

HARVARD LAW REVIEW

FEDERALISM AND THE CORPORATION:
THE DESIRABLE LIMITS ON
STATE COMPETITION IN CORPORATE LAW

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ARTICLES

FEDERALISM AND THE CORPORATION:
THE DESIRABLE LIMITS ON
STATE COMPETITION IN CORPORATE LAW

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Corporate law scholars have long debated whether state competition for corporate charters is a "race for the bottom" or a "race for the top." In this Article, Professor Bebchuk offers an analysis of the dynamics and performance of state charter competition. He shows how the presence of managerial opportunism and externalities may lead states to adopt undesirable corporate law rules. Professor Bebchuk identifies the various issues with respect to which state competition is likely to fail, and he advocates an expansion of federal regulation to govern all of these issues. He also connects the state competition question with the question of contractual freedom in corporate law and argues that many scholars should reconsider their inconsistent views regarding these two questions. Finally, Professor Bebchuk concludes by addressing potential objections to the expansion of federal corporate regulation.

THIS Article addresses a fundamental question in the law of corporations: What is the desirable role of state competition in shaping corporate law? The Article puts forward a new framework for examining this longstanding question. It analyzes the dynamics and effects of state competition and identifies the areas of corporate law in which state competition works well and the areas in which it works poorly. In particular, it shows that state competition is likely to fail with respect to certain important issues that state corporate law has traditionally governed. Based on this analysis, the Article advocates a substantial expansion of the role of federal law in shaping corporate law rules.¹

* Professor of Law, Harvard University. I wish to express my gratitude to my teacher Victor Brudney, who long ago got me interested in the subject of state competition in corporate law and who has much influenced my approach to it. I also would like to thank Christine Jolls for her invaluable assistance. For their very helpful comments, I am grateful to Ian Ayres, Stephen Choi, Robert Clark, Richard Epstein, Marcel Kahan, Louis Kaplow, Henry Hansmann, Michael McConnell, Roberta Romano, Frederick Schauer, Cass Sunstein, Detlev Vagts, Jay Westbrook, and participants in workshops at Harvard, Stanford, and the University of Chicago. Finally, for financial support, I am grateful to the National Science Foundation and to the Harvard Law School Program in Law and Economics, which is funded by the John M. Olin Foundation.

¹ Throughout this Article, the term "rules" refers to all types of rules, including statutory provisions, judge-made doctrines, and regulations. Similarly, the term "law officials" (whether federal or state) refers to all those who play a role in the adoption of rules, including legislators, judges, and regulators.

The American legal system accords primary responsibility for regulating corporate affairs to the states.² To be sure, federal law governs some important issues, including insider trading, disclosure, and the making of tender offers.³ Nevertheless, much of the law regulating a corporation's affairs stems from its state of incorporation.⁴ State law governs such major corporate matters as the allocation of power between managers and shareholders, fiduciary duties owed to shareholders, and fundamental corporate changes such as mergers and dissolutions.⁵

The important role of state law in the governance of corporate affairs makes critical to any corporation the corporate law rules of its state of incorporation. Because corporations are relatively free to select their states of incorporation,⁶ and because states benefit from having corporations incorporate within their boundaries,⁷ states are likely to compete to attract incorporations. The widely recognized leader in the state charter competition is Delaware.⁸ Indeed, a major fraction of publicly traded companies in the United States is incorporated in Delaware and thus governed by Delaware corporate law.⁹

While the central role of state law has long been a familiar feature of American corporate law, it also has been the subject of vigorous debate in corporate law scholarship. On the one hand, critics of state competition view it as a "race for the bottom," in which Delaware and other states are driven to offer rules that benefit managers at the expense of shareholders.¹⁰ According to this view, state competition

² See Roberta Romano, *The State Competition Debate in Corporate Law*, 8 *Cardozo L. Rev.* 709, 709 (1987).

³ See ROBERT C. CLARK, *CORPORATE LAW* § 8.1, at 265 (1986) (discussing insider trading); *id.* § 9.2, at 366, § 10.2.3, at 413 (discussing disclosure); *id.* § 13.32, at 549 (discussing tender offers).

⁴ See Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 *DEL. J. CORP. L.* 885, 887 n.6 (1990); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. LEGAL STUD.* 251, 252 (1977).

⁵ See generally CLARK, *supra* note 3, § 3 (discussing the allocation of power between managers and shareholders); *id.* §§ 4-7 (discussing fiduciary duties); *id.* §§ 10-11 (discussing fundamental corporate changes).

⁶ See Alva, *supra* note 4, at 887; Winter, *supra* note 4, at 252.

⁷ See *infra* notes 24-25 and accompanying text.

⁸ See Alva, *supra* note 4, at 887-88; Leo Herzl & Laura D. Richman, *Delaware's Preeminence by Design*, *Foreword* to R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS*, at F-1, F-1 (2d ed. 1990); Romano, *supra* note 2, at 709.

⁹ See Alva, *supra* note 4, at 889; see also *infra* notes 29-31 and accompanying text (citing statistics that indicate Delaware's dominance in the state charter competition).

¹⁰ See William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *YALE L.J.* 663, 665-66 (1974); Melvin A. Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 *U. MIAMI L. REV.* 187, 188-91, 196-98, 202-09 (1983); Donald E. Schwartz, *Federalism and Corporate Governance*, 45 *OHIO ST. L.J.* 545, 548-51 (1984).

works poorly and should be curtailed.¹¹ On the other hand, supporters of state competition regard it as a "race for the top."¹² According to this view, charter competition drives Delaware and other states to offer rules that maximize shareholder value;¹³ consequently, the regulation of corporate affairs should be left to the states.¹⁴

The question of state competition arises not only in the United States but also in any federal system in which companies incorporated in one state can operate without difficulty in the federation's other states. Accordingly, the European Economic Community has also confronted this question. The direction that the Community has thus far pursued is one of imposing more substantial constraints on state competition than the constraints existing in the United States.¹⁵ Indeed, the founders of the Community seem to have taken for granted the need to prevent the largely unrestricted state competition that prevails in the United States.¹⁶

¹¹ See, e.g., Cary, *supra* note 10, at 701 (proposing the adoption of a minimum federal standard "in order to remedy the Delaware syndrome").

¹² See Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259, 260-61 (1980); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 549-50 (1984); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 398 (1983); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919-20 (1982); Winter, *supra* note 4, at 256-57.

¹³ See Dodd & Leftwich, *supra* note 12, at 282; Easterbrook, *supra* note 12, at 571; Fischel, *supra* note 12, at 919-20; Winter, *supra* note 4, at 256-57. Indeed, the belief that state competition tends to produce value-maximizing rules has led some commentators to adopt a strong presumption that state corporate law rules are efficient. See sources cited *infra* notes 45, 198.

¹⁴ See Dodd & Leftwich, *supra* note 12, at 282; Fischel, *supra* note 12, at 921-23; Winter, *supra* note 4, at 290-92.

¹⁵ For an overview of the Community's developing program of "harmonization" (as the program of adopting uniform minimum standards has come to be called), see Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws*, 89 MICH. L. REV. 2150, 2151 (1991); and Manning G. Warren III, *Global Harmonization of Securities Laws: The Achievements of the European Communities*, 31 HARV. INT'L L.J. 185, 197-98 (1990). The Constitution of the European Community expressly authorized the Community to establish "minimum standards" for corporate law issues. See TREATY ESTABLISHING THE EUROPEAN ECONOMIC COMMUNITY [EEC TREATY], art. 54, § 3, cl. g. The Community has thus far issued nine directives, and several others have been proposed and seem likely to be adopted. The existing and proposed directives govern many important corporate law issues that in the United States are left to state law, such as incorporation, creation and maintenance of capital, mergers, corporate governance (including the voice of labor), and takeover defensive tactics. See Conard, *supra*, at 2153-54.

¹⁶ See Conard, *supra* note 15, at 2154. When the Community's harmonization program was started, there was rivalry for the administration of the program but no opposition to the concept of harmonization itself. Indeed, the case for harmonization was so much taken for granted that there was initially little express discussion of the reasons for it. Only later did commentators start to discuss the arguments for and against the Community's program of harmonization. See,

This Article puts forward a new approach to the question of state charter competition. My analysis indicates that this competition works well in some areas of corporate law but poorly in others; that is, state competition produces a race for the top with respect to some corporate issues but a race for the bottom with respect to others. More importantly, my analysis identifies those issues with respect to which state competition is likely to produce undesirable rules. This analysis provides workable criteria that I use to delineate the desirable limits on state competition and advocate a significant expansion of federal corporate law.¹⁷

Part I of the Article provides background necessary for understanding the state competition question and my analysis of this question. After providing some basic facts about the state charter competition, it critically reviews existing theories about the desirability of this competition. It then surveys the empirical evidence on state competition and explains why this evidence does not resolve the debate over the merits of state competition. Next it discusses the premises concerning states' objectives that underlie my analysis as well as the analyses of both supporters and critics of state competition. Finally, Part I outlines briefly the shortcomings of state competition.

The Article's analysis of the shortcomings of state competition is carried out in Parts II and III. Part II analyzes the ways in which divergence of interests between managers and shareholders may lead state competition to produce corporate law rules that reduce shareholder value. States competing to attract incorporations have an incentive to offer rules that are attractive to managers, who have substantial influence on incorporation decisions. To be sure, because the interests of managers and shareholders are somewhat aligned, there are many corporate issues with respect to which managers seek, and states in turn have an incentive to provide, rules that enhance share-

e.g., RICHARD M. BUXBAUM & KLAUS J. HOPT, LEGAL HARMONIZATION AND THE BUSINESS ENTERPRISE 8-11 (1988).

For an analysis of the advantages and disadvantages of allowing state competition in the Community, see David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L. L.J. 423, 441-55 (1991). Charny's views on the shortcomings of state competition are similar to those presented in this Article.

¹⁷ My analysis of the dynamics of state competition builds upon an earlier framework that I developed for analyzing the desirability of allowing companies to opt out by charter amendment of the legal rules that would otherwise govern their affairs. See Lucian A. Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, Foreword to Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1399-1404 (1989) [hereinafter Bebchuk, *Foreword*]; Lucian A. Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1822-27 (1989) [hereinafter Bebchuk, *Limiting Contractual Freedom*]. This Article carries out the project anticipated in my foreword to the *Columbia Law Review* symposium. See Bebchuk, *Foreword*, *supra*, at 1414-15. The connection between my and others' work on contractual freedom and the question of state competition is discussed in Part V below.

holder value. As the analysis shows, however, the operation of market forces and the requirement of shareholder approval of reincorporations are insufficient to ensure that managers seek value-maximizing rules with respect to corporate law issues in general. Rather, with respect to certain issues, managers are likely to seek — and states in turn may well adopt — rules that serve the private interests of managers even if these rules are value-decreasing.

The analysis of Part II identifies three types of issues with respect to which managers' opportunism may well lead to undesirable state law rules. First, state competition is likely to produce such rules with respect to issues that involve a potential transfer of significant value from shareholders to managers. Such issues include self-dealing transactions, taking of corporate opportunities, and insider trading. Second, state competition is likely to fail with respect to issues that directly affect the strength of market discipline, such as the regulation of takeover bids and proxy contests. Third, state competition is likely to yield undesirable rules with respect to issues that involve potential transfers between public shareholders and controlling shareholders, such as the regulation of going-private and parent-subsidiary freeze-outs. I argue that all of these issues, some of which are and traditionally have been governed by state corporate law, should be subject to federal rules or, at least, to federal minimum standards.

Part III analyzes the ways in which state charter competition leads to socially undesirable rules in the presence of externalities. In designing corporate law rules, states competing to attract incorporations will have an incentive to focus on the interests of managers and shareholders and to ignore the interests of third parties not involved in incorporation decisions. Therefore, whenever significant externalities are present, states will tend to provide corporate law rules that differ from the socially desirable ones in a direction that systematically disfavors such third parties. Furthermore, the analysis shows that significant externalities are present in important areas of corporate law, including the regulation of takeover bids, proxy contests, and corporate disclosure and the protection accorded to creditors and other non-shareholder constituencies. I argue that federal law should be expanded to govern — or at least set minimum standards for — all aspects of these areas of corporate law.

Part IV of the Article discusses the connection between the question of state charter competition and the question of contractual freedom in corporate law. The contractual freedom question concerns the degree to which companies should be allowed to opt out of corporate law rules by adopting charter provisions to that effect. Commentators of all stripes have expressed stronger support for limits on the contractual freedom of companies than for limits on state competition. As Part IV shows, however, the desirability of contractual freedom and the desirability of state competition depend on the same set of

considerations. Whatever concerns may lead one to support a mandatory rule with respect to a given corporate law issue should also lead one to support federal law rules for the same issue. This conclusion suggests that many commentators should reexamine their uncritical views of state competition.

While the focus of the Article is on the shortcomings of state competition, Part V offers some brief notes on issues that federal regulation raises. Part V discusses the possible imperfections of the federal law process and then explains the considerations that lead me to believe that, with respect to the issues identified by the analysis in Parts II and III, the federal process would not perform worse than state competition. Part V also discusses the implications of international charter competition for any program of federal regulation.

Finally, before proceeding, it is worth noting that the focus of this Article is on publicly traded companies. The decisionmaking process of close corporations differs substantially from that of publicly traded companies and requires a separate analysis.¹⁸ Moreover, because close corporations generally incorporate in the states in which their principal places of business are located,¹⁹ the state competition debate has naturally focused on publicly traded companies.²⁰

I. THE STATE COMPETITION QUESTION

A. *Factual Background*

American corporate law has always been largely the province of the states. Federal law was totally silent on the internal governance of corporations until the enactment of the Securities Act of 1933. Although federal securities law now plays a significant role in regulating corporate affairs, states still retain primary responsibility for corporate regulation, and state law governs the major aspects of corporate law.²¹

A corporation is governed for corporate law purposes by the law of its state of incorporation, regardless of where it conducts its business operations.²² Therefore, corporations can shop around for attractive

¹⁸ See Victor Brudney & Robert C. Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 1000-06 (1981).

¹⁹ See WILLIAM L. CARY & MELVIN A. EISENBERG, *CASES AND MATERIALS ON CORPORATIONS* 98 (6th ed. 1988); Ian Ayres, *Judging Close Corporations in the Age of Statutes* 13-19 (Oct. 1991) (unpublished manuscript, on file at the Harvard Law School Library).

²⁰ For a recent analysis of the development of state law with respect to close corporations, see Ayres, *supra* note 19.

²¹ See Cary, *supra* note 10, at 663; Romano, *supra* note 2, at 709; Winter, *supra* note 4, at 252-53; see also sources cited *supra* notes 4-5 (discussing the many aspects of corporate law that state law governs).

²² See Alva, *supra* note 4, at 887 n.6; Winter, *supra* note 4, at 252.

corporate domiciles by comparing the legal regimes offered by different states.²³ States, in turn, have an interest in having companies incorporated within their boundaries. Incorporations yield franchise tax and fee revenues²⁴ and also provide patronage for local law firms, corporation service companies, and other businesses.²⁵ The ability of corporations to incorporate in states whose legal regimes they find attractive, together with the eagerness of states to attract incorporations, result in state competition for corporate charters.

Since its inception, the competition between states has always been characterized by the dominance of a particular state. The early leader was New Jersey.²⁶ In 1896, New Jersey adopted the first of the modern liberal corporation statutes, and it subsequently became home to many of the largest corporations of that time.²⁷ After restrictive amendments to its corporation law were made in 1913, New Jersey lost the leading role to Delaware, whose corporation law was at the time a close copy of New Jersey's original statute.²⁸ Delaware is at present the domicile of more than half of all Fortune 500 companies and more than forty percent of all companies listed on the New York Stock Exchange.²⁹ It is also the leading destination of companies that reincorporate: Delaware attracted eighty-two percent of publicly traded firms that reincorporated in the past three decades³⁰ and ninety percent of the New York Stock Exchange-listed companies that reincorporated between 1927 and 1977.³¹

Delaware's dominance of the state charter competition has resulted in the widespread diffusion of its law. Other states, anxious to stem the exodus of corporations from their jurisdictions, have followed Delaware in adopting various legal rules.³² Delaware has played a

²³ See Alva, *supra* note 4, at 887-88.

²⁴ See *id.* at 888; Cary, *supra* note 10, at 668-69; Winter, *supra* note 4, at 255. In Delaware, the dominant state for incorporations, corporate franchise taxes and fees accounted for approximately 20% of general fund revenues in 1990. See Alva, *supra* note 4, at 888 & n.8.

²⁵ See Cary, *supra* note 10, at 668; 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, 762 (1987); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 492-93; Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 240-41 (1985).

²⁶ See Cary, *supra* note 10, at 664.

²⁷ See Herzel & Richman, *supra* note 8, at F-1 to -2.

²⁸ See Cary, *supra* note 10, at 664-65; Herzel & Richman, *supra* note 8, at F-1 to -2.

²⁹ See Alva, *supra* note 4, at 887; Herzel & Richman, *supra* note 8, at F-1; Macey & Miller, *supra* note 25, at 483.

³⁰ See Romano, *supra* note 25, at 242, 244.

³¹ See Dodd & Leftwich, *supra* note 12, at 263.

³² See Cary, *supra* note 10, at 671 (noting Delaware's influence on statutory modernization and on case law in other states); *id.* at 666 n.18 (remarking that the intent of Michigan's new corporation code was, in the words of one of its sponsors, to "out-Delaware Delaware"); Winter,

major role in the spread of innovations concerning a range of corporate law issues, including election of directors, charter amendments, shareholders' meetings, appraisal rights, dividend policy, mergers, indemnification of officers, and antitakeover defenses.³³ Whether the widespread adoption of these and other innovations has harmed or benefitted shareholders is the critical point of contention in the state competition debate.

B. Existing Theories of State Competition

1. *The Race for the Bottom.* — The race for the bottom theory claims that state competition for corporate charters harms shareholders by driving states to adopt corporate law rules that are too lax with respect to managers and controlling shareholders.³⁴ William Cary forcefully advanced the argument that state competition is "a race for the bottom," noting that Delaware was both the consistent leader in loosening constraints on managers³⁵ and the indisputable winner of the state charter competition.³⁶ In Cary's view, Delaware (and, to varying degrees, other states) successfully used corporate law rules that disregard shareholders' interests to attract managers responsible for incorporation decisions.³⁷ Cary concluded that substantive federal regulation of corporations' internal affairs was necessary to protect shareholders from exploitation by managers.³⁸

The problem with the race for the bottom analysis is its failure to consider the existence of market constraints on managers' behavior. Cary viewed corporate law as the sole source of protection for share-

supra note 4, at 255 (concluding that statutory changes were national in scope and that Delaware law was no longer significantly different from that of other states); *see also* Alva, *supra* note 4, at 889–90 (arguing that if Delaware adopts a provision attractive to corporations, then other states wishing to retain the companies incorporated within their boundaries will have to follow).

Delaware is not always the first state to provide innovative corporate law rules. *See* Romano, *supra* note 25, at 233, 240 (finding that of four major corporate law changes — explicit standards for director and officer indemnification, mergers without stockholder vote under certain circumstances, elimination of appraisal rights when shares are traded on a national exchange, and antitakeover statutes — only one was first adopted by Delaware). However, in cases in which Delaware is not the first state to change its law, it follows the innovator's lead quicker than any other state. *See id.* at 240.

³³ *See* Romano, *supra* note 25, at 233; Winter, *supra* note 4, at 254–55.

³⁴ *See* Cary, *supra* note 10, at 672; Eisenberg, *supra* note 10, at 188–91, 202–09; Schwartz, *supra* note 10, at 550.

³⁵ *See* Cary, *supra* note 10, at 669–70 (describing the Delaware statutory provisions that free managers from shareholder interference); *id.* at 670–84 (reviewing the Delaware judicial decisions that "create[d] a 'favorable climate' for management").

³⁶ *See id.* at 668–69; *supra* notes 29–31 and accompanying text.

³⁷ *See* Cary, *supra* note 10, at 665–66.

³⁸ *See id.* at 701.

holders.³⁹ As critics of the race for the bottom view were quick to point out, however, market forces must be taken into account in any analysis of state charter competition.

2. *The Race for the Top*. — The race for the top theory holds that state charter competition benefits shareholders by driving states to adopt corporate law rules that enhance shareholder value. Pointing to the existence of market forces that check management opportunism, Ralph Winter, Frank Easterbrook, Daniel Fischel, and others have rejected the conclusions of the race for the bottom theory.⁴⁰ These scholars do not dispute Cary's initial contention that Delaware and other states have successfully used liberal corporate law rules to influence the incorporation decisions of managers.⁴¹ Instead, they quarrel with the presumed divergence between these decisions and shareholders' interests.

Market forces, the argument runs, will discourage managers from seeking incorporation in states with legal rules that permit managers to "exploit" shareholders. Incorporation in such states would increase the company's vulnerability to takeovers (which threaten managers' jobs), lower managers' compensation and other employment-related benefits, and harm managers' present and future job prospects.⁴² In other words, the operation of various market forces aligns managers' interests with those of shareholders insofar as the incorporation decision is concerned. State competition for corporate charters is therefore a race not for the bottom, but for the top; states vie for incorporation business by offering corporate law rules that maximize shareholder value.⁴³ Delaware's dominance is thus attributable to its adoption of optimal rules.⁴⁴

An important implication of the race for the top theory is that existing state corporate law rules, which result from a competitive race for the top, should be regarded as presumptively efficient.⁴⁵

³⁹ In particular, Cary argued that the willingness of investors to entrust their funds to public companies could be maintained only by mandating disclosure and management accountability, and by providing opportunities for derivative or direct shareholder action. See *id.* at 671.

⁴⁰ See Dodd & Leftwich, *supra* note 12, at 261; Easterbrook, *supra* note 12, at 549-50; Easterbrook & Fischel, *supra* note 12, at 398; Fischel, *supra* note 12, at 915, 920-21; Winter, *supra* note 4, at 254.

⁴¹ See Easterbrook, *supra* note 12, at 549-50; Winter, *supra* note 4, at 254.

⁴² See Fischel, *supra* note 12, at 919; Winter, *supra* note 4, at 256, 264-66; see also Easterbrook, *supra* note 12, at 564 (arguing that the market for corporate control generally aligns managers' and shareholders' interests in corporate decisions); *id.* at 554 (arguing that compensation considerations induce managers to serve shareholders' interests).

⁴³ See Dodd & Leftwich, *supra* note 12, at 281-82; Easterbrook, *supra* note 12, at 571; Fischel, *supra* note 12, at 919-20; Winter, *supra* note 4, at 256.

⁴⁴ See Fischel, *supra* note 12, at 919-20; Winter, *supra* note 4, at 258.

⁴⁵ See Easterbrook, *supra* note 12, at 545; Fischel, *supra* note 12, at 919-20; Winter, *supra* note 4, at 256. For applications of this presumption by scholars subscribing to the race for the top view, see sources cited *infra* note 198.

Accordingly, the adoption of antitakeover measures by many states presents a puzzle for race for the top adherents, who generally believe that impediments to takeovers are inefficient.⁴⁶ If antitakeover measures are inefficient, then race for the top logic predicts that states will not adopt them. Nonetheless, states have done so overwhelmingly.⁴⁷ This divergence between the theory's prediction and the actual practice of states has not gone unnoticed.⁴⁸

Whatever its shortcomings, the race for the top theory has contributed to the state competition debate by highlighting the effect of market discipline on managers' incorporation decisions. As this Article will demonstrate, however, the various market forces upon which the race for the top theory relies cannot discourage managers from seeking certain undesirable corporate law rules. State antitakeover statutes are not an anomaly but simply one manifestation of this phenomenon.⁴⁹

3. *The Race for Predictability and Stability.* — According to both the race for the bottom and race for the top theories, states' performance in the competition for incorporations is determined by the substantive content of their legal rules. An alternative view, developed by Roberta Romano, is that a state's success in the state charter competition depends on its ability to offer corporations a credible commitment to predictability and stability.⁵⁰ Romano's analysis is motivated by Delaware's sustained ability to dominate the competition for charters, notwithstanding the similarity in content between Delaware's and other states' corporate law rules and the high tax burden associated with incorporation in Delaware.⁵¹ Romano suggests that

⁴⁶ See *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496, 500 (7th Cir.) (Easterbrook, J.), cert. denied, 493 U.S. 955 (1989); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1164 (1981); Winter, *supra* note 4, at 287–89.

⁴⁷ For descriptions of the widespread adoption of state antitakeover statutes, see Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 113–14 (1987); and Romano, *supra* note 2, at 725. For an example of a judicial decision facilitating antitakeover tactics, see *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1142 (Del. 1990).

⁴⁸ See, e.g., Romano, *supra* note 25, at 265–66 (noting the serious inconsistency in the logic of the position that, on the one hand, state competition induces efficient corporate law rules and, on the other hand, antitakeover measures are inefficient); Romano, *supra* note 2, at 726 (same). The puzzle posed by the clash between race for the top logic and states' adoption of antitakeover measures is discussed in more detail in section II.C below.

⁴⁹ State antitakeover statutes will be discussed in section II.C and subsection III.B.4 below.

⁵⁰ See Romano, *supra* note 25, at 273–79, 280–81; see also Romano, *supra* note 2, at 720–25 (discussing Delaware's dependency on a responsive relationship with corporations and the constraints that make a less responsive climate unlikely).

⁵¹ See Romano, *supra* note 25, at 226. Romano and other commentators have noted the similarity of states' corporate law rules. See Coffee, *supra* note 25, at 768 (noting that, in the competition among states, "the competitors are seldom that far apart"); Romano, *supra* note 25, at 235 (describing the empirical evidence of the diffusion of innovative corporate law rules through the states); Romano, *supra* note 2, at 709 (finding "substantial uniformity across the

Delaware's continued dominance stems from several factors that enable it to guarantee predictable and stable legal rules.⁵² First, Delaware depends more heavily than its competitors on incorporation revenues — including receipts from franchise taxes and fees and the income of local service firms — and thus can be counted on to maintain the predictability and stability sought by incorporation decisionmakers.⁵³ Second, Delaware's corporation code can be revised only by a two-thirds vote of both houses of the state legislature and is therefore likely to be stable.⁵⁴ Finally, the substantial body of Delaware precedent, along with the small size and corporate expertise of Delaware's judiciary, ensure predictable outcomes for corporate litigation.⁵⁵

But, even if the predictability and stability of Delaware's legal rules are attractive to corporations, the question whether state competition is desirable remains unanswered. For the features of predictability and stability hardly amount to a complete characterization of Delaware law. Clearly a critical dimension of Delaware's corporate law is the substantive content of its rules. Consider, for example, two alternative legal rules for the governance of a given corporate law issue (for example, managerial self-dealing). While both rules might be characterized by predictability and stability, they may differ significantly in their substance and thus in their effect on shareholder value. Accordingly, the question remains whether Delaware's (predictable and stable) corporate law rules are value-maximizing or, instead, diverge systematically from the value-maximizing rules (say, by treating managers too laxly).

Furthermore, even if the predictability and stability characterizing Delaware's corporate law are attractive features, this does not tell us whether state competition is desirable. Federal corporate law could provide predictability and stability as well. A federal corporate law system would offer a large body of precedent upon which it could

states"); see also *supra* note 32 and accompanying text (discussing the influence and spreading of Delaware corporation law). For figures indicating the weight of the tax burden in Delaware relative to other states, see Macey & Miller, *supra* note 25, at 492 n.86; and Romano, *supra* note 25, at 255-56, 257 & tbl. 7, 258.

⁵² See Romano, *supra* note 25, at 273-79; Romano, *supra* note 2, at 721-22.

⁵³ See Romano, *supra* note 25, at 240, 242; Romano, *supra* note 2, at 721-22.

⁵⁴ See Romano, *supra* note 25, at 241; Romano, *supra* note 2, at 722. As Romano acknowledges, the supermajority requirement could impede Delaware's adoption of desirable corporate law innovations. See Romano, *supra* note 25, at 241; Romano, *supra* note 2, at 722. But if corporations follow a risk-averse strategy in their incorporation decisionmaking, Romano reasons, then the constitutional provision making legislative change more difficult by mandating a two-thirds vote of approval for all corporate law changes will "be a desirable feature," because the provision "increases the likelihood that [Delaware law will] be no worse than it was at the time of incorporation." Romano, *supra* note 25, at 241.

⁵⁵ See Romano, *supra* note 25, at 277-78; Romano, *supra* note 2, at 772.

draw, as all cases would be brought under the same set of legal rules. Moreover, judicial expertise could be ensured through a special court that would hear only corporate law cases. Thus, the main difference between a state competition system and a federal corporate law system is that competitive pressures shape the choice of substantive rules in the former system but not in the latter. Whether such competitive pressures are beneficial or detrimental is precisely the question that needs to be answered.⁵⁶

C. Empirical Evidence

Empirical work on the state competition question has focused on identifying how reincorporations affect a corporation's stock price. Event studies by Peter Dodd and Richard Leftwich and by Roberta Romano found that the stock of reincorporating companies does not

⁵⁶ The three major theories of state competition described in this section focus on what might be called the "demand side" of this competition. That is, they focus on the preferences of incorporation decisionmakers as the determinants of state corporate law arrangements. Several commentators have also considered the "supply side" of the competition for charters. See Coffee, *supra* note 25, at 762-64; Macey & Miller, *supra* note 25, at 498-509. These commentators argue that Delaware's corporate law arrangements are determined not only by Delaware's desire to attract incorporators, but also by interest-group pressure exerted by the Delaware bar.

Indeed, the Delaware bar's apparent influence on the Delaware rules that concern the ability of shareholders to sue has been widely recognized. See Cary, *supra* note 10, at 686-88; Coffee, *supra* note 25, at 763; Macey & Miller, *supra* note 25, at 512. For example, under Delaware law, shareholder-plaintiffs need not post security for expenses, and they can bring suits against non-resident directors relatively easily. See Cary, *supra* note 10, at 686-87; Coffee, *supra* note 25, at 763; Macey & Miller, *supra* note 25, at 511-12; Winter, *supra* note 4, at 274-75 & n.72. Because the Delaware rules that facilitate suits against Delaware corporations do not appear to be aimed at attracting incorporations, commentators have viewed these arrangements as a consequence of interest-group pressure exerted by the Delaware bar. See Cary, *supra* note 10, at 687; Coffee, *supra* note 25, at 763; Macey & Miller, *supra* note 25, at 510-13.

In considering the view that the interests of the Delaware bar influence Delaware corporate law, it should be first noted that interest group pressure can come into play only to the extent that Delaware has "market power" in the state charter competition. If Delaware had no market power, it would not be able to adopt rules that sacrifice the interests of incorporation decisionmakers for the interests of the Delaware bar without producing a migration en masse from Delaware to friendlier grounds. Delaware probably has some degree of market power for the reason proposed in Romano's analysis, that is, Delaware's ability to offer predictable and stable corporate law rules. See *supra* notes 50-52 and accompanying text.

More important for our purposes, however, the litigation-friendly tendencies of Delaware law — to the extent such tendencies exist — are just one dimension of Delaware's corporate law. As I pointed out in discussing Romano's thesis, the content dimension of Delaware's rules remains critical. Consider again the example of two alternative rules that Delaware might adopt for the governance of managerial self-dealing, one allowing little or no such self-dealing and the other allowing a great deal of such behavior. While the rules might encourage litigation equally (and, accordingly, benefit the Delaware bar equally), they might differ significantly in their effect on shareholder value. The critical question is whether Delaware will choose the rule that better serves shareholders' interests.

decline in value when the reincorporation plans become public.⁵⁷ Race for the top adherents have pointed to these results as evidence that confirms their view.⁵⁸

The results of these event studies, however, do not resolve the debate over the desirability of state competition. To start with, stock price movements around the time of reincorporation may reflect the market's reaction not to the reincorporation itself, but rather to other developments that coincide with, or even were signalled by, the decision to reincorporate.⁵⁹ Managers may well systematically choose to reincorporate when they have favorable information about the future of their company.⁶⁰ In such a case, the market may, around the time of the reincorporation decision, receive this favorable information or even infer it from the managers' decision to reincorporate. Consequently, even if the market did view the effect of the reincorporation itself to be negative, the market's reaction to the favorable information about the company may outweigh this negative effect, and the stock price may not decline around the time of reincorporation.

Second, and perhaps more importantly, the absence of negative returns upon reincorporation may indicate not that the legal rules of the destination state are beneficial to shareholders but rather that the legal rules of the original state and the destination state are equally harmful to shareholders. This observation is consistent with the failure of the empirical studies to uncover significant positive or negative returns in most cases⁶¹ and with the degree to which states' corporate

⁵⁷ See Dodd & Leftwich, *supra* note 12, at 281-86; Romano, *supra* note 25, at 279-81. Events that might cause a company's reincorporation plans to become public include the approval of the reincorporation by the company's board of directors, incorporation of a shell successor corporation in the destination state, signing of a merger agreement between the company and its successor-subsiary, mailing of proxy materials to shareholders, shareholder approval of the company's merger with the shell successor corporation, and/or publication of a *Wall Street Journal* article concerning the company's domicile change.

⁵⁸ See Dodd & Leftwich, *supra* note 12, at 281-82; Easterbrook, *supra* note 12, at 550; Fischel, *supra* note 12, at 920-21.

⁵⁹ See Romano, *supra* note 25, at 267 & n.58; Coffee, *supra* note 25, at 767-68.

⁶⁰ Indeed, in order to avoid experiencing a price decline, managers might systematically prefer to schedule a reincorporation decision at a time when they have such favorable information. In addition, incorporation in a state with favorable corporate law rules might increase in importance when the company seems to be on the road to success and growth that might produce a higher volume of corporate litigation.

⁶¹ See Dodd & Leftwich, *supra* note 12, at 277 (finding no market reaction); Romano, *supra* note 25, at 271 (finding no significant abnormal returns for reincorporations that were motivated by antitakeover and tax considerations). Although Romano found significant abnormal returns for reincorporations motivated by planned acquisition programs, *see id.* at 271, this result may be attributable to stockholders' positive response to the signalling of the planned acquisition programs, *see* Coffee, *supra* note 25, at 767; Romano, *supra* note 25, at 267-68.

law rules are similar.⁶² As long as there is little difference between the legal rules of the corporation's original state of incorporation and its state of reincorporation, the decision to reincorporate is likely to affect shareholders only minimally. Whether this similarity in state corporate law rules reflects a race for the top or a race for the bottom remains an open question.⁶³

Finally, even if the event studies did show that a company's decision to reincorporate does not reduce its value overall, such a showing still would not rule out the possibility that state competition produces desirable results with respect to some corporate issues but not with respect to others.⁶⁴ This observation is not just a fine point; as Parts II and III will demonstrate, state competition can indeed be expected to yield such differential effects.

In addition to the event studies of reincorporation decisions, the body of empirical work concerning state competition includes a study of the effect that major changes in Delaware law had on the stock market price of Delaware corporations.⁶⁵ The study "found no statistically significant market reaction to any" one of seven major Delaware court decisions, "all of which appeared to make significant, unanticipated changes in Delaware corporate law."⁶⁶ This finding, however, also cannot resolve the state competition question. It is difficult to predict in advance which particular companies will be affected in the future by a given precedent. Therefore, it is not surprising that the rendering of any particular precedent has little impact on companies' stock prices. Moreover, even if a particular change in the law were found to have caused a significant increase or decrease in companies' value, such a finding would shed little light on the question of the *systematic* effects of state competition. It is possible that Delaware has produced one or more decisions that advanced shareholders' in-

⁶² See Coffee, *supra* note 25, at 768; Romano, *supra* note 25, at 235, 238; Romano, *supra* note 2, at 709; see also *supra* notes 32-33 and accompanying text (describing the diffusion of innovative corporate law rules through the states).

⁶³ See Coffee, *supra* note 25, at 768 (stating that event studies of reincorporations can, at best, show only "the margin at any given time that separates [Delaware] from its nearest rival," and that they cannot show the "total distance that [state charter] competition [has taken us] from the legal regime that would result absent such competition").

⁶⁴ Suppose that a company migrates from state *A* to state *B* and that state *B* has a value-decreasing legal rule for the governance of a particular corporate law issue *X*. The move to *B* will not decrease the company's overall value if the desirability to shareholders of *B*'s rules with respect to issues other than *X* outweighs the undesirability to them of *B*'s legal treatment of *X*. It follows that, even if reincorporations could be shown not to decrease shareholder value overall, such a showing would not demonstrate that state competition produces value-maximizing rules with respect to *all* types of corporate law issues.

⁶⁵ See Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CAL. L. REV. 551 (1987).

⁶⁶ *Id.* at 553.

terests but nonetheless has various legal rules that are harmful to these interests.

In sum, the body of empirical evidence that addresses the state competition question is inconclusive. Moreover, the preceding discussion of the existing work suggests that additional event studies would be unlikely to shed much light on the desirability of state competition. As the remainder of this Article will suggest, however, the potential for progress using theoretical analysis has not been exhausted.

D. What States Maximize

The analysis of this Article is premised on the assumption that, in designing corporate law rules, states — at least those that are successful in the competition for corporate charters — seek to maximize the number of companies incorporated within their boundaries. Both the race for the bottom and the race for the top theories make this assumption, at least implicitly.⁶⁷ But possible objections to this premise have not been explored; therefore, before proceeding, it is important to examine these objections.

States clearly derive benefits from in-state incorporations. Incorporations bring with them franchise tax and fee revenues as well as patronage for in-state law firms, corporation service companies, and other businesses.⁶⁸ Thus, states have an interest in increasing in-state incorporations. But the assumption that states design their corporate law rules to maximize the number of in-state incorporations might still be challenged on the ground that it does not accurately represent the complex reality of the state lawmaking process. I discuss below the three main ways in which this assumption might fail to capture the full spectrum of factors affecting states' behavior, and I explain why the assumption is nonetheless appropriate for the purpose of analyzing the effects of state competition on corporate law.

The first objection might be that although states have an interest in having more companies incorporated in-state, they also may have other interests that are directly affected by the content of the states' corporate law rules. In particular, a large state (for example, New York) may have among its citizens a significant fraction of the shareholders of its in-state corporations. Such a state, so the argument goes, may have a direct interest in the substantive content of its corporate law — in particular, in the effects of this law on shareholder

⁶⁷ See Romano, *supra* note 25, at 228 (stating that in both the race for the bottom and the race for the top theories, a state's objective is revenue-maximization, and revenue is thought to depend directly upon the volume of domestic incorporations).

⁶⁸ See Alva, *supra* note 4, at 888 & n.8; Cary, *supra* note 10, at 668-69; Macey & Miller, *supra* note 25, at 492-93; Romano, *supra* note 2, at 710.

value — and not only an interest in how this law affects incorporation decisions.⁶⁹

In considering this objection, it should first be noted that the leader in the state charter competition is, and always has been, a relatively small state.⁷⁰ Delaware, the current leader, is sufficiently small to make it likely that Delaware citizens hold an insignificant fraction of the shares of Delaware companies. Consequently, Delaware does not have a significant *direct* interest in the consequences of its corporate law for shareholder value; it has a major interest only in how these consequences affect incorporation decisions. Note that the small size of the winning state is no coincidence. Rather, there are structural factors that give us reason to expect that the leader of the competition among states will be a small state like Delaware.⁷¹

Moreover, while a large state like New York may have a significant direct interest in having in-state companies governed by value-maximizing rules, it does not follow that the state's design of corporate law rules would not be substantially influenced by the desire to make these rules attractive to those who make incorporation decisions. For example, suppose that New York seeks to further the interests of its citizen-shareholders and disregards the interests of those who make incorporation decisions.⁷² To the extent that companies respond by incorporating elsewhere, the state's adoption of rules that maximize shareholders' welfare would not help the state's citizen-shareholders. That is, because a given state's corporate law governs only companies incorporated in-state, the law's effect on the number of in-state incorporations is bound to be given much weight.

A second objection to the assumption that states seek to maximize in-state incorporations might be that, even if such maximization is a state's goal, not all of the individuals involved in the lawmaking process will necessarily focus on this goal. Legislators, judges, members of bar committees, and many other individuals influence and

⁶⁹ Of course, if the race for the top logic is correct, then the state's interest in serving its shareholder-citizens and the state's interest in attracting incorporations would coincide, as both interests would lead it to adopt value-maximizing corporate law rules.

⁷⁰ The original leader was New Jersey, and the leader since New Jersey's demise has been Delaware, *see supra* p. 1443.

⁷¹ Delaware's small size is central to Romano's explanation of the state's dominance of the state charter competition. In particular, Romano identifies two factors particularly important to Delaware's success — the importance of incorporation-related revenues in light of Delaware's otherwise small revenue base, and the small size of the Delaware judiciary. *See Romano, supra* note 25, at 240, 277–78; Romano, *supra* note 2, at 721–22. Other commentators have emphasized the lack of competing political lobbies in Delaware as a determinant of Delaware's charter competition success. *See Alva, supra* note 4, at 918–19; Coffee, *supra* note 25, at 762–63.

⁷² The analysis in the text focuses on a case in which the state's interest in fostering shareholders' welfare conflicts with its interest in attracting incorporations. If the two interests coincide, then the assumption that states choose corporate law rules to attract incorporations is unquestionably appropriate.

participate in the development of a state's corporate law.⁷³ These actors may not have a single-minded focus on maximizing in-state incorporations. In particular, individual players may be influenced in part by public-regarding aims, their conceptions of shareholders' and society's interests, or personal considerations.⁷⁴

⁷³ For a recent description of the role of individuals in the formation of Delaware's corporate law, see Alva, *supra* note 4, at 917-19.

⁷⁴ It might be argued that the above discussion applies only to members of state legislative and executive branches and not to the judicial branch. State judges, so the argument goes, are insulated from the forces of influence and pressure to which members of other branches are subject, and consequently the judges will not be concerned about the state's interest in attracting incorporations. The judges will be guided solely by their sense of integrity — by their desire to do what is right. Consequently, the argument concludes, although state competition and the desire to attract incorporations are likely to affect state statutory provisions, they are unlikely to have an effect on judge-made law.

It is far from clear, however, that even state judges of great integrity — judges solely concerned with doing the right thing — will ignore the state's interest in attracting incorporations. Rather, it is quite possible that, when such a judge uses her discretion to form judge-made law, she will take this state interest into account. First, the judge may believe that considering legislative intent is part of the "right" interpretive strategy. For example, when a Delaware judge applies and interprets the Delaware corporate code, she may well be aware, and accept as her working assumption, that the code was designed with the intent of attracting and maintaining in-state incorporations. Second, the judge may view it as "right" to use her discretion in a welfare-enhancing way and, furthermore, may believe that the "right" welfare calculus is one that attaches less weight (if any at all) to the interests of out-of-state citizens than to the interests of the state's citizens. Such a judicial strategy will again lead the judge to give weight to the state's (and the state citizens') interest in attracting incorporations.

Furthermore, state judges might not be completely insulated from the forces of influence and pressure that make members of other branches concerned about the state's interest in attracting incorporations. To be sure, judges are undoubtedly much less affected by such forces than members of other branches. But judges might to some extent be affected by the preferences of members of the other branches and thus, in turn, by the forces of influence and pressure to which these members are subject. For example, the judges of the Delaware Chancery Court and the Delaware Supreme Court are appointed by the state governor, with the consent of the state senate, for a period of twelve years. See DEL. CONST. art. IV, §3; Macey & Miller, *supra* note 25, at 500. It is only human for judges, at least sometimes and on the margin, to not want to disappoint those who are responsible for their appointment. Furthermore, Delaware judges might well be aware that if they rendered decisions that produced a prospect of corporate migration, their decisions would likely be wholly or partly reversed by the legislature. Thus, for example, when the Delaware Supreme Court decision in *Smith v. Van Gorkom*, 488 A.2d 858, 874-78, 881 (Del. 1985), was perceived to create increased liability of directors and consequently the prospect of out-of-state migration by Delaware companies, the Delaware legislature reacted by adopting section 102(b)(7) of the Delaware Corporation Code, see DEL. CODE ANN. tit. 8, § 102(b)(7) (1991), to enable companies to limit the liability of directors. Whether or not a judge views the avoidance of such reversals as part of doing her job "right," it is only human to expect that she will prefer to avoid reversals.

For all of the above reasons, I conclude that not only state legislators and executives, but also state judges are affected by the state's interest in attracting incorporations. Consequently, state competition is likely to have an effect not only on state statutory provisions, but also on state judge-made law. In particular, to the extent that we find that states' interest in attracting incorporations would be served by having undesirable rules with respect to a given issue, we can conclude that state competition is also likely to have a detrimental effect on the judge-made

For the purpose of analyzing the effects of state competition on corporate law, however, the appropriate assumption is that a state's interest in attracting incorporations shapes the behavior of the individuals actually involved in the state's lawmaking process. If a state's interest in attracting incorporations plays no role in shaping the behavior of such individuals, then state competition has neither a good nor a bad effect on corporate law rules; it is irrelevant. Accordingly, if we assume that state competition has *some* effect and set out to analyze whether this effect is good or bad, then the appropriate assumption for the analysis is that the individuals involved in the lawmaking process are at least partially moved by the state's interest in attracting incorporations. It follows that, to the extent that we find that a state's interest in attracting incorporations will be served by adopting undesirable rules, we can conclude that state competition is detrimental. In this case, to be sure, the fact that the individuals involved in the lawmaking process may be moved only partially by the state's interest in attracting incorporations is some consolation; for it implies that the undesirable effect of state competition is less severe than it would be if these individuals all focused solely on the state's interest. But this refinement would not change at all the basic conclusion that state competition has certain systematic undesirable effects on corporate law.

Finally, a third objection to the premise that states seek to maximize in-state incorporations might be that successful states (such as Delaware) may consider in their lawmaking not only the response of incorporation decisionmakers, but also the response of federal lawmakers (courts, legislators, and agencies). That is, Delaware may elect not to adopt certain value-decreasing rules even if they are desired by incorporation decisionmakers, because adopting such rules might trigger federal intervention.⁷⁵ For example, some commentators have suggested that the decision by the Delaware Supreme Court in *Singer v. Magnavox Co.*,⁷⁶ which changed earlier case law and sig-

law (if any) that applies to this issue. To be sure, as discussed above, judges may be less affected by the state's interest in attracting incorporations than are state legislators and executives. In this case, the undesirable effect of state competition on judge-made law will be less severe than on state statutory law. But again, this refinement would not undermine the validity of the basic conclusion — that state competition has certain systematic, undesirable effects on both statutory and judge-made state law. For this reason, I use the term "rules" throughout to refer to rules established by *all* state law officials, including judges.

⁷⁵ In some sense, the state's interest in attracting incorporations without triggering federal intervention is just a refinement of its interest in maximizing the number of in-state incorporations. This is because *long-run* maximization of in-state incorporations requires states not only to provide corporate law rules attractive to incorporation decisionmakers, but also to avoid a situation in which federal law intervenes and stops the game altogether.

⁷⁶ 380 A.2d 969 (Del. 1977), *overruled by* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

nalled a willingness to apply close scrutiny to freezeouts, was motivated by a desire to avoid an expansion of federal law into this area.⁷⁷

Again, although states such as Delaware may well be guided in part by their interest in avoiding federal intervention, for the purpose of analyzing the effects of state competition, the appropriate assumption remains that state law is shaped by states' desire to attract incorporations. To be sure, the fear of federal repercussion imposes a constraint on states. In particular, it imposes an upper bound on the degree of apparent harm that Delaware's corporate law rules can cause. But within the range of options that can be chosen without triggering federal intervention, states can be expected to choose the rules that are most attractive to incorporation decisionmakers. Thus, if we concluded that state competition tends to produce undesirable rules for the governance of certain issues, then the constraint imposed by the fear of federal intervention would only mitigate somewhat the magnitude of the identified adverse effect of state competition. It would not change the basic conclusion that state competition has such an adverse effect.

E. Toward a New Theory

Before proceeding to my analysis of the shortcomings of state charter competition, I wish to outline this analysis and explain briefly how it relates to the two opposing schools of thought, the race for the bottom theory and the race for the top theory. While the two theories differ on whether state competition produces desirable corporate rules, they do share certain basic premises. Both theories view the socially desirable rule with respect to any given corporate law issue as the rule that maximizes shareholder value.⁷⁸ Moreover, both theories assume that, in designing corporate law rules, states seek to make their law attractive to managers who make incorporation decisions.⁷⁹

⁷⁷ See CLARK, *supra* note 3, § 12.3, at 520-21.

⁷⁸ See, e.g., Cary, *supra* note 10, at 666, 671-72 (arguing that state charter competition is undesirable because it harms shareholders' interests); Fischel, *supra* note 12, at 921-22 (arguing that state competition is desirable because it induces corporate law rules that maximize shareholder value); see also Winter, *supra* note 4, at 256 (emphasizing that Cary's claim is not that state corporation law ignores overriding social goals, but rather "that Delaware is preventing *private* parties from optimizing their *private* arrangements" (emphasis in original)). Winter, for one, states explicitly that his analysis is directed at cases in which no third-party effects are involved. See Winter, *supra* note 4, at 253, 259.

⁷⁹ That managers make incorporation decisions and, accordingly, drive the adoption of state corporate law rules is stated explicitly in the work of race for the top theorists. See Easterbrook, *supra* note 12, at 545; Fischel, *supra* note 12, at 919-20; Winter, *supra* note 4, at 252. It is also clearly implicit in Cary's statement of the race for the bottom position. See Cary, *supra* note 10, at 668, 671-72; see also Macey & Miller, *supra* note 25, at 474 (noting that Cary's theory of state competition is an outgrowth of Berle and Means' recognition that managers, not shareholders, control corporate decisionmaking).

The race for the bottom and race for the top theories differ only with respect to the question of which rules are attractive to managers — that is, whether managers may seek rules that provide them with private benefits at the expense of shareholders or, instead, generally seek rules that maximize shareholder value.⁸⁰

My analysis of the possible shortcomings of state charter competition is divided into two parts. Part II of this Article focuses on the problems that result from the possible divergence between managers' and shareholders' interests. To focus on these problems, Part II assumes, as have the existing theories of state competition, that the socially desirable rules are those that maximize shareholder value. I analyze the extent to which the existing checks on managers imposed by market forces and by the requirement of shareholder vote for reincorporation lead managers to seek (and states in turn to provide) rules that maximize shareholder value. The analysis shows that these checks have some, but far from total, effectiveness. Furthermore, the effectiveness of these checks varies widely from one area of corporate law to another. Consequently, managers are likely to seek rules that maximize shareholder value with respect to certain identifiable issues but not with respect to certain other identifiable issues.

Part III of this Article explores the possibility that state competition may produce undesirable rules because some corporate law issues involve externalities (with respect to creditors, potential buyers, or other third parties). This is a possibility to which both the race for the bottom adherents and the race for the top theorists have paid little attention.⁸¹ When externalities are present, state competition raises serious concerns wholly apart from any problems that may arise from a divergence between managers' and shareholders' interests. In the presence of externalities, the social desirability of a corporate law rule depends not only on its effect on shareholders' interests, but also on its effect on other parties. Consequently, even if managers seek (and states in turn provide) rules that maximize shareholder value, the presence of externalities implies that these rules may well diverge from the socially desirable ones. Part III identifies certain corporate law issues that are likely to involve significant externalities. Accordingly, state competition may well produce socially undesirable results regardless of the effectiveness of the existing market checks on managerial decisions.

⁸⁰ Indeed, apart from the type of corporate law rules thought to attract managers and "the adjective selected to characterize state laws," the theories of state competition put forth by the two sides are difficult to distinguish. See Romano, *supra* note 25, at 228. As Romano puts it, "critics of the federal system agree with [the race to the top view] of the behavior of states and firms but substitute the phrase 'manager utility' for 'firm value,' as the object furthered by corporation codes, and 'permissive' or 'worst' for 'optimal' or 'most efficient,' as the characteristic outcome of the competitive legislative process." *Id.* at 229.

⁸¹ See sources cited and discussed *supra* note 78.

At the outset, I wish to emphasize that, in my view, the appropriate starting point for the analysis that follows is a presumption that, absent some reasons to the contrary, state competition is more likely to produce an efficient rule than federal regulation.⁸² As this Article shows, such reasons to the contrary do exist with respect to many important corporate law issues. But this presumption does provide a useful analytical starting point, and it is justified by the significant advantages that state competition offers whenever distorting biases are absent.

To start with, a regime of state corporate law is characterized by competitive pressure to produce the legal rules most attractive to those making incorporation decisions. By contrast, federal law officials are not subject to the discipline of such competitive pressure. Clearly, when the rules desired by those making incorporation decisions are indeed the socially desirable ones, such competitive pressure is beneficial.⁸³

Moreover, state competition may yield informational advantages. State law officials are likely to have more information than would federal law officials with respect to the rules that are attractive to those making incorporation decisions. Incorporation decisions serve as an automatic feedback mechanism that supplies information about the relative attractiveness of various sets of rules.⁸⁴

These benefits of state competition are simply a special case of the familiar point that, as long as competition operates to reward producers of the best product, competition is socially desirable. Thus, in

⁸² Cf. Winter, *supra* note 4, at 291-92 (stating that federal intervention should be undertaken only after the need for such intervention has been clearly shown).

⁸³ See, e.g., Fischel, *supra* note 12, at 922 (stating that federal intervention would destroy the healthy effects of state charter competition and replace the current system of fifty states striving to achieve the climate sought by companies with a "scheme of regulation by fiat").

⁸⁴ As Winter stressed, there is no effective mechanism at the federal level for evaluating the reaction of companies to corporate law rules. See Winter, *supra* note 4, at 290.

A third advantage of a state competition regime is that it enables different rules to coexist. A single rule may not be optimal for all publicly traded companies. A regime of state competition can offer a variety of rules, and companies can sort themselves out according to their particular needs. See Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 179, 184-90 (1985) (offering data to support the theory that firms "will select their state of incorporation adaptively"); cf. Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 28 (1983) (discussing the competition among the states in the context of state antitrust law). Although I agree that this advantage is theoretically valid, in my judgment it should not be given much weight. As indicated earlier, see *supra* pp. 1443-44, 1446, there is in fact a great degree of uniformity among the rules provided by different states. This uniformity suggests that it is far from clear that public companies — or at least those who make incorporation decisions — differ all that much in the rules they seek. Moreover, and most importantly, to the extent that having several options for companies to choose from is desirable, one can contemplate a federal arrangement that provides several such options. The federal-state choice hinges upon whether federal or state law officials should determine the options among which companies will be able to choose.

the corporate context, we should limit charter competition only in those instances in which competition works to reward not those who provide the best product but rather those who provide a product with certain undesirable characteristics. It is to the identification of these instances that I now turn.

II. STATE COMPETITION AND MANAGERS' OPPORTUNISM

This Part analyzes the ways in which divergence between the interests of managers and shareholders leads state competition to produce undesirable corporate law rules. To focus on the problems resulting from managers' opportunism, I assume in this Part that corporate law rules have no externality effects. Consequently, the socially desirable rule with respect to any given corporate issue is that which maximizes shareholder value. Accordingly, state charter competition works well if it produces rules that maximize shareholder value. As the analysis shows, however, state competition may well fail to do so with respect to certain issues. With respect to the identified issues, states seeking to attract incorporations may adopt rules that serve managers' and dominant shareholders' interests even if the rules are value-decreasing.⁸⁵

A. *The Managerial Opportunism Problem*

1. *The Centrality of Reincorporation Decisions.* — Public companies make incorporation decisions at different stages in their corporate lives. They are incorporated in a particular state when they first go public, but may later reincorporate in another state. Reincorporation is generally achieved by merger or consolidation with a newly-formed company incorporated in the destination state and created expressly for reincorporation purposes.⁸⁶ Reincorporation generally requires a decision by the company's board and approval by the company's shareholders.⁸⁷

As explained above, the appropriate premise for an analysis of the desirability of state charter competition is that states — at least those that are successful in the charter competition — design their corporate law rules to maximize the number of in-state incorporations. States therefore have an interest both in initial incorporation decisions and in subsequent incorporation decisions, and my analysis will take both

⁸⁵ The term "managers" is used in the analysis below to refer generally to those individuals — whether executives or directors — who can bring about a decision by a company's board to reincorporate. Although companies differ in how influence is divided among executives, inside directors, and independent directors, this division is not important for our purposes.

⁸⁶ See Dodd & Leftwich, *supra* note 12, at 263; Romano, *supra* note 25, at 248 n.38.

⁸⁷ See CLARK, *supra* note 3, § 10.2.4, at 416–17 (stating that under state corporation law, mergers must be approved by board resolution and shareholder vote).

types of decisions into account. It should be emphasized at the outset, however, that states seeking to attract incorporations will focus largely on making their corporate law rules attractive to those making *reincorporation* decisions.

States tend to focus on reincorporation decisions because the number of explicit or implicit reincorporation decisions that public corporations make in any given period of time is greater than the number of initial incorporation decisions that companies going public for the first time make in the same period. During any given year, the number of initial incorporations is fairly limited. By contrast, during the same period, every public company makes an explicit or implicit reincorporation decision. That is, because an existing corporation can reincorporate with relative ease,⁸⁸ it may be viewed as making in any given period of time either an explicit decision to move elsewhere or an implicit decision to remain in its home state.

Considering the situation of Delaware, the dominant state in the charter competition, may illustrate the importance of reincorporations in states' calculus. In choosing its corporate law rules, Delaware undoubtedly considers the effect that its choices will have on its ability to attract initial incorporations. But Delaware will be much more concerned with retaining companies already chartered in Delaware and with inducing companies incorporated elsewhere to relocate to Delaware. Accordingly, Delaware's choice of corporate law rules will be determined primarily by its desire to ensure that its rules are attractive to those making explicit or implicit reincorporation decisions.

Given that states are likely to focus on the effect that their corporate law rules will have on reincorporation decisions, this Part initially assumes, for simplicity of exposition, that states are concerned *solely* with reincorporation decisions. Section II.F adds initial incorporations to the picture and shows that the conclusions of the analysis remain valid.

2. *Reincorporations and Managers.* — For purposes of analyzing companies' reincorporation decisions, it is useful to distinguish situations in which companies are controlled by dominant shareholders at the time the reincorporation decision is made from situations in which companies are not under such control at the time of the reincorporation decision. The analysis of this Part initially focuses on companies not controlled by a dominant shareholder at the time of the reincorporation decision. In the absence of a dominant shareholder, ownership (divided among a dispersed body of shareholders) is divorced from control, which is in the hands of the managers. Section II.E

⁸⁸ See Roberta Romano, *Answering the Wrong Question: The Tenuous Case of Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1599-1600 (1989).

extends the analysis and considers the case of companies controlled by a dominant shareholder.

Focusing then on companies with a dispersed body of public shareholders, it is important to recognize that managers of such companies have considerable influence over reincorporation decisions. While this point will be elaborated and supported by the analysis that follows, the basic reasons for this point can be stated up front quite simply. To start with, if the managers seek to maintain the current state of incorporation, they can easily have their way; a company cannot move to another state if its managers do not bring a reincorporation proposal to a shareholder vote. Managers thus have a veto power over corporate migration. Consequently, as long as the managers of Delaware companies continue to be pleased with Delaware law, Delaware will have incorporated in-state at least the number of companies currently incorporated in Delaware. Furthermore, even if the managers would like to have the company migrate to some other state, the managers are also likely to have their way. To be sure, in this case the managers will have to obtain shareholder approval. As section II.D will explain, however, the requirement of shareholder approval is frequently an ineffective constraint because of problems of information, collective action, and distorted choice.

Thus, a state focusing on reincorporation decisions will pay substantial attention to the desires of managers. The question, of course, is which legal rules will make the law of a state attractive to managers who make (explicit or implicit) reincorporation decisions. Consider a given corporate issue *X*, and suppose that there are two possible rules for the governance of this issue, *A* and *B*, and that *A* is the value-maximizing rule. The question is whether *A* is necessarily the better choice for a state seeking to make its law attractive to managers making reincorporation decisions.

In examining this question, it is useful to divide the issues governed by corporate law into two groups: issues that do not involve a potential transfer of value from shareholders to managers and issues that do involve such a potential transfer. When an issue does not involve a potential transfer, there is no divergence of interest between managers and shareholders, and, thus, there is no reason for managers to prefer a value-decreasing rule. After all, there is no question that, although managers may well have some private interests, the interests of managers and shareholders are somewhat aligned, and managers accordingly prefer, all other things being equal, to have a higher share value.⁸⁹ Thus, whenever a given corporate law issue does not implicate managers' private interests, managers will undoubtedly want to

⁸⁹ See *infra* subsections II.B.1–II.B.4 (describing market forces that somewhat align managers' and shareholders' interests).

have the issue governed by the value-maximizing rule, and states will have an incentive to offer this rule.

Therefore, the analysis below focuses on those corporate law issues that do involve a potential transfer between shareholders and managers. With respect to such "redistributive" issues, the question arises whether states, seeking to make their law attractive to managers making incorporations decisions, may elect to provide rules that serve managers' private interests even if such rules are value-decreasing.

In addressing this question, two possible constraints on managerial discretion must be considered. One constraint, examined in section II.D, is the requirement that reincorporation be approved by shareholder vote. The main constraint that is stressed by supporters of state competition, however, is the disciplinary force exerted by various markets — the market for corporate control, the managerial labor market, the market for additional capital, and the product market.⁹⁰ Market discipline, it is argued, generally leads managers to prefer value-maximizing rules even when alternative rules seem to serve better the private interests of managers. When a rule is value-decreasing, so the argument goes, its adverse effect on shareholder value — operating through various market mechanisms — makes it on the whole unattractive to managers.

The effectiveness of market discipline, however, varies greatly across issues. In particular, there are two types of issues with respect to which market discipline can hardly be relied on to induce managers to seek value-maximizing rules. These two types of issues are those that are "significantly redistributive" and those that directly affect the strength of market discipline. The next two sections will demonstrate in turn the ineffectiveness of market discipline with respect to each of these two types of issues.

B. Significantly Redistributive Issues

With respect to redistributive issues, the effectiveness of market discipline in discouraging managers from seeking value-decreasing rules depends on the relationship between the size of the potential transfer involved (the distributive element) and the magnitude of the potential effect on overall value (the efficiency element). An issue is "insignificantly" redistributive if the distributive element is very small relative to the efficiency element — for example, the potential direct transfer to managers is \$1, whereas the effect on shareholder value is \$1,000. By contrast, an issue is "significantly" redistributive if the distributive element is significant relative to the efficiency element — for example, the potential transfer is \$200, whereas the effect on

⁹⁰ See Easterbrook, *supra* note 12, at 543-46, 553-57, 564; Fischel, *supra* note 12, at 919; Winter, *supra* note 4, at 256-58, 262-66.

shareholder value is \$1,000. As this example indicates, for an issue to be classified as significantly redistributive does not require that the potential transfer exceed in size the potential efficiency effect; the transfer need only constitute a significant fraction of this effect. Clear examples of significantly redistributive issues are managerial self-dealing, taking of corporate opportunities, and insider trading.

Below I examine the operation of the various markets that may affect the decisions of managers. I show that, although market discipline will probably discourage managers from seeking inefficient rules with respect to insignificantly redistributive issues, it is unlikely to have such an effect with respect to significantly redistributive issues.

1. *Market for Corporate Control.* — Race for the top adherents regard the market for corporate control as exerting a powerful disciplinary force. In their view, the fear of losing control induces managers to seek, and states in turn to provide, value-maximizing rules.⁹¹ If a company reincorporates in a state that provides a certain value-decreasing rule, the company's share price will decline to reflect the loss associated with this rule. Consequently, the company will become more vulnerable to a takeover bid or a proxy contest.⁹² Because a takeover bid or a proxy contest may wrest from managers the control that is valuable to them, so the argument goes, the prospect of such a bid or contest discourages managers from seeking value-decreasing rules.⁹³

Because the threat of a takeover bid or a proxy contest provides managers with incentives to avoid unnecessary reductions in share value, it undoubtedly contributes to discouraging managers from seeking inefficient rules with respect to insignificantly redistributive issues. This threat, however, does not align the interests of managers and shareholders perfectly. As the market for corporate control operates, any limited reduction in share value increases only to a limited extent the likelihood of ouster in a takeover or a proxy contest. The likelihood is small that the limited reduction in share value would lead to a takeover bid or proxy contest that otherwise would not have occurred.⁹⁴ Consequently, the market for corporate control cannot be

⁹¹ See Easterbrook, *supra* note 12, at 564; Fischel, *supra* note 12, at 919; Winter, *supra* note 4, at 256, 264-66.

⁹² See Winter, *supra* note 4, at 266.

⁹³ See Easterbrook, *supra* note 12, at 564; Fischel, *supra* note 12, at 919; Winter, *supra* note 4, at 266. The race for the top argument that the market for corporate control induces managers to seek only value-increasing state law rules is a straightforward application of the general argument that the threat of takeovers induces managers to maximize shareholder value. For the original statement of the argument that the market for corporate control aligns managers' and shareholders' interests, see Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 112-13 (1965). For a more recent discussion of the disciplinary role of tender offers in particular, see Easterbrook & Fischel, *supra* note 46, at 1165-74.

⁹⁴ Whether a takeover bid will occur depends on whether the value of the company in the

relied upon to discourage managers from seeking value-decreasing rules with respect to issues that are significantly redistributive. Consider, for example, a value-decreasing state law rule that reduces by \$1,000,000 the total value of a large company originally worth \$1,000,000,000. This 0.1% reduction in the company's total value is likely to increase only minimally the probability of a takeover bid or proxy contest. Therefore, if the corporate issue governed by this rule is significantly redistributive, and the value-decreasing rule produces a direct benefit to managers worth, for example, \$200,000, the very small increase in the probability of ouster resulting from incorporation in a state with this value-decreasing rule will be unlikely to discourage managers from incorporating in such a state.⁹⁵

2. *Managerial Labor Market.* — Like the market for corporate control, the managerial labor market induces managers to take shareholders' interests into account.⁹⁶ Managerial compensation schemes constitute one mechanism that provides managers with such incentives.⁹⁷ Because managers' compensation is often tied to the firm's performance, it is argued, managers have an incentive to enhance shareholder value.⁹⁸ Similarly, managers' compensation often includes shares of the company's stock, thus providing managers with a direct interest in the value of this stock.⁹⁹ Furthermore, the market for managerial labor also disciplines managers by virtue of the detrimental effect that reductions in shareholder value have on their employment opportunities.¹⁰⁰ A company's success may well affect the managers'

eyes of some potential buyer exceeds the sum of the market price, the expected premium that would be necessary for a takeover, and the expected transaction costs involved in such a takeover. The likelihood that the company's market price is just slightly above this threshold, so that a small reduction in this price would be necessary and sufficient to satisfy the above condition, is generally quite small.

⁹⁵ To be precise, the market for corporate control would not discourage managers from seeking a given value-decreasing rule as long as the direct private benefit to the managers from the rule exceeds the increase in the probability of the managers' losing their control as a result of this rule multiplied by the private benefits to managers of being in control.

⁹⁶ See Easterbrook, *supra* note 12, at 554-55; Fischel, *supra* note 12, at 919.

⁹⁷ See Easterbrook, *supra* note 12, at 554; Fischel, *supra* note 12, at 919.

⁹⁸ See Easterbrook, *supra* note 12, at 554; Michael C. Jensen & Jerold L. Zimmerman, *Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. 3, 4-5 (1985); Artur Raviv, *Management Compensation and the Managerial Labor Market: An Overview*, 7 J. ACCT. & ECON. 239, 240 (1985).

⁹⁹ See Easterbrook, *supra* note 12, at 554 (noting that managers who are awarded with stock options or phantom stock will tend to exercise their discretion to serve shareholders' interests because doing so increases the value of their stock holdings); Fischel, *supra* note 12, at 919 (arguing that stock option plans provide managers with an incentive to keep stock prices high and thus to maximize shareholders' wealth); Jensen & Zimmerman, *supra* note 98, at 4-5; Raviv, *supra* note 98, at 240.

¹⁰⁰ See Fischel, *supra* note 12, at 919 (arguing that managers have strong incentives to maximize the market value of their services). As Fischel further notes, the impact of share price on managers' employment prospects not only encourages them to act in the shareholders'

opportunities for continued employment and promotion at the company as well as their future employment prospects at other firms.¹⁰¹

These features of the managerial labor market do serve to align shareholders' and managers' interests. They clearly lead managers to prefer, all else being equal, to avoid a reduction in share value. Thus, the managerial labor market may well induce managers to seek only value-maximizing rules with respect to issues that are not significantly redistributive. However, the operation of this market does not perfectly align the interests of managers and shareholders; it does not induce managers to avoid all reductions in share value regardless of the size of the direct private benefit to them.

Because reductions in share value may have nothing to do with managerial failure, the managerial labor market operates in such a way that managers are penalized only to a limited extent for a reduction in share value.¹⁰² Indeed, empirical evidence indicates that when a company's total stock market value increases, the annual salary and bonus of its CEO increase on average by an amount equal to only 0.002% of the change in the company's total value, and the CEO's total pay-related wealth increases by just 0.075% of the change in the company's total value.¹⁰³ The evidence also indicates that 80% of CEOs hold less than 1.38% of their company's stock, and that the median percentage of CEO ownership is 0.25%.¹⁰⁴

Because the managerial labor market operates in such a way that managers bear only a very limited fraction of any reduction in total share value, managers may well favor corporate law rules that are

interests, but also encourages them to monitor other managers' behavior. Because the managerial labor market uses the performance of the firm as a whole to gauge individual managers' abilities, each manager thus has a stake not only in the manager's own performance, but also in the performance of other managers at the firm. *See id.*

¹⁰¹ *See* Eugene Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 292 (1980).

¹⁰² Even if managerial compensation schemes were set optimally in the shareholders' interests, we would still expect these schemes to impose rather limited penalties on reductions in share value. Reductions in share value need not be the result of managers' actions. Therefore, given that managers are risk-averse, the optimal compensation scheme does not penalize managers drastically for reductions in share value, which may depend in part on factors beyond the control of the managers. *Cf.* Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74, 74-80 (1979) (analyzing the optimal contract in a principal-agent relationship); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55, 66 (1979) (same). Similarly, because future employers realize that share value is only a "noisy" signal of managers' quality, it is unlikely that any given reduction in share value will result in a drastic reduction in a manager's future employment prospects. *See* Fama, *supra* note 101, at 304-06.

¹⁰³ *See* Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top Management Incentives*, 98 J. POL. ECON. 225, 260 (1990). "Total pay-related wealth" includes not only the increase in the compensation in the year in which the change in value takes place, but also the estimated positive effect on compensation in future years.

¹⁰⁴ *See id.* at 237.

significantly redistributive in management's favor, in spite of any adverse effect that such rules may have on the value of managers' compensation and stock holdings. Consider a rule that would produce a loss of \$10,000,000 in total stock market value and a gain of \$3,000,000 to the managers. It seems likely that the managers would prefer this rule to its value-maximizing alternative because the \$3,000,000 direct benefit is likely to exceed substantially the rule's adverse effect on the managers' compensation and stock holdings.

Similarly, the effects of a reduction in share value on future employment and promotion are unlikely to be substantial enough to discourage top managers from seeking value-decreasing rules that are significantly redistributive in their favor. Although poor company performance does somewhat increase the risk of dismissal of top managers, the evidence suggests that even managers of poorly performing firms face a very small chance of dismissal.¹⁰⁵ And the effect of company performance on future employment is not of significant concern to most top managers, because such managers are likely to remain at their firms until retirement.¹⁰⁶

3. *Market for Additional Capital.* — Race for the top adherents also rely on the market for additional capital as a source of market discipline.¹⁰⁷ When managers make incorporation decisions, they may contemplate the need to return to the equity markets to raise additional capital. To the extent that the company's state of incorporation has value-decreasing rules, so the argument goes, the corporation's effort to raise additional capital will be more difficult.¹⁰⁸ Conse-

¹⁰⁵ See Jerold B. Warner, Ross L. Watts, & Karen H. Wruck, *Stock Prices and Top Management Changes*, 20 J. FIN. ECON. 461, 487-88 (1988); Michael S. Weisbach, *Outside Directors and CEO Turnover*, 20 J. FIN. ECON. 431, 443 (1988). *But see* Anne T. Coughlan & Ronald M. Schmidt, *Executive Compensation, Management Turnover, and Firm Performance: An Empirical Investigation*, 7 J. ACCT. & ECON. 43, 60-61, 65 (1985) (arguing that the probability of management turnover is inversely related to stock price performance). Because CEOs are rarely fired openly, researchers looked at all cases in which a CEO departed before the normal retirement age and assumed that some of these departures were in fact camouflaged dismissals. Even among firms that performed most poorly, researchers found that the likelihood of a CEO departure before retirement age was small and that the effect of a decrease in performance on the likelihood of departure was also quite small. For example, looking at the difference between the median performing firm and a firm in the bottom 20% in terms of performance, Weisbach found that the likelihood of the CEO's departure increased only from 4.9% to 5.6%, *see* Weisbach, *supra*, at 443; Warner, Watts, and Wruck found that it increased only from 11.6% to 12.4%, *see* Warner, Watts & Wruck, *supra*, at 478; and Coughlan and Schmidt found that it increased only from 7.7% to 10.5%, *see* Coughlan & Schmidt, *supra*, at 64. Note that a decline from median performance to a performance in the bottom 20% is quite substantial (larger than one may think would arise from most value-decreasing corporate law rules).

¹⁰⁶ *See* Jensen & Murphy, *supra* note 103, at 34-35 (finding that most departing CEOs leave their positions only after reaching normal retirement age).

¹⁰⁷ *See* Easterbrook, *supra* note 12, at 543-46; Winter, *supra* note 4, at 256, 275.

¹⁰⁸ *See* Winter, *supra* note 4, at 275 (noting that investors "must be attracted before they can be cheated").

quently, incorporation in a state with value-decreasing rules will be unattractive to managers.

Incorporation in a state that provides certain value-decreasing rules, however, would not generally prevent a company from raising additional equity. To be sure, fully informed investors would be willing to pay less for shares than they otherwise would. But managers would still be able to raise the same amount of capital simply by offering a larger number of shares (thus reducing the remaining stake of the existing shareholders).

Thus, reincorporation in a state with value-decreasing rules will not prevent the raising of additional capital to finance expansion; it will simply increase the cost to existing shareholders of such financing. That this reduction in the value of existing shares is undesirable to the managers is due to the operation of the corporate control market and the managerial labor market. Thus, the market for additional equity does not impose on managers any constraints that are significantly different from those that have already been examined.

Finally, the effect of future capital needs on managers' decisions is even weaker than the above discussion may indicate because extra capital can be obtained in the form of debt rather than equity. As long as the reincorporation in a state with value-decreasing rules does not change the likelihood that the company will default on its debt, which often would be the case, it will not change the cost of debt. Even if the cost of debt were to increase, this increase, again, would not hinder expansion but only reduce the value of the existing shareholders' stake. At most, then, future capital needs create the same type of incentives that the examination above has found insufficient to eliminate managerial opportunism.

4. *Product Market.* — Race for the top adherents view product markets as another source of constraints on managers.¹⁰⁹ According to this argument, if management acts inefficiently, the company's business will contract or fail, and the managers will find themselves with a shrunken empire or indeed no empire at all.¹¹⁰ This prospect is thought to discourage managers from seeking incorporation in states with value-decreasing rules.

Although product market competition does provide managers with some valuable incentives, it cannot discourage managers from seeking value-decreasing rules that are significantly redistributive in their favor. For one thing, most rules of this kind would not affect operational efficiency of the company. That is, such rules gener-

¹⁰⁹ See Easterbrook, *supra* note 12, at 557; Winter, *supra* note 4, at 264. For a statement of the general argument that product market competition constrains the behavior of managers, see D. Hart, *The Market Mechanism as an Incentive Scheme*, 14 BELL J. ECON. & ORG. 553-54; Winter, *supra* note 4, at 264.

would not alter the cost and quality of the company's products but rather the manner in which the value produced by the company is divided between managers and shareholders. Accordingly, such rules would not adversely affect the company's ability to compete in product markets. For example, a rule that permitted the managers of Hewlett-Packard to make certain insider trading profits at the expense of shareholders would likely have little effect on the prices at which Hewlett-Packard can sell its printers.

Furthermore, even if a certain value-decreasing rule does affect a company's operational efficiency, the disciplinary force of product markets is quite limited. Product markets are often not perfectly competitive; large companies generally operate in markets characterized by oligopolistic or monopolistic competition.¹¹¹ Because the survival of firms in such markets is hardly threatened by the existence of some operating inefficiencies, managers may well be willing to sacrifice some operating efficiencies for the direct and substantial benefits provided to them by rules that are significantly redistributive in their favor.

5. *Conclusion.* — The markets for corporate control, managerial labor, additional capital, and company products discipline managers' decisions to some extent. The operation of these markets may well ensure that managers will seek (and states in turn will provide) only value-increasing rules with respect to issues that are not significantly redistributive. However, as the analysis of this section has shown, the various market forces invoked by race for the top adherents do not ensure that managers will not seek value-decreasing rules with respect to other types of issues. In particular, market discipline notwithstanding, managers may seek such rules with respect to issues that are significantly redistributive.

C. Issues that Directly Affect the Strength of Market Discipline

While redistributive issues involve the private interests of managers, they need not directly implicate the strength of market discipline. Therefore, the above analysis took as a given the strength of the disciplinary force exerted by the markets for corporate control, managerial labor, capital, and the company's products. In the case of certain corporate law issues, however, the choice of a legal rule directly affects the strength of these market forces.

The best and most important illustrations of this point are rules that affect the disciplinary force exerted by the market for corporate control. For any given company, the likelihood that it will receive a takeover bid depends not only on the market price of its stock but also on the set of rules governing such bids — both the rules governing

¹¹¹ See JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 277-303 (1988).

the behavior of bidders and the rules governing the use of defensive tactics by targets. Similarly, the likelihood that a proxy contest will be initiated with respect to a company may well depend not only on the company's stock price, but also on the rules governing the various aspects of proxy contests, including the disclosure required of challengers, the challengers' access to the proxy machinery, and the potential reimbursement from the corporation. Therefore, rules that make it more difficult or less profitable to make a takeover bid or launch a proxy contest weaken the disciplinary force of the market for corporate control.

Similarly, the disciplinary force of the managerial labor market may well depend on the legal rules governing certain corporate law issues. A good example is the extent to which courts scrutinize the process by which managers' compensation is set. Rules that make it easier for managers to secure generous compensation regardless of their company's performance clearly weaken the disciplinary force of the market for managerial labor.

It is worth noting that although issues that directly affect the strength of market discipline are generally redistributive, they need not be *significantly* redistributive. For example, consider a rule that makes a takeover virtually impossible. Such a rule may reduce the value of a large company by two billion dollars while providing the managers with extra security worth only twenty million dollars.

With respect to all issues that directly implicate the strength of market discipline, managers making incorporation decisions may well seek rules that weaken this discipline even if these rules are value-decreasing. Consider, for example, whether managers would find attractive a state with a value-decreasing rule that impedes takeover bids and proxy contests. Even if managers recognized that this rule reduces share value, they may well prefer it. Recall that a major reason that managers care about share value is the market for corporate control; all other things being equal, any reduction in share value increases the probability of ouster in a takeover or proxy contest. But in the case of a rule that makes bids and contests more difficult, all other things are not equal. The direct effect of the rule in reducing the likelihood of ouster at any given stock price may be sufficiently significant so that, despite the accompanying reduction in share value, the probability of ouster with the rule will be substantially smaller than without it. To take an extreme case, consider a state law rule that completely insulates managers from tender offers and thereby reduces shareholder value. In considering the appeal of this rule, managers are unlikely to be deterred by the threat of a takeover. The rule will completely eliminate this very threat, and thus the likelihood of a takeover will be smaller with this value-decreasing rule than without it.

To examine this argument, suppose that Delaware's corporate law includes certain value-decreasing rules. As the analysis below will show, the shareholders of a given company may well approve a proposed move to Delaware despite the presence of these rules. First, the proposed move to Delaware may on the whole increase shareholder value. Second, even if the proposed move were harmful to shareholder value, shareholders may still approve it because they may have imperfect information about the consequences of the move. Third, even if shareholders were aware that the proposed move would decrease shareholder value, they may still vote for the move if the managers tied the move to another measure or course of action desired by shareholders.

1. *The Move May Increase Shareholder Value Overall.* — Suppose that Delaware's rule for the governance of a certain corporate law issue, *X*, is value-decreasing. Even assuming that shareholders are aware of the expected consequences of Delaware's rule with respect to *X*, the shareholders may prefer, and vote in favor of, a move to Delaware. For the shareholders may judge the effects of the move to be positive overall.

First, although Delaware's rule for the governance of *X* is value-decreasing, the rules Delaware offers with respect to some issues, which are insignificantly redistributive or non-redistributive, may well be superior to the rules offered by the company's current home state. As discussed above, state charter competition works well with respect to certain issues.¹¹⁹ The benefit to shareholders from Delaware's rules for the governance of these issues may outweigh the costs to shareholders of Delaware's rule for the governance of *X*.

In addition, as Roberta Romano's analysis has pointed out, Delaware's long domination of the state charter competition provides its corporate law with some attractive features that are independent of the substantive content of its corporate law rules.¹²⁰ These advantages include the availability of a large body of precedent as well as a specialized and experienced judiciary.¹²¹ Shareholders may rationally attach a value to these features, and this value may also contribute to a conclusion that, notwithstanding Delaware's value-decreasing rule with respect to *X*, the move to Delaware would be value-increasing on the whole.

Finally, it is important to note that Delaware's value-decreasing rule for the governance of *X* may be no different than the rule governing *X* in the company's home state. Indeed, because Delaware's dominant position in the state charter competition has produced wide-

¹¹⁹ See *supra* p. 1457.

¹²⁰ See *supra* pp. 1446-47.

¹²¹ See Romano, *supra* note 25, at 277-78; Romano, *supra* note 2, at 722.

them as beneficial or detrimental to shareholders.¹¹⁷ Antitakeover rules provide managers with direct benefits. And, as this section has shown, because such rules weaken the disciplinary force of the market for corporate control, market discipline can hardly be relied on to discourage managers from seeking these rules.

D. The Need for Shareholder Vote to Reincorporate

The analysis in sections B and C demonstrated that, despite the operation of market forces, managers may well prefer that their company be governed by certain value-decreasing rules. This conclusion by itself indicates that states, at least those states that are already successful in the charter competition, may well elect to provide these rules. For a state as successful in the charter competition as Delaware, retaining the companies it already has is of great importance. As explained earlier, a reincorporation requires a board decision, and managers thus have a veto power over their company's departure from its present state of incorporation. Thus, as long as the managers of Delaware companies are pleased with Delaware's corporate law, these companies will not migrate. Therefore, if the managers of Delaware companies prefer, despite the operation of market forces, a certain value-decreasing rule, Delaware will have an incentive to provide this rule.

In addition to retaining the companies a state already has, however, a state may be also interested in attracting more companies. In considering how to attract out-of-state companies, a state will know that making its law attractive to the managers of these companies may not be sufficient to bring in these companies. A reincorporation requires not only a board decision but also an approving vote by the company's shareholders.¹¹⁸ It may be argued that this need for shareholder approval can discourage states seeking to attract reincorporations of out-of-state companies from providing value-decreasing rules.

¹¹⁷ My personal view is that some common state law rules governing takeovers — in particular, those enabling certain defensive tactics — are harmful. I do believe, however, that control share acquisition statutes can be beneficial. My overall view with respect to state law rules governing takeovers is that they discourage takeovers more than is desirable for target shareholders. See Lucian A. Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1693, 1771-74 (1985); Lucian A. Bebchuk, *The Sole Owner Standard for Takeover Policy*, 17 J. LEGAL STUD. 197, 197-99 (1988).

¹¹⁸ Reincorporation requires shareholder approval because the usual reincorporation mechanism is a merger with a newly formed company incorporated in the destination state, see source cited *supra* note 87, and mergers must be approved by shareholders, see CLARK, *supra* note 3, § 10.2.4, at 416-17; see also 8 DEL. CODE ANN. § 251 (1991) (requiring shareholder approval for mergers).

Facing a vote on a proposed move to Delaware, the great majority of shareholders would rationally elect to remain ignorant about the expected consequences of the move. For any shareholder who holds a small stake in the company, the expected benefit of acquiring and processing information about the move is very small; the shareholder's own vote is highly unlikely to be pivotal to the vote's outcome and thus is highly unlikely to affect the shareholder's interests.¹²⁵ Because the expected benefit to individual shareholders of casting an educated vote is so small, shareholders lack sufficient incentives to acquire information about the effects of the proposed reincorporation.¹²⁶ Indeed, given the extremely small likelihood of casting a decisive vote, small shareholders will rationally decline to inform themselves even if they can do so at fairly minimal cost — say, by spending three hours reading proxy materials.¹²⁷

Indeed, small shareholders will likely remain uninformed even if, at the time of the vote on the proposed move, the company happens to have one or more large shareholders who do have a good assessment of the move's consequences. To start with, such large shareholders

note 17, at 1836–40 (discussing imperfect information as a problem for shareholder approval requirements).

¹²⁵ An individual shareholder's chance of casting the deciding vote is small even in the case of shareholders with such significant blocks as one or two percent of the company's stock. The probability of casting the deciding vote is obviously even smaller in the more common case of shareholders with insignificant holdings. See Gary Chamberlain & Michael Rothschild, *A Note on the Probability of Casting a Decisive Vote*, 25 J. ECON. THEORY 152, 152–53 (1981).

¹²⁶ The rational ignorance dimension of the voting mechanism may be described as a collective action problem. If an individual shareholder votes in an informed manner, then the expected outcome of the vote will be closer to the outcome that would have been obtained in the presence of perfect information. The benefits associated with a better outcome of the vote are enjoyed not only by the individual shareholder in question, but also by all other shareholders, yet the costs of acquiring and processing information are borne by the shareholder alone. Accordingly, the individual shareholder will underinvest in the acquisition and processing of information. For general discussions of the collective action problem that afflicts the voting mechanism, see ANTHONY DOWNS, *AN ECONOMIC THEORY OF DEMOCRACY* 208–16 (1957); ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY* (1970); and MANCUR OLSON, *THE LOGIC OF COLLECTIVE ACTION* 60–65 (2d ed. 1971). In the context of corporate voting, a shareholder's acquisition and processing of information is a public good and, like public goods generally, will be produced by private parties at a suboptimal level.

¹²⁷ It is worthwhile to note that the situation of a shareholder confronted with a corporate vote differs significantly from the situation of a shareholder considering an initial purchase of shares. While, as explained in the text, an individual shareholder's decision about how to vote is unlikely to affect the outcome of the vote and, accordingly, unlikely to affect the purchaser's interests, a potential purchaser's decision whether to buy shares is certain to affect the decision-maker's interests. Therefore, a potential purchaser has a much greater incentive to make an informed decision than a shareholder facing a corporate vote. In light of the distinction between a shareholder's decision about how to vote and a potential purchaser's decision whether to buy shares, even those who believe that shareholders will fully inform themselves before committing their money must still recognize the likelihood that shareholders may *vote* on the basis of imperfect information.

spread diffusion of its corporate law rules,¹²² it is likely (though by no means certain) that competing states have the same value-decreasing rule with respect to *X*. That is, state competition may well have produced an equilibrium in which not only Delaware but also the company's current home state, and possibly other states, all provide value-decreasing rules for the governance of *X*. In such an equilibrium, of course, shareholders' evaluation of a proposed move to Delaware would disregard Delaware's rule with respect to *X*.

It is important to emphasize that the shareholders' *overall* preference for Delaware, despite its value-decreasing treatment of *X*, does not imply that state charter competition produces generally optimal results. Consider first the case in which shareholders prefer the legal treatment of *X* in their company's home state to the value-decreasing treatment of *X* in Delaware but nevertheless approve a move to Delaware because Delaware's legal regime as a whole better serves their interests.¹²³ If state competition did not lead to Delaware's value-decreasing treatment of *X*, the shareholders would find reincorporation in Delaware even more attractive. Thus, if federal law governed *X* and applied a value-maximizing rule with respect to it, shareholders would be better off. For such a federal rule would in no way eliminate the benefits that make incorporation in Delaware attractive to shareholders in the first place.

Consider now the case in which the legal treatment of *X* in Delaware is identical to the legal treatment of *X* in the company's home state and in which shareholders prefer Delaware on independent grounds. Again, shareholders would find Delaware even more attractive if the legal treatment of *X* were not determined by a race for the bottom with respect to *X*. Governance of *X* by federal law would eliminate the adverse consequences of the race for the bottom forces and permit a movement away from the undesirable equilibrium in which many or all states have value-decreasing legal rules governing *X*.

2. *Shareholders May Be Imperfectly Informed.* — Even if a move to Delaware would, on the whole, reduce a given company's value, the company's shareholders may well vote to approve such a reincorporation. The shareholders are likely to vote in this way because, in contrast to the assumptions made thus far with respect to the shareholder approval process, shareholders may well be imperfectly informed about the consequences of reincorporation in Delaware.¹²⁴

¹²² See *supra* notes 32–33 and accompanying text.

¹²³ Delaware's legal regime as a whole may better serve the shareholders' interests either by virtue of its substantive provisions governing issues other than *X* or by virtue of Delaware's unique institutional features.

¹²⁴ For a discussion of the general problem of imperfect information in corporate voting, see CLARK, *supra* note 3, § 9.5, at 389–96; see also Bebchuk, *Limiting Contractual Freedom*, *supra*

issues, spanning all areas of the company's affairs. This complexity exacerbates the informational problems that are commonly present in shareholder voting.

3. *The Move May Be Tied to Another Measure.* — Finally, even if a proposed reincorporation would, on the whole, decrease a corporation's value and shareholders are aware of this consequence of the move, shareholders may nonetheless vote in favor of reincorporation. To obtain such approval, managers may use their control over the corporate agenda and the company's policy. In particular, managers may tie the reincorporation issue to some other matter, thus distorting shareholders' votes on the proposed reincorporation.¹³⁰

For example, management may couple the proposal, either explicitly or implicitly, with another measure or course of action that shareholders desire independently. Management also might threaten, explicitly or implicitly, to follow a course of action less desirable to shareholders if the proposed reincorporation is not approved. As long as such a tie or threat is credible and the overall package is more desirable to shareholders than the alternative, shareholders will rationally elect to vote in favor of the proposed reincorporation even if they know that the reincorporation by itself will be value-decreasing.¹³¹

4. *Conclusion.* — The preceding analysis shows that the requirement of shareholder approval for reincorporation proposals cannot be relied on to discourage managers from seeking — and states in turn from providing — value-decreasing rules with respect to certain corporate law issues. This conclusion, however, does not imply that the shareholder approval requirement serves no purpose. To the contrary, the requirement may establish some boundaries on how far Delaware (and other states) will go (and how far managers will want them to go) in providing value-decreasing rules. For our purposes, however, the important point is that, notwithstanding the requirement of shareholder approval, Delaware and other states have significant room (and incentives) to adopt value-decreasing rules for the governance of certain corporate law issues.¹³²

¹³⁰ The problem of distorted shareholder voting (in the context of approving dual class recapitalizations) has been analyzed in detail by Professor Gordon. See Jeffrey N. Gordon, *Ties that Bind: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 CAL. L. REV. 1, 39-60 (1988).

¹³¹ Market discipline cannot be relied upon to discourage managers from using their control over the corporate agenda and company policy to distort shareholders' votes on a proposed reincorporation that decreases shareholder value. The very fact that the reincorporation is formally proposed to shareholders despite its adverse effect on shareholder value indicates the existence of some shortcoming in market discipline. And the same factors that are behind this shortcoming are likely to impede the effectiveness of market discipline in inducing managers not to abuse their power in order to extract approval from shareholders.

¹³² Even after concluding that the approval requirement does not at present provide an

may well lack sufficient incentive to disseminate their information to other shareholders; they would bear all the costs of the dissemination even though its benefits would be shared by all shareholders. In addition, even if the large shareholders attempted to disseminate information to other shareholders, the dissemination would likely be ineffective. As explained above, small shareholders may well lack sufficient incentives even to read materials sent to them. Moreover, the anticipation that attempted dissemination would be ineffective would discourage the large shareholders from attempting it in the first place.¹²⁸

The informational problems discussed in the preceding paragraphs afflict not just votes on reincorporation proposals but shareholder voting generally.¹²⁹ The magnitude of these problems, however, appears to be especially large in the reincorporation context because of the substantial amount of information necessary to evaluate fully the complex consequences of reincorporation in a new state. The only cases in which shareholders become sufficiently informed to oppose management involve votes on proposals whose main consequences are fairly apparent, such as proposals to adopt antitakeover provisions. By contrast, assessing the merits of reincorporation in Delaware (or any other state) requires that shareholders consider a great variety of

¹²⁸ It may be argued that shareholders can inform themselves cheaply about the merits of a proposed reincorporation by observing the stock market reaction to the reincorporation proposal. This argument, however, is not valid. To start with, shareholders typically would have difficulty discerning the market's reaction to the proposed reincorporation. Movements in the market price of the company's stock in the wake of the proposal reflect not only the market's reaction to the proposal, but also the market's reaction to other information about the company, the industry, and the economy that becomes available at the time. Indeed, the proposal itself may well convey to the market important information about other developments concerning the company (such as future acquisitions) that are more significant than its proposed reincorporation. See Coffee, *supra* note 25, at 767-68; Romano, *supra* note 25, at 267 & n.58. See generally *supra* notes 59-60 and accompanying text (explaining the problems with inferring from stock market reactions the desirability to shareholders of reincorporation as distinguished from other events signalled by reincorporation). Thus, because movements in stock price reflect reactions to different types of information, shareholders may well be unable to draw reliable inferences from such movements about the merits of a proposed reincorporation.

Furthermore, the argument considered — that shareholders can rely on stock market reactions to inform themselves about the merits of a reincorporation proposal — is logically inconsistent. If proposals of value-decreasing reincorporations were generally accompanied by price drops and such price drops induced shareholders to reject reincorporation, then there would be no reason for price drops in the first place. That is, in a rational market, a price drop could accompany the proposal of a value-decreasing reincorporation only if shareholder approval of the reincorporation proposal were possible. In economic terminology, the case in which a proposal of a value-decreasing reincorporation is accompanied by a price drop and is subsequently rejected by shareholders (either as a result of the market decline or for other reasons) is not an equilibrium: price drops can occur in an equilibrium only if there is a positive probability that the proposal will receive shareholder approval.

¹²⁹ See Bebchuk, *Limiting Contractual Freedom*, *supra* note 17, at 1836-40.

ation decision is made. I now turn to the case in which a dominant shareholder is present. As explained below, when a company with a dominant shareholder makes a reincorporation decision, its managers may well seek, and states wishing to attract such a corporation will in turn provide, rules that transfer wealth from public shareholders to the controlling shareholder — even if these rules are value-decreasing.¹³³ Examples of rules that potentially involve such transfers are those rules that govern the allocation of opportunities between a parent and its subsidiary, and those rules that govern fiduciary duties and appraisal rights in going-private and parent-subsidiary freezeouts.

In a company with a dominant shareholder, that shareholder generally controls the selection of managers. Thus, in such a case managers have a strong incentive to make incorporation decisions that serve the interests of that shareholder. Neither market forces nor the requirement of shareholder approval will discourage the managers from serving the interests of the dominant shareholder. To start with, the presence of a dominant shareholder makes the shareholder approval requirement even less effective than in the case of a company without a dominant shareholder.¹³⁴ Often the controlling shareholder will be able to gain the necessary approval simply by voting its own shares. And even if the controller's own shares are insufficient in

manding supermajority requirement may put some shareholders in a position to block a reincorporation and thus give them an undesirable hold-up power.

Thus, what remains to be considered is the possibility of raising the decisive fraction of approving shareholders to some high level that is still reasonably below unanimity, for example, two-thirds or three-quarters. Such a requirement, however, would not effectively screen reincorporation proposals. Although such a requirement would probably enable the great majority of good reincorporations to take place, it could not be relied upon to prevent all bad reincorporations. As the analysis of this section has demonstrated, the great majority of shareholders, including institutional investors, do not have sufficient incentive to become well informed about the consequences of a proposed reincorporation. Thus, it may well be that not even as much as one-third or one-quarter of the shareholders of a company will become well informed about these consequences. The problem, in essence, is that there is no supermajority level that would be not so high as to make difficult the adoption of many good reincorporations yet at the same time high enough to ensure that the fraction of informed shareholders would be sufficient to prevent bad reincorporations. For the fraction of shareholders that would be well informed in a given reincorporation vote depends on various features of the company and the situation, and, accordingly, it cannot be specified in general or in advance.

In an earlier article, I analyzed in detail the difficulties in designing rules to improve the effectiveness of shareholder approval requirements. See Bebchuk, *Limiting Contractual Freedom*, *supra* note 17, at 1852–58. In addition to supermajority requirements, that analysis also demonstrated the ineffectiveness of appraisal rights. Although that analysis was explicitly concerned with shareholders' approval of charter amendments, the arguments it made largely apply also to the context of shareholders' approval of reincorporations.

¹³³ A rule that transfers wealth from public shareholders to the controller will reduce total shareholder value if the loss suffered by public shareholders exceeds the gain enjoyed by the controller.

¹³⁴ See Victor Brudney & Marvin A. Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297, 299–307 (1974).

E. Companies with a Dominant Shareholder

This Part has focused until now on companies that do not have a dominant shareholder at the time an (explicit or implicit) reincorporation

effective check on managers, it may be argued that the approval process is not inherently imperfect. In particular, it may be argued, the imperfections of the approval process could be remedied by adopting, possibly by federal law, regulations aimed at improving this process. An analysis of possible such regulations, however, indicates that it is very difficult to design regulations that would turn the approval requirement into an effective constraint. To illustrate this point, I discuss below two possible reform strategies.

Consider first the possibility of adopting disclosure requirements that would require managers to provide shareholders voting on a reincorporation with a great deal of information. To start with, recall that the analysis of this section identified three reasons why shareholders may approve a move to Delaware even if Delaware provides a value-decreasing rule with respect to a given issue. The considered disclosure requirements would have no effect with respect to two of these reasons — the possibility that the move is positive on the whole despite the value-decreasing rule, and the possibility that the managers will tie the reincorporation, at least implicitly, to another measure or policy. Thus, the disclosure requirements would aim only at one problem discussed in this section — the possibility of shareholders' being imperfectly informed about the consequences of the move to Delaware — and it is far from clear that the disclosures that regulations can mandate would do much to remedy this problem.

Indeed, following the existing general proxy rules, managers already provide shareholders voting on a reincorporation proposal with a great deal of "raw" information about the proposed move and the differences between the two states' corporate law systems. But providing shareholders with all the relevant raw facts can do little to solve the problem of imperfect information. Even with all these facts, a shareholder would not be able to form a judgment on whether the move is desirable on the whole without making a significant investment in evaluating and aggregating this information. And, for the reasons explained above, most shareholders would not have an incentive to do so. Finally, one may consider requiring managers to reveal to shareholders not all the relevant raw facts, but rather the conclusion that can be derived from them regarding whether the reincorporation would be desirable. But because there is generally no objective, indisputable answer to this question, such a requirement would be practically meaningless.

Consider next the possibility of imposing a supermajority requirement for a reincorporation. Again, such a regulation would have no effect with respect to two of the three reasons identified in this section regarding why shareholders may approve a reincorporation in Delaware even if Delaware has certain value-decreasing rules; such a regulation would, again, aim only at addressing the problem of shareholders' imperfect information. Some of the shareholders may have accurate information about the consequences of a proposed reincorporation, it may be argued, and a supermajority requirement would have the desirable effect of making the reincorporation depend on the approval of these informed shareholders.

Now a supermajority requirement can clearly make it more difficult to obtain shareholder approval of a reincorporation. But an effective approval requirement is not simply one that makes reincorporations in general more difficult. Reincorporations may be value-increasing (that is, "good") as well as value-decreasing (that is, "bad"). An effective approval process is one that screens incorporation proposals well, distinguishing good reincorporations from bad, and enabling the former while preventing the latter. Unfortunately, designing a supermajority requirement that would effectively serve such a screening function does not seem feasible.

To see this point, observe first that the presence of good reincorporations implies the clear undesirability of any supermajority requirement that is close to unanimity. Because many shareholders, aware of the very small effect of their vote, are unlikely to bother to participate in any corporate vote, a demanding supermajority requirement, say one of ninety percent, would make it quite difficult to have even a very desirable reincorporation. Moreover, such a de-

In a world with only initial incorporations, a state seeking to maximize local incorporations must make its corporate law attractive to those parties who control companies at the time that the companies first go public. Suppose that an entrepreneur has set up a company, wishes to sell the company's shares to public investors in a public offering, and now must choose the state in which the company will be incorporated at the time it goes public (and forever thereafter). What corporate law rules would such an entrepreneur seek and states thus have an incentive to provide? The answer depends upon the extent to which the price that the entrepreneur expects to obtain in the public offering of the company's shares accurately reflects the consequences of the corporate law rules governing the company.

To understand this point, suppose that the entrepreneur expects buyers of stock to be perfectly informed about all the consequences of the incorporation state's law. In this case, the entrepreneur will not wish to have any rule that is inefficient — even if the rule seems to provide the entrepreneur with some direct benefit. Suppose, for example, that the entrepreneur expects to manage the company after it goes public and that a certain rule concerning self-dealing would produce (relative to an alternative rule) a direct benefit of \$10 to the first manager but a reduction of \$20 in the company's value. Given that buyers of stock are aware of the consequences of the self-dealing rule, the entrepreneur can expect to obtain \$20 less for the company's shares than if the company were governed by the alternative rule. The entrepreneur's interest, therefore, would not be served by the self-dealing rule. Thus, as long as the price of shares sold in initial public offerings accurately reflects the consequences of any given corporate law rule, entrepreneurs will seek, and states will have incentives to offer, only value-increasing rules.¹³⁶

The logic of the above analysis also indicates, however, that if buyers of stock are imperfectly informed about the consequences of corporate law rules, the entrepreneur's interests may be best served by a rule that provides the entrepreneur with some direct benefit even if the rule is value-decreasing. Consider again the above example of a rule that produces a direct benefit of \$10 for the entrepreneur and imposes a loss of \$20 on the shareholders, and suppose now that potential buyers of stock are imperfectly informed and will assess the rule's cost to them at only \$5. In this case, the entrepreneur will

¹³⁶ Another way to see why entrepreneurs will seek efficient corporate law rules when pricing is accurate is to view the shares sold by the entrepreneur as a product, and to view each of the corporate law rules governing the company as a feature of this product. When the potential buyers of a product have complete information about each feature of the product, it will be in the producer's interest to make an efficient choice with respect to all of the product's features. Analogously, it will be in the entrepreneur's interest to seek efficient corporate law rules when potential purchasers are fully informed.

number, the controller's hold over the proxy machinery will usually enable it to gain easily the extra votes necessary to ensure approval.

Similarly, market forces can do very little to discourage the managers of a company with a controlling shareholder from seeking value-decreasing rules that transfer value to a controller. The market for corporate control exerts no disciplinary force because, with a dominant shareholder in place, takeover bids and proxy contests are not possible. Similarly, the managerial labor market will not discourage the managers from seeking such rules; in fact, the managers may well expect increased compensation and higher chances of being retained if they act in ways that serve the controller's interests. In sum, notwithstanding market forces and the shareholder approval requirement, managers of companies with a dominant shareholder may well seek, and states in turn may well provide, rules that transfer wealth from public shareholders to the controlling shareholder.

F. Initial Incorporation Decisions

Thus far, this Part has assumed that states focus solely on (explicit and implicit) incorporation decisions made subsequent to initial incorporation. I now introduce initial incorporation decisions into the analysis. By "initial incorporation decision" I mean the choice of the company's state of incorporation at the time the company first goes public.¹³⁵

I consider below whether the presence of initial incorporation decisions affects the validity of the preceding sections' conclusions. It is useful to proceed with this examination in two stages: first, to consider how state competition would work in a hypothetical world in which companies make only initial incorporation decisions; and second, to consider the case of a world such as ours, in which companies make both initial incorporation decisions and reincorporation decisions. The analysis shows that introducing initial incorporations does not change the basic conclusion that state competition works poorly with respect to certain corporate law issues.

1. A World with Only Initial Incorporations. — Consider a hypothetical world in which, because of legal or practical impediments to reincorporation, public companies make only initial incorporation decisions. In such a world, buyers of stock in a company's initial public offering can expect that the corporate law rules of the state in which the company is incorporated at present will govern the company forever.

¹³⁵ The company, of course, may have moved from state to state prior to going public. But incorporation decisions of close companies differ from those of public companies. See *supra* p. 1442.

Thus, even if all incorporation decisions were made before public companies first went public, state competition may well produce undesirable results with respect to some corporate law issues. But this is not the argument that I wish to stress. Instead, I turn now to show that, because companies in the real world also make reincorporation decisions, state competition works poorly in certain contexts regardless of the accuracy of stock prices in initial public offerings.

2. *A World with Both Initial Incorporations and Reincorporations.* — Consider now a world such as ours, in which companies make both initial incorporation decisions and reincorporation decisions. As the analysis of the preceding sections has shown, states that seek to attract reincorporations may well adopt value-decreasing rules with respect to a certain set of issues. Let us call this set *X*. As explained below, introducing initial incorporations into the analysis does not change the basic conclusion that state competition is likely to produce undesirable results with respect to the set *X* of issues.

Consider first the incentives of states, such as Delaware, that have enjoyed considerable success in the competition for corporate charters and that serve as domicile for many companies. As explained in the preliminary discussion of the centrality of reincorporations,¹³⁹ states such as Delaware are likely to focus on ensuring that their corporate law rules are attractive to those who make (explicit or implicit) reincorporation decisions. By focusing on such decisions, these states can hope not only to attract companies currently incorporated elsewhere, but also, perhaps more importantly, to retain the many companies currently incorporated in-state. The interest of these states in making their corporate law attractive to those making reincorporation decisions seems likely to outweigh their interest in making their law attractive to those making initial incorporation decisions. Thus, with respect to any issue, if such a state is forced to choose between a rule that would be attractive to those making reincorporation decisions and a rule that would be attractive to those making initial incorporation decisions, it would likely adopt the former rule.

It remains to consider, however, the incentives of those states that do not presently serve as domicile for many public companies. These states may of course focus on attracting reincorporating companies. But states that initially have very few in-state incorporations also may seek to increase the number of such incorporations by adopting a strategy of offering corporate law rules designed to attract initial incorporations. In particular, such a state, say Kansas, may seek to attract initial incorporations by adopting efficient rules with respect to the set of issues *X*. In this way, so the argument goes, Kansas

¹³⁹ See *supra* subsection II.A.1.

prefer the self-dealing rule to its value-maximizing alternative; for the rule will reduce by only \$5 the amount obtained for the shares sold in the public offering while yielding a direct benefit of \$10.

Thus, one's conclusions about the merits of state competition in a hypothetical world with only initial incorporations depend on one's view about whether the price at which shares are sold in a public offering accurately reflects the consequences of all the corporate law rules governing the company going public. This question is one on which commentators have different views. In the view of some commentators, stock prices reflect the consequences of all relevant corporate law rules.¹³⁷ To be sure, these commentators recognize that many buyers of stock rationally may elect not to study the various corporate law rules governing a company. But they believe that certain sophisticated players do engage in such activity and that various market mechanisms incorporate these players' information into prices. Thus, when examining the case of a world with only initial incorporations, commentators who hold this view would conclude that there is no basis for concern that opportunism on the part of those taking companies public would prevent state competition from working well.

Other commentators, however, believe that the price of stock in initial public offerings may well fail to reflect accurately the consequences of all the corporate law rules governing a company.¹³⁸ Although these commentators agree that market mechanisms improve the accuracy of prices, they believe that such mechanisms are not sufficiently effective to ensure the accurate pricing of every corporate law rule. Consequently, even when considering a hypothetical world with only initial incorporations, these commentators still would find a basis for concern about the consequences of state competition. In particular, they would be concerned that opportunism on the part of those parties that take companies public would lead states to adopt rules that favor these parties even when such rules are value-decreasing.

¹³⁷ See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1430-32.

¹³⁸ See, e.g., LUCIAN A. BEBCHUK, FREEDOM OF CONTRACT AND THE CORPORATION: AN ESSAY ON THE MANDATORY ROLE OF CORPORATE LAW 50-62 (Harvard Program in Law and Economics Discussion Paper No. 46, 1988); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1411-27 (1985); Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703, 1718-19, 1730-31 (1989); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1676-77 (1989); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1516-18 (1989); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1569-73 (1989).

Delaware. Indeed, if the strategy of Kansas is successful and attracts many initial incorporations, a later shift to Delaware-like rules is precisely what is likely to occur. Once Kansas has chartered many corporations, it will have an incentive to focus on — or at least pay significant attention to — ensuring that these corporations remain chartered in Kansas.¹⁴⁴

The above discussion assumes that companies initially incorporated in Kansas would have the option of reincorporating elsewhere later on. Without such an option, buyers of stock in a Kansas company would expect the company to be governed forever by efficient rules with respect to the set of issues *X*; they would neither expect that the company might later migrate nor fear that Kansas, wary of such potential migration, might abandon its value-maximizing rules. Thus, what remains to be considered is the possibility that Kansas, as part of its strategy, would adopt rules that eliminate companies initially incorporated in Kansas from reincorporating elsewhere. But while the adoption of a rule that prohibits migration would eliminate certain problems, it would create others. Most importantly, under such a rule companies would not be able to migrate to other states for “good” reasons as well as “bad.” In particular, initial incorporators thus will have reason to fear that, once enough companies are incorporated in Kansas with no way out, Kansas may take advantage of them, say by greatly increasing franchise taxes. Therefore, the adoption by Kansas of a rule that prohibits reincorporation elsewhere would not accomplish the goal of attracting initial incorporations.¹⁴⁵

Thus, whether or not the prices obtained in public offerings accurately reflect the consequences of the governing corporate law rules, the introduction of initial incorporations into the analysis does not change the basic conclusions of the preceding sections. As a result of the possible divergence between shareholders’ interests and the interests of those making incorporation decisions, state competition is likely to produce undesirable results with respect to a significant set of issues.

G. Conclusion: Managers’ Opportunism and the Shortcomings of State Competition

This Part has identified several types of issues with respect to which state competition is likely to produce value-decreasing rules.

¹⁴⁴ Only a strategy that is not expected to attract many public companies to Kansas could allay the rational fear that, once successful, Kansas would have an interest in changing course. But a strategy that is not expected to attract many companies would not be worth undertaking.

¹⁴⁵ Moreover, for a rule that prohibits migration to be effective, it must be accompanied by substantial limits on the freedom of Kansas companies to merge with out-of-state companies. Otherwise, the prohibition on reincorporation could be easily circumvented by a Kansas company merging into, say, a much smaller Delaware corporation. The necessary limits on the freedom to merge may well involve significant costs.

would be able to attract a significant fraction of the initial incorporations taking place. Over time, Kansas would become home to many public companies, and these companies would be governed by efficient rules with respect to the set of issues *X*.

It should be pointed out at the outset that, for such a strategy to have a chance of succeeding, the price in initial public offerings of Kansas companies must reflect the value of the efficient rules offered by Kansas. Now note that the Kansas rules are likely to be "innovative" by virtue of their departure from the familiar rules that Delaware and other states with many in-state incorporations offer. And there are reasons to believe that the pricing of "innovative" rules is especially likely to be inaccurate.¹⁴⁰ But in any event, let us grant that buyers of stock would be perfectly informed about the rules offered by Kansas. As explained below, even under this strong assumption, it is far from clear that the considered strategy would work.

To start with, even if Kansas offers efficient rules with respect to the set of issues *X*, Delaware law may still, on the whole, be better for shareholders and thus more attractive to initial incorporators. First, as discussed earlier, Delaware is likely to offer efficient rules with respect to issues that do not belong to the set *X*.¹⁴¹ Furthermore, even if Kansas imitates all of the rules provided by Delaware with respect to issues that do not belong to the set *X*, Delaware still offers certain significant advantages such as a substantial body of precedents and an experienced judiciary.¹⁴²

More importantly, buyers of stock in the initial public offering of a Kansas company will not expect the company to be governed forever by the efficient rules that Kansas now offers with respect to the set of issues *X*. Accordingly, they will substantially discount the value that they attach to the fact that these efficient rules now govern the company. The buyers will have such expectations for two reasons. First, although the company is now incorporated in Kansas, it later may reincorporate in some other state, such as Delaware.¹⁴³ Second, Kansas may, at some later point in time, replace its current value-maximizing rules for the governance of *X* with the rules in force in

¹⁴⁰ See Gordon, *supra* note 138, at 1569-73. Gordon argues that investors will view innovations with suspicion and therefore tend to draw negative inferences from departures from prevailing corporate law rules. Consequently, investors will pay less for the stock of companies governed by innovative arrangements. See *id.*

¹⁴¹ See *supra* subsection II.D.1.

¹⁴² See *supra* subsection I.B.3.

¹⁴³ The fact that a reincorporation would require a vote of shareholder approval does not eliminate this possibility. Managers may be able to obtain the required approval even if the move to Delaware would be value-decreasing. This may result from the problem of uninformed voting, see *supra* subsection II.D.2, or from the problem of distorted voting (as a result of the managers' coupling the reincorporation proposal with some other measure), see *supra* subsection II.D.3.

III. STATE COMPETITION AND EXTERNALITIES

This Part describes the ways in which — and the issues with respect to which — state charter competition leads to socially undesirable results in the presence of externalities. To focus on the problems resulting from the presence of externalities, it will be useful to ignore in this Part the agency problems on which Part II focused. To this end, I assume that companies' managers have only the shareholders' interests in mind. In this case, managers making incorporation decisions will seek corporate law rules that maximize shareholder value, and states seeking to attract incorporations will provide such rules. When externalities are present, however, rules that maximize shareholder value may well diverge from the socially desirable ones.

A. The Externality Problem

Consider a given corporate law issue that implicates not only the interests of shareholders, but also those of third parties.¹⁴⁸ From the perspective of efficiency, the socially desirable rule is the one that maximizes the aggregate wealth of society's members.¹⁴⁹ Accordingly, because interests other than those of shareholders are involved in the choice of the legal rule governing the considered issue, these interests must be taken into account in arriving at the socially optimal rule. But shareholders, managers, and entrepreneurs who seek to maximize shareholder value will ignore these interests in evaluating corporate law rules. Consequently, if states seek to attract incorporations by offering rules that enhance shareholder value, the offered rules may well differ from the socially desirable ones. In particular, the rules produced by state competition will be systematically less favorable to non-shareholder parties than the socially desirable ones.

Note the difference in this regard between federal and state law. If a rule is designed at the federal level, it is possible that officials shaping this rule will take into account the interests of parties other than shareholders. But if the rule is designed by the states, then the competition among them will lead state law officials to exclude consideration of such interests. This powerful, structural bias against the

poorly with respect to the identified issues, one might oppose federal intervention if one believed that these other shortcomings would be so severe that the federal law process would perform even worse than state competition. Section V.A therefore discusses the possible imperfections of the federal law process, and explains the reasons for my view that, with respect to the identified issues, the federal process would perform better than state competition.

¹⁴⁸ For a discussion of the general problem of externalities in corporate law, see Bebchuk, *Foreword*, *supra* note 17, at 1405–06.

¹⁴⁹ This definition of efficiency is standard in economic analysis of law. See, e.g., A. MITCHELL POLINSKY, *AN INTRODUCTION TO LAW AND ECONOMICS* 7–10 (1983). For discussions of the normative premises and problems with this definition, see, for example, *Symposium on Efficiency as a Legal Concern*, 8 *HOFSTRA L. REV.* 485 (1980).

First, state competition is likely to work poorly with respect to issues that are significantly redistributive, including self-dealing, taking of corporate opportunities, and insider trading. Second, state competition may well produce undesirable results with respect to issues that directly implicate the strength of market discipline, including the regulation of corporate takeovers and proxy contests. Third, state competition is likely to produce value-decreasing rules for the governance of issues that involve potential transfers between public shareholders and a dominant shareholder, including going-private freezeouts, parent-subsidiary mergers, and the allocation of opportunities between parent companies and subsidiaries.

With respect to all of these issues, state competition can be expected systematically to produce rules that favor managers and dominant shareholders more than would the value-maximizing rules. This conclusion in no way depends on a direct assessment of the merits of Delaware's or other states' law governing these issues. It simply follows from a recognition of the structural forces at work in the state charter competition.¹⁴⁶

The identified shortcomings of state competition suggest that it may be desirable to constrain this competition with respect to the issues identified above. That is, it may be desirable to subject these issues to federal rules or at least to federal minimum standards. For the identified structural distortions would not be in play in the federal lawmaking process.

Federal law already governs some of the identified issues. In particular, federal law currently regulates insider trading and aspects of takeover bids and proxy contests. But some of the identified issues are not governed by federal law. Consequently, the analysis of this Part suggests that we should consider the possibility of a significant expansion of federal law. Most importantly, we should consider expanding federal law to govern — or at least set minimum standards for — managers' fiduciary duties, the fiduciary duties of controlling shareholders in freezeouts and allocation of opportunities, and the various aspects of takeover bids and proxy contests now governed by state law.¹⁴⁷

¹⁴⁶ Note that the conclusion is not that, in the identified contexts, state competition necessarily produces rules that sacrifice to the greatest conceivable extent the interests of public shareholders in favor of the interests of managers and dominant shareholders. Some state law rules may be so value-decreasing that market constraints or the need for shareholder approval would effectively prevent their adoption. Alternatively, fear of federal intervention may dissuade states from adopting extremely value-decreasing corporate law rules. *See supra* notes 75–77 and accompanying text. My conclusion is simply that, in certain contexts, state competition likely produces legal rules that sacrifice maximization of shareholder value for wealth transfers to managers and dominant shareholders.

¹⁴⁷ While the federal law process would not suffer from the identified distortions, it may have other shortcomings. Thus, even after recognizing that state competition is likely to perform

over bid or a proxy contest not only affects the interests of the target's shareholders, but also confers benefits on those seeking to acquire control. If rules governing takeovers and contests are designed solely to serve shareholders' interests, however, potential benefits to bidders and challengers will not be taken into account.¹⁵⁰

The externality associated with takeover bids was first analyzed by Sanford Grossman and Oliver Hart.¹⁵¹ The success of a takeover bid generally provides some gains to the bidder. Thus, because rules governing takeover bids influence the likelihood that a given bid will succeed, the design of these rules clearly affects not only the interests of target shareholders, but also the interests of bidders. When states design takeover rules, they will tend to disregard the externality identified by Grossman and Hart. Accordingly, such state corporate law will tend systematically to facilitate bids to a lesser degree than is socially desirable.¹⁵²

Turning now to proxy contests, Marcel Kahan and I have pointed out the externality implicated by such contests: success in a proxy

¹⁵⁰ To be sure, certain effects on bidders and challengers may be desirable to shareholders and, accordingly, may be reflected in legal rules designed to serve shareholders' interests. For example, rules that benefit bidders and challengers may help shareholders by inducing bidders and challengers to perform monitoring roles that are valuable to shareholders. The point, however, is that the effects of legal rules on bidders and challengers get no independent weight in a calculus aimed solely at serving shareholders' interests, but would receive independent weight in a calculus aimed at maximizing aggregate social wealth.

¹⁵¹ See Sanford J. Grossman & Oliver D. Hart, *Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation*, 11 *BELL J. ECON.* 42, 42-43 (1980).

¹⁵² While Grossman and Hart's article analyzes third-party benefits to bidders from legal rules that facilitate takeover bids, Frank Easterbrook and Daniel Fischel argue that such rules confer third-party benefits also on others. See Easterbrook & Fischel, *supra* note 137, at 1438; Easterbrook & Fischel, *supra* note 46, at 1176-77. They argue that rules that facilitate takeovers of certain companies benefit other potential targets because such rules encourage search activity by potential bidders. Increased search activity benefits all companies that may be subject to this search both because its presence disciplines managers and because it may lead to a premium offer by a bidder.

I do not find Easterbrook and Fischel's argument persuasive. A state law arrangement that facilitates takeovers of certain companies (or, indeed, a charter provision providing for such an arrangement) will increase search activity by potential bidders only with respect to the group of companies governed by the arrangement. Easterbrook and Fischel's argument appears to assume that potential bidders cannot tell prior to studying a target whether the target is governed by the takeover-facilitating arrangement and that bidders will thus devote equal attention to companies governed by the arrangement and companies not governed by the arrangement. But if the takeover-facilitating arrangement is adopted by state law (or by a charter provision), potential bidders should be able to identify in advance and at minimal cost the companies governed by the arrangement. In particular, if the arrangement is adopted by state law, the bidder would need only to determine the state of incorporation of any company that it considers studying. Thus, a potential bidder would engage in significant search activity only if a company were in fact governed by the takeover-facilitating arrangement. It follows that the fact that a given company is governed by such an arrangement would not confer a positive externality on companies not governed by the arrangement.

consideration of such interests is absent from the federal lawmaking process.

The difference between federal and state law follows from the fact that state corporate law, unlike federal law, does not govern a company unless the company chooses to incorporate in-state. Suppose that a state considers shaping a corporate law rule to take into account the interests of parties other than shareholders. Such a strategy may lead companies to migrate to other, more shareholder-friendly domiciles. In the end, the state may both lose its incorporations and fail to achieve any protection of third parties' interests. The fundamental difference between federal and state law is this: if the former provides protection to parties other than shareholders, shareholders cannot easily avoid its reach, whereas if the latter does so, they can.

It is worth emphasizing that the claim here is not that state law is designed in general without attention to externalities, only that state corporate law is designed in this way. While a state's corporate law applies only to those companies that elect to be incorporated in the state, other bodies of state law may well apply to all business operations that take place in the state and that impose externalities on the state's citizens. When a state designs consumer law, tort law, or employment law to govern operations conducted within the state, it will likely pay attention to the effects of the adopted rules on the state's consumers, potential tort victims, and employees. But the state in these cases can do so without fear that companies will be able to avoid the adopted rules while continuing their operations within the state. By contrast, companies can — simply by reincorporating elsewhere, without any change in their operations — completely avoid their state's corporate law rules.

Thus, there can be no question that, in the presence of externalities, state competition may produce undesirable results. The important question, however, is whether this problem is significant in a practical sense. The problem's significance depends on the pervasiveness and severity of externalities in corporate law. Some may question whether corporate law issues involve significant externalities; in particular, they may argue that non-shareholder parties are well protected by bodies of law other than corporate law or by privately adopted contractual rules. As explained in the following section, however, certain important areas of corporate law do implicate significant externalities.

B. Corporate Law Issues that Involve Significant Externalities

1. *Regulation of Takeover Bids and Proxy Contests.* — The legal rules governing takeover bids and proxy contests are an important element of corporate law. As explained below, the success of a take-

2. *Protection of Creditors.* — Let us now turn to corporate law rules governing the relationship between a company and its creditors. Clearly, if a corporate law rule can be designed to transfer value from creditors to shareholders, then shareholders may well find the rule attractive even if it is inefficient (that is, produces a gain to the shareholders that is smaller than the creditors' loss). Therefore, to the extent that rules affecting creditors are left to state law, the concern arises that state competition will produce inefficient rules that diverge systematically from the socially desirable ones in ways that are unfavorable to creditors.

To be sure, it may be argued that state corporate law will not provide rules that are harmful to creditors — that is, rules that transfer value from creditors to shareholders — because creditors are able to protect themselves contractually. Lenders, so the argument goes, will anticipate the effects of state law rules and will charge an appropriate interest rate. Thus, such rules cannot be used by shareholders to transfer value from creditors. And since any efficiency costs associated with such rules will ultimately be borne by shareholders, shareholders will never want to have inefficient rules even if the rules seem to (but actually do not) benefit them at the expense of creditors.

Not all creditors, however, can protect themselves contractually against the adverse consequences of state law rules.¹⁵⁵ For one thing, there are involuntary creditors such as tort victims. Because these creditors do not become creditors as a result of voluntary decisions to enter into contracts with the company, they cannot protect themselves by adjusting the interest rate or some other contractual term. In addition, there are some voluntary, contractual creditors that cannot protect themselves against the adverse consequences of corporate law rules. The transactions of these creditors with a company may be

may not prevent some takeovers that would impose substantial negative externalities (but are not resisted by incumbent managers).

If one considers the negative externalities created by control transfers to be a serious problem, then one should seek legal rules that discourage takeovers that create such externalities (rather than rules that discourage takeovers resisted by incumbent managers). While an examination of how such rules may be designed is beyond the scope of this Article, it should be clear that states generally have no incentive to develop and adopt such rules as part of their state corporate law. If one were to believe that such rules are indeed desirable, then one's only hope would be that such rules would be provided by federal law or by bodies of state law other than state corporate law (that is, by bodies of state law that apply not to companies incorporated in the state but to companies operating within the state).

¹⁵⁵ See Henry B. Hansmann & Reinier Kraakman, *Toward Unlimited Shareholder Liability for Corporate Torts*, 100 YALE L.J. 1879, 1920 (1991) (noting that some classes of creditors cannot arrange for ex ante compensation for bearing the risks associated with the limited liability of corporations).

battle confers benefits on the challenger.¹⁵³ Again, state law rules designed to serve shareholders' interests will not take these benefits into account. Accordingly, the rules provided by states with respect to proxy contests will tend systematically to favor incumbents and discourage control challenges relative to the socially desirable rules.

Thus, this Article's analysis has identified two distinct reasons for why, to the extent that takeover bids and proxy challenges are governed by state corporate law, state rules will tend to facilitate such bids and challenges less than is socially desirable. First, as Part II demonstrated, because managers have substantial influence on incorporation decisions and because takeovers and proxy contests affect managers' private interests, states have incentives to provide rules that facilitate takeover bids and proxy contests less than is desirable to target shareholders. Second, as this section has pointed out, the rules that are desirable to target shareholders are themselves ones that facilitate takeover bids and proxy contests less than is socially desirable. Therefore, both the manager-shareholder agency problem and the externality problem push in the same direction, driving states to provide rules that discourage bids and contests more than is socially desirable. Thus, the case for federal regulation of all aspects of takeover bids and proxy contests appears to be very strong.¹⁵⁴

¹⁵³ See Lucian A. Bebchuk & Marcel Kahan, *A Framework for Analyzing Legal Policy Toward Proxy Contests*, 78 CAL. L. REV. 1073, 1089-95 (1990).

¹⁵⁴ Some may argue that the impediments erected by state corporate law to transfers of control (by takeovers or by proxy contests) are desirable because of the negative externalities imposed by transfers of control. While the discussion above has focused on the positive externalities that control transfers confer on those who obtain control, it may be argued that such transfers may also involve negative externalities. In particular, it may be argued that some transfers of control may impose externalities on consumers (for example, when a takeover creates increased market power), on workers (for example, when a takeover results in dismissals), on communities (for example, when a takeover leads to relocation of headquarters) and so on. Because transfers of control create such externalities, so the argument goes, they might be undesirable even if they benefitted the shareholders of the target and the acquirer. Therefore, the state corporate law rules that impede takeovers and proxy contest would be desirable.

Note that this argument does not assume that, in adopting rules that discourage takeovers (and proxy contests), state law officials are motivated by the negative externalities created by takeovers. Indeed, as we have seen, state law officials are unlikely to take externalities into account when designing corporate law rules. Rather, granting that state law officials adopt rules discouraging takeovers in order to protect managers, the argument is that the adopted rules are nonetheless desirable because they reduce the negative externalities produced by transfers of control.

I find this argument in favor of state corporate law impediments to takeovers and proxy contests unconvincing. State competition leads state law officials to adopt rules that impede takeovers in general or either those takeovers resisted by incumbent managers. These rules are a very poor means of addressing the negative externalities produced by control transfers. Negative externalities do not arise in the case of all takeovers, and whether or not they arise is not correlated with whether or not the takeover is resisted by incumbent managers. Thus, the state corporate law rules may prevent beneficial takeovers that do not impose any negative externalities (but nonetheless are resisted by managers for some self-serving reason), and they

Furthermore, a company's disclosure may benefit other companies with overlapping lines of business by facilitating comparison across firms.¹⁶¹ Finally, investment by a disclosing company in the development and use of an optimal disclosure format has a positive externality effect on companies generally, because it enables these companies to communicate information more effectively to their own investors.¹⁶²

A system of state law regulation of corporate disclosure cannot achieve optimal disclosure rules because states competing to attract incorporations have no reason to take into account the externality effects of the disclosure rules they adopt. The existence of positive externalities associated with disclosure implies that state law governance of disclosure would tend systematically to result in suboptimal disclosure levels and formats.

4. *Protection of Constituencies Other than Providers of Capital.* — A classic question in the theory of corporate law is whether a corporation's managers should ever exercise their discretion to further the interests of constituencies other than providers of capital. This question has often been debated under the rubric of corporate social responsibility.¹⁶³ Corporate social responsibility may include attention to constituencies such as workers, communities, and consumers, and to goals such as preservation of the environment.¹⁶⁴ Indeed, the corporate law of some countries provides workers with certain formal

enable rival companies to attract investors without having to bear all the costs of providing information to such investors. See CLARK, *supra* note 3, § 17.5, at 759; Easterbrook & Fischel, *supra* note 159, at 685, 686.

¹⁶¹ See Easterbrook & Fischel, *supra* note 159, at 686. The argument is that, to the extent that the company reveals comparative information, it confers third-party benefits on companies in the same line of business by enabling them to free-ride on their competitor's disclosure of this information to investors. See *id.*; see also CLARK, *supra* note 3, § 17.5, at 759 (arguing that the production of comparative information about firms implicates positive externality effects).

In both the case in which companies benefit from a given company's provision of comparative information and the case in which firms benefit from a given company's provision of information generally, the less companies in the industry differ, the greater the positive spillover associated with the company's disclosure. See Easterbrook & Fischel, *supra* note 159, at 686. Of course, the greater the spillover associated with the above disclosure, the greater the externality effects implicated by disclosure regulation.

¹⁶² See Easterbrook & Fischel, *supra* note 159, at 686–87; see also Michael J. Fishman & Kathleen M. Hagerty, *The Optimal Amount of Discretion to Allow in Disclosure*, 105 Q.J. ECON. 427, 439–40 (1990) (concluding that their formal model of information disclosure provides support for the proposition that the specification of disclosure formats benefits companies generally).

¹⁶³ See, e.g., CLARK, *supra* note 3, § 16.1–4, at 675–703; David L. Engel, *An Approach to Corporate Social Responsibility*, 32 STAN. L. REV. 1, 5–11 (1979).

¹⁶⁴ See generally RALPH NADER, MARK GREEN & JOEL SELIGMAN, *TAMING THE GIANT CORPORATION* (1976) (arguing that corporations should be made more responsive to society's needs).

sufficiently small in value to make it difficult, given the informational and transactional costs involved, to adjust the terms of trade to counteract the state law rules governing the company. Because these two groups of creditors are unable to protect themselves contractually, it is possible to design corporate law rules that transfer value from these creditors to shareholders. And states would have an incentive to offer precisely such rules.

To illustrate this general point, consider the rules that govern the amount of dividends that companies may pay out to shareholders. When a company does not have "enough" capital, a payment of dividends may transfer to the shareholders some of the capital that would be otherwise used to pay debtholders. Regulation of corporate dividend policy is an important corporate law issue and traditionally has been accomplished by state law.¹⁵⁶ As is well recognized, the limits on dividends established by state law are generally so weak and ineffectual as to have virtually no practical significance.¹⁵⁷ To be sure, companies often agree to much stricter limitations on their dividend policy as part of their contracts with banks and bondholders.¹⁵⁸ But why does state law not go somewhat in that direction and establish some basic meaningful limits on dividend payments? This Article suggests a simple answer: because companies are free to choose their states of incorporation (and thus the state corporate law that governs them), states have an incentive to offer shareholders rules that impose practically no significant restrictions on the payment of dividends.

3. *Regulation of Corporate Disclosure.* — Disclosure of information by a given public company may well confer significant benefits on other companies. Consequently, if the regulation of such disclosure were left to the states, states would likely adopt rules that produce substantially less disclosure than is socially desirable.

Easterbrook and Fischel have identified the externality effects associated with corporate disclosure.¹⁵⁹ To start with, a company's revelation of information may confer benefits not only on the company itself (by enabling it to attract investors), but also on competitors.¹⁶⁰

¹⁵⁶ See CLARK, *supra* note 3, § 2.5, at 86 (describing state corporate law dividend statutes); *id.* § 14.3, at 610–24 (same).

¹⁵⁷ See, e.g., *id.* § 2.5, at 87–88.

¹⁵⁸ See *id.* § 2.5, at 88; Clifford W. Smith, Jr. & Jerold B. Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117, 131–136 (1979) (discussing the nature and frequency of contractual restrictions on dividend payments).

¹⁵⁹ See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 669–87 (1984).

¹⁶⁰ See *id.* at 685; see also CLARK, *supra* note 3, § 17.5, at 758–59 (discussing third-party effects of disclosure on a company's competitors). A company's disclosure of information helps its rivals whenever the disclosure reveals something about the company's ability to compete or about the industry in which it operates, because such information is useful to rivals in planning their own operations. See Easterbrook & Fischel, *supra* note 159, at 685. Disclosure may also

holder constituencies.¹⁷⁰ These statutes, however, are largely directed at managers considering the use of defensive tactics in the face of hostile takeover bids,¹⁷¹ and they generally permit managers (rather than require them) to take various constituencies' interests into account.¹⁷² Because meaningful judicial review of managerial decision-making is virtually impossible when the spectrum of permissible decision factors includes interests that are not easily verifiable or quantifiable, the primary effect of these constituency statutes is simply to enhance managers' discretion in responding to hostile takeover bids. Accordingly, the constituency statutes should be understood not as measures to safeguard these constituencies' interests but rather as instruments by which managers can block hostile takeovers. Thus, the adoption of the statutes is best explained on the grounds that Part II described — the managerial role in incorporation decisionmaking leads states to provide rules that unduly discourage takeovers.

5. *Positive Externalities from Standardization?* — Up to this point, this Part has focused on externalities that arise in connection with specific areas of corporate law. This section now considers a general externality argument that may be made for having any given corporate law issue governed at the federal level. A regime in which all companies are subject to the same standard rules may be thought preferable to one in which they are subject to a multitude of different rules. Making a given company subject to a standard rule may confer benefits on other companies subject to that rule. For parties that deal with the former company may become familiar with the rule and thus face lower information costs when dealing with such other companies. Furthermore, parties dealing with these other companies will have more precedents on which to rely. Thus, it may be argued, there is a benefit from having federal law govern all corporate law issues, not only those issues that present special reason to suspect that state competition fails with respect to them.¹⁷³

This general externality argument, however, does not appear to be sufficiently weighty to justify an expansion of federal law beyond the specific corporate law areas in which state competition is likely to

¹⁷⁰ See, e.g., ILL. REV. STAT. ch. 32, para. 8.85 (1989); IND. CODE § 23-1-35-1(d) (1988); OHIO REV. CODE ANN. § 1701.59(E) (Baldwin 1991).

¹⁷¹ For example, although the Indiana constituency statute on its face applies to managers' decisionmaking generally, the language of the statute makes clear that its purpose is to allow managers to defend against hostile takeovers. See IND. CODE § 23-1-35-1(f) (1988).

¹⁷² See, e.g., IND. CODE § 23-1-35-1(d) (1988).

¹⁷³ The positive externality produced by the adoption of "standard" rules is noted by Gordon. See Gordon, *supra* note 138, at 1567-69. Charny systematically analyzes this externality and views it as a consideration that should be given significant weight in delineating the limits on state competition. See Charny, *supra* note 16, at 442-445. My judgment on the weight that should be accorded to this consideration differs from Charny's for the reasons described below.

rights to participate in corporate governance and thus ensures that managerial decisions will be attentive to at least one constituency other than providers of capital.¹⁶⁵

State corporate law in this country, however, has traditionally taken the position that the managers' duty is to serve shareholders' interests — specifically, the maximization of long-run profits. The classic statement of this position is *Dodge v. Ford Motor Co.*,¹⁶⁶ which held that a business corporation is organized and carried on primarily for the profit of the stockholders and that managers cannot devote themselves to "a general purpose and plan to benefit mankind."¹⁶⁷

In this Article, I do not wish to examine or take a position on the substantive merits of the question whether managers should serve constituencies other than providers of capital. I grant that the most efficient legal rule may be one that requires managers to serve only shareholders' interests and leaves the protection of other constituencies to non-corporate bodies of law such as antitrust law, consumer protection law, and employment law. The resolution of this question requires a full-fledged analysis of managerial monitoring and incentives under alternative regimes and is therefore beyond the scope of this Article.¹⁶⁸ What I wish to stress, however, is that the decision about the appropriate goal of managers should be made at the federal level rather than at the state level. For even if the socially desirable rule were one that required managers to take into account the interests of constituencies other than providers of capital, state law would be unlikely to provide such a rule. Those that make incorporation decisions would not want to have such a rule, and states competing to attract incorporations would thus have an incentive not to provide such a rule, even if it were socially desirable.¹⁶⁹

To be sure, several states have in recent years passed constituency statutes that enable the consideration of the interests of non-share-

¹⁶⁵ For example, under Germany's codetermination system, workers in large firms participate equally with providers of capital in electing representatives to the firm's board of directors. See Henry Hansmann, *When Does Worker Ownership Work? ESOPs, Law Firms, Codetermination, and Economic Democracy*, 99 *YALE L.J.* 1749, 1803 (1990).

¹⁶⁶ 170 N.W. 668 (Mich. 1919).

¹⁶⁷ See *id.* at 684. Indeed, several states have even limited the purpose for which shareholders may review corporate records to the long-run maximization of share value. See CLARK, *supra* note 3, § 3.1, at 100, 102-104.

¹⁶⁸ For an analysis of the implications for managerial monitoring and incentives of managers' responsibility to groups other than providers of capital, see Henry Hansmann, *Ownership of the Firm*, 4 *J.L. ECON. & ORG.* 267, 281-301 (1988).

¹⁶⁹ See REPORT OF THE CORPORATION LAW REVISION COMMISSION OF NEW JERSEY, N.J. STAT. ANN. § 14A, at x-xi (1969), reprinted in Cary, *supra* note 10, at 666 (stating that any attempt to provide protection to employees, customers, and the general public through state incorporation acts would "drive corporations to more hospitable jurisdictions").

structural distortion, which leads states to disregard the third-party effects of their corporate law rules, would not be present in the federal lawmaking process.

This general conclusion can be used to evaluate the existing balance between state and federal corporate law. Federal involvement is at present greatest in the area of disclosure. Federal law largely governs the disclosure of information by and with respect to public companies.¹⁷⁸ The analysis of this Part suggests that the substantial role federal law plays in disclosure regulation may well be warranted.

Takeovers, proxy contests, and creditor protection are now governed by a combination of federal and state law. The federal involvement is significant. In particular, the Williams Act regulates the behavior of bidders,¹⁷⁹ the Securities and Exchange Act of 1934 regulates proxy contests,¹⁸⁰ and the Bankruptcy Act provides rules that protect the interests of creditors in corporate bankruptcy.¹⁸¹ Major aspects of these areas, however, are governed by state corporate law. In particular, state law governs the fiduciary duties of managers in the face of a takeover bid; it also governs important aspects of proxy contests, such as the reimbursement of campaign expenses and the access by challengers to the list of shareholders. Similarly, state corporate law governs significant aspects of the relationship between a company and its creditors, such as limitations on dividend payments. The analysis of this Part suggests that it may well be desirable to adopt federal law rules — or at least federal minimum standards — with respect to all of these issues.

Finally, state law now decides (and gives a negative answer to) the question whether corporate managers have a fiduciary duty toward, and must take into account the interests of, constituencies other than providers of capital. The analysis of this Part suggests that it may well be desirable for this question to be answered at the federal rather than the state level. To be sure, requiring managers to focus on shareholders' interests may be the socially desirable rule and the one that federal law officials would adopt. But it may well be desirable for the governing rule to be determined by a federal lawmaking process — which would potentially take into account the full social consequences of alternative rules — rather than by a state lawmaking process which is structurally biased in favor of shareholders' and managers' interests.¹⁸²

¹⁷⁸ See, e.g., Easterbrook & Fischel, *supra* note 159, at 669–70.

¹⁷⁹ See CLARK, *supra* note 3, § 13.3–4, at 546–68.

¹⁸⁰ See *id.* § 9.2, at 366–74.

¹⁸¹ See 11 U.S.C.A. §§ 101–1330 (West 1979 & Supp. 1992) (codifying the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549, as amended).

¹⁸² Again, even after recognizing that state competition may well produce socially undesirable rules with respect to the identified issues, one might oppose federal intervention if one believed

produce inefficient rules. To start with, although positive externalities from standardization do undoubtedly exist in theory, their size is likely to be quite limited. For those issues with respect to which structural problems of managerial opportunism and externalities do not exist, the positive externalities of standardization seem smaller than the benefits of having states compete to supply the best rules.¹⁷⁴

Furthermore, and more importantly, state law governance of a given issue does not imply foregoing the benefits of standardized corporate law rules. For the way in which state competition works — and has worked — is not that American companies are governed by fifty totally different sets of corporate law rules. Rather, a substantial fraction of these companies is subject to the rules established by the most successful state, Delaware. Moreover, with respect to most corporate law issues, companies incorporated outside of Delaware are likely to be subject to the same or similar rules; for other states often move in the same direction as Delaware, either responding to the same structural incentives or simply following Delaware's lead.¹⁷⁵ Thus, state competition, as it has thus far operated, is consistent with realizing most of the benefits of standardization.¹⁷⁶ As Dean Bayless Manning put it, “[W]e now have a national corporate law — Delaware law.”¹⁷⁷

C. Conclusion: Externalities and the Shortcomings of State Competition

This Part has shown that state competition may well produce socially undesirable results whenever a corporate law issue involves significant externalities. Furthermore, the analysis has identified several areas of corporate law that involve such significant externalities — the regulation of takeovers and proxy contests, the protection of creditors, disclosure regulation, and the protection of constituencies other than providers of capital. Because of the presence of significant externality effects, it may well be desirable to have federal decision-making about the legal rules governing these areas. For the identified

¹⁷⁴ Indeed, the benefits from standardization seem to be much larger with respect to the construction of many technical products, such as VCRs and certain types of communication and computer systems, than with respect to the construction of corporate law rules. Nevertheless, the magnitude of the benefits from standardization in the case of these technical products has not been thought to be substantial enough to warrant limiting competition between suppliers of these products.

¹⁷⁵ See *supra* notes 32–33 and accompanying text.

¹⁷⁶ To stress again a point made earlier, the problem with state competition is not the lack of a standard rule but the likelihood that the standard rule will differ — with respect to certain corporate issues — from the rule that is socially desirable.

¹⁷⁷ Bayless Manning, *State Competition: Panel Response*, 8 CARDOZO L. REV. 779, 783 (1987).

cient to check such managerial behavior with respect to certain corporate law issues.¹⁸⁷ The second argument in support of mandatory rules is based on the presence of externalities. In particular, it has been argued that mandatory rules are necessary to prevent companies from adopting opt-out provisions that impose negative externalities on other parties and that are consequently socially undesirable.¹⁸⁸

These arguments roughly parallel the arguments that this Article has developed in favor of limiting state competition. The parallelism is no mere coincidence. Rather, it follows from the logical connection between the state competition and contractual freedom questions. Both questions turn on whether, in the presence of agency relationships and externalities, companies¹⁸⁹ should be able to choose among different legal rules for the governance of their affairs.¹⁹⁰

When an issue is subjected to state law, with states free to offer different rules, the issue essentially is not subject to mandatory legal treatment — even if states do not allow companies incorporated in-state to opt out of the state law rule governing this issue. Consider an issue governed by state law, and suppose that each of the fifty states imposes a mandatory legal rule with respect to the issue. In an important sense, companies do have an ability to opt out. By reincorporating, companies can opt out of the rule in their home state and replace it with any one of the rules offered by the other states. To be sure, companies do not have the unlimited choice they would have if they were allowed to adopt opt-out charter provisions. But companies may still have some choice. And, more importantly, the existing choices offered by states would probably include the very rules that companies would wish to have. Because states compete to attract incorporations, some state would likely provide (as a mandatory rule for companies incorporated in-state) the very rule that companies would tend to adopt if they were free to make their own rules; for this would make the state more attractive to those making incorporation decisions.

Thus, logical consistency requires that one's view on the desirability of contractual freedom with respect to a given issue inform one's view on the merits of having state corporate law govern this issue. Suppose one holds the view that companies should not be allowed to

¹⁸⁷ See Bebchuk, *Limiting Contractual Freedom*, *supra* note 17, at 1835-47.

¹⁸⁸ For an overview and evaluation of this argument, see Bebchuk, *Foreword*, *supra* note 17, at 1405-06.

¹⁸⁹ Throughout this Part, the term "companies" refers to the parties — shareholders or managers — that effectively control corporate decisions in a given context.

¹⁹⁰ The contractual freedom question turns on whether companies should be able to choose between the (default) rule of their home state and alternative arrangements, and the state charter competition question turns on whether companies should be able to choose among the laws of different states.

IV. STATE COMPETITION AND CONTRACTUAL FREEDOM: CONNECTING THE DEBATES

Alongside the state competition question, another basic question in corporate law is that of contractual freedom: to what extent should companies be allowed to opt out of corporate law rules (established either by state or federal law) by adopting charter provisions to that effect? This longstanding question has in recent years been the subject of lively debate,¹⁸³ culminating in a symposium issue of the *Columbia Law Review*.¹⁸⁴ The aim of this Part is to show how the state competition and contractual freedom questions are logically interconnected.¹⁸⁵ In particular, I suggest that those who support mandatory rules with respect to some corporate law issues, as most scholars of corporate law do,¹⁸⁶ cannot consistently support state regulation of these issues.

In the contractual freedom debate, two main arguments have been advanced in support of placing limits on opting out by companies. The first argument is that, if opting out is permitted, managers may propose, and shareholders approve, certain midstream charter amendments that will reduce shareholder value but serve managers' private interests. In particular, I have argued that market forces are insuffi-

that the federal process would perform even worse as a result of some other shortcomings. For the reasons discussed in section V.A below, my own view is that the federal process would perform better than state competition with respect to the identified issues.

¹⁸³ See, e.g., RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 372 (3d ed. 1986); Bebchuk, *Limiting Contractual Freedom*, *supra* note 17, at 1820-25; Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403, 1443-44 (1985); Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 861-66 (1983); Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55 (John W. Pratt & Richard J. Zeckhauser eds., 1985); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 923-25 (1988); Easterbrook & Fischel, *supra* note 12, at 401-02; Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 698 (1982); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261-65 (1982); Jonathan R. Macey, *From Fairness to Contract: The New Direction of the Rules Against Insider Trading*, 13 HOFSTRA L. REV. 9, 39-47 (1984).

¹⁸⁴ See Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395 (1989). The symposium contains articles both in support of contractual freedom, see Easterbrook & Fischel, *supra* note 137, and in opposition to the view that companies should be generally free to opt out of corporate law rules, see Robert C. Clark, *Contracts, Elites, and Traditions in the Making of Corporate Law*, 89 COLUM. L. REV. 1703 (1989); Coffee, *supra* note 138; Eisenberg, *supra* note 138; Gordon, *supra* note 138. For an overview of the debate over the desirability of contractual freedom, see Bebchuk, *Foreword*, *supra* note 17.

¹⁸⁵ The value of connecting the state competition and contractual freedom debates is also discussed in Charny, *supra* note 16, at 425-26, 437-38.

¹⁸⁶ Even Easterbrook and Fischel, the leading proponents of contractual freedom, support mandatory rules prohibiting defensive tactics designed to ward off hostile takeovers. See Easterbrook & Fischel, *supra* note 137, at 1436-42.

in particular, they endorse mandatory rules with respect to the important case of takeover bid regulation because takeover bids have externality effects.¹⁹² Easterbrook and Fischel, however, have expressed broad support for state charter competition and the corporate law rules that it produces.¹⁹³ But, for the reasons explained above, if mandatory rules for the governance of takeover defensive tactics are desirable because of the externality effects associated with takeover bids, then state competition is also likely to produce undesirable rules with respect to these issues. Accordingly, Easterbrook and Fischel should support, as they have not done, governance by federal law of managerial fiduciary duties in the face of takeover bids.¹⁹⁴

Consider now those commentators who, unlike their free-market counterparts, do support mandatory rules for a wide range of corporate issues, including many of the most important ones.¹⁹⁵ Most of these commentators still seem to accept the current dominance of state law in the governance of corporate affairs.¹⁹⁶ The analysis of this Part suggests, however, that these commentators should reconsider their views on the desirable balance between state and federal corporate law.

V. SOME NOTES ON FEDERAL INTERVENTION

This Part discusses issues that arise when one considers the possibility of expanding the federal role in corporate law to address the identified shortcomings of state competition. Section V.A considers the possible imperfections of the federal law process and explains the reasons for my belief that this process would perform better than the state law regime with respect to the issues identified by the analysis. Section V.B discusses the implications of international charter competition for a program of federal regulation.

¹⁹² See *id.* at 1437-39 (noting that mandatory rules may be justified in the presence of externalities and that the regulation of takeover bids implicates externality effects); see also Easterbrook & Fischel, *supra* note 46, at 1176-77 (describing the negative externality effect of managerial resistance to takeover bids).

¹⁹³ See Easterbrook & Fischel, *supra* note 12, at 398, 427; Fischel, *supra* note 12, at 919-20.

¹⁹⁴ Indeed, had Easterbrook carried his recognition that the regulation of takeovers implicates externality effects to its logical conclusion, he would not have been as puzzled by states' adoption of antitakeover rules as he was in *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F.2d 496 (7th Cir.), *cert. denied*, 493 U.S. 955 (1989). See *supra* notes 115-116 and accompanying text. For if one believes that takeovers create positive externalities, then one should expect states to provide rules that discourage takeovers to a greater degree than is socially desirable.

¹⁹⁵ See, e.g., Coffee, *supra* note 138, at 1690; Eisenberg, *supra* note 138, at 1524; Gordon, *supra* note 138, at 1597-98.

¹⁹⁶ See, e.g., Gordon, *supra* note 138, at 1552.

opt out of the legal rule governing a certain issue. Then one must believe that, due to the presence of managerial opportunism or externalities, contractual freedom with respect to this issue would produce value-decreasing rules. But then one would also have a strong reason to be concerned about having the issue governed by state law. For, by the analysis of Parts II and III, the problems of managerial opportunism and externalities imply that state competition, like contractual freedom, will produce socially undesirable rules.

The interconnection of the state competition and contractual freedom questions can perhaps be best expressed by stating that there is an inherent tension, or even contradiction, in any view that supports a mandatory state rule. By and large, issues should be governed either by a state rule from which companies are free to opt out or by a mandatory federal rule. This choice is the one that must be addressed squarely with respect to any corporate law issue.

The connection between the state competition and contractual freedom questions can be illustrated further by considering what may be termed the enforcement dimension of mandatory state rules. As already pointed out, the presence of state competition reduces the effectiveness of a mandatory state rule. Indeed, skepticism may be expressed about the value of mandatory state corporate law rules on the grounds that state competition presents an insurmountable enforcement problem for such rules. But this skepticism assumes that we are wedded to a regime in which state law governs the issues with respect to which mandatory rules are thought to be appropriate. The concern about the enforceability of mandatory state rules poses no problem for the view put forward in this Article — that it is desirable, and perfectly consistent, to impose limits on both contractual freedom and state competition.

The logical connection between questions of state competition and contractual freedom requires many commentators to reconsider their previously expressed views of state competition. While most commentators endorse mandatory rules for the governance of some corporate law issues, there is widespread support for the dominant role of states in the governance of corporate affairs. The analysis of this Part, however, suggests that commentators who support mandatory rules with respect to certain issues must reexamine whether they wish to support (as many of them have done in the past) governance of these issues by state rather than federal law.

Consider first commentators with free-market views, such as Frank Easterbrook and Daniel Fischel. While Easterbrook and Fischel view contractual freedom as generally desirable,¹⁹¹ they do believe that corporate law rules should be mandatory with respect to certain issues;

¹⁹¹ See Easterbrook & Fischel, *supra* note 137, at 1446.

suffer from the structural biases that afflict the performance of state competition with respect to the identified issues. As we have seen, states have an interest in making their laws attractive to those making incorporation decisions, and this interest introduces two structural biases. First, with respect to issues that involve managerial opportunism, states have an incentive to make themselves attractive to managers and dominant shareholders, and states therefore may well provide rules that benefit managers and dominant shareholders even if the rules are value-decreasing. Second, with respect to issues that involve externalities, states have an incentive to disregard the interests of parties other than managers and shareholders, and this disregard may well lead states to adopt value-decreasing rules that systematically disfavor the third parties upon whom externalities are imposed. Because federal law officials would not be affected by incorporation decisions in the same way that state law officials are, the federal law process would not suffer from the above two structural biases.

Thus, for one still to oppose federal rules with respect to the identified issues, one must believe that the federal law process would suffer from some other shortcomings, and, moreover, that these shortcomings would be so severe that they would outweigh the advantage of eliminating the two significant biases that afflict state competition. Below, I briefly discuss and evaluate the two main imperfections that may be involved in the federal law process.

1. *Errors Due to Lack of Information or Effort.* — Suppose initially that federal law officials would all be well-meaning in that they would prefer to adopt the socially desirable rules over some other rules. It may still be argued that the federal law process would fail because federal law officials would generally err in identifying the socially desirable rules. As noted earlier, in a state law regime, the incorporation decisions of companies provide state law officials with information, whereas, under a federal law system, officials would not be able to get information from this mechanism.¹⁹⁹ Also, in a state law regime, the fear of visible failure in the form of corporate migration may discipline officials, whereas federal law officials may lack such a competitive pressure to do their best.²⁰⁰ Therefore, so the argument goes, because federal officials would lack information and incentives to exert effort, they would frequently err in identifying the socially desirable rules — and consequently would perform poorly — even if they were all well-meaning and wanted to adopt only socially desirable rules.

But, supposing federal law officials would generally be well-meaning and would want to adopt only socially desirable rules, the prob-

¹⁹⁹ See *supra* p. 1457.

²⁰⁰ See *id.*

A. Would Federal Law Do Even Worse?

Most of this Article is devoted to analyzing the shortcomings of state competition, and the main contribution that this Article seeks to make is the identification of the areas in which state competition is likely to work poorly. Gaining such an understanding of the shortcomings of state competition is valuable regardless of the normative implications, if any, that one draws from the analysis. Regardless of how flawed state competition is with respect to the identified issues, some may believe that federal law would perform even worse with respect to these issues and that state competition should therefore be left unconstrained. But even those holding this view should know the ways in which state competition fails. An understanding of the shortcomings of state competition is necessary for the formation of an accurate picture of the performance of our corporate law system, and scholars of corporate law should have such a picture.

For one thing, the race for the top view implies that state corporate law rules should be considered as presumptively efficient,¹⁹⁷ and scholars subscribing to this view have applied such a presumption in evaluating the desirability of various existing and alternative rules.¹⁹⁸ As the analysis of this Article has demonstrated, however, a presumption of efficiency is quite inappropriate for the rules produced by state competition with respect to many issues. Indeed, with respect to the issues identified by the analysis, one should treat the rules produced by state competition not with deference but rather, on the contrary, with caution and with alertness to the possibility that the rules are distorted by the structural biases resulting from managerial opportunism and externalities.

My own view, however, is that the conclusions reached regarding the shortcomings of state competition do have normative implications. In particular, I believe that we would be better off having federal law govern the identified issues and that federal law, though imperfect, would likely perform better than state competition with respect to these issues. While a full analysis of the possible imperfections of the federal process is beyond the scope of this Article, I wish to explain briefly the basis for my view that the federal law process would likely perform better.

In evaluating the relative performance of the federal law process, the best starting point is the observation that this process does not

¹⁹⁷ See sources cited *supra* note 45.

¹⁹⁸ See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 STAN. L. REV. 857, 860 (1983) (arguing that the fact that states did not prohibit insider trading prior to the enactment of the federal securities laws is evidence of the efficiency of allowing insider trading); Easterbrook & Fischel, *supra* note 12, at 397-98 (using the presumption that state competition yields efficient corporate law rules in analyzing corporate voting rules).

maximizing rules. But it may be argued that federal law officials sometimes may instead seek rules serving some special interest groups. To be sure, federal law officials would not be concerned about incorporation decisions and thus would not be affected by the distorting biases that afflict state competition. But it may be claimed that the decisions of such officials would be subject to some other distorting biases and, in particular, to those resulting from the pressures and efforts of interest groups. The critical question, then, is whether the influence of interest groups is likely to distort the federal law process so much that it would perform even worse than state competition with respect to the identified issues. In examining this question, it is useful to discuss separately those corporate law issues that involve managerial opportunism and those that involve externalities.

(a) *Issues Involving Managerial Opportunism.* — As we have seen, with respect to issues involving a sufficiently severe problem of managerial opportunism, state competition may well produce inefficient rules that favor managers (and dominant shareholders). The argument that needs to be examined is that, because of lobbying by managers' interest groups (as well as those of dominant shareholders), the federal law process would produce rules that are even worse.²⁰³

I do not find this argument convincing. To start with, managers (and dominant shareholders) can also lobby state law officials. Indeed, there are some reasons to believe that the lobbying power of manager interest groups relative to that of public shareholder interest groups is stronger on the state level than on the federal level.²⁰⁴ And, even if this is not the case, it is hard to see why this relative power would be weaker on the state level than on the federal level.²⁰⁵

More important, in a state competition regime, even if managers (and dominant shareholders) engage in no lobbying, they will still

²⁰³ In theory, it is also possible to raise the argument that interest groups of public shareholders would seek to get from federal law officials some value-decreasing rules that would nonetheless benefit public shareholders at the expense of managers and dominant shareholders. But public shareholders would generally be quite unlikely to benefit from value-decreasing rules and thus would generally not have any interest in pushing to have such rules adopted.

²⁰⁴ See Romano, *supra* note 47, at 133, 145. Romano argues that lobbyists can have greater influence on legislators when resource and staffing constraints make it difficult for legislators to gather information independently. See *id.* at 133. Romano concludes that both her study of the experience of one state (Connecticut) and a regression analysis of states' experience in the aggregate provide support for the proposition that lobbying by manager interest groups can be most effective in small states with part-time legislatures. See *id.* at 133-34, 145.

²⁰⁵ In evaluating the lobbying power of managers' interest groups on the state level, one should be careful not to draw inferences from the amount of existing lobbying. Given that the dynamics of state competition already provide states with powerful incentives to adopt rules favorable to managers, there is commonly little reason or need for managers to lobby state decisionmakers. In those instances in which managers want a state to adopt a rule that it has not yet provided, they may well have ample ability to lobby for it. See Romano, *supra* note 47, at 123-24.

lems of information and effort hardly imply that federal law officials would perform worse with respect to the identified issues than state law officials. Even if federal law officials had less information overall and exerted less effort, the critical point is that, unlike state law officials, they would not be putting whatever information and willingness to work they would have in the service of the wrong objective. With respect to the identified issues, the rules desired by those who make incorporation decisions — and the rules that state law officials therefore seek to provide — may well differ from the socially desirable rules. As far as getting close to the set of socially desirable rules is concerned, we may well be better off with officials who would shoot relatively inaccurately at the right target than with officials who would shoot with somewhat greater accuracy but at another, wrong target.²⁰¹

To be sure, if federal law officials were to shoot totally in the dark — if they had no clue about what the socially desirable rules are — then their interest in hitting the right target would provide us with little cause for celebration. But if one is not so pessimistic about the information that federal law officials would have and the effort that they would exert — and I am not — then the possibility that these officials may make some errors should not lead one to conclude that they would perform worse than state law officials with respect to the identified issues.²⁰²

2. *Lobbying by Interest Groups.* — The above discussion — regarding the possibility that federal law officials may err in identifying the socially desirable rules — assumed that these officials would be well-meaning and would want to adopt only socially desirable, value-

²⁰¹ Alternatively stated, the point is that, with respect to the identified issues, the fact that incorporation decisions provide state law officials with information and pressure to make an effort hardly provides a reason for preferring that these officials — rather than federal law officials — make the choice. The information provided by incorporation decisions merely helps state law officials identify the rules that are desired by those who make incorporation decisions. Similarly, the competitive pressure exerted by incorporation decisions merely induces state law officials to make a greater effort to identify the rules desired by those who make incorporation decisions. Thus, both factors make state law officials more likely to provide the rules that are desired by those who make incorporation decisions. But this conclusion provides little reason to prefer that state law officials choose rules with respect to the identified issues. For the identified issues are exactly those with respect to which those who make incorporation decisions may well prefer rules that differ from the socially desirable ones.

²⁰² It is worth noting that our past experience with the SEC does not provide us with a basis for a pessimistic belief that federal law officials would lack information and the willingness to exert effort. Although observers may differ in their views about the rules that the SEC has produced over the years, I believe that few would claim that SEC officials have generally acted with little information and with a lack of zeal. Indeed, the possibility of having federal rules produced by a specialized and active federal agency may lead some to believe that, in fact, federal law officials can draw on more overall information and deploy more human resources than state law officials. Cf. Romano, *supra* note 47, at 133 & n.57 (suggesting that because state law officials have limited resources and limited staffs to devote to information gathering and processing, they are especially susceptible to lobbying).

(b) *Issues Involving Externalities.* — Some of the issues now governed by state corporate law affect not only the shareholders and managers of the governed company, but also other parties, such as creditors, potential acquirers of control, rival companies, workers, and so forth. As we have seen, with respect to issues involving such externalities, states have an incentive to disregard the interests of third parties and to provide protection to such interests only if such protection happens to be in the interest of shareholders and managers. While federal law officials would not face such an incentive to disregard the interests of third parties, the question is whether such officials may nonetheless perform even worse than their state law counterparts because of the influence of various interest groups.

A worse performance of the federal law process with respect to issues involving externalities cannot result from lobbying by manager and shareholder interest groups. Because states already have an incentive to give weight only to the interests of shareholders and managers, lobbying by shareholders and managers by definition cannot lead the federal law process to give even more weight to these interests. Thus, the only possibility that needs to be considered is that the worse performance of the federal law process would result from lobbying by the non-shareholder groups affected by the relevant issues. To the extent that the lobbying power of such groups is not too strong relative to that of shareholders and managers, their lobbying would do no more than ensure that federal law officials would take into account the interests of these groups, which would likely be desirable. Thus, to oppose federal rules for issues affecting non-shareholder groups, one would have to believe that the lobbying power of such groups would be so strong relative to that of shareholders and managers that federal law officials would distort their rules in favor of these non-shareholder groups. Moreover, one would also have to believe that this distortion would be so severe that it would be worse than the existing distortion of state corporate law against these non-shareholder groups.

I have identified in Part III four corporate law areas that involve significant externalities — the protection accorded to creditors, disclosure regulation, the regulation of control contests, and corporate social responsibility. I doubt that critics of federal law would make the

Ltd. Partnership v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988), was not reversed — which it subsequently was by the Delaware Supreme Court, *see* Paramount Communications, Inc. v. Time Inc., 571 A.2d 1140 (Del. 1990) — it may be in the interests of clients to migrate out of Delaware). Other impediments to takeovers may have resulted not from any active lobbying, but rather from the general distortion of state corporate law in favor of managers. In any event, although the development of takeover regulation in the last two decades does not provide a decisive proof, it does seem to support the hypothesis that managers' interests are likely to have a weaker influence on the federal law process than on the state law process.

benefit from the substantial, structural bias in their favor introduced by the dynamics of state competition. Given Delaware's interest in making its law attractive to managers and dominant shareholders, officials of Delaware who are well-meaning — that is, ones who seek only to advance Delaware's interests and who pay no attention to the activities of interest groups — would still give great weight to the interests of managers; for state competition already builds the interests of these parties and dominant shareholders into Delaware's interest. It is for this reason that manager interest groups do not engage in frequent, active lobbying activity in Delaware;²⁰⁶ while they do not lack the ability to do so, the dynamics of state competition make it unnecessary for them to do so.

By contrast, on the federal level, the lobbying efforts of managers (and dominant shareholders) would not be made against the background of such a distorted baseline. Federal law officials who are well-meaning — that is, ones who only seek to do their job right and pay no attention to the efforts of interest groups — would not aim at an objective with a built-in focus on the interests of managers and dominant shareholders. Thus, whereas managers and dominant shareholders do not need to lobby at all to have state law officials focus on their interests, they would need to engage in significant lobbying efforts to distort the federal process in their favor. At most, if the power of managers' interest groups on the federal level would be overwhelming relative to that of public shareholders' interest groups, the former would do as well under the federal process as under the state competition regime. Otherwise, managers' interests (and dominant shareholders' interests) are likely to have weaker influence overall on the federal law process than on the state law process.²⁰⁷

²⁰⁶ See Alva, *supra* note 4, at 917–18. According to Alva, the only time that significant lobbying took place with respect to Delaware corporate law legislation was in connection with the enactment of Delaware's antitakeover statute. See *id.* at 904.

²⁰⁷ In examining the issue just discussed, it may also be useful to compare how federal and state law have performed with respect to takeover regulation in the last two decades. Although various groups have pushed for federal regulation that would discourage takeovers, Congress has not gone beyond the Williams Act. Thus, federal law officials have not provided the significant impediments to takeovers that incumbent managers would have liked. But states have gone beyond the Williams Act and have adopted several generations of antitakeover statutes. See Romano, *supra* note 47, at 113–14. And state fiduciary duty law has enabled incumbent managers to use powerful defensive tactics. See, e.g., *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1154–55 (Del. 1990).

Some of the impediments to takeovers erected by states have been the result of active lobbying by incumbent managers and those acting on their behalf. See Romano, *supra* note 47, at 133–34, 136–37 (describing how management interest groups engaged in lobbying to get antitakeover statutes enacted); see also Letter from Marty Lipton, Partner, Wachtell, Lipton, Rosen & Katz, to Clients (November 3, 1988) (on file at the Harvard Law School Library) (suggesting that if the *Interco* decision of the Delaware Chancery court, see *City Capital Assoc.*

we attach significance to the question whether a state or a federal process is better for regulating a given issue, we presumably lack confidence or agreement concerning what constitutes the best rule. When we lack confidence or agreement about the identity of the socially desirable rule, we seek to choose that process which would be most likely to produce this rule. It is precisely this kind of inquiry that the analysis of this Article seeks to inform.²¹⁰

B. International Charter Competition

Thus far I have limited my discussion to charter competition among states within the United States (or some other federal system). But companies raising capital or operating in the United States may also have the option of incorporating (or reincorporating) in another country. Thus, even if state competition in the United States is constrained, some international charter competition will remain. The effectiveness of this competition will depend on the extent to which companies incorporated outside of the United States will face an economic disadvantage (relative to companies incorporated within the United States) when raising capital or operating in the United States.²¹¹

with respect to the issue anyway — even if such a rule were not desirable — would not be bothersome to someone who believed that such a rule is indeed desirable.

²¹⁰ Finally, it is worth considering another fault that critics of federal law may put forward — the possibility of a “disaster.” Above, I considered the two main imperfections of the federal law process — errors in identifying the socially desirable rules and distortions resulting from the influence of interest groups — and I explained why in my view these imperfections are unlikely to lead to worse results with respect to the identified issues than the state process. But it may be argued that, even assuming that these imperfections are smaller in magnitude than those of the state law process on an *expected value basis*, the worst case scenario under the federal law regime is more worrisome. With a state law regime, so the argument goes, there is a certain lower bound on how bad state corporate law can become; if for some reason Delaware law became quite bad, companies would have a way out. But with respect to federal law, it may be asserted, there would be the possibility of a disastrous state of the law with companies having nowhere to go.

I do not find this disaster scenario sufficiently real to undermine my support for federal rules with respect to the identified issues. As should be clear, the problem of potential disaster is not an independent problem, but rather one that depends on one's evaluation of the problems of errors and interest groups. In particular, the disaster scenario should affect one's position only if one is sufficiently pessimistic about the potential severity of these two problems, and for the reasons explained in this section, I am not.

In deciding whether to be pessimistic about the possibility of a disaster, one may wish to consider the experience we have had with federal corporate law rules thus far. We have had a substantial body of federal corporate law for sixty years. Although opinions may differ on the overall quality of this body of law, in my view it is very hard to see anything in this experience that reinforces the plausibility of the disaster scenario.

²¹¹ The international charter competition is not as effective as the state charter competition because, whereas companies incorporated in one state can operate in any other state without any significant disadvantage, companies incorporated abroad may face such a disadvantage

above argument with respect to the first three areas. We already have federal regulation of some aspects of these three areas, and whether or not one believes that the federal rules are desirable, I doubt that critics would claim that the rules are severely distorted in favor of the affected non-shareholder groups (say, creditors in the area of protection accorded to creditors) and against shareholders and managers.

But my guess is that some may well raise the considered argument in opposing federal regulation of the question of corporate social responsibility — that is, whether managers should use their discretion to advance the interests of constituencies other than shareholders. Critics may well oppose resolution of this issue by federal law on grounds that lobbying by groups of workers, consumers, environmentalists, and so forth would lead to the adoption of rules that would produce an inefficient scheme of corporate governance.

It seems to me that such an objection to federal resolution of the corporate social responsibility issue would be based largely on a strongly held view with respect to what the best substantive rule for this issue is. In other words, the opposition to federal resolution would not be based on a judgment that, because the power of non-shareholder groups would be so much greater than that of shareholders and managers, the federal law process would be more distorted than the existing state process. Rather, the opposition would likely be based on an a priori view that the optimal rule is one that directs managers to focus generally on shareholders' interests (leaving the protection of other constituencies to bodies of law other than corporate law). If one believes this to be the desirable rule, then one will surely support state resolution of this issue, for state competition can be relied on to produce this rule, and thus there is only something to lose and nothing to gain from a federal law resolution. The fact that state competition would likely produce this rule even if it were not socially desirable would not bother someone who is confident that this rule is in fact the socially desirable one.²⁰⁸

The above point can be stated in a more general form. If one is confident that a certain rule is desirable for a given issue, and if state competition provides this rule with respect to this issue, then by definition one will have no reason to want federal regulation of this issue, no matter how flawed the state process is.²⁰⁹ Thus, whenever

²⁰⁸ My own view is that the rule directing managers to focus on shareholders' interests is likely to be the optimal rule. But I do not have sufficient confidence in this judgment to oppose resolution of this issue by the federal law process.

²⁰⁹ For example, suppose that one believes that (i) state competition is distorted in favor of managers, and (ii) the optimal rule with respect to a certain issue involving managerial opportunism is a lax rule currently provided by state competition. Then one would have no reason to support federal regulation of this issue, despite one's view that the state law process is distorted in favor of managers. The fact that state competition would produce this lax rule

VI. CONCLUSION

This Article has developed an analytical framework for identifying the corporate law issues with respect to which state charter competition is likely to work poorly. One major source of the shortcomings of state competition is the possible divergence between the interests of managers and controlling shareholders and the interests of public shareholders. Notwithstanding market forces and the need for shareholder approval to reincorporate, there are many issues with respect to which managers may well seek, and states in turn may well provide, rules that do not maximize shareholder value but rather serve the private interests of managers and controlling shareholders. In particular, the analysis has shown that state competition is likely to produce undesirable results with respect to issues that are significantly redistributive, issues that directly affect the strength of market discipline, and issues that involve potential transfers from public shareholders to a controlling shareholder.

The second major source of the shortcomings of state competition is the presence of externalities. Because states seeking to attract incorporations have an incentive to focus on the interests of shareholders and managers, they will tend to ignore the interests of other parties. As a result, state competition may well produce undesirable rules whenever significant externalities are present. Because of this externality problem, state competition cannot be relied upon to produce socially desirable rules with respect to the regulation of takeovers, proxy contests, and disclosure; it also cannot be relied upon to provide socially desirable rules with respect to the protection accorded to creditors and other non-shareholder constituencies.

Based on this analysis of the shortcomings of state charter competition, this Article has put forward a set of recommendations concerning the desirable balance between state and federal corporate law.

for example, harmonizing, and obtaining mutual recognition of, the rules of the major economies. For a discussion of the problems involved in the application of United States rules to foreign companies and the alternative strategies that may be adopted in response, see generally U.S. SECURITIES AND EXCHANGE COMMISSION, *INTERNATIONALIZATION OF THE SECURITIES MARKETS* (1987).

Finally, it should be noted that, to the extent that international charter competition is not completely eliminated, then, even if we were to adopt federal rules for given issues, we would still have some competition, and those who make incorporation decisions would still have some ability to choose among different sets of rules. This would mean that federal involvement would not completely eliminate the identified shortcomings of state competition. But it would also mean that federal involvement would not imply foregoing all the alleged virtues of state competition. For example, federal law officials would be able to draw from incorporation decisions some information about the rules desired by those making incorporation decisions. And, to the extent that one worries about a disaster scenario, *see supra* note 210, the ability of companies to incorporate abroad would provide a check as well as an advanced warning mechanism.

While an examination of the complex problems introduced by international charter competition is outside the scope of this Article, I wish to note briefly the implications of the presence of such competition for federal intervention.²¹² The presence of international charter competition implies that, even when an issue is governed by a federal rule, companies may still have some ability to opt out of this rule by incorporating abroad. Thus, a federal rule would not completely eliminate the ability of those who make incorporation decisions to seek a different rule.

A main corollary of this observation is that if we decide that a given corporate law issue warrants federal regulation, then we should also consider limiting the ability of the relevant companies to escape the federal rule by incorporating abroad. This is because the dynamics of international charter competition are similar to those of state competition. Therefore, if we conclude that companies should not be provided with unconstrained freedom to choose through their state incorporation decision the rule governing them with respect to a given issue, this conclusion should carry over to the international context. That is, if state competition is likely to produce undesirable results with respect to a given corporate law issue, then unconstrained international charter competition is likely to have undesirable consequences as well.

Therefore, if we conclude that a given issue should be governed by a federal rule because of problems of managerial opportunism, we should consider applying this rule not only to companies incorporated in the United States but to all companies, regardless of their place of incorporation, that have a sufficiently substantial fraction of their shareholders in the United States. Similarly, if we decide that a federal rule should govern a given corporate law issue because of the presence of significant externalities, we should consider applying this rule not only to companies incorporated in the United States, but to all companies that have a sufficiently substantial fraction of their operations within the United States.²¹³

when operating in the United States. For one thing, foreign companies face prohibitions and restrictions on their participation in certain United States sectors, including domestic air transport, nuclear energy, broadcasting, telecommunications, and insurance. See EDWARD M. GRAHAM & PAUL R. KRUGMAN, *FOREIGN DIRECT INVESTMENT IN THE UNITED STATES* 96 (1989); SARKIS J. KHOURY, *TRANSNATIONAL MERGERS AND ACQUISITIONS IN THE UNITED STATES* 93-100 (1980).

²¹² The state competition literature has thus far largely disregarded the possibility of international charter competition. See, e.g., Romano, *supra* note 2, at 712 ("Practically speaking, there would be no competing sovereigns [under a federal corporation law system] to attract disaffected corporations.")

²¹³ Applying federal rules to companies incorporated outside the United States obviously involves a host of enforcement problems as well as other problems. For this reason, alternative strategies for addressing the problem of international charter competition may be explored —

My analysis largely endorses federal intervention with respect to those corporate law areas currently governed by federal law, including insider trading, corporate disclosure, certain aspects of takeover bids and proxy contests, and creditor protection in bankruptcy. Moreover, the analysis suggests that the federal role should be expanded significantly to cover important areas currently governed by state law. In particular, federal rules, or at least federal minimum standards, are warranted with respect to self-dealing transactions, taking of corporate opportunities, freezeout mergers, all aspects of takeover bids and proxy contests, and limitations on dividends.

Finally, this Article has identified the connection between the state competition debate and the debate on contractual freedom in corporate law. The two questions turn out to be very much related. In particular, whenever concerns exist that justify limiting the ability of companies to opt out of the rule that governs a given corporate law issue, the same concerns also likely justify limiting state competition with respect to this issue. Therefore, those who endorse mandatory rules for certain issues cannot consistently support, as many of them have in the past, state law governance of these issues.