

3-27-2005

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Recommended Citation

Romano, Roberta, "Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?" (2005). *New York University Law and Economics Working Papers*. Paper 16.

http://lsr.nellco.org/nyu_lewp/16

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Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?

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March 27, 2005

Abstract

This article provides an analysis of why regulatory competition in corporate law has operated, for the most part, successfully in the United States, and critiques the position of commentators who are skeptical of the significance and extent of state competition. The article begins by setting out the context in which regulatory competition has been most recently criticized, the U.S. Congress's response to corporate accounting scandals in the Sarbanes-Oxley Act, and by briefly noting how the problematic features of that legislative response underscore the benefits of regulatory competition. It then evaluates recent criticisms of regulatory competition that focus on the role of the federal government, or the incentives of states other than the leading incorporation state, Delaware, and conclude that U.S. corporate law is not the product of state competition. The article contends that these permutations on the state competition debate do not provide a satisfactory positive explanation of the behavior or the influence of the states and federal government. The minimum policy implication of the analysis is that it would be imprudent for policymakers to overlook the competitive regulatory experience in U.S. corporate law when assessing the approach to take to company and securities law.

Prepared for the Special Issue of the Oxford Review of Economic Policy on Corporate Governance and the Corporate Governance Conference at the Saïd Business School, University of Oxford, January 28, 2005. I would like to thank Marcel Kahan, Ehud Kamar, Jonathan Macey and participants at the Conference and the Fordham Law School Advanced Business Law Seminar for comments.

The U.S. Congress's response to corporate accounting scandals, enacting the Sarbanes-Oxley Act ("SOX"), which imposed corporate governance mandates on public companies in addition to a new regulatory structure for the accounting profession, might suggest that Congress had decided to embark upon a new approach to federal securities regulation beyond its conventional disclosure approach because it perceived a failure in state corporate law. Indeed, the expansion of federal regulation into corporate governance matters as a result of SOX has quite reasonably led some commentators to refocus attention on the impact of the federal government on the states for understanding regulatory competition. Several of these commentators, however, view SOX not as a manifestation of a new federal approach to state law in response to the scandals, but rather, as paradigmatic of a longstanding relation between the federal government and state corporate law, particularly that of Delaware, the leading incorporation state, domicile to approximately half of the largest publicly-traded U.S. firms.

In one commentator's view, for example, state law operates in the shadow of federal oversight and is, for all practical purposes, the implementation of federal legislative preferences (Roe, 2004), such that congressional interventions in areas touching upon corporate law and governance are characterized as federal authorities' intentional "revers[als of] state corporate law that they dislike," and federal inaction as intentional upholding of "laws that they ["federal authorities"] tolerate" (Roe, 2003, at 592). The states are further analogized to federal agencies, instruments that effectuate the federal government's will (Roe, 2004; Bratton and McCahery, 2004). Other commentators consider state corporate law (and here it should be understood that the term "state corporate law" is interchangeable with Delaware) as inherently incapable of coping with regulatory crises, and thus view states – Delaware – as perfectly content to cede

authority to Congress in such contexts (Bratton and McCahery, 2004; Kahan and Rock, 2004). Several of these commentators further share the perspective that state corporate law cannot be understood as a competitive regulatory regime, in which states provide the service of an incorporation statute and modify their corporation laws in order to retain and attract domestic incorporations (although the commentators vary in their characterization of the significance of federal-state relations, or inter-state incentives, in dismissing the working of a market). In this article, I contend that such a perspective of state corporate law, that denies the existence or minimizes the relative importance of inter-state competition in shaping state corporate law (and in particular, Delaware's actions), is mistaken, and it is unsatisfactory as a positive explanation of the behavior or intentions of the relevant parties.

After briefly setting out the background of the enactment of SOX, Part One of the article emphasizes that SOX did not address the crux of the recent scandals, and that it cannot credibly be characterized as a conscious congressional effort to improve upon state corporate law. Moreover, the pertinent empirical research suggests that the SOX mandates through which Congress preempted state corporate law will not have the salutary effect that its proponents assert; that provides a plausible explanation why those federal policy initiatives were not included in state corporate law in the first place. Congress's apparent legislative blunder highlights one of the advantages of a competitive corporate law regime: it is less likely to make regulatory mistakes than a centralized one, and any mistakes by a particular state are more easily corrected. The first part concludes by reviewing additional advantages of regulatory competition that further make plain the deficiencies in SOX and explain why competitive federalism has been a resilient feature of U.S. corporate law, and is a benefit, not a threat as some believe, to good

corporate governance.

Part Two of the article assesses the claim that there is no competition across states, and that Delaware's behavior is best understood as a monopolist. Part Three evaluates the contention that the federal government, and not the states, is the key player in the making of U.S. corporate law. There is, without question, still much that we do not fully understand about the making of corporate law. But the system dynamics that we observe are best explained as the working of competition among states rather than by either of those alternative contentions.

I.

The Enron Corporation collapsed in an accounting scandal involving large-scale financial statement misrepresentations and undisclosed self-interested transactions by the senior financial officer. A year earlier Enron had been the seventh largest U.S. company as measured by market capitalization, and was a highly-regarded energy trading and distribution firm, identified as a top performer with leadership heralded as foresighted innovators (Barrett, 2000: 124; Lear and Yavitz, 2000: 40). Enron's failure occurred at a time when the United States was in an economic recession, coinciding with a sharply declining stock market that had been exacerbated by the terrorist attacks of September 11, 2001. In this context, public and media attention was focused on the Enron scandal, and Congress followed up with numerous investigatory hearings into those events. Moreover, in the months following Enron's demise, accounting and executive self-dealing scandals embroiled additional public companies. When similar problems led WorldCom, Inc. to file the largest-ever bankruptcy reorganization proceeding in U.S. history, after months of a stalled legislative process Congress acted quickly, adopting the extensive regulatory regime for accountants and public issuers imposed by SOX (Romano, 2005a).

A number of commentators have critiqued SOX (and the SEC's implementation of it) for providing an unresponsive solution to the actual problem presented by the corporate failures.¹ In my judgment, there is merit in varying degree in those critiques. But I would emphasize a further gloss, that SOX will not, in all likelihood, prevent "future Enrons" because a substantial component of the accounting failure that contributed to Enron's collapse is altogether different in kind from the accounting issues addressed by SOX (which are whether the SEC exerted sufficient control over the accounting profession), or the garden-variety accounting fraud that toppled WorldCom. The problem is an inherent limitation of accounting itself. There is a mismatch between what accounting is meant to accomplish and does best – measuring the value of corporate assets that can be objectively calculated as they trade in markets, such as plant and equipment – and the environment in which many modern business corporations operate – significant assets are intangible and financial derivatives are used in hedging and speculative transactions. Intangible assets present particularly difficult measurement problems, as there is no market in which their value can be established; the measurement problem is compounded for non-traded derivatives because they involve forward-looking transactions for which the historical perspective of accounting is inappropriate (Litan and Wallison, 2000; Romano, 2002: 55-56).

There is no self-evident solution to this fundamental challenge to accounting's analytical

¹These perspectives include emphasizing the source of the failure as: the use of (inadequately regulated) financial derivatives (Partnoy, 2003); director and auditor judgment biases and incentives preventing the detection or reporting of fraud, left unchanged by SOX (Ribstein, 2002); corporate organizational problems of cognitive biases in small group decisionmaking and diffusion of responsibility, exacerbated, not mitigated, by SOX (Beecher-Monas 2003); and audit failure in the context of the risk-taking ethos of successful entrepreneurship, with SOX inadequately addressing the failure of auditing profession practices (Bratton, 2002, 2003).

foundations because the transactions that are the most difficult to measure, including complex derivative transactions, have bona fide business purposes. This is a deep and troubling concern that has not yet been acknowledged by regulators or Congress, and the implication of SOX, that increased regulation of the accounting profession will solve the problems associated with Enron's accounting failures, is, from this perspective, illusory. Given the complexity of the issues that need to be resolved, if history is a guide, it is furthermore improbable that a solution could originate with Congress or regulatory personnel, as opposed to learning by experimentation on the part of market participants with expertise and financial stakes, such as, financial analysts, businesses, investors, and the accounting profession. An apt illustration of such a dynamic is the international bank capital requirements related to market risk adopted by banking regulators, which rely upon measurement techniques developed by private financial institutions in order to evaluate the market risk of their complex trading positions.

More important to this article's concerns regarding the relation between corporate governance and regulatory competition, not only were key contributory factors to Enron's collapse not addressed by SOX, but also, the SOX provisions intruding on state law – the corporate governance mandates, such as the requirements of independent audit committees and prohibition of executive loans – were not even the subject of any considered attention by Congress during the legislative discussion or the many committee hearings that led up to the legislation (Romano, 2005a). The mandates were, instead, recycled proposals by corporate governance policy entrepreneurs (particularly former SEC officials), that resonated with the

Senate banking committee chairman, who drafted the bill.² Those policy entrepreneurs were skillfully able to take advantage of the window of opportunity provided by the Enron scandal and the coincident timing of a stock market decline preceding a mid-term congressional election, to have their preferred governance proposals inserted into legislation.³

Members of Congress instead focused their attention during SOX's legislative process on the establishment of a new accounting industry regulator and on ensuring that criminal penalties for accounting fraud were enhanced (Romano, 2005a). Neither of those principal foci of legislative attention implicated state corporate law. State corporate law did not regulate the conduct of the accounting profession, and to the extent that accountants could be held liable for assisting a fiduciary breach under state law, that liability is unaffected by the new regulator created by SOX. In addition, fraudulent accounting statements have long been prosecuted as federal criminal violations under the federal mail and wire fraud statutes. Therefore, the most actively debated issues in SOX would not have suggested to legislators (who, to begin with, are not, in general, highly informed about financial market regulation) that there might be a need to consider the role of the states with regard to other parts of the legislation.

² Although the chairman had to fashion a bill capable of garnering a bipartisan majority of the committee, more salient provisions than the governance mandates (accounting for stock options and the composition of the new accounting regulator) were priorities of the committee members whose votes were needed to move the legislation out of committee (Hilzenrath et al., 2002; Romano, 2005a). The proposals of the former SEC officials often were extensions of policies that they had advocated while at the agency (Karmel, 2004; Romano, 2005a).

³ As discussed in Romano (2005a), the enactment of SOX during a financial crisis is not unique for congressional action: the expansion of federal regulation into securities markets has typically followed large stock market declines, and the substance of the resulting regulation has tended not to have much, if any, connection to the legislative purpose, mitigation of the economic turmoil inducing it.

Only one provision that can be characterized as related to corporate governance, the restriction on non-audit services, garnered almost an equal amount of attention to the creation of an accounting regulator and enhancement of criminal penalties. That was a provision with a well-known history: two years earlier restriction of non-audit services had been a matter of considerable controversy between the SEC and the accounting profession, in which members of Congress sided with the accountants (Levitt, 2002: 287-98). The connection between the regulation and state corporate law did not arise in the earlier, as well as revived SOX, debate, because the issue was framed as regulation of the accounting profession, which is in the SEC's domain, and not of issuers, where states are recognized to have a role. In keeping with that characterization, the non-audit services restriction is included in SOX's section on the regulation of the accounting profession, which is not a subject of state corporate law, and not in the statute's issuer corporate governance section. I consider it a governance mandate, however, because it restricts the services firms can purchase from auditors, which state law leaves to management's discretion, and the service provided by the auditor is undoubtedly a component of a firm's governance system. But given the connection of the issue to the regulation of the accounting profession throughout the long legislative history, even legislators (or their aides) attuned to state law issues would not have been inclined to draw such a connection.

The absence of the SOX governance initiatives in state corporate law is neither fortuitous, nor the product of managers' influence on state legislatures to produce corporation codes that permit managers to extract wealth from shareholders. To the contrary, there would appear to be good reason for their omission: on those initiatives for which a substantial scholarly literature exists, such as audit committee independence and restrictions on non-audit services, the bulk of

the empirical literature indicates decisively that the initiatives will not reduce accounting improprieties or otherwise improve performance (Romano, 2005a). This is also the case for the findings of the limited research relevant to the executive loan prohibition in SOX (Romano, 2005a).

The learning of the empirical research is altogether consistent with the understanding of the workings of regulatory competition, that competing regulators have superior incentives than a single regulator regarding the adoption of requirements of no efficacy, or whose efficacy is not worth their cost. Competing regulators have superior incentives because, when firms can choose their regulatory regime, they will not opt for a regime that imposes increased costs unless the accompanying benefits are worth the additional expense. Firms will exit the regime that is not cost-justified for one that is, and regulators will learn from the pattern of inflows and outflows of firms which rules meet a cost-benefit test. Under the plausible assumption that regulators seek to maximize the number of regulated firms within their jurisdiction (Niskanen, 1971: 38-41), regulators in a competitive environment will, accordingly, not only react more quickly to regulatory mistakes, but also select a different set of rules from monopoly regulators, from whose regulatory authority firms cannot exit.

In short, regulatory competition offers a distinctive advantage over a single regulator in the corporate law setting: it better aligns the incentives of issuers, and of regulators, with the perspective of investors, and has thereby an increased likelihood of promulgating rules that investors prefer. That is because issuers will be drawn to the regime preferred by investors in order to lower their cost of capital. Issuers respond to investors' preferences over the choice of regime because financial capital is mobile, and the number of investment options is virtually

unlimited with derivatives. The richness of modern capital markets enables investors to set the price, that is, the securities of firms operating under regimes with fewer provisions or defaults that investors prefer will trade at a discount to those of firms operating under regimes offering greater protection. And the feedback mechanism of firm movement across competing regimes spurs regulators to respond to the investor-derived preferences of firms.

A further advantage of regulatory competition is the facilitation of experimentation leading to policy innovation. The flow of firms across jurisdictions provides regulators with an incentive to modify their regimes both to attract, as well as to retain, firms within their jurisdiction (the incentive may be financial – revenues from fees assessed on local firms or increased incomes of residents servicing those firms – or utility-maximizing – regulators’ preference in presiding over larger domains, which is a result of adopting regulations that firms prefer). In fact, legal innovations in corporate law have diffused across the states over time, at a rapid rate in recent years, in a process that often begins with variation in approach (as several states enact differing statutory solutions to solve a perceived problem) and eventually is resolved with one of the variations coming to predominate as the preferred solution (Romano, 2005b).

Delaware attentively updates its code, issuing frequent revisions on technical as well as substantive matters almost on an annual basis, and the drafters of the Model Business Corporation Act, which is an alternative corporate law regime to Delaware that has been adopted by many states, and is influenced by Delaware law, also engage in periodic revision (see, e.g., Romano, 2005b). It is, in this regard, instructive that the sole regulator in the related field of securities law, the SEC, does not engage in periodic, systematic reassessment or updating of its issuer regulations at a pace approaching the frequency of the principal producers of corporate law

(nor is it charged to do so by Congress), such that issuer-related rules are often not revisited for decades (for example, the shareholder communications rules, as discussed in SEC, 1992). And, of course, Congress's attentiveness is rare and episodic, enacting amendments to the federal securities laws only approximately once every decade or two. Consistent with this characterization is the response of the Delaware legislature, which has acted quickly (18 months) to reverse a state supreme court decision (*Smith v. Van Gorkom*) considered to be mistaken, as well as to clarify the statutory definition of voting stock after the question arose in a chancery court decision (*In re Digex, Inc. Shareholders Litigation*). By contrast, the average interval for reversals of U.S. Supreme Court decisions involving statutory interpretation in the comprehensive study by Eskridge (1991) of the 1967-90 Congresses was twelve years, with 68% of the reversals occurring more than two years after the decision (none of the cases involved the federal securities laws; SOX overturned a U.S. Supreme Court opinion decided ten years earlier).

There is a further, important difference in the form regulation takes between state codes and SOX. State corporate law is in essence enabling, following a menu approach that permits firms to alter statutory defaults to fit their needs. By contrast, the SOX governance provisions, consistent with the federal securities laws and their implementing regulations, are mandates. The difference in the form of regulation between states and the federal government is not mere coincidence: When there are competing regulators, mandatory provisions that are not cost-justified will tend not to survive over time because firms will exit the regime with the undesirable mandates, migrating to regimes in which they are absent. Highly suggestive supporting data of the push from competition to cost-effective regulation are contained in an article by William Carney (1997: 319-24). Examining the difference in content of U.S. states'

corporate law and that of the nations of the European Union (EU), where jurisdictional competition has been prevented by a choice-of-law rule based on a corporation's physical presence and tax considerations, he found that the EU company law directives (which harmonize the corporate laws of member-states by containing minimum requirements) include a high proportion of mandates, most of which are not in any U.S. state's code, having been repealed many decades earlier as not conducive to modern business practices. It is possible that the mandatory rules in place in the EU are appropriate for EU firms that, in contrast to U.S. firms, tend to have more concentrated ownership structures, but that justification has not been advanced as the rationale for the rules that Carney examines (they are not rules involving the protection of minority shareholders, for example).

II.

Some commentators contend that given Delaware's dominant position in the charter market, corporate law in the United States cannot be characterized as the product of competitive market forces. Marcel Kahan and Ehud Kamar (2002) have provided the most cogent and sustained statement of this position. They focus on the fact that other states have not attempted to duplicate what they emphasize makes Delaware the preeminent incorporation state – a high franchise fee structure and a specialized court. They also infer a lack of competition from the fact that state officials excluding those in Delaware, for the most part, do not express an active interest in attracting domestic corporations.⁴

⁴ Bebchuk and Hamdani (2002) also contend that states do not compete for charters because firms tend to incorporate either in Delaware or in their headquarters state; in another article, one of the authors, however, relied on that incorporation pattern to suggest that state competition was a race to the bottom (Bebchuk and Cohen, 2003). As noted in Romano (2002:99-101) with respect to the inference from the data in Bebchuk and Cohen, there is a

However, other states' replication of institutions that are critical to Delaware's chartering success is not necessary for demonstrating that there is state competition; rather, states that are competing for firms can and do employ different strategies from those that make Delaware successful, instead of precisely mimicking it. Nor is active recruitment of incorporations by government officials, or statements that they are seeking incorporations necessary for competition. No doubt corporate law is not high on the agenda of the vast majority of state officeholders, but it need not be in order for there to be a competitive charter market. The critical factor for the working of the charter market is the role of the local corporate bar and their clients; the necessary ingredient for competition is that corporate law initiatives be brought to legislatures' attention and that legislatures are inclined to be responsive to those proposals. The activities of lawyers, coupled with occasional lobbying by firms or business organizations, that bring corporate law initiatives to the legislature, are what drive competition.

Moreover, not all states need to be equally responsive to corporate constituent demands or involved in competing for firms for the chartering market to be competitive. As long as some states respond to goading of local attorneys and firms to Delaware's initiatives, and have the potential to unseat it or seriously make inroads into its business should it become unresponsive to

similar theoretical and empirical problem with Bebchuk and Hamdani's contention: both sets of authors provide no model or statement of what they believe the incorporation pattern would look like if there was a competitive market. They would appear to expect that firms would be randomly distributed across the states, indifferent to domicile, rather than, as found, proportional to their headquarters, or that there should be a disproportionate number of firms in Delaware and some other state that would thereby be identified as "competing." But why any distribution other than the existing pattern would be more probative of competition is far from self-evident. The data discussed in the text in part II.A, *infra*, that more responsive states (measured by speed of enactment of statutory innovations) retain more of local corporations as domestically domiciled, are, in my judgment, good evidence that the current incorporation pattern is consistent with competition.

firms' requirements, Delaware will behave as if it was situated in a competitive market.

Accordingly, although some commentators, drawing on the no-competition analysis, assert that Delaware is a monopolist and that state competition is of little or no import, if not a hindrance, for understanding U.S. corporate law or for ascertaining the appropriate policy for the U.S. or other nations (e.g., Eisenberg, 2004; Gilson, 2004), I consider such a conclusion to be mistaken.

A. Evidence on Competition and the Role of the Bar

There are three distinct pieces of data that suggest that states compete for incorporations. First, corporate law innovations diffuse across states in an S-shaped curve (the proportion of adopters increases with time) (Romano, 1985, 2005b; Carney, 1996). This pattern is similar to the diffusion of technological innovations in industry, which is a pattern that is interpreted in the industrial organization literature as a sign of competition. Kahan and Kamar (2002: 715) contend that the fact that state initiatives involving public goods, such as education, follow a similar diffusion pattern implies that statutory enactments (corporate or otherwise) following such a pattern are not indicia of competitive behavior. This reasoning is incorrect. States compete for citizens, following Tiebout's celebrated insight, and not simply for firms, and offering better services, such as superior public education, is a well-recognized inducement states and local governments use to lure and retain individuals within their jurisdictions.

Second, state franchise revenues are significantly positively related to the responsiveness of a state's corporate law to firm demands (responsiveness is measured as a function of the rate and extent to which legal innovations considered desirable by reincorporating firms are enacted), and the effect is unaltered when Delaware is excluded from the analysis (Romano, 1985). And third and more important as a mechanism of competition, firms migrate from states with low

levels of responsiveness (using the same measure) to those with higher levels (Romano, 1985). Those two findings are from a study I conducted a number of years ago and may well be out-of-date in some respects. But there is nothing to suggest that anything has dramatically changed in the interim: A recent study of reincorporations after the enactment of limited liability statutes in the mid to late 1980s, for example, replicates one of those two findings, reporting that states that were laggards in adopting such a statute lost more firms to Delaware than those that were rapid adopters (Moodie, 2004).⁵ The process depicted in these data can be characterized as “defensive competition” – states compete with Delaware by attempting to prevent local corporations from switching domicile (Romano, 1985: 238). If states did not seek to retain corporations, then we should not observe positive relations between both revenues and reincorporation flows and the states’ responsive updating of their corporation codes.

Kahan and Kamar (2002:686) focus on the first datum, state law responsiveness, and conclude that states’ corporation code revisions are not “principally directed to the goal of attracting incorporations,” citing, as behavior inconsistent with that goal, the failure of officials of states other than Delaware to assert as a legislative motive, competition for incorporations, and some states’ adoption of the Model Business Corporation Act, as that entrusts their codes’ drafting to a committee of non-local lawyers. But they adopt an unduly restrictive definition of

⁵ There is also anecdotal evidence consistent with the relation between firm domicile and legislative responsiveness remaining: Illinois was at the bottom of the responsiveness ranking as calculated in Romano’s 1985 study, and Kahan and Kamar note that it was still equally unresponsive in the late 1980s, with regard to adopting a statutory solution to the directors’ and officers’ liability insurance crisis. In addition, Romano (1985) found that after Delaware, Nevada obtained the highest net positive inflow of reincorporations, and it is still at the number two position and a high inflow state, as measured by the match between domicile and physical location in 1999 in Bebchuk and Cohen (2003).

competition, that refers solely to state officials' actions to induce foreign corporations to reincorporate from another state, rather than actions to maintain local firms' domicile in-state. Either form of state action presents a significant competitive threat to Delaware (whatever the reason that other states update their codes to keep firms from reincorporating), that forces Delaware to respond to maintain its edge as the domicile of choice. More important, neither pattern that they describe – officials' failure to express an active desire to increase incorporations or reliance on the Model Act – refutes the existence of state competition. This is because the principal actors ensuring state competition are members of the bar and not government officials.

Namely, the corporate bar in every state has a strong financial interest in enacting corporate statutes that enable them to attract and retain corporate clients, and, indeed, they advocate their state's adoption of the Model Act (as opposed to more individualized statutory updates) when they consider that path the more efficacious means for obtaining an up-to-date code. As a consequence, they do not have to be on the drafting committee of the Model Act for it to serve their purpose. Indeed, the Model Act helps to solve a free-rider problem that Kahan and Kamar suggest could prevent local lawyers from investing in efforts to revise state law to attract incorporations.⁶

⁶ Kahan and Kamar also examine the correlation between states' responsiveness in adopting Model Act provisions considered important by the drafters and in adopting provisions that I identified as important to reincorporating firms in my 1985 study of reincorporation, and they find that the two rankings are insignificantly negatively related. Kahan and Kamar consider this to be inconsistent with state competition. However, we would not expect there to be a correlation if the Model Act and Delaware served as competing networks, and that would appear to be so, at least in some instances. In examining Model Act provisions that had not been adopted by a majority of states (compared to those that had been adopted by a majority as identified by Carney, 1998), I found that Delaware often had a different statute than the Model Act, and its provision was followed by a group of states, accounting for much of the discrepancy in adoption rates (Romano, 2005b). Another plausible explanation for the finding of no correlation,

Corporate lawyers are typically familiar with both Delaware law and the law of their home state. Given limits of time, resources and the cognitive process, lawyers have to specialize and cannot develop a mastery of the law of all fifty states, so they quite reasonably focus their expertise on a home-state and Delaware. That raises the question why the corporate bar should care to have a local statute enacted at all, for they could have clients incorporate in Delaware (a state need not have its own statute, as it recognizes the right of foreign corporations to do business in-state). My short answer depends on the well-known fact that Delaware is an expensive domicile, whose cost is worthwhile for a firm with national operations and significant business transactions that expose it to potential litigation, such that the certainty offered by Delaware's legal system is decisive (Romano, 1985). For a smaller-sized firm that does not expect to undertake such transactions (or whose profitability is uncertain), a Delaware domicile might not be worth the cost compared to paying lower fees in a state that has a reasonably up-to-date statute.⁷ An added benefit is that should there be litigation, the defendants will be less likely

regardless of whether the Model Act and Delaware should be considered alternative networks, is that my study identified provisions of interest to reincorporating firms, that impacted on transactions increasing the possibility of shareholder litigation, and at least two, possibly three of the provisions identified by the Model Act drafters as important are not similar in nature. To the extent that those Model Act provisions do not implicate litigation or litigation-prone transactions, one would not expect there to be a correlation between states' responsiveness to the two sets of provisions (the Model Act provisions would not be expected to affect firms' propensities to reincorporate in Delaware, compared to the acquisition-related provisions tracked in Romano's responsiveness measure, and therefore the two sets of statutes would be directed at attracting different types of firms).

⁷ See, for example, Atlantis Plastics Inc. (1994) (reincorporating from Delaware to Florida noting that the Delaware statute "does not offer corporate law advantages sufficient to warrant payment of the [Delaware] franchise tax burden" and that the Florida statute is based on the Revised Model Business Corporation Act, that "for the most part" "provides flexibility in management" similar to the Delaware code).

to have to bear the additional expense of litigation at a distance from home. As a consequence, a competent attorney faithfully servicing a client would fully appreciate such a tradeoff, and would value – hence lobby for – a local up-to-date code, which offers clients a choice. This is especially the case when having the alternative code can enhance a firm’s financial condition, by lowering its operating costs, as that can be expected to redound to the attorney’s benefit as well as to the firm. The corporate bar, operating, to use Ronald Gilson’s felicitous metaphor, as “transaction cost engineers” (Gilson, 1984), would have a financial incentive in maintaining a responsive local statute.⁸

Local officials may be well-nigh oblivious regarding a statute’s effect on the number of local incorporations,⁹ but members of the bar, attuned to the requirements of clients, are not, and it is those individuals who lobby for legislative reform and are the motor of charter competition. While Delaware officials are quite explicitly interested in attracting corporations, and have far more powerful incentives to update their codes than other states’ officials, they too rely on the

⁸ Daines (2002) advances an agency-costs gloss on attorney support of local incorporation. A firm incorporated in Delaware has a larger pool of attorneys from which to choose (since both in- and out-of-state attorneys are familiar with Delaware law). Hence, he suggests, attorneys will advise local incorporation in order to limit competition, benefitting themselves at the client’s expense. In support of this view, he finds that smaller law firms are more likely to recommend a local incorporation for IPO firms than larger (more national) law firms. A benign interpretation of the data, involving expectations of IPO profitability, is, however, a plausible alternative explanation (Bhagat and Romano, 2005). There is, without doubt, much that we do not fully understand and that needs to be clarified regarding the interaction between the incentives of the bar and firms’ domicile decisions.

⁹ It should be noted that although Kahan and Kamar contend that state officials have no interest in attracting corporations, practitioners in many states apparently think otherwise, and have explicitly expressed the view (sometimes critically) that state statutes were enacted to prevent reincorporations in Delaware (see Romano, 2005b: n. 35, providing citations of practitioners attributing enactments of limited liability statutes to charter competition with Delaware; and Moodie, 2004).

local bar for code updating, and in this regard, the engine of legislative innovation is the same in Delaware as in most other states.¹⁰

The perspective of the corporate bar in Delaware is broader than that of the bar in other states, as Delaware attorneys represent both target and acquirer firms, and this impacts Delaware law in the takeover context. In particular, Delaware has only one takeover statute while most states have multiple takeover statutes, and the Delaware statute is far milder (less restrictive of bids) than the comparable statutes of other states (Romano, 1987: 139-45). Kahan and Kamar rightly note that states enacting takeover statutes may have the welfare of constituents other than shareholders in mind (such as local firms' employees), which is another difference with Delaware, where shareholder-manager interests have greater influence, compared to those of third-parties, and where no one firm can have sufficient political clout to obtain protective takeover legislation, given the large number (and non-physical presence) of incorporations (Romano, 1987, 1993:60, 2002:96-98).¹¹

¹⁰ There is a large literature on the role of the corporate bar in the enactment of state corporation codes, and whether the bar favors its own interest at the expense of shareholders in that process. See, for example, Alva (1990); Carney (1996; 1998); and Macey and Miller (1987).

¹¹ In hearings on Delaware's takeover statute, three union members were called as witnesses in support of the bill, with two testifying that the bill would prevent hostile takeovers that adversely affected local employment. But their testimony was not the key to adoption. More witnesses (eight) testifying in support of the bill raised concern over the impact on franchise tax revenues from firms' reincorporating into states with takeover statutes, were Delaware not to enact legislation. A total of fifteen witnesses testified in support of the bill. In addition, legislators questioning witnesses opposed to the bill often inquired about their views on the impact of non-enactment on the number of domestic incorporations, and not on local employment levels. This summary is my tally from the tapes of the hearing. Delaware House (Jan. 20-21, 1988). The characterization that the concern over incorporations, and not employment, was determinative, is also supported by the fact that the factor that had changed in January 1988 compared to earlier years when Delaware had adopted no takeover statute, was the support of the Delaware bar, and not that of labor unions, regarding the need to regulate hostile

However, because the data on hostile takeovers suggest that there are no significant adverse effects on the job security of production employees, such statutes are more likely to benefit management and arguably serve as a mechanism to attract in-state incorporations (Bebchuk and Cohen, 2003). A plausible conjecture is that many, if not most, managers prefer to be covered by takeover statutes, while many, if not most, shareholders would not prefer to be so covered. But the evidence that the presence of takeover statutes determines the number of incorporations that a state attracts is exceedingly thin, because when other features of state corporation codes are included in statistical analyses of domicile choice, indicator variables for takeover statutes are insignificant (compare Bebchuk and Cohen, 2003; Subramanian, 2002; with Daines, 2002; Kahan, 2004; Moodie, 2004). The role of state takeover statutes in charter competition is therefore subtle and not well understood, and serves as a cautionary reminder that state competition need not always be for the better.¹²

Kahan and Kamar (2002: 705) dismiss the role that lawyers play in facilitating state competition by contending that “lawyers’ interest” in updated corporation codes is “in many ways not related to attracting incorporations.” The alternative motivations that they advance for the bar’s legislative activity are to enhance their reputations, or to solve a problem for specific clients. But whatever phrase is used to describe the motivation, the observed behavior is identical. Namely, a principal byproduct of, if not the motivation for, developing a reputation regarding the enactment of a corporate statute is precisely to maintain and attract clients (whether

takeovers, and those were the witnesses who voiced concern over the potential loss of incorporations.

¹² For a detailed discussion of why state competition, notwithstanding this caveat, is still preferable to national takeover regulation see Romano (1988, 2002).

because of one's expertise regarding the operation of the statute, or one's political connections in being able to obtain legislation). Increasing the number of clients, and correspondingly the number of local incorporations, is also a byproduct of attorneys' seeking to amend a corporation code in order to resolve a client's problem. A statutory gap or ambiguity that creates a problem for one client's transaction will often implicate a situation that could arise for another firm so that updating a statute to solve one firm's needs will benefit others.

Kahan and Kamar would appear to acknowledge that the motivation of lawyers' legislative activity that they suggest as alternatives to the competition-related explanation (the financial motive of increasing the pool of in-state domiciled clients) are actually indistinguishable, when they further seek to distinguish a lawyer's motivation to obtain clients from a motivation to attract or retain local incorporations. For if the two are equivalent, then the case has been made for charter competition with the corporate bar as the medium. They suggest that lawyers could obtain clients by promoting legislative strategies that enact arcane, complex and abstruse rules to benefit themselves at the expense of their clients and other lawyers (since the drafting lawyer alone would know or understand the rules' operation) or that enact rules that are as distinct from the Delaware code as possible, to limit competition from out-of-state lawyers, actions characterized as potentially resulting in a loss of incorporations to Delaware (as firms sought its code's more desirable features).

But Kahan and Kamar's speculation on this front has no discernible connection to the reality of state codes. Corporation codes cannot plausibly be characterized as consisting principally of complex and arcane provisions that are traps for the unwary. Most state codes do not sharply differ from either the Delaware or Model Act statutes on key dimensions of interest

to firms. This would not be the case if attorneys were successfully lobbying to obtain idiosyncratic and abstruse legislation as Kahan and Kamar hypothesize.

B. The Structure of Franchise Fees and Courts

The other principal basis for Kahan and Kamar's contention that states do not compete is states' failure to adopt the institutional arrangements that are key to Delaware's success: high franchise fees and a specialized court. There are two distinct difficulties with this claim. One involves the assumption that competition requires all states to compete with Delaware and the characterization of the financial incentives at stake, and the other involves the assumption that competition requires all states to mimic Delaware.

First, the relation between Delaware's success in attracting incorporations and its ability to commit to maintaining a responsive legal regime (Romano, 1993: 37-38) suggests that only a subset of states – small states for whom franchise fees could constitute a significant part of their tax revenues – are potential competitors for Delaware's leading position. One would not expect most states to copy Delaware's franchise fee structure, since regardless of the franchise tax rate, the income stream will not serve as a commitment device to attract firms; most large states, in fact, earn more absolute revenues than Delaware does from the franchise fees they charge. Moreover, the small number of states that could seek to compete with Delaware through a credible commitment strategy would initially have considerable difficulty succeeding if they attempted to duplicate Delaware's higher franchise fee structure. Because Delaware's current position enables it to offer a superior product (in terms of predictability and commitment to responsiveness), those states would have to charge lower, not higher, fees, to attract firms. It is, consequently not possible to draw any clean inference regarding states' franchise fee structure

with respect to whether or not they are competing for incorporations.

Kahan and Kamar relate the issue of franchise fees to a further claim concerning the absence of competition, that states other than Delaware have no financial incentives to compete, because they currently receive little revenue from franchise fees, and the larger amounts that could be obtained if they were to compete would still be trivial compared to their other revenue sources. It is certainly true that the financial gains from attracting additional local incorporations would be quite small for many states, particularly large ones. But as earlier noted, prior research found a positive relation between the proportion of total tax revenue states received from franchise fees and their corporate-law responsiveness, which suggests that even apparently relatively small monetary amounts influence behavior.

In addition, in so far as the engine driving competition in states is the corporate bar, the more pertinent factor for assessing the financial incentives to compete is the relative size of the financial gains to be had by the corporate bar from servicing clients, rather than the relative size of potential franchise revenues to state budgets. In an innovative and laudable effort to derive an estimate of the income attorneys derive from Delaware's incorporation business, Kahan and Kamar (2002: 698) state that the income earned by the Delaware corporate bar is no more than that of one top New York law firm's practice, to advance the claim that attorneys, and hence states other than Delaware, would not financially benefit from competition. But that is an inapposite comparison. The more appropriate benchmark is their estimate that Delaware attorneys' income averaged approximately 50% higher than would be expected given their state's demographics (Kahan and Kamar, 2002: 695-96). A differential in compensation of that magnitude would be a powerful incentive for an individual, and it is the activities of individual

attorneys, typically working through the local corporate bar group, that are key in prodding state legislatures to be responsive. Kahan and Kamar (2002:699) would appear to acknowledge this point but seek to diminish its import by asserting that attorneys' income from a state's incorporation business is an impetus only for "low-cost" lobbying for "laws that attract corporations" but not for "more serious and costly efforts to compete." However, the former activity is, without question, the mode of operation of competition, and Kahan and Kamar's thesis that states do not compete therefore ultimately devolves into one of relative degree of competition. There is, then, no basis for the characterization of some commentators that the literature "has demonstrated" that there is no competition among states for corporate charters (e.g., Gilson, 2004).

The second problem with Kahan and Kamar's contention that the failure of other states to replicate key Delaware institutions indicates a lack of competition is that it assumes that states cannot be effective competitors by offering a different price and quality package than that of Delaware. Creating a specialized court is not, however, the sole strategy¹³ that a state that

¹³ There is a question whether a specialized court for corporate law would be cost-effective for states with a small number of domestic firms, and thus a small pool of potential litigants. Namely, most corporations never experience a shareholder lawsuit over their lifetimes, and even in Delaware, the number of firms incorporated in Delaware is orders of magnitude greater than the number of cases heard in a given year (Romano, 1991; Thomas and Thompson, 2004). A very large number of firms would therefore be necessary to generate sufficient litigation to develop a stock of precedents that provides the legal certainty that firms obtain from a Delaware domicile. Kahan and Kamar note that other states can compensate for their lack of decisional law by adopting Delaware's precedents as their own; that is why a specialized court is not an entry barrier to competition in the charter market. But the small pool of potential litigants could result in the court's having to rely on Delaware precedents for a long transition period and that would still make its product inferior to Delaware's for an extended period of time, thereby increasing the state's incentive to adopt the alternative strategy discussed in the text of a statutory approach that reduces the need for a specialized court. It should be noted that in this regard, Kahan and Kamar's thesis of a lack of competition does not depend on entry barriers. Rather,

currently does not have a large number of domestic corporations can adopt: the state could compete by offering instead a legal regime that does not rely as heavily on the judiciary as does Delaware's, obviating the need for a specialized court. Following the guidance of the Model Business Corporation Act, a state can enact more explicit statutory rules regarding corporate conduct, that operate as bright-line tests which minimize the need for judicial expertise by reducing judicial discretion and increasing legal predictability, compared to the standards approach adopted by Delaware courts. Some Model Act provisions are, in fact, straight codifications of Delaware court decisions (which is why the Delaware statute contains no similar provisions) (Romano, 2005b).

This tradeoff between rules and standards by states is at times a self-conscious decision, as it is used as a marketing device by states and lawyers seeking to attract incorporations. For instance, the Connecticut bar promotes the Connecticut Business Corporation Act for “contain[ing] more explicit guidance to corporations and their lawyers than the [Delaware General Corporation Law] which relies heavily on case law to interpret the statute” (Lotstein and Calio, 2000: 10). In short, states can and do compete with Delaware for the business of local incorporations by following a *different*, rather than identical, strategy with respect to their corporation law, which is the precise opposite of Kahan and Kamar's intuition regarding what

they contend that there are no significant entry barriers (Kahan and Kamar, 2002:725-26), noting how Delaware was able to replace New Jersey as the dominant incorporation state, having adopted its code and stock of precedents, and that is why they infer a lack of competition from the absence of states' duplicating Delaware's court system. Bebchuk and Hamdani (2002) dispute their view, adopting Michael Klausner's thesis that Delaware's dominant market position is due to entry barriers associated with network externalities, and further inferring from that thesis that the output of state competition is inefficient (suboptimal). For an analysis of why state competition is not inefficient because of network externalities, see Romano (2002:83-92).

behavior would be an indicia of competition.

III.

A master proposition of the U.S. Constitution is that the federal government reigns supreme over the states when there is a conflict, and under the conventional contemporary understanding of the commerce clause, Congress can within limits preempt state law. Mark Roe (2003, 2004) has asserted that because of this political arrangement, the federal government dictates the content of Delaware's corporation code, such that the state can only adopt rules that the federal government approves.¹⁴ For convenience, I will refer to this position as the federal supremacy hypothesis.

Although versions of the federal supremacy hypothesis have been bandied about in the corporate law literature for some time (e.g., Gilson and Black, 1995: 1256; Gordon, 1991; Bebchuk and Hamdani, 2002), Roe has provided the most sustained elaboration of the position. The nub of Roe's position is that Delaware law consists solely of terms that the federal government approves, because if it disapproved of the content, it would preempt the offending Delaware law (and state legislators, cognizant of this possibility, accordingly, simply do what they think the federal government wants them to do). In short, Delaware behaves as if it were an instrument of federal authorities. Roe (2003: 592) further contends that even if Delaware officials were oblivious of the federal government, his thesis is still correct because the federal government will preempt any Delaware law that it dislikes.

¹⁴ Roe's thesis is stated with respect to Delaware, although the analysis is equally applicable to any state, in order to underscore his view of the relative unimportance of states. While he titles his work as viewing the federal government as the competitor of Delaware, rather than other states, in actuality, his thesis is that the federal government determines the content of Delaware's code, and not that it competes with the state.

Roe considers his thesis to be a positive and not normative explanation of the making of corporate law. But his federal supremacy thesis has no predictive content, and thus fails as a positive theory. One cannot test a thesis that is articulated so as to be ostensibly confirmed by whatever occurs. This is a fatal flaw for a positive theory. The thesis is also overstated. For even if Delaware officials on occasion were to reflect upon the possibility that the state could be preempted, as might any sentient state actor in a federal system, that alone would not demonstrate that the federal government is more influential than other states on Delaware's corporate lawmaking, or more specifically, as Roe contends, that it determines the content of state corporate law.

The basis of Roe's federal supremacy argument consists of a list of potential threats or specific actions by the federal government that, he contends, demonstrate that it controls the content of Delaware corporate law.¹⁵ First, Roe contends that the federal government's ability "to inspire fear," has enabled it to dictate the content of state corporate law, providing examples

¹⁵ In Roe (2004) the federal government's preferences are ascribed to interest groups, other than managers and shareholders, who align with one of those two groups to enact federal legislation disadvantaging the other, although Roe does not offer a theory to explain why any specific alignment would be effective in Congress at a particular time on a particular subject. In this regard, interest groups serve as a device to flesh out his theme of the importance of the federal government, as he contends that the interest groups influential at the federal government level differ from those influencing Delaware. Roe asserts that his approach has produced a new insight that Delaware responds to shareholders and managers (as opposed to other interest groups) because they are the ones that pay the franchise fee. That is not a new theory of corporate law, but rather, it is the explicit premise of the state competition debate. Roe's depiction of the difference between interest group politics in Delaware and the federal government parallels, for example, the analysis in the state competition literature of the difference between the politics of Delaware and other states in the takeover regulation context (see Romano, 1987, 1988, 1993, 2002). It should also be noted, in this regard, that most of the examples Roe advances of federal legislation (antitrust and securities laws) were preceded by enactment of similar statutes (or antitrust prosecution) in states other than Delaware.

of the efforts of the Roosevelt, Taft and Wilson Administrations, along with William Cary's famous law review article decades later, to enact a federal incorporation statute (none of which succeeded). He asserts that these examples indicate that Delaware officials must reasonably manage their affairs due to concern over preemption. This claim leaves much to be desired, as Roe has no concomitant list of actions taken by state officials to respond to these incidents: no law was changed, nor was the judicial appointment process or the composition of the courts, which Cary vigorously attacked. It should also be noted that Roe also does not identify any "threatening" statement, let alone action, by federal officials that could have played a role in Delaware's major legislative initiatives in recent times, such as the 1967 code modernization or the limited liability statute's enactment.

One of the more recent examples that Roe provides of how the federal government "can inspire fear," illustrates the core problem with his thesis: that as an poorly-specified positive theory, any datum can be offered in support, even when it is actually inconsistent with the thesis. This is a quotation, taken upon the enactment of Delaware's second generation takeover statute from A. Gilchrist Sparks, III, the chairman of the Corporate Law Section of the Delaware State Bar Association, which drafted the statute, which Roe characterizes as providing Sparks' "view" of why the Delaware "law should only be moderate," a fear of federal preemption (Roe, 2003:605).¹⁶ In providing this isolated quotation, Roe has created a misimpression of what the

¹⁶ Mr. Sparks was present as the sole witness on the House floor to address any questions that might arise during the vote on the bill. The quotation was taken from the only colloquy between Mr. Sparks and a legislator. The representative was planning to offer an amendment to the bill to create an opt-in statute, and the quotation was in response to his question whether the bar's formulation as an opt-out statute was due to concern about competition from other states (that firms would have shareholders vote on reincorporating rather than opting into a statute). The complete response, which contains Roe's quotation was: "That's certainly part of it. Except

central concerns were of the Delaware legislators and attorneys, including Mr. Sparks, during the legislative process. It is crystal clear, from the two days of hearings on the bill held the week before it was enacted and the quotation arose, that Delaware officials, as well as the bar members, were responding to the actions of *other states*, and not concerned about the response of the federal government, in drafting and adopting the statute.¹⁷ The press coverage similarly characterized the process: “During last year’s debate by lawyers and legislators in Delaware over revising its takeover law, the predominant question was whether a new law would precipitate defections to other states.” (Labaton, 1988).

that I think in a way what we want to do is maintain, is we want to get out there and as we did in 102(b)(7) [the limited liability statute] and take a position of leadership in a moderate way. And you say why do we want to do it in a moderate way? Why don’t we want to pass the most restrictive thing that we can pass? And the reason for that is to the extent that our legislation is viewed either in the short run or the long run as unbalanced and unreasonable we all know that ultimately somewhere down the road we’ll have to pay the price for that in the context of the federal government coming in and taking in some portion of that privilege from us. We do not want that to happen because of what New York state or some other states do. We want to use our power and our privilege to be the home for these corporations in a constructive way and set a model of balanced leadership so that those more restrictive models do not become the model in this country so that we will not lose control of our own destiny in this area by reason of what other states do by reacting to special interest groups.” Delaware House (Jan. 26, 1988, Tape 7).

¹⁷A joint hearing of the House and Senate Judiciary committees was held on the bill on January 20-21, 1988. The persistently expressed concern throughout the hearing on the takeover statute was the potential loss of franchise tax revenues from Delaware corporations that might reincorporate into one of the 27 states that had already enacted a takeover statute since the Supreme Court’s decision in *CTS Corp. v. Dynamics Corp. of America*, permitting state regulation, were Delaware not to act. Approximately half (eight) of the proponents of the bill raised this issue, including the Secretary of State. (This concern was also provided as the justification for the statute’s formulation as an opt-out rather than opt-in statute, which was the only item of legislative controversy, as the chamber majority leaders introduced amendments to make the bar’s bill an opt-in statute, which failed). No other issue received as much attention. The other arguments made in support of the statute by more than one witness were to stem job losses caused by hostile takeovers (three witnesses), and to prevent abusive takeover tactics that reduced the price received by minority dispersed shareholders (five witnesses, three of whom also raised the state competition issue). Delaware House (Jan. 20-21, 1988).

The *only* references to possible federal preemption voiced at the hearings were by *opponents* of the bill, five of whom asserted that if Delaware enacted the bar's proposed statute it could, or would, lead to federal preemption of state regulation of takeovers or of corporate law. These witnesses included the sole federal official testifying on the legislation, then-SEC commissioner Joseph Grundfest, who also provided the legislators with a letter from the Chairman of the Council of Economic Advisers expressing concern regarding any restriction on takeovers, and who referred to letters from then-SEC chairman David Ruder and another commissioner sent to the Delaware bar expressing the view that the federal government should preempt state takeover regulation.¹⁸ These witnesses were referring to the bar's "moderate" statute, and not, as might be inferred from Roe's quotation, a proposed "stricter" statute.

Roe's quotation from Mr. Sparks on the floor of the House is the *sole* statement by any supporter of the bill, Delaware official and member of the bar, of any concern over federal preemption in consideration of the bill's formulation, including Mr. Sparks' own testimony at the hearings. In sum, a fair reading of the hearing would conclude that fear of preemption was not even a minor part of Delaware's consideration of the substantive content of its bill, as Roe suggests. Indeed, given the posture of the preemption issue in the takeover statute's consideration, if Roe's contention that federal officials' statements "inspire fear" in Delaware legislators were accurate, then the state should *not* have enacted the takeover statute, which it did. For the only discernable position of federal officials was opposition to the "moderate" bill

¹⁸ Delaware House (Jan. 20, 1988, Tape 1).

the bar had advocated.¹⁹

Roe next lists specific federal legislation preempting state action – the federal antitrust laws and SEC regulations – to bolster his federal supremacy thesis, but the connection between the federal actions he outlines and the content of state corporate law is nonexistent: states did not alter their corporate law regimes after those enactments. In addition, the enactment of federal antitrust laws is qualitatively different from federal securities regulation, and simply has no relevance to the issue of preemption and the determination of state corporate law.

More specifically, Roe interprets the federal antitrust statutes, which enabled the federal government to prevent certain (anticompetitive) corporate mergers that were permitted under state corporate law, as an example of how the federal government dictates the boundaries of state corporate law, on a par with securities laws whose substantive content overlaps with corporate law. His rationale for positing this equivalence is the rhetoric of state and federal officials

¹⁹ Roe also mischaracterizes the remarks of members of the Delaware bar regarding the adoption of a takeover statute discussed in Alva (1990). Roe (2003: 630 n.170) cites Alva as “describing the merger bar’s concerns that ‘passing this proposal would be the proverbial camel-back breaking straw that would force Congress to enact national corporate chartering.’” In fact, the “camel-back breaking” concern of the bar that Roe quotes, in Alva’s description, was not a statement but a question asked from the floor at a corporate law section meeting held to receive comments before the section council’s meeting on a proposed takeover statute (not the enacted statute) that the council was not planning to put to the legislature. The committee chairman, Mr. Sparks, dismissed that preemption concern in his response, as reported by Alva, that “any effects of that type were uncertain and indeterminable.” Alva (1990:908). In addition, Roe cites Alva as reporting that two prominent anti-takeover lawyers opposed Delaware’s takeover statute, and suggests that the reason was concern over federal preemption. However, as Alva (1990:906) describes the situation, the attorneys were opposed to the original proposal that was a control share acquisition statute because they considered the statute ineffective at preventing hostile bids, and thought it might even encourage them; federal preemption, referred to by only one of the two attorneys, was not the central concern. Those attorneys do not appear to have voiced the same opposition to the business combination freeze statute that was subsequently enacted, which would suggest that their earlier opposition was not due to fear of preemption, as such a concern would be as relevant to the enacted statute as to the initial proposal.

(before and after the enactment of the Sherman Act) objecting to New Jersey's adoption of a corporation statute that permitted the creation of the Standard Oil Trust Company's monopoly. But the Sherman Act cannot be characterized as a preemption of state corporate law. The federal government did not, in that statute, rewrite state corporation codes and prohibit corporations from either owning stock in other corporations, merging or otherwise entering into business combinations. And the states did not respond by repealing their corporation statutes that permitted such combinatory activity.²⁰

Acknowledging that federal action was limited to prohibiting only certain transactions, Roe (2003:609) still goes on to state that the Act is relevant to his federal supremacy thesis because the federal action left the states with the power to regulate "only the less important nonmonopolizing mergers." That line of defense however, will not do: corporation codes were not perceived solely as tools through which states could exercise authority over which mergers were undertaken from the perspective of affecting market structure, as they were drafted as enabling statutes that permitted a corporation to enter into combinations without special government approval, and independent of the transaction's importance to the national economy. New Jersey may well, as Roe relates, have enacted its statute to facilitate the creation of Standard Oil's monopoly, but other states would not appear to have copied that statute with such an intention in mind, and there were no limitations imposed on the statutes' applicability (the age of

²⁰ New Jersey repealed its corporate combination provisions on the eve of then Governor Wilson's ascent to the Presidency, decades after the Sherman Act was enacted, but only a few years thereafter New Jersey reenacted those provisions. Other states, including Delaware, did not alter their codes. In contrast, when the Supreme Court held state takeover statutes unconstitutional in *Edgar v. MITE*, state legislatures responded by adopting new and entirely different regulations, which they believed would pass constitutional muster.

special charters had long since passed).

More important, it is incorrect to characterize the enactment of federal antitrust laws as a move toward “preemption” of corporate law; rather, it was an exercise of federal regulatory authority to eliminate third-party externalities imposed when states are ineffective regulators (no different, for instance, from enactment of federal environmental laws). Such externalities are rarely produced in corporate law, which concerns manager-shareholder relations. That is precisely at the core of the theory of charter competition, and no participants in that debate would contend that the federal government has no role in preventing negative externalities from jurisdictional spillovers. The federal government could be expected to prevent national monopolies facilitated by state law, whatever the substantive state law basis facilitating their creation, and therefore preemptive action would not reasonably be considered to have any special implication for corporate law. Moreover, it is simply not credible to view the Sherman Act as causing states to be concerned about the content of their corporation codes out of fear of further preemption. To the contrary, the states have continued to facilitate corporations’ ability to combine, by relaxing code requirements that rendered acquisitions difficult (rules related to relaxing shareholder voting and appraisal rights in mergers were, for example, key components of Delaware’s corporate law innovations in the late 1960s, see, e.g., Romano 2005b).

In contrast to the federal antitrust laws, the New Deal federal securities regulation obviously did preempt areas that could have been covered by state corporate, as well as state securities, law. Thus, had states wanted to develop mandatory disclosure schemes under their corporation codes, that was no longer possible after the legislation. But Roe fails to explain why reference to the enactment of the federal securities is a contribution to the charter competition

debate (or is evidence that the debate is misconceived). It is certainly true that the federal securities laws are a critical element in the U.S. regulatory landscape for corporations. It does not follow, however, as Roe contends, that the federal government therefore determines the content of state corporate law. The key components of state corporate law, fiduciary duties and the allocation of authority between directors, officers and shareholders, have remained unaffected by the New Deal securities legislation and subsequent amendments (depending on its application, SOX is a potential exception as it arguably alters the allocation of authority between officers and directors in its audit committee provisions).

In particular, Roe does not identify instances of a chilling or formative effect that the federal securities laws have had on the subsequent development of Delaware (or other states') law, whether substantive or procedural. Consider, in this regard, Roe's illustration from the 1970s of how the federal government has ostensibly affected Delaware's regulation of going-private transactions. He states that the SEC "did not hide its disgust" with Delaware cases permitting such transactions (leaving shareholders the recourse of appraisal rights actions for a fair price) and notes that "eventually" the SEC promulgated rules requiring the disclosure of the true purpose of going-private transactions (Roe, 2003: 616-17). He then states that "shortly afterwards, Delaware reversed itself" protecting shareholders rights.

Roe's chronology, however, is incomplete and hence provides a misleading impression of the progression of events and a federal impact. In March 1977, in *Santa Fe Industries v. Green*, the U.S. Supreme Court rejected the contention that a going-private transaction without a business purpose violated the federal securities laws, leaving such fiduciary issues to the states. On September 23, 1977, the Delaware Supreme Court ruled in *Singer v. Magnavox* that a

business purpose was required to go private (which had not been the standard prior to the *Santa Fe Industries* decision). The SEC rules to which Roe refers were not proposed until November 1977, and not actually adopted until 1979; they did not precede the Delaware court's decision. Moreover a few years after the SEC rules were adopted, the Delaware Supreme Court eliminated *Singer's* business purpose test for going-private transactions in 1983 in *Weinberger v. UOP*, and adopted instead a fair price standard.

Thus, the “reversal” to which Roe refers (the *Singer* decision), was decided after the Supreme Court had assented to Delaware's prior course of action not requiring a purpose, and before the agency had released, let alone adopted, going-private disclosure rules relating to the purpose. And the decision to require a purpose was itself reversed by the Delaware court subsequent to the SEC rules that focused upon the transaction's purpose. Since, under Roe's analysis, the SEC's rules are an expression of a “federal preference,” Delaware's elimination of a purpose test is, in fact, an action in defiance of an expressed federal preference for a business purpose for going-private transactions, which should not have occurred if the state feared retaliation. Needless to say, Congress did not preempt Delaware's regulation of going-private transactions, or other areas of corporate law, in response to that ostensible defiance. Roe might respond that this demonstrates that the federal preference has changed (and Delaware has once again correctly read the tea leaves), although the SEC has not repealed the disclosure requirement of the transaction's purpose, which would establish the preference change. But the more satisfactory interpretation of the state's actions, given the sequence of events, would seem to be the more straightforward one, and not one requiring a convoluted story of altered federal preferences: the Delaware court is not best understood as an implementer of the federal

government's will, as Roe would have it, but as an independent actor, which may consider the viewpoints of others, such as the SEC, of what Delaware corporate law should be, but then acts according to its own lights.

Roe (2003:615) further contends that federal disclosure requirements dictate the substance of corporate law because they control what transactions are undertaken, “effectively determin[ing] which self-dealing transactions are halted and which ones slip through.” This assertion is overblown. Disclosure rules do not prevent self-dealing transactions from occurring nor their fairness from being adjudicated by state courts. The Supreme Court has consistently held that the only private right of action under the federal statutes is for a specific disclosure violation, and not for the substantive fairness or validity of a transaction (*e.g.*, *Santa Fe Industries v. Green*; *Schreiber v. Burlington Northern*). At best, were the disclosure regime to work as its advocates would expect, it would alter individual managers' behavior, but it would not affect state-made substantive law one iota, because it does not dictate what a state court would consider to be fair. And state law more immediately affects those individuals' behavior, as it explicitly determines what conduct is fair. Disclosure rules lack the preemptive force of substantive law. Not surprisingly, Roe provides no examples of the adoption of federal disclosure requirements that have resulted in a change in state corporate law.

Roe does offer, as a principal example of his thesis, the assertion that when the Delaware judiciary has changed course in upholding takeover defenses it was because the judiciary's perception of whether it would be preempted by the federal government had shifted (that is, the court loosened up on the permissibility of defenses when it determined that it would not be

preempted).²¹ While not all commentators would agree that the case law changes he cites were unexpected deviations and not doctrinally justifiable (e.g., Carney and McChesney, 1991), accepting Roe's depiction of the cases, the thesis is not a testable proposition. It is impossible to prove or disprove, that Delaware judges, in forcing an auction in one takeover case and in preventing an auction in a subsequent case, were responding to perceived inaction by the federal government in both cases but drawing a different inference, with respect to what action they should take, from the federal government's inaction.²² But there are also data inconsistent with his thesis. Congress did not, as Roe suggests, perceptibly shift from being pro-preemption to against in the relevant time frame. Rather, there was never any chance that Congress would enact legislation preempting the states even when the decisions more favorable to takeover

²¹ He also suggests that recent Delaware decisions evaluating directors' independence by factors other than direct financial interests are explained by the judges' fear of further preemption by Congress given SOX. However, Chancellor Strine (2002) of the Delaware chancery court wrote a paper suggesting that a new approach to directors' independence was probable in the aftermath of the Enron scandal, well before Congress enacted SOX. Yet that preemptive legislation is the event that Roe characterizes as the motivation for Delaware decisions post-SOX considered to have broken new ground on the definition of independence (one of which was written by Chancellor Strine). It is probable that Chancellor Strine was affected by the same popular concern over the Enron fallout as the members of Congress enacting SOX: the immense investor losses due to the failure of Enron gatekeepers to detect management misconduct and misleading accounting, which directed attention to Enron's outside directors who met the conventional financial independence test. The publicity directed at Enron's board and the scale of the financial disaster would naturally lead a court to consider whether a change in the definition of independence was necessary, regardless of the prospects of federal action.

²² The SEC, through its regulatory authority over takeover bids, overruled the Delaware supreme court's approval of a defensive tactic in the form of a selective self-tender offer, as Roe notes. But that action did not stop the court from continuing to approve defensive tactics that were as, or even more effective, than the self-tender defense in subsequent decisions. The court therefore does not appear to have been deterred in the least by the federal action, despite Roe's characterization of its mindset.

auctions came down; a majority of legislators were always opposed to such action.²³

Roe (2004: 1) has further amplified his federal supremacy thesis of corporate lawmaking by characterizing Delaware as the functional equivalent of a federal government agency, whose “parameters of freedom to act are defined by Congress’s agenda.” The contention that Delaware, a state, is the functional equivalent of a federal agency does not have a passing resemblance to institutional reality. First, Congress has, and indeed exercises, actual and direct control over federal agencies: it approves agency budgets and the appointment of their leadership. It also controls the agency rule-making process, and provides explicit instructions that agencies must follow in, for example, the Administrative Procedure Act and the Regulatory Flexibility Act (instructions on what agencies can and cannot do also appear in authorizing and appropriation statutes). Agencies have no authority beyond the explicit jurisdiction of their authorizing statutes, which are enacted by Congress (this is the rationale, for instance, for federal courts’

²³ Roe (2003: 629) mischaracterizes congress as favoring preemption when he states that the “principal bill” that it considered in “the late 1980s” would have preempted state takeover regulation. The bill to which Roe refers, a House bill sponsored by the relevant committee chairmen and supported by the SEC chairman, in fact, never even got out of committee. (It should also be noted that it was introduced in 1987 after the decisions that he cites as more favorable to takeovers, and not before them.) By contrast, a Senate bill sponsored by the relevant committee chairman was reported out of committee and debated on the Senate floor, see 134 Cong. Rec. S8101 and ff. (June 17, 1988) and that bill included a provision affirming state authority to regulate takeovers. The greater legislative progress of the Senate bill that lacked a federal preemption provision casts doubt on Roe’s characterization of the House bill containing a preemption provision as the “principal” bill of the period. In addition, the vast majority of congressional proposals for legislation before the *CTS* decision replicated the states’ approach to restrict takeovers (Romano, 1988), and this was at a time when Delaware had not yet enacted a statute. Moreover, as Bratton and McCahery (2004) note, congressional activity on takeovers rapidly dropped off once the Supreme Court upheld state regulation. That indicates that the earlier congressional interest was to see that hostile takeovers were restricted, which was only an issue if the states could not do so; had the principal preference been preemption, as Roe posits, then congressional activity should have persisted after *CTS*.

restrictions on SEC action). Finally, Congress can and does demand agency executives to provide it with information about their activities and to justify their decisions. None of these instruments through which Congress exercises explicit control over agencies are applicable to its relations with states and it would be found to be lawless under the Constitution if it attempted to do so.²⁴

Congress does have a “nuclear option” (preemption) to use against the states. But such a threat is highly circumscribed and must be used in a extremely judicious manner, because states can correlatively exercise control over Congress (a critical factor missing from an agency analogy, which suggests a one-way control of the delegated lawmaker by Congress). Congress is constituted by representatives based in states, and those state representatives shape what Congress can and cannot preempt. Delaware elects two Senators and one Representative, and therefore, in contrast to an agency, it has explicit influence on Congress (if proposed legislation truly jeopardized a state’s authority, its Senators can take a variety of blocking actions, including legislative holds and filibusters, to protect the state’s interest). More important, because preempting one state’s actions has implications for all other states (their actions are preempted as well), it is often not simply a few legislators whose interests are at stake on any particular issue. Moreover legislators in states without a specific interest in a particular area of law will not be

²⁴ To be precise, Congress has no constitutional power over Delaware’s expenditures related to producing corporate law, which are fully funded by its franchise fees, as well as over the setting of those fees. Nor does Congress have any say whatsoever regarding state personnel (elected officials or agency employees), or the process by which state corporate laws are to be enacted. Finally, Congress cannot simply require state officials to report on their state’s legislative, judicial or administrative activities (unrelated to federally funded programs) or to respond to questions Congress has on matters related to the officials’ exercise of their jurisdictional authority. It does not possess regarding states, in short, the financial and structural instruments that it can and does employ as credible threats to discipline federal bureaucrats.

favorably predisposed to preempt another state with such an interest (Delaware on corporate law, for instance), or to do so lightly, as they fully understand that their state could be similarly situated in the future and could need the support of the target state delegation. In fact, when Congress amended the federal securities laws to make private securities litigation more difficult, and preempted private state securities actions that could evade the federal restrictions, it explicitly excluded state corporate law claims, in a provision commonly known as the “Delaware carve-out.”

IV.

If, as this article has maintained, the absence of state competition and the federal supremacy theses are mistaken, why would those contentions have intellectual currency?²⁵ I would suggest that these hypotheses resonate in some quarters because they offer a way out for commentators who do not wish to choose between the polar positions of a race to the top or to the bottom in corporate law and their implications for securities regulation. The normative implications of the theses that no states compete and that federal supremacy trumps state competition rationalize the status quo, a federal securities regime, with corporate law left to the states. For otherwise, if states are understood to compete to produce corporate charters, then that regime produces on the whole either good or bad results, a “race to the top” or a “race for the bottom,” with normative implications in one direction or the other for institutional design. In this regard, the “race to the top” perspective is more intellectually unsettling than that of the “race to the bottom.” That is because with a race to the bottom position one can advocate an additional

²⁵ For instance, Gilson (2004) states: “[R]ecent work with respect to regulatory competition in the United States has demonstrated, at least to my satisfaction, that there is no regulatory competition among states for corporate charters.”

measured dose of federal intervention to fix ostensibly troubling state law issues without much alteration to the institutional landscape, whereas a race to the top perspective would suggest a need to reexamine the foundations of the federal government's role in securities regulation as the object of regulation is the same.

Textbook learning has often associated the federal securities laws and the SEC with the success of the U.S. economy. In my view, the scholarly literature suggests that that is an altogether inaccurate picture of the SEC's contribution. If anything, it is the competition of states in producing corporate law that has, however modestly, facilitated the reorganization of the U.S. economy in the last several decades, a reorganization that has occurred in spite of much of the federal securities regime. This article has only been able to provide a thumbnail sketch of the argument in support of regulatory competition; an elaboration can be found in Romano (2002). But the minimum policy implication of this literature is hopefully clear: it would be imprudent for policymakers to ignore the competitive regulatory experience in U.S. corporate law when assessing the approach to take to company and securities law.

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