law, well-specified indemnification rules, and an expert judiciary.[8] The firms also were said to seek a guarantee that their domiciliary state would maintain its legal system's desirability.[9] A chartering jurisdiction remained free to change its politics and transform itself into an unresponsive domicile even as its domiciliary firms had incurred access costs *ex ante*.[10] To be competitive, a jurisdiction had to reduce this defection possibility by making a credible commitment to remain constant to its customer firms' interests. For Delaware, the requisite commitment followed from the combination of a large number of incorporations and a small population.[11] This situation caused franchise tax revenues to make up a substantial portion of its tax draw,[12] which in turn subordinated its politics to its chartering business.[13] Delaware also invested in assets specific to its incorporation business—its code and case law and its judicial and administrative expertise—and set up internal process rules to protect these reputational assets from impairment by anti-managerialist politicians and judges.[14] The capital, thus accumulated and protected, bolstered Delaware's market position. Other states could not credibly precommit to offer superior service, and thus were deterred from incurring the start-up costs necessary for

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[6] *Id.*

[7] *Id.*

[8] *Id.* at 33-34, 39 n.20.

[9] *Id.* at 32.

[10] *See id.* at 42-43 (giving example of New Jersey's corporate code revamping just after turn of century).

[11] The need for a "supermajority" of two-thirds of both legislative houses to change the Delaware code also helped. *Id.*

[12] *Id.* at 36-37. Franchise taxes amounted to 17.7% of Delaware's total tax revenues in 1990. *Id.* at 10.

[13] *Id.* at 38.

[14] These assets include directing corporate matters to a specialized chancery court, appointing rather than electing its judges, limiting judges to twelve-year terms, and requiring two-thirds majorities of both houses of its legislature to approve corporation code amendments. *Id.* at 38-42.

entry into the market.[15] A first-mover advantage in Delaware resulted.[16]

This scenario still holds a central place in our working model of corporate law. But jurisdictional competition theory's concomitant assertion that charter competition assures optimal constraints on management misbehavior, the "race to the top" story, quickly went the way of history. The theory bypassed the problem of the shareholders' lack of influence over state lawmaking processes with a reference to the control market deterrent: Management's option of exit through reincorporation in another state adequately disciplined the states, while the possibility of shareholder exit by tender to a hostile offeror adequately disciplined management. This tale could not be told after managers and state politicians collaborated[17] in the 1980s to hobble the market deterrent with anti-takeover legislation.[18] It became manifest that management capture of the state lawmakers led to suboptimal corporate lawmaking in the midst of active competition for charters.

Charter competition's proponents accordingly shifted to a middle ground position, defending the state system except to the extent that it permitted constraints on the market for corporate control.[19] Other observers revived Cary's point that state corporate law should

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[15] *See id.* at 40 (noting length of time would be "considerable" to equal Delaware legal expertise).

[16] *Id.* at 40-41, 43-44.

[17] *See* Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 n.11 (1988) (showing that although anti-takeover legislation is interest-group legislation, it did not result from efforts of centrally organized management lobbying effort but rather from individual corporation interests).

[18] For descriptions, see Lucian Ayre Bebchuk & Allen Ferrell, *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999); Arthur Pinto, *The Constitution and the Market for Corporate Control: State Antitakeover Statues After* CTS Corp., 29 WM. & MARY L. REV. 699 (1988); Elliott Weiss, *What Lawyers Do When the Emperor Has No Clothes: Evaluating* CTS Corp. v. Dynamics Corp. of America *and Its Progeny-Part I*, 78 GEO. L.J. 1655 (1990).

[19] *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 222 (1991) (concluding that race-to-top stands as refuted, but proposition that competition creates "powerful tendency" to enact shareholder beneficial laws remains vital); Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGS. 225 (1985) (trying to bring empirical research to bear no issue); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1528 (1989) (expressing more confidence in view that Cary was wrong than in view that Delaware was leading race to top).

be preempted, at least in part.[20] The middle ground result, they said, developed from a defect in the charter competition system. Given the competition, the states had to focus on the variables that influence reincorporation decisions.[21] That focus caused the states to cater to management preferences rather than concern themselves with the maximization of shareholder value. Accordingly, states pursued suboptimal policies of management accommodation respecting fiduciary rules and anti-takeover legislation.[22]

This debate continues, directed to the question of the desirability of federal intervention.[23] As such, the debate figures only peripherally in my teaching. Federal intervention in corporate law does not, after all, hold a place on Washington agendas these days. At the same time, however, the operative description of Delaware lawmaking under charter competition, to which there is little fundamental disagreement, takes a more prominent place in my pedagogy with each passing year. This prominence follows from the fact that Delaware's importance as the corporate lawgiver has increased in the quarter-century since the publication of Bill Cary's article. As Delaware cases take up a greater proportionate share of the syllabus, my description of corporate law becomes a description of characteristics of Delaware cases and of the personalities of Delaware judges. Charter competition figures prominently in that description.

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[20] Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1495 (1992); Bebchuk & Ferrell, *supra* note 18; William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1925-48 (1995); Roberta S. Karmel, *Is It Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 91-96 (1991); *see* Joel Seligman, Essay, *The Case for Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 971-74 (1990) (proposing limited federal preemptive in three specific areas); *see also* Joel Seligman, *The New Corporate Law*, 59 BROOK. L. REV. 1, 60-63 (1993) (suggesting need for concurrent federal legislation that does not entirely preempt state legislation).

[21] Bebchuk, *supra* note 20, at 1452, 1454.

[22] *Id.* at 1462-63, 1468, 1488. In addition, competition can cause the states to use their lawmaking power to impair market discipline even further, as the proliferation of anti-takeover statutes demonstrates. *Id.* at 1467; *see also* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471, 483 (1987) (stating state competition generates efficient rules).

[23] A new empirical debate also can be expected in light of Robert Daines's paper, *Does Delaware Law Improve Firm Value?* (New York University Law and Business Working Paper, Oct. 1999) (finding statistically significant increment in value, measured by Tobin's Q, for firms incorporated in Delaware).

I also look to charter competition to explain Delaware's growing prominence in the basic course. I do so, however, without offering empirical evidence showing an increase in Delaware's market share of the charters of publicly-traded firms. Delaware's enhanced prominence as a corporate lawmaker does not require a bigger market share than the oft-stated figure of fifty percent. Instead, the enhanced prominence results from the nature of Delaware's customer base and the product it sells. Charter competition caused state corporate codes to converge in their broad outlines long ago.[24] Delaware's code stands out more for its stability over time than for its clarity or state-of-the-art drafting. It follows that Delaware's case law, judges, and speedy process figure much more prominently than its code in explanations of the success of its legal product line.[25] Studies of reincorporating firms confirm this assessment, showing that firms migrate to Delaware because they either anticipate activities that increase the risk of litigation or plan to engage in mergers and acquisitions, the latter of course also being an activity that carries a high risk of litigation.[26] Couple this tendency with the consistent intensity of merger and acquisition activity during the last two decades, and Delaware emerges as a magnet that attracts litigation respecting mergers and acquisitions. The result is a stack of Delaware merger and acquisition cases that towers above the stack of cases reported by all other jurisdictions combined.

Delaware's enhanced presence in the basic course reflects this fact, even without mergers taking a large time allocation in the syllabus. When I took the basic course twenty-five years ago, we read *Cheff v. Mathes*[27] in connection with fiduciary duties and ran

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[24] William J. Carney, *Federalism and Corporate Law: A Non-Delaware View of the Results of Competition*, *in* INTERNATIONAL REGULATORY COMPETITION AND COORDINATION: PERSPECTIVES ON ECONOMIC REGULATION IN EUROPE AND THE UNITED STATES 153, 169-82 (William Bratton et al. eds., 1996).

[25] Bayless Manning identified the judiciary as the prime attraction, comparing Delaware to the medieval law merchant. Andrew G. T. Moore II et al., *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 784-85 (1987) (describing Manning's response in roundtable discussion). For confirmation of this point from a game theory perspective, see Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1414-15 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW (1991)).

[26] ROMANO, *supra* note 5, at 33-34.

[27] 199 A.2d 548 (Del. 1964).

out of time before we got to the casebook's merger chapter. We otherwise learned very little about mergers and management duties respecting them. Now, complex merger cases come up early in the term because of the wide variety of issues decided therein during the intervening quarter-century. They figure into the basic discussion of the allocation of authority between management and shareholders[28] and in the presentation of the duty of care,[29] and they also take up a larger proportional place in discussions of fiduciary duty. When I try to explain these cases' results and the opinions' characteristics to my students, I find myself returning again and again to charter competition and its effects on litigation in Delaware.

Since I take the middle-ground view of charter competition, the notion of Delaware as a responsive sovereign figures into these explanations. Since I also subscribe to the notion that the charter competition system has a structural defect that causes corporate law to tilt markedly in the direction of favoring management interests, however, Bill Cary's lessons always remain on the table in my class, although with a difference in emphasis. I speak of capture rather than corruption, omitting the public interest story of regulatory motivation that grounded Cary's denunciation of Delaware as a corrupt sovereign. What Cary characterized as defection from a duty to pursue the general good can be given a more technocratic gloss by reference to capture theories of regulation. These theories depict regulation as an arena in which special interests compete to use government power for advantage and make the public choice assumption that regulators should not be expected to behave differently than actors in private economic relations.[30] There is still a normative judgment at the bottom line, when the regulatory results are shown to be economically suboptimal. The self-inter-

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[28] *See* Williams v. Geier, 671 A.2d 1368 (Del. 1996) (holding stockholder vote dispositive); Blasius Indus. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988) (holding directors violated duty of loyalty to shareholders).

[29] *See* Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (holding board negligent in shareholder class action suit).

[30] Michael E. Levine & Jennifer L. Forrence, *Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis*, 6 J.L. ECON. & ORG. 167, 168-69 (1990).

ested behavior of the regulators thus emerges as an ordinary course phenomenon that prompts no special moral opprobrium.[31]

However, neither does it prompt any sort of commendation. To the extent that Delaware does earn a commendation in the framework of a capture model, it does so because it must answer to more than one interest group. Management remains the prime concern in this multiple demand picture, of course. But the system also allows shareholders, lawyers, and even judges to register competing demands. Although it remains pronounced, the tilt toward management is not absolute. The cases take on a complex, mediative quality as they try to satisfy the competing claimants. This quality, in turn, disrupts student expectations. They come to the basic course expecting the cases to be principled in a narrow sense. Under the expected regime, judges are disinterested public servants whose empowerment and integrity follow from a commitment to common-law principles. The students expect the principles to come to bear in the cases from a dominant position, controlling rather than following from the facts even while building in possibilities for flexible application in the interest of justice. This rule of principle imports coherence to the system along with stability over time. A case law that is sold by its jurisdiction to business actors presents a stark contrast. It must remain responsive and subordinated to dynamically changing business fact patterns even as it mediates among conflicting interests. This causes it to be unstable over time and apparently disconnected from a rule of principle. I try to persuade my students that there is an important element of coherence nonetheless, and I draw on a multiple demand model of Delaware regulatory capture in trying to teach that lesson. Even so, Delaware's legitimacy from the point of view of the narrow rule of principle presents a very different question. I remit that question to the students to answer for themselves. It is their privilege to join Cary's judgment of corruption. I stress, however, that to do so automatically is to miss the point of the exercise.

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[31] I find this point, by the way, a hard one to teach. Most students come to the class with the same public interest assumptions that inform Cary's article. They have an understandable inclination to join him in condemnation.

The succeeding parts of this Essay develop these points more fully. Part II sets out a multiple demand model of regulatory capture of Delaware. Part III brings the model to bear on the case law, looking at its impact, first on the judicial role, and second on a problem of indeterminacy much-discussed of late.

II. A MULTIPLE DEMAND MODEL OF DELAWARE REGULATORY CAPTURE

A. REINCORPORATION AND MANAGEMENT CONTROL

In the standard story of regulatory competition theory, jurisdictions can compete only to the extent that citizens have mobility among them. Free entrance and exit give the citizens a basis to choose, turning them into consumers of public goods and regulation. Citizen choice, in turn, deters regulatory capture. When interest groups gain undue influence and procure costly regulation, the citizens disadvantaged thereby exit the captured jurisdiction. Regulatory competition thus keeps regulators' attention focused on citizen preferences on the assumption that regulators do not like to see their citizens migrate elsewhere. Corporate charter competition, however, does not follow this pattern. Mobility and exit once again are the mainsprings. But capture is not thereby deterred because with corporations the capturing interest controls the mobile consumer and the system simultaneously deprives the disadvantaged interest of mobility.

The system works well from the point of view of the chartering firm, considered as an entity without internal conflicts of interest. Exit through reincorporation gives the managers a potent *ex post* enforcement device that keeps the chartering state responsive to its interests. The chartering state's desire to continue to attract new incorporations discourages any blocking of the exit route for fear of scaring off future prospective incorporators. The combination of the state's rent incentive and the exit deterrent also mitigates any collective action problems the firms might encounter in getting needed legislation in the future. Should desired legislation not be obtained, exit can be effected unilaterally, and there will remain up to forty-nine states from which to choose. Since the chartering

state's rent flow includes fees to practicing lawyers in addition to franchise taxes, there always will be key actors on the supply side ready to work with the firms in securing regulation that suits their preferences. No trade association needs to be formed for the purpose of assuring effective lobbying. Delaware practice confirms this point. It delegates to its bar association both agenda control over, and drafting responsibility for, any amendments to its corporate code. The bar and legislature have a longstanding "understanding" that amendments to the corporations code must first be drafted and approved by the bar association's corporate law section and the bar association itself.[32]

Even as the charter system allows for exit from an unsatisfactory jurisdiction and compels the jurisdiction's lawmakers to attend to the preferences of the firms incorporated therein, it holds out no guarantee of responsiveness to the more particular preferences of the firms' shareholders. This imbalance stems from the fact that the exit privilege applies to firms rather than to shareholders, and corporate law has evolved under charter competition so as to block shareholder access to the determination of the firm's reincorporation decision. Although the shareholders have a vote respecting reincorporation, a favorable board vote must come first. Management thus controls the agenda.[33] The market system holds out no route around this barrier because it creates no incentives to encourage the development of a shareholder-favorable state. Nor could the market for corporate control provide the shareholders any relief, even assuming the removal of antitakeover legislation. Successful control contests, whether by takeover or proxy fight, merely displace one group of managers with another. The displac-

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[32] *See* Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 899-901 (1990). 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. *Id.* at 899-901, 910. The legislature rubber stamps the bar's recommendations; the executive branch's role is limited to representation at bar association meetings on invitation. *Id.* at 898-99; *see* Moore et al., *supra* note 25, at 779-81 (describing this "understanding" more fully). Active drafting and discussion is largely limited to the corporate law section. David S. Schaffer, Jr., *Delaware's Limit on Director Liability: How the Market for Incorporation Shapes Corporate Law*, 10 HARV. J. L. & PUB. POL'Y 665, 682-84 (1987).

[33] Bratton & McCahery, *supra* note 20, at 1929-36.

ing group, unless it has taken the firm private, remains in an agency relationship with the firm's shareholders and thus has no reason to look for a jurisdiction activated by the shareholder interest. Meanwhile, capture by charter competition exacerbates the shareholders' collective action problems even as it ameliorates management's problems. State law not only blocks shareholder access to the charter and the reincorporation machinery, it provides only management with routine compensation for expenses incurred in voting contests.[34] Finally, because of the peculiarities of our federal constitutional structure, the competing jurisdictions that lack an incentive to balance shareholder and manager interests have national lawmaking power over the shareholders of their domiciliary corporations. In the corporate variant of regulatory competition, then, exit from one jurisdiction provides no remedy for the dissatisfactions of the disadvantaged interest group. The system instead locks it in.

The bar and the judiciary emerge as the only groups within the chartering state having any incentive to advance the shareholders' interest. The judicial role is discussed in Part III; here I note that only limited assistance can be expected from the bar. Litigating lawyers promote shareholder welfare as an incident to making a living as enforcers of the fiduciary deterrent. This focus is not the same as an interest in promoting shareholder value. For example, the lawyers have an incentive to promote lawmaking that enhances shareholder value by strengthening the corporate-control market only if the change will prompt additional litigable disputes. The same would go for lawmaking that enhances possibilities for relational monitoring by nominees of institutional shareholders. Shareholder-favorable incentives accordingly are unlikely to issue from the bar in practice. Fiduciary breaches that bring rents to lawyers stem from excess management influence; any market or self-regulatory governance strategy that has a cognizable chance of working well in practice ultimately threatens to diminish those

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[34] This regime compensates only shareholder winners in board control contests and provides no compensation at all to shareholders who oppose management positions in issue contests. Rosenfeld v. Fairchild Engine & Airplane Corp., 128 N.E.2d 291, 293 (N.Y. 1955). For discussion, see Lucian Arye Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Towards Proxy Contests*, 78 CAL. L. REV. 1071, 1126-29 (1990).

rents by reducing the incidence of unproductive influence activities. In addition, the bar's interest diverges from the shareholders' interest even within the sphere of fiduciary enforcement, with the bar favoring a system that trades substantial money judgments to shareholders in exchange for substantial attorneys' fees.

In short, no interest group in the chartering state has a rent incentive reliably tied to the advancement of the shareholders' interest in the minimization of agency costs within the firm. This situation leaves the shareholders to self-organize in order to advance an agenda in state lawmaking processes. The same collective action problem that prevents political action within firms, however, presumably makes this organization difficult. The charter competition system makes it even more difficult by structurally limiting prospects for payoffs: Any meaningful shareholder effort would have to register successfully in multiple jurisdictions.[35]

B. COMPETING DEMANDS

1. Threatened Federal Intervention as a Proxy for the Shareholder Interest. The capture model of corporate lawmaking incentives should not be taken to imply a "race to the bottom" conclusion. Many matters of state corporate law find shareholder and management interests in alignment. In addition, the deal struck between the chartering state and management can never be entirely secure because the possibility of removal of corporate lawmaking to the federal level inheres in our federal constitutional structure. Delaware, as the entity most dependent on corporate law revenues, is the contracting state most prone to view that possibility as a threat.

It seems safe to assume that Delaware actors remain highly averse to possible destructive exercises of federal preemptive power. Although this is a low-probability event, the potential level of injury to Delaware remains high and federal law reform discussions during the past twenty-five years have given occasional cause for concern.

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[35] It comes as no surprise that federal law has emerged as the preferred venue for organized shareholder efforts to alter legal structures so as to make firms operate more effectively.

Federal assumption of the large fiduciary component of the corporate law product might deprive Delaware of the principal justification for its premium price. An outbreak of price competition could follow in the market, along with erosion of Delaware's position as an informational center. Litigation business, meanwhile, would disperse across the country as plaintiffs shop for hospitable federal venues. Delaware actors accordingly have high-powered incentives to avoid exciting the creation of new federal law.[36] This structural constant creates secondary incentives for Delaware lawmakers to respond to shareholder interests.[37]

Recognition of a perceived federal threat implies a model in which Delaware faces conflicting demands, each threatening potential negative consequences. First, the management interest must be satisfied to prevent corporate migration out of the state and entry into competition among competing states. Second, federal actors, as proxies for the shareholders, must be satisfied to avoid destructive intervention. The conflicting demands complicate the business of response; Professor Eisenberg has suggested that the conflict leaves Delaware with an incentive to avoid taking the lead in adopting rules favoring managers at the shareholders' expense. Other states have a different incentive. If they offer innovative side payments to management, 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.[38] It remains under pressure to follow new developments elsewhere, but emerges in a mediative role.

Evidence of the multiple demand model's robustness can be found in the pattern of Delaware lawmaking. Given statutory convergence and the dominance of the management interest, the problems of

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[36] Anecdotal evidence shows that Delaware lawmakers keep federal intervention in mind when they take politically sensitive steps. Alva, *supra* note 32, at 906-08.

[37] A number of commentators have recognized this possibility. Bebchuk, *supra* note 20, at 1455; Cary, *supra* note 1, at 688; Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512 (1989).

[38] Eisenberg, *supra* note 37, at 1512-13; *see also* Bebchuk, *supra* note 20, at 1455 (pointing out that there remains range on which states can maneuver without fear of federal intervention).

conflicting demand show up only intermittently in the corporate legislative process. Anti-takeover legislation is the principal recent instance, and Delaware's corporate bar moved late and with caution in putting an anti-takeover statute before its legislature.[39] The conflicts become more apparent in the adjudication of fiduciary cases, as we will see in Part III.

A question arises as to how Delaware, alone in this competing demand situation, can structure a mediative response without losing business in a market still keyed to management preferences. 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. The benefits of a mediative jurisprudence, however, are more questionable from the point of view of individual managers seeking an optimal environment. An individual manager's incentive would appear to lie in causing the firm to migrate to a state adopting a less equivocal anti-takeover policy and in free-riding on the firms that stay in Delaware. Of course, once a large number of firms did likewise over time, successfully shopping for more responsive jurisdictions, federal intervention would become more likely. The same thing might happen if a large number of firms left Delaware in a bunch, starting a new race to the bottom.

Two factors make the multiple demand picture plausible in light of the constant threat of management exit. First, no full-service alternative domicile exists, and only a handful of other jurisdictions have strong incentives to incur the start-up costs to market a full service operation. None of those potential competitors has any assurance that a third jurisdiction will not duplicate its efforts.[40] Nor, given the low cost of reincorporation,[41] does the potential competitor have any assurance that its new customers will remain.

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[39] *See* Alva, *supra* note 32, at 906-08 (discussing concerns regarding anti-takeover legislation in Delaware).

[40] *See* Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 182 (1991) (explaining "prisoner's dilemma" in which jurisdictions fear making investments that new competitors could duplicate or undermine).

[41] *See* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 551, 574, 586-90 (1990) (noting low cost of reincorporation).

Second, the shareholders' newly discovered capability of self-protective collective action may effectively 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.[42] Thus, departure from Delaware may not be the open option it used to be, and charters may have become somewhat embedded within the supposedly dynamic competitive system.

2. *The Bar as Interest Group.* Full description of the incentives that shape Delaware law requires mention of conflicting interests on the supply side. Even as the managers implicitly rely on the Delaware bar to represent their interests in the state, management's interests are far from perfectly aligned with those of the bar since litigation against managers provides a source of the bar's income. Delaware's process rules advance this local interest. The rules encourage derivative litigation,[43] making sure that the local bar gets a share of the action by requiring that Delaware lawyers make appearances and filings.[44] Competing demands also result in some systemic concessions to managers, but the concessions by no means counter Delaware's reputation as a fee-generating center for corporate lawyers.[45]

Jonathan Macey and Geoffrey Miller have explained the litigation rules with a supply-side account that highlights the impact of

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[42] *See* ROMANO, *supra* note 5, at 68-69 (discussing shareholder pressure on Pennsylvania firms to opt out of state's anti-takeover statute); Bernard S. Black, *Shareholder Passivity Reexamined,* 89 MICH. L. REV. 520, 571 (1990) (noting that anti-takeover amendments that passed got only 50% to 60% of the votes).

[43] Delaware differs from many jurisdictions in not requiring plaintiffs in shareholder derivative actions to post security for expenses. DEL. CH. CT. R. 23.1 (1991). Delaware facilitates service of process on nonresident directors with a broad consent to service statute. DEL. CODE ANN. tit. 10, § 3114 (Supp. 1998). Delaware also is liberal in its fee awards to derivative plaintiffs' lawyers. Under its nonpecuniary settlement practice, defending managers can trade a high fee for a small overall recovery. John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards,* 8 CARDOZO L. REV. 759, 761-62 (1987).

[44] DEL. SUP. CT. R. 12 (1991), DEL. CH. CT. R. 170 (1991).

[45] Cary, who favored strict fiduciary law control of management conduct, explained the concessions as a special exception keyed to the interests of the Delaware bar. Cary, *supra* note 1, at 686-88.

internal interest group politics on Delaware law.[46] Macey and Miller assert that, unlike Delaware, a state acting as a pure profit maximizer would limit legal fees incident to the domicile therein so as to maximize franchise tax revenues.[47] Delaware fails to conform to this product model's predictions because the bar acts as a small, cohesive interest group that extracts special concessions from the legislature at the expense of the general public.[48]

Macey and Miller rightly emphasize the organized bar's political power. However, two factors that align the interests of the bar with those of the rest of the state should be added to their description. First, the federal threat may temper the incentive of Delaware's lawyers to lobby for a reduction in direct charges to customers. Increasing Delaware's market share substantially above the level of one half of public incorporations would make Delaware even more of a "national" lawmaking center, enhancing its visibility and vulnerability to challenge at the national level. Given a state with a monopoly position, traditional federalism objections to intervention carry less weight. Second, rules that encourage litigation in Delaware play a secondary role in production. As noted above, Delaware's case law and judges figure prominently in its substantive law product line. Delaware, however, cannot unilaterally control the production of Delaware caselaw. 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 fact gives Delaware a reason to offer incentives to plaintiffs. Plaintiff cooperation gives Delaware the opportunity to apply its own law, preserving the first mover advantage and generating a flow of cases. These cases, in turn, are products sold in the charter market. The need to satisfy the demands of the national plaintiffs' bar reinforces the internal bargaining position of Delaware's bar, further explaining the state's delegation to the bar of the corporate legislative function. However, the delegation to the bar also helps to stabilize the capture arrangement with management.

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[46] Macey & Miller, *supra* note 22, at 471-72.
[47] *Id.* at 472-73, 498, 503-04.
[48] *Id.* at 504-03.

III. THE JUDICIARY AS INTEREST GROUP: DELAWARE CASE LAW AND MULTIPLE DEMANDS

The Delaware judiciary plays an independent role in a multiple demand model. Its incentives are multifaceted. Like all judges, Delaware judges stake reputational capital in their working roles. As Delaware judges, they must pursue the state's interest in balancing the conflicting interest group demands. They accordingly act as mediators. But they are not merely arbitrators in robes. As judges, they have an independent reputational incentive to protect the legitimacy of the system in a public policy sense.[49] Delaware judges have represented a commitment to this aspect of the judicial role in the past, describing themselves as not only mediators between management and shareholders but also protectors of market risk-taking who nevertheless impose ethical constraints.[50] Finally, judges cannot escape expectations that they should operate under the rule of principle, narrowly defined.

1. The Move to a More Even-Handed Mediation. Cary accused the Delaware courts of monolithic fidelity to management interests, citing a cluster of cases as evidence: (1) *Cheff v. Mathes*,[51] which permitted management "with impunity" to spend corporate money to entrench itself against tender offers;[52] (2) *American Hardware Corp. v. Savage Arms Corp.*,[53] which refused to enjoin a defensive

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[49] *See* Eric Rasmussen, *Judicial Legitimacy as a Repeated Game*, 10 J. L. ECON. & ORGS. 63, 72-74, 78-80 (1994) (offering repeat game model of judicial motivation with infinite time horizons resulting in multiplicity of equilibria in which outcomes depend on players' expectations and showing that judges follow precedent if there is self-enforcing system based less on compulsion than need to uphold systemic legitimacy); *see also* Thomas J. Miceli & Mertin M. Cosgel, *Reputation and Judicial Decisionmaking*, 23 J. ECON. BEHAV. & ORG. 31, 44-49 (1994) (modeling preferences of judges on utility function that includes both private and reputational component, with decision as to whether to follow precedent turning on trade off between two components, and equilibrium rate of adherence to precedent depending on distribution of preferences across population).

[50] *See* Moore et al., *supra* note 25, at 779-82 (describing views of then-associate justice of Delaware Supreme Court). They also have acknowledged the federal threat. *See* William T. Quillen, *The Federal-State Corporate Law Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 129 (1993) (stating that Delaware's "middle of the road" approach has ensured its position as premiere state of incorporation).

[51] 199 A.2d 548 (Del. 1964).

[52] Cary, *supra* note 1, at 673-75.

[53] 136 A.2d 690 (Del. 1957).

shareholders' meeting called on short notice or to act respecting a proxy statement the court acknowledged to be incomplete;[54] (3) *Federal United Corp. v. Havender*,[55] which permitted firms to use charter amendments effected through common shareholder voting power to strip preferred stockholders of contract rights and first articulated the doctrine of independent legal significance;[56] (4) *Hariton v. Arco Electronics, Inc.*,[57] which extended the doctrine of independent legal significance to mergers and acquisitions so as to assure a literal rather than purposive and policy-driven reading of the code;[58] (5) *Sinclair Oil Corp. v. Levien*[59] and *Getty Oil Co. v. Skelly Oil Co.*,[60] both of which left the burden of proof on complaining minority shareholders in conflict of interest situations;[61] and (5) *Graham v. Allis-Chalmers Manufacturing Co.*,[62] which absolved management of a duty of care respecting subordinates' criminal conduct absent actual knowledge.[63]

The Delaware courts proved sensitive to Cary's allegations of corruption,[64] becoming noticeably more responsive to the shareholder interest in the quarter century since 1974.[65] Not all of the cases Cary cited are good law today. *Cheff*, a mainstay of management takeover defensive practice, fell to *Unocal*[66] and *Revlon*[67] during the takeover wars of the 1980s. *Graham* was undermined

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[54] Cary, *supra* note 1, at 675-77.
[55] 11 A.2d 331 (Del. 1940).
[56] Cary, *supra* note 1, at 677-78.
[57] 188 A.2d 123 (Del. 1963).
[58] Cary, *supra* note 1, at 679.
[59] 280 A.2d 717 (Del. 1971).
[60] 267 A.2d 883 (Del. 1970).
[61] Cary, *supra* note 1, at 680-83.
[62] 188 A.2d 125 (Del. 1963).
[63] Cary, *supra* note 1, at 683-84.
[64] *Id.* at 684, 696-98.
[65] For empirical confirmation, see Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, 104-08 (1990) (presenting study of Supreme Court cases decided between 1974 and 1987 which shows larger number of proshareholder results than promanager results).
[66] Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 954-55 (Del. 1985) (noting changed circumstances since *Cheff* and applying expanded review of tender offer defensive tactics under proportionality test).
[67] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1985) (inventing duty of management to defend tender offer to auction company in limited circumstances).

more recently,[68] untenable in light of a generation of contrary management practice under the monitoring model of corporate governance.[69] A similar fate could be suggested for *Getty Oil*. *American Hardware* might well come out differently today, given *Unocal* and other cases more closely scrutinizing management procedural manipulations[70] and misrepresentations.[71] *Havender* and *Hariton* are still good law, but they operate in a less relentlessly management-favorable context. A good faith duty to preferred stockholders has been acknowledged,[72] and mergers are subject to a more broad-ranging fiduciary scrutiny. Only *Sinclair Oil* stands unqualified.

The break with the past first manifested itself in 1977 when *Singer v. Magnavox Co.*[73] imposed strict fiduciary standards on parent firms in cash-out mergers. *Singer* is famous for having come down after the Supreme Court removed an immediate threat of federal preemption of state fiduciary rules under the antifraud rules of the securities laws.[74] The story told at the time was that the brush with preemption at the hands of the federal judiciary and the critical atmosphere provoked by Cary and others prompted the Delaware Supreme Court to reverse its direction so as better to accommodate the interests of investors and thereby diminish the possibility of future threats of intervention. The federal threat thus had impressed upon the Delaware courts the practical importance

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[68] *In re* Caremark Int'l, Inc. Derivative Litig., 698 A.2d 959, 969-70 (Del. Ch. 1996).

[69] *See* E. Norman Veasey & William E. Manning, *Codified Standard–Safe Harbor or Uncharted Reef? An Analysis of the Model Act Standard of Care Compared to Delaware Law*, 35 BUS. LAW. 919, 929-30 (1980) (discussing *Getty*).

[70] Blasius Indus. v. Atlas Corp., 564 A.2d 651, 659-60 (Del. Ch. 1988) (confirming that deferential business judgment rule did not shield from scrutiny directors' decision to add two new members to board of directors because decision interfered with effectiveness of shareholder consent process).

[71] Zirn v. VLI Corp., 621 A.2d 773, 778 (Del. 1993) (confirming director duty of full disclosure to shareholders in connection with merger).

[72] *See, e.g.*, HB Korenvaes Invs. v. Marriott Corp., 1993 Fed. Sec. L. Rep. (CCH) ¶ 97,728 (Del. Ch. 1993) (acknowledging such duty in context of proposed spin-off and special dividend to be paid to common stockholders).

[73] 380 A.2d 969 (Del. 1977).

[74] Santa Fe Indus. v. Green, 430 U.S. 462, 479-80 (1977). Prior to *Santa Fe Industries* 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 promulgated thereunder.

of solicitude to shareholder interests. Note, however, that judicial reputations depend on comparisons with the performance of judges on other courts, state and federal. Thus, a critical atmosphere can arouse reputational concerns even with a less immediate federal threat.

The *Singer* rule did not last long, being in turn rejected in 1983 for a looser, process-based approach in *Weinberger v. UOP, Inc.*[75] However, the post-Cary behavior pattern persisted as the courts articulated unexpected new shareholder-protective applications of basic fiduciary rules. In addition to *Unocal* and *Revlon,* this occurred with *Smith v. Van Gorkom*[76] and *Cede & Co. v. Technicolor, Inc.,*[77] both surprisingly aggressive in their applications of the duty of care to board approvals of proposed mergers, and in *Paramount Communications, Inc. v. QVC Network, Inc. (In re Paramount Communications, Inc. Shareholders' Litigation),*[78] with its broadly phrased directive to managers under hostile attack to enhance shareholder value. Less surprising but equally important is the recent invalidation of a delayed-redemption poison pill in *Quickturn Design Systems, Inc. v. Shapiro.*[79] The pattern is volatile, however. Equally famous cases restrict the application of the new rules. In addition to *Weinberger,* one thinks of *Moran v. Household International,*[80] with its validation of the poison pill, and *Paramount Communications, Inc. v. Time, Inc.,*[81] with its apparent allowance of extraordinary latitude to managers defending against a tender offer that disrupts preexisting plans for a friendly merger. Occasional trial balloons float around as well, like the Delaware Supreme

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[75] 457 A.2d 701, 704, 715 (Del. 1983) (overruling *Singer* in favor of less restrictive process scrutiny of cash-out mergers).

[76] 488 A.2d 858, 873-81 (Del. 1985) (expanding duty of care to cover board approval of arm's-length merger).

[77] 634 A.2d 345, 366-71 (Del. 1993) (applying heightened duty of care scrutiny of boardroom merger decision and suggesting expanded remedial concept inclusive of post-merger gain).

[78] 637 A.2d 34 (Del. 1994) (holding that management has obligation to achieve best value reasonably available for shareholders).

[79] 721 A.2d 1281 (Del. 1998).

[80] 500 A.2d 1346, 1356-57 (Del. 1985) (sustaining poison pill defense under *Unocal*).

[81] 571 A.2d 1140, 1150-54 (Del. 1989) (limiting application of *Unocal* and *Revlon*).

Court's dicta that disinterested director and shareholder ratification justifies business judgment scrutiny of self-dealing transactions.[82]

This back-and-forth pattern is one of the big puzzles to be solved in a basic course. Direct charter market pressure does not appear to be implicated, although we certainly have seen its influence on the Delaware legislature during the past quarter century. There, we also encounter one case of legislative modification of a shareholder-oriented ruling: After *Smith v. Van Gorkom*'s application of the duty of care caused nervousness in boardrooms and a substantial increase in insurance premiums, the legislature, prompted by the corporate committee of the state bar, amended the code to permit firms to opt out of the duty of care by charter amendment.[83] However, in only one judicial opinion do we see a straightforward reconsideration and overruling of a previous case: *Weinberger*'s rejection of *Singer* replaces a hastily-adopted, substantive approach in favor of a more workable, process-based scrutiny. The other judicial switchbacks all purport to lie within the ordinary scope of stare decisis: The Delaware Supreme Court has a habit of loudly—perhaps too loudly—announcing that "applicable principles of established Delaware law"[84] determine the result in the case. I tell my students that whenever they see this announcement, they should assume that from that point to the end of the opinion the court is making it up as it goes along.

2. *Indeterminacy and Management Tilt.* At this point the credible Corporations teacher needs to address two points: (1) The cases' indeterminacy, which manifests itself to the students despite the courts' representations of fidelity to precedent, and (2) a persistent and perceptible tilt in management's favor, which manifests itself to the students despite the cases' thick fiduciary rhetoric.

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[82] Oberly v. Kirby, 592 A.2d 445, 466 (Del. 1991); Marciano v. Nakash, 535 A.2d 400, 404 (Del. 1987). Vice Chancellor Jacobs refused to base a holding on the dicta in *In re Wheelabrator Technologies, Inc. Shareholders' Litigation*, 663 A.2d 1194, 1204-05 (Del. Ch. 1995).

[83] DEL. CODE ANN. tit. 8, § 102(b)(7) (1991) (permitting opting out of personal liability for directors for duty of care violations).

[84] *E.g.*, Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 41 (Del. 1993).

a. Indeterminacy. I do not think the indeterminacy point needs reproving in the context of this Symposium.[85] It is sufficient to cite Ed Rock's report of Samuel Arsht's summary of Delaware law as follows: "Directors of Delaware corporations can do anything they want, as long as it is not illegal, and as long as they act in good faith."[86] The summary is accurate, provided that "legality" is understood to be defined in terms of adherence to process rules and bad faith is understood to be very hard to prove. Even given these qualifications, however, this standard is very broad. It is a standard that creates space for a volatile pattern of application in a world of dynamic deal-making, even as it also means that Corporations joins Torts as a course that really can be summarized on a single index card.

Students have trouble comprehending a case law this open-ended. Seen from a conventional point of view, it also is hard to teach. Delaware judges, reflecting a recognition of the importance of fidelity to the traditional conception of the judicial role, go to extraordinary lengths to explain new formulations of fiduciary law as inevitable results of prior precedents. While it would be wrong to dismiss their reasoning altogether and teach the cases as *sui generis* results of single-shot mediations, the cases certainly cannot be presented as the subjects for conventional lawyerly synthesis. Here not only do the fact patterns dominate principles, but principles come and go with unusual rapidity.

Historical realism is my main explanatory strategy respecting this indeterminacy.[87] As the 1980s takeover wave rose, the balance of interests between shareholders and managers shifted rapidly. One could not follow the traditional model of the judicial role of integrity and keep to a heavy-handed notion of stare decisis and at the same time do a good job in a politically sensitive and mediative role in a jurisdiction with a market position to protect. Something had to give, and in revolutionary times stare decisis is an obvious choice. The road from *Cheff* to *Unocal* to *Time* was bound to be

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[85] Doug Branson's empirical confirmation, based on a study of Delaware Supreme Court opinions from 1984 to 1987, still stands. Branson, *supra* note 65, at 104-08.

[86] Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997).

[87] For some alternative approaches, see Branson, *supra* note 65, at 108-12.

bumpy, given the complexity of interests at stake and the constantly changing market conditions. Of course, we still see volatility in the more relaxed conditions of the 1990s–in *QVC* the Delaware Supreme Court takes another long look at tender offer defense and does not hesitate to undertake major rewriting.[88] But historical explanation still works well. *QVC* is a further adjustment to a changing normative atmosphere. Shareholder value became a global norm in the 1990s and managers building their resumes took care to enhance it. The old-fashioned, egotistical entrenchment displayed in the case had come to fall outside of business community standards. *Time* left a mess on the table for cleaning in any event. Finally, there was that second rule in the Delaware canon: Martin Davis always loses.

The odd cases like *Van Gorkom* lend themselves particularly well to market-based historical explication. *Van Gorkom* came down early in the 1980s and showed us that the Delaware Supreme Court already sensed that it was about to see a mergers and acquisitions market unlike any in previous history. One year earlier the court had made a critical theoretical shift when it moved scrutiny of cashout mergers from a fairness basis to a process basis in *Weinberger*. *Van Gorkom* uses the duty of care, traditionally corporate law's purest process duty, to signal to the acquisitions market that, while Delaware would tolerate all sorts of antic dealmaking on substantive grounds and would refrain from show-stopping fairness scrutiny, it was going to insist that boardroom process records be squeaky clean and accord respect to shareholder value as the game's nominal object. That request was not unreasonable. Of course, *Van Gorkom* is a pathological case so far as concerns its business details. Thus, in my class there are two scapegoats for the excesses of the era: Michael Milken and Jerry Van Gorkom.

It recently has been suggested that Delaware cases' indeterminacy stems from more strategic concerns and amounts to an abuse of the state's dominant position in the charter market. The story is that indeterminate case law enhances Delaware's market position

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[88] Paramount Communications, Inc. v. QVC Network, Inc., 637 A.2d 34, 41 (Del. 1993).

by making its law incompatible with the law of other states.[89] If Delaware articulated a more conventional collection of rules and standards, it would be easier for other states to mark up Delaware law and go into competition. The states could then follow Delaware law even as they made their own corporate law, enhancing their attractiveness to reincorporating firms. To the extent that Delaware law is indeterminate, in contrast, it cannot successfully be adopted by a potential competitor. As soon as the competing state signs on to the existing body of precedents, Delaware goes off in another direction, leaving the competitor out of conformity. Indeterminacy, then, makes Delaware the only state that can make Delaware law. This fact enhances the value of the Delaware judiciary in the charter market and decreases the chance that another state can replicate what Delaware has to sell.[90] But the result is suboptimal from the point of view of Delaware's customers; determinacy is vital to business actors, who want to be able to plan the future with certainty and execute transactions with a minimal risk of liability.[91] This result nevertheless is a rational course for Delaware to take so long as that diminution in value of the law to its customers is less than the diminution in value of other states' laws to their customers.[92] At the same time, indeterminate law triggers more litigation, giving the Delaware courts more chances to show off their expertise in the charter market and enhance their reputational value.[93]

The last point above might be fair. Otherwise this analysis strikes me as a wrongheaded application of the "law as product" analogy, which, like freedom, needs to be limited for the sake of its own preservation.

Delaware's first-mover advantage can be explained much more simply, without reference to the idea of network benefits and technical compatibility.[94] As noted above, it is not Delaware's code

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[89] Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1927-28 (1998).

[90] *Id.*

[91] *Id.* at 1919.

[92] *Id.* at 1931.

[93] *Id.* at 1935.

[94] The basic application is described in Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995).

but its personnel and their reliable customer service incentives that keep it ahead and deter market entry by a competing state. A potential competitor would have to create courts of experts as knowledgeable as Delaware's existing bench. This process would be difficult. Well-known, experienced corporate lawyers would have to be recruited to the bench despite uncertainty respecting competitive success.

Such a speculative venture calls for an entrepreneurial initiative of a sort usually seen only in the private sector. However, even if a second state actually put together a plausible court and proceeded to compete on the basis of price, it is not clear that compatibility with Delaware law would present a problem. If Delaware's law really is suboptimal to its customers due to indeterminacy, then the competing state gets something to sell: clear precedents respecting mergers and acquisitions that provide a basis for management planning. Such a strategy implies incompatibility, which in turn means that corporate lawyers would have to incur the costs of learning the new, competing line of precedents. But at this point in the scenario, entrepreneurial incentives are easy to assume, provided that the competing state's precedents really do add value. A subset of corporate lawyers expert in the new law would appear overnight to sell reincorporation into the new state, a fee-generating event. The only requisite is that the new state, like Delaware, allow lawyers nationwide to give opinions as experts in its law, an easy concession to make. In sum, when conditions are right, business law institutions can change overnight without being retarded by sunk costs in precedent legal institutions. The wildfire spread of the limited liability company presents a recent example.[95] Network benefits simply do not seem to lock out business law innovations where client demand is strong.

More importantly, it is not at all clear that Delaware's case law really creates an opening for a competing state. In theory, of course, indeterminacy does make law less valuable to the firm as a whole

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[95] For a law-as-product explanation of this possibility that rejects a regulatory competition overlay, see William W. Bratton & Joseph A. McCahery, *An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition*, 54 WASH. & LEE L. REV. 629, 657-86 (1997).

in that an expanded range of possibilities means more risk, and more risk diminishes value. The question in practice is whether managers operating in an uncertain, second-best world, rather than the firm as a whole, really would prefer the hypothesized level of legal certainty. Presumably, enhanced certainty would be beneficial to them if it implied no tradeoffs. For example, a "just say no" rule respecting takeover defense would import certainty[96] and also make life easier for managers. But such a regime would carry tradeoffs in a world with multiple demands.

Clear rules import policy transparency, disabling the mediative lawmaker. As we have seen, corporate managers find it in their interest to stay with Delaware, even though Delaware does not have the most management-favorable code, because Delaware's mediative nods in the shareholders' direction have protected corporate law from federal intervention. A set of strong, clear rules pitched to the management side would enhance the risk of wakening the federal dragon. This risk is not a *de minimis* possibility, particularly in an activist era in which actors in the capital markets publicly monitor corporate governance developments. At the same time, a set of strong, clear rules pitched to the shareholder side are manifestly against Delaware's interest in maintaining its market position and against the interests of its primary customers.

As a third possibility, one could hypothesize a clear set of rules designed to clarify and stabilize the balance that Delaware maintains today. Presumably, such a set of rules would attempt to embed prevailing precedents in the slavish manner of a restatement, uniform code, or student outline. The question then arises whether Delaware's business customers really want such a stable rulebook. For simplicity, let us assume that litigation volume decreases in a world with this rulebook,[97] but that it by no means disappears. Planning accordingly does not become certain, even as probability distributions become tighter. This situation arguably enhances value. But it carries a cost. Embedded rules imply a sacrifice of responsiveness to marketplace developments—what we

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[96] *See* Bebchuk & Ferrell, *supra* note 18, at 1191 (noting "pro-uncertainty tilt" of Delaware law because it lacks such firm anti-takeover provisions).

[97] I make the assumption only for argument's sake.

had when earnings value was based on a five-year past average as a matter of precedent. Under present Delaware law, there is always room to validate a new transaction and the lawyer consistently takes the role of facilitator. Under locked-in rules, the lawyer could sometimes revert to the old-fashioned role of naysayer, something clients do not want to see.

In sum, even if we assume that indeterminacy carries cognizable costs for the clients, it is not clear that the traditional alternative holds out benefits sufficient to justify a change of direction. This ambiguity is especially the case when the clients are entrepreneurs, whose concern lies with the next deal and not with the neatness of the past pattern of cases. One wonders whether Delaware's business customers are bothered at all by the untidy pattern of its cases. The real complainants are formalist lawyers and legal academics unable to adjust to a politicized common-law regime that disempowers them even as it generates fees (and articles).

b. Management Tilt. The foregoing rebuttal of the indeterminacy charge presupposes a judicial tilt toward the management side. It in fact is not difficult for a lawyer to coax clear instructions from Delaware's process precedents. How hard is it to appoint a special committee with an independent lawyer and investment banker and then to negotiate with it at arm's length? Not hard at all, and the problem lies in the fact that the negotiation process costs the management client money and inhibits its freedom of action. Indeterminacy creeps into the cases because the client pushes against the process envelope and the matter is later litigated in front of a court disinclined to find liability. If the client/customer who has gone over the edge is indeed to be let off the hook, the statement of the rule evolving in the cases is bound to become somewhat convoluted.

This problem is compounded by the fact that judicial role integrity requires that the result of such a case be justified in terms of the fiduciary principle. When management-favorable results are smuggled in under a haze of fiduciary verbiage, fiduciary rule statements look indeterminate because they do not in fact determine the result of the case.

Arguably, this rhetorical skill is an important aspect of the Delaware courts' expertise. If, for example, we review the pattern

of Delaware decisionmaking during the height of the takeover era, the inference arises that the Delaware courts took advantage of information asymmetries to develop a body of law that gave an appearance of greater weight to shareholder interests than is justified on close inspection of actual results. In the handful of highly-publicized cases, the courts announced vague standards that held out the prospect of enhancement of shareholder value. In the less well-publicized cases that followed, however, they took the opportunity held out by complex facts to refrain from applying the standards in management-constraining ways.[98] The full set of results tallied by the lawyers who make reincorporation decisions signaled considerably more room for management maneuver than did the public profile signaled by the leading cases.

Edward Rock has highlighted another aspect of this phenomenon. He shows that Delaware judges use the cases' complex fact patterns to make moral pronouncements about management behavior. The culpable manager, however, is not hit necessarily with an injunction against his or her deal or a money judgment.[99] Instead, the court announces its dissatisfaction with the manager's conduct in the course of denying an injunction against the transaction or dismissing the complaint. It is the actor replicating the disapproved conduct in the subsequent deal who risks a negative judgment.[100] Rock explains this judicial behavior pattern in normative terms. Delaware judges operating in this mode, duly connected to the business community through a network of lawyers and investment bankers, communicate normative standards. They thereby perform the moral side of the judicial role. Significantly, the resulting behavioral deterrent is reputational rather than financial.[101]

I cannot fault Rock's description, but I would like to expand on its implications. I agree that when Delaware judges take the moral role, they do so more in the mode of preachers than as traditional

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[98] For a reading of the cases after *Unocal* along these lines, see VICTOR BRUDNEY & WILLIAM W. BRATTON, BRUDNEY & CHIRELSTEIN'S CASES AND MATERIALS ON CORPORATE FINANCE 1087-95, 1129-30 (4th ed. 1993).

[99] A money payment (probably in the form of a settlement) may follow where the injunction against the deal is denied but the complaint is not dismissed. Rock, *supra* note 86, at 1039.

[100] *Id.* at 1023-39.

[101] *Id.* at 1012-16.

sovereign enforcers. But the similarity obtains less because preachers can impair one's reputation when they denounce one publicly than because talk is the only weapon they have in a world in which church and state are separate. Moral suasion is the preacher's enforcement device and he or she must live with the knowledge that more than a few congregants nod agreement and then cheerfully go home to live miscreant lives. Delaware judges operate like preachers because charter competition prevents them from assuming the conventional judicial role of positive law enforcer. In the conventional setup, only the legislature acts prospectively. The litigant who breaches an extant duty on a new fact pattern loses the case and pays a judgment. It is hard to see from an abstract perspective what makes corporate managers such delicate beings that they require an exemption from the ordinary rules of the game. The point must be that the exemption has been purchased.

Rock confronts the point as follows:

> In the corporate context, however, the assumption of "direct deterrence" is particularly implausible: There are hundreds of corporations, the directors and officers of which have comprehensive liability insurance; damage liability is extremely rare; and, after the enactment by Delaware of section 102(b)(7) of the General Corporation Law, which allows Delaware corporations to opt out of director liability for breach of the duty of care, damage liability has become even rarer. If the principal sanction is not directly financial but reputational, then one must explain how this sanction works, an account entirely absent from the standard account. And yet the system seems to work.[102]

And work the system does, with reputational enforcement playing at best a secondary role and the residual prospect of an injunction or damages playing the primary role. The system appears to satisfy

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[102] *Id.* at 1012 (citation omitted).

management, which is happy to pay attorneys to churn litigation that rarely entails more substantial costs in terms of money judgments or lost deals. Clearly the lawyers also are satisfied. For the shareholders, the system is more problematic even in our era of global shareholder valuism. But it still is clearly superior to the pre-Cary system.

The question, moreover, is not whether the reputational enforcement system does or does not work. Of course it works. The question is whether it might work better if Delaware deployed its injunctive power more liberally in cases of management defalcation. Unfortunately, we shall see no experiments with that alternative approach because charter competition locks Delaware into its present pattern.

IV. CONCLUSION

Those of us who would prefer to see fiduciary cases that more vigorously protect the shareholder interest can complain about Delaware cases as we teach and write about them. But we cannot reasonably expect to see a significant shift in the decisional pattern so long as management's voice remains strongest amidst the multiple voices that register demands in Delaware. Nor can we reasonably attack the role integrity of Delaware's judges. They do precisely what their sovereign principal demands of them, displaying the finest loyalty.