Two Cheers for Corporate Law Federalism

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ABSTRACT

Recent contributions to the literature on United States (U.S.) corporate federalism question whether states compete at all for corporate charters. Network effects call into question whether serious competition is possible or desirable. This paper argues that federalism in establishing corporate law nonetheless remains both possible and desirable. One benefit is that federalism provides a range of laws, with differing laws appealing to differing business organizations.

Federalism also encourages increased legal innovation and adaptation. It is probably true that most states other than Delaware do not actively compete to become a destination for corporate charters. However, all states still have good reasons for updating their corporate laws to better serve the companies which do incorporate within their jurisdiction. Delaware has strong incentives to respond to improvements made by other states. All states also get an important informational benefit from federalism—they can observe how forty-nine other states are adapting their laws and how companies respond to those changes. Delaware’s dominance does make it more prone to favor the interests of managers and less prone to consider the interests of other constituencies such as employees. However, the threat of intervention by national actors such as Congress, the Securities and Exchange Commission (SEC), and stock exchanges helps prevent Delaware from becoming too managerialist in its laws.

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I. INTRODUCTION

We have a variety of goals for our system of making corporate law. We want the legislators, judges, and bureaucrats who make and enforce the laws to be experts and yet also unbiased as between the competing interest groups the laws affect. A desire for expertise, predictability, and familiarity with the law suggests having one jurisdiction that makes the law. On the other hand, a desire for innovation, continual adaptation to new circumstances, and legal variety suggests that there are benefits to be had from competition between jurisdictions. It appears that we cannot achieve the best results for all of these desires simultaneously; here, as in so much of life, we must make tradeoffs.

Our mixed federal system manages to achieve a pretty good balance. One state dominates in setting corporate law, but other states still offer alternatives, and behind them all stands the federal government, setting, or threatening to set, a variety of corporate law-related rules. This structure manages to achieve many of the benefits of competition in rule-setting, especially innovation, while reaping the benefits of predictability gained from having one dominant law and keeping the law from becoming too biased in favor of one corporate interest group at the expense of others.

Delaware has long dominated as the state where large public U.S. corporations choose to incorporate. For even longer, debate has raged over whether it is a good idea to allow corporations to choose where to incorporate.\footnote{“Even longer” because New Jersey dominated before Delaware, and there was much debate over New Jersey then. \textit{See} Christopher Grandy, \textit{New Jersey Corporate Chartermongering 1875-1929}, 44 J. ECON. HIST. 677, 677-78 (1989).} For several decades, corporate law scholars have debated whether the competition between states to attract incorporation is a race-to-the-bottom or a race-to-the-top.\footnote{Michael Klausner, \textit{Corporations, Corporate Law, and Networks of Contracts}, 81 VA. L. REV. 757 (1995).} Under both the race-to-the-bottom and the race-to-the-top theories, states will tend to gravitate to the set of laws the corporate decision makers prefer. Thus, states will tend to have relatively similar laws, as indeed generally seems to be the case. Why, then, should one state, Delaware, be able to take, keep, and even extend a wide lead in the race? Michael Klausner\footnote{A network effect means that corporations would prefer to incorporate in the state other corporations prefer. Thus, once a state took the lead, that lead would be reinforced. \textit{See} id. at 763.} posited that the answer lies with network effects.\footnote{Lucian Arye Bebchuk & Assaf Hamdani, \textit{Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters}, 112 YALE L.J. 553 (2002).} The existence of such effects raises new questions, though. Once one state has taken a clear lead, how much competition actually exists between states? Two recent papers, one by Lucian Arye Bebchuk and Assaf Hamdani,\footnote{Marcel Kahan & Ehud Kamar, \textit{The Myth of State Competition in Corporate Law}, 55 STAN. L. REV. 679 (2002).} and the other by Marcel Kahan and Ehud Kamar,\footnote{Lucian Arye Bebchuk & Assaf Hamdani, \textit{Vigorous Race or Leisurely Walk: Reconsidering the Competition Over Corporate Charters}, 112 YALE L.J. 553 (2002).} conclude that there is now little effective competition between states.
The existence of network effects complicates what sort of competition is actually desirable. Having one dominant jurisdiction becomes desirable so that the network effects can be achieved. However, we would like enough competition between states to still achieve four other goals. First, we would like to have a variety of laws that will appeal to differing business organizations with differing needs. Second, we want the state that becomes dominant to offer good corporate laws. Third, after that state has become dominant, we would like it to continue to improve its laws and adapt them to changing circumstances. Fourth, we want regulatory decision makers to fairly reflect the interests of all constituencies affected by corporate law.

This Article argues that the U.S. system of corporate federalism goes a good way to meeting all of those goals, although no system can fully satisfy all of them. The existence of a dominant state achieves network effects. Yet, each of the four goals of competition is still met to some degree. Some legal variety (the first goal) remains. State competition can at least play a role in increasing the chance that a state with good laws becomes dominant in the first place (the second goal). Delaware’s dominance gives it some incentive to innovate, and both Delaware and other states get an important informational benefit from state competition—they can observe how forty-nine other states are adapting their laws, and how companies respond to those changes. Both factors help create a healthy degree of legal innovation (the third goal). The federal government also makes a great deal of important corporate law, and the threat of federal intervention limits what Delaware can do. This helps ensure that the interests of all constituencies are fairly represented in making corporate law (the fourth goal). The federal government’s presence helps stop overly pro-managerial developments in state law while still leaving room for much lawmaking and experimentation at the state level.

This Article develops its argument as follows. Part II reviews the relevant literature. Part III focuses on the first goal, legal variety. Several states offer laws that appeal particularly to corporations, other than the standard public corporations, which prefer Delaware. Nevada appeals to close corporations; Maryland appeals to investment companies. Although these states thereby put little pressure on Delaware in its core market, the separation of the charter market into niches is itself desirable. However, there is rather less differentiation of business organization law into niches than one might expect, in part because of network effects and in part because the optimal corporation law may not differ all that much for most large businesses.

Parts IV through VI focus on the third goal,7 encouraging innovation and adaptation while still achieving the benefits of network effects. Part IV partially debunks the “stalking horse” argument that Bebchuk and Hamdani make. They argue that states other than Delaware will not make costly improvements in their corporate laws to attempt to attract new companies because they know that Delaware will simply match the change and keep companies from going elsewhere, thereby stranding the costs of the change as a waste. That is not so, however, to the extent that the benefits to companies that have already chosen to incorporate in the state outweigh the costs of the change. Since all

7. I address the second goal in my earlier paper. See id.
states retain a significant number of corporations, and since most substantive changes to corporate law can be made at a relatively low cost, the stalking horse problem should not prevent most improvements to substantive corporate law. The stalking horse problem has more bite for potential changes in a state’s legal infrastructure, which are more expensive. Thus, the relative importance of the stalking horse problem may help explain why most states other than Delaware do regularly change their substantive corporate law, but do not try to seriously compete in legal infrastructure.

Part V explores whether Delaware’s dominance undermines incentives to innovate for state decision makers in Delaware and elsewhere. Borrowing from writing in industrial organization, Bebchuk and Hamdani argue that just as monopolists have weaker incentives to offer optimal product quality, so too does Delaware have weaker incentives to offer optimal corporate law than it would if its lead were not so secure. Consideration of this argument requires us to think carefully about how competition may reduce slack. Competition has two important effects: motivational and informational. The motivational effect is that when those in a competitive market offer low quality, they soon lose market share, which has a variety of bad effects on decision makers. Monopolists offering low quality face much less punishment.

This motivational slackness effect does occur to some extent for state legislators and judges outside of Delaware. Most states gain little from attracting corporations to their state. States outside of Delaware nonetheless have other reasons to refine their corporate laws. The corporate bar, in particular, advocates reform, and for most suggested changes there will be no organized opposition, so change can be made at a low cost. The very lack of exit as an effective option induces corporations to develop their ability to exercise voice within the states. Thus, states outside of Delaware will still adapt their laws with some frequency, even without the motivational spur of competition. Delaware, in contrast, will be motivated by competition to change its law in response to other states. Gains from incorporation are important to Delaware, and it wants to retain those gains. Thus, charter competition does help to motivate decision makers in the dominant jurisdiction—the most important jurisdiction, after all.

The other important way competition affects slackness is informational. Even if decision makers are motivated to provide a high-quality product, they may not necessarily know what constitutes high quality. With greater competition, decision makers can observe what others are doing and what users find attractive and there is more diversity of ideas with which to experiment. This informational benefit remains in the corporate charter market for both decision makers in Delaware and in other states.

Part VI considers the Model Business Corporation Act as an alternative to Delaware law and concludes that the Model Act has offsetting effects. On one hand, the Model Act reduces the states’ cost of making changes in their laws. This means non-dominant states are likely to change their laws more often, thereby placing more pressure on Delaware to keep up. On the other hand, the Model Act also reduces the diversity of approaches to corporate law. States experiment with fewer new ideas as a result of the Act. However, more of the experimental ideas are likely to be accepted than if the Model Act did not exist. If powerful network effects in corporate law indeed exist, then a mechanism like the Model Act is probably a helpful way for non-dominant states to maintain some of the benefits of vigorous competition.

Part VII considers the fourth goal of competition, ensuring that all constituencies are
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fairly represented in making corporate law. It compares three alternatives—national incorporation, vigorous state competition, and less vigorous state competition—and examines how well the law is likely to protect shareholders under those alternatives. Various considerations determine whether a system with weakened state competition will have a greater or lesser managerialist tilt than the other two systems. However, two points come through. First, Delaware judges are more likely to be responsive to corporate political considerations, and hence more pro-manager than federal judges or judges in other states, as corporate cases are much more central to the Delaware courts. Second, Delaware politicians and judges are likely to be less responsive to the interests of non-shareholder constituencies, such as employees and customers, than politicians or judges in other states or at the national level, because the non-shareholder constituencies affected by Delaware law have few means to persuade Delaware decision-makers. These two factors suggest that Delaware’s dominance may lead to a somewhat stronger managerialist tilt than would appear either in a national system or in a state competition where no state has such a strong lead. In another paper, I argue that our mixed federal system of corporate lawmaking helps limit this managerialist tilt while still achieving gains from state competition.8 Federal rulemakers such as Congress and the SEC can and sometimes do create what is effectively corporate law, although labeled securities law, if they are unhappy with the Delaware status quo. Other areas of law as well, such as labor, employment, banking, consumer protection, and environmental law, help regulate corporations and protect the interests of various constituencies. The threat of such federal intervention induces Delaware politicians and judges to make less managerialist rules than they otherwise would, while still allowing them to draw upon their great expertise.

Finding the right balance between state and national lawmaking, and between limiting managerial opportunism while still creating valuable flexibility, is very hard. I do not claim that our current system is right in all of its details. However, I do claim that its general contours help achieve a number of worthwhile goals. Radical suggestions for change, such as national incorporation or the elimination of federal securities law, are thus suspect. The task is hard enough, and the imperfections real enough, that I cannot give our federal system of making corporate law a full three cheers. But it is well worth two cheers.

II. THE PREVIOUS LITERATURE

The modern literature on Delaware and the race-to-the-bottom in corporate law began with William Cary’s classic article.9 Cary argued that Delaware had gained its lead in corporate charters by heading a race-to-the-bottom. Delaware appealed to corporate managers by offering an overly-lax law which allowed them to entrench their power at the expense of shareholders. Three years later, Ralph Winter set out the main contours of the response to Cary.10 Winter argued that a variety of market mechanisms induce

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8. See Brett H. McDonnell, Delaware, Federalism, and the Expertise/Bias Tradeoff, work in progress (on file with author).
corporate managers to choose an efficient corporate law which sets the proper balance between protecting shareholders and giving corporate decision makers adequate flexibility.

For the next several decades, the debate focused largely on the various mechanisms alleged to constrain managers and how well those mechanisms actually work in practice.\(^{11}\) A slightly separate branch of the debate considered public choice arguments concerning the political economy of charter competition.\(^{12}\) Several studies examined the empirical effects of Delaware incorporation on firm value.\(^{13}\) Most work assumed, though, that there was a strong competition between states for corporate charters. The disagreement was over whether this competition was a good or a bad thing.

Yet, that debate was missing something. Neither Cary nor Winter could explain terribly well how Delaware has managed to keep and even extend its dominant position.\(^{14}\) Only more recently have legal scholars gotten around to trying to explain this and explore its significance for the charter competition debate. An important theoretical breakthrough came in the work of Michael Klausner on network effects in corporate law.\(^{15}\) Klausner described a variety of reasons why a state’s lead in the charter market might become self-reinforcing once established. A state with more companies will have more corporate caselaw, leading to greater predictability.\(^{16}\) If fees from incorporation comprise a significant share of a state’s revenue, that can commit the state to remaining responsive to corporations in the future.\(^{17}\) Because of its dominance, Delaware’s judiciary is quite experienced and sophisticated in corporate law issues. Corporate lawyers and service companies have also specialized in Delaware because of its

\(^{11}\) See McDonnell, supra note 6, at 692–96 for an overview.


\(^{14}\) More than half of all public firms in the U.S. are incorporated in Delaware, see Daines, supra note 13, at 526, and nearly 60% of all Fortune 500 companies are incorporated there, see Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. Cin. L. Rev. 1061, 1061 (2000).

\(^{15}\) See Michael Klausner, supra note 2; Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (Or “The Economics of Boilerplate”), 83 Va. L. Rev. 713 (1997).

\(^{16}\) Not everyone believes that predictability is an obvious feature of Delaware law. Indeed, some argue that Delaware has a tendency to produce overly-ambiguous law. See infra note 20. Both positions have some merit, but I think that the greater-predictability effect is more important. Consider, for instance, the area of fiduciary duties in response to hostile takeover offers. Delaware has certainly wobbled some, but the rules of Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) and Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) set a basic framework, and the great accumulation of cases applying that framework allows practitioners to find cases that come close to the facts they face much of the time. Admittedly, it is sometimes hard to distinguish seemingly similar cases with differing results, but there is still a wealth of guidance in Delaware, whereas in most states there is very little guidance of any sort. Therefore, most of the time, Delaware cases as persuasive authority are the best guidance available.

\(^{17}\) Roberta Romano first developed this point. See Romano, supra note 13, at 280.
dominance, reducing the costs of their services for firms using Delaware law.18

Not everyone is convinced that corporate law exhibits significant network effects.19 However, if they do exist, they pose some serious questions for the traditional story of state competition. Once a state has achieved a great enough lead, it may be quite hard for other states to compete with it even if they offer better laws. Moreover, a state with inferior laws may come to win the race if it manages to get a lead in the early period of competition. I see this as posing at least two problems for state competition. First, how can we be sure that a state with good law becomes dominant in the first place? Second, can competition be of much use in promoting legal innovation once one state becomes dominant?20

I began to give an answer to the first question in my previous work on charter competition.21 Competition between states may well increase the chances that a state with good corporate law will become dominant in the first place. There may, however, be a limit to how much competition is beneficial—too much competition may overly delay any state from becoming dominant, hence delaying the onset of network benefits, and at some point may not even improve the chances that a state with good law will become dominant in the first place. I am unaware of any other work which has concentrated on that first question. In this paper, I turn to the second question—now that Delaware has achieved dominance, does any real competition between states remain, and does that competition help promote innovation in the law?

Recent empirical work by Daines22 and Bebchuk et al.23 starkly poses the problem for the traditional story of competition. Two major points emerge from this work. First, there is a significant home bias effect. That is, firms are more likely to incorporate in the state in which their headquarters is located than in other states. All states have managed to keep a large number of firms using their corporate laws due to this effect, although states differ in how effective they are at inducing their home companies to stay at home when incorporating or going public.24 Second, except for a few niche areas, when public firms incorporate anywhere but their home state, they overwhelmingly, as in a rate of 95% or better, choose Delaware.25 The question is why this happens, and what the

18. See McDonnell, supra note 6, at 704, for an overview of these points.
20. Marcel Kahan and Ehud Kamar have also seen a third problem created by network effects. They believe that such effects may give Delaware an incentive to make its laws overly ambiguous as a way to prevent other states from copying its laws and hence competing more effectively. See Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 COLUM. L. REV. 1908 (1998) (arguing that indeterminate laws are an additional competitive advantage to Delaware); Marcel Kahan & Ehud Kamar, Price Discrimination in the Market for Corporate Law, 86 CORNELL L. REV. 1205 (2001) (arguing that ambiguity of law is a factor leading to price discrimination among companies that incorporate in Delaware). I will not deal with that issue in this paper. Roberta Romano poses some strong challenges for this theory. See Romano, supra note 19, at 519-26. The biggest problem is how one could ever tell when a body of law is excessively indeterminate, as opposed to optimally indeterminate.
23. See Bebchuk et al., supra note 13.
24. See Daines, supra note 22, at 1575-78.
25. See id. at 1572.
effects are on the market for corporate charters.

The recent papers by Bebchuk and Hamdani\textsuperscript{26} and by Kahan and Kamar\textsuperscript{27} start to work on those questions. Bebchuk and Hamdani point to several sources of competitive advantage for Delaware. One is the network externalities analyzed by Klausner.\textsuperscript{28} Another is investment in institutional infrastructure. An important advantage of Delaware is its Chancery Court, which can move quickly and has specialized expertise. Setting up such a court requires a significant up-front investment. Delaware made that investment long ago. Any state now considering such an investment, however, would be unlikely to receive an adequate return on its investment given Delaware’s competition.\textsuperscript{29}

Bebchuk and Hamdani argue that given these advantages, Delaware will face quite limited competition from other states. They identify a “stalking horse problem” for any state considering costly innovation in corporate law: Delaware can always match such innovation and maintain its market share, and do so quite quickly. In that event, the state will not recoup the costs of its innovation. Given such a prospect, other states will not innovate in the first place.\textsuperscript{30} They also argue that price competition by other states is likely to be ineffective, as the franchise tax paid by public companies is small relative to the advantages of incorporating in Delaware.\textsuperscript{31} Finally, they argue that successful challengers to Delaware would need to appeal to corporate managers as well as shareholders, since managers have veto power over reincorporation, but it will be difficult to offer a law which adds value to both groups.\textsuperscript{32}

As a consequence of Delaware’s advantage, they argue that Delaware will face much “slack” in setting its corporate law. That is, Delaware will be able to set a law which falls well off from the optimum without facing much punishment in terms of lost incorporations. Analogizing to the role of product market competition in disciplining firm agents, they argue that this is likely to make Delaware less responsive and less prone to set efficient law.\textsuperscript{33} This is important, because even if Delaware is effectively a monopolist, one needs to argue why such a monopolist will not set high quality corporate law and capture the benefits from such law through setting a higher price. Bebchuck and Hamdani’s monopoly slack argument attempts to answer that question.\textsuperscript{34} They also argue that states other than Delaware will have little incentive to innovate and experiment, as they have little chance of capturing any of Delaware’s business and recouping the costs of their experimentation.\textsuperscript{35}

Bebchuck and Hamdani also note a “home-state bias”: many corporations simply

\begin{footnotesize}
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\item \textsuperscript{26} See Bebchuk & Hamdani, supra note 4.
\item \textsuperscript{27} See Kahan & Kamar, supra note 5.
\item \textsuperscript{28} See Bebchuk & Hamdani, supra note 4, at 586-88.
\item \textsuperscript{29} See id. at 588-89. Fisch has a strong analysis of the peculiar structure and functioning of Delaware’s Chancery Court. See Fisch, supra note 14. Recently, some states have set up commercial courts, but it is unclear whether those really create an attractive alternative for out-of-state corporations. See infra notes 119-120 and accompanying text.
\item \textsuperscript{30} See Bebchuk & Hamdani, supra note 4, at 593-95.
\item \textsuperscript{31} See id. at 590-91.
\item \textsuperscript{32} See id. at 591-93.
\item \textsuperscript{33} See id. at 597-99.
\item \textsuperscript{34} See id.
\item \textsuperscript{35} See Bebchuck & Hamdani, supra note 4, at 605-06.
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incorporate in the state in which they are headquartered. They cite several possible reasons. One of these reasons is the additional costs of incorporating out-of-state, which smaller firms in particular are unwilling to bear. Another is that firms, particularly large firms in small states, may be more likely to get favorable treatment in their home state. A third possible reason is opportunistic behavior by the law firms that take a firm public. This home-state bias helps create slack in states other than Delaware, as states will still retain many corporations even if they offer sub-optimal law.

Bebchuk and Hamdani argue that their analysis suggests the benefits of a stronger role for federal law than race-to-the-top advocates prefer. If state competition is weak, then its benefits are likely to be less than is usually argued. The federal government might have less of a managerialist bias and might be willing to devote more resources to corporate law innovation. They also argue that their analysis strengthens the case made for a proposal by Bebchuk and Allen Ferrell whereby the federal government would offer its own set of rules governing takeovers and would give shareholders in all corporations, no matter where incorporated, the right to choose to opt-in to the federal rules on their own initiative, without the approval of corporate managers.

Kahan and Kamar’s recent paper has some overlap with Bebchuk and Hamdani. They also argue that states other than Delaware do little to compete for Delaware’s market, going into more empirical detail than Bebchuk and Hamdani. Even those states that do seem to be competing, such as Nevada and Maryland, are really appealing to specialized niches that will not be of interest to most public corporations. They also point to a specialized court and well-developed case law as part of Delaware’s advantage. However, they place more stress on political factors in explaining why other states do not compete with Delaware. Kahan and Kamar argue that profit-seeking is not likely to be a major goal for states, as profits are likely to be small relative to other matters which matter to state politicians and profits may come too late to benefit elected politicians. They also argue that other political constraints may stop states from competing, pointing to several instances.

Kahan and Kamar are more tentative than Bebchuk and Hamdani as to the implications of their analysis for the federalism debate in corporate law. They argue that states other than Delaware are likely to be slower to innovate and more pro-manager than

36. Id. at 568-72.
37. Id. at 573.
38. Id. at 573-74.
39. Id. at 574 (citing John C. Coates IV, Explaining Variation in Takeover Defenses: Blame the Lawyers, 89 CAL. L. REV. 1301 (2001)).
40. See Bebchuck & Hamdani, supra note 4, at 608-10.
41. Id.
42. Id. at 610-14.
43. See Lucian Arye Bebchuk & Allen Ferrell, A New Approach to Takeover Law and Regulatory Competition, 87 VA. L. REV. 111 (2001) (introducing the idea of an optional federal takeover law as an element of "choice-enhancing intervention").
44. See Kahan & Kamar, supra note 5, at 701-15.
45. Id. at 716-22.
46. See id. at 725-26.
47. See id. at 728-30.
48. See id. at 730-35.
if charter competition were more robust. 49 Delaware is more pro-manager than it would be if competition were stronger. 50 However, unlike Bebchuk and Hamdani, Kahan and Kamar argue that, as a monopolist, Delaware is likely to have stronger incentives to innovate than if there were strong competition, because monopolists receive more of the benefits from innovation. 51 This difference between the two papers mirrors a long-standing division among economists as to the relative benefits of competition and monopoly in promoting innovation. 52

Kahan and Kamar think there is much uncertainty as to how political forces would play out at the federal level compared to the state level. On the one hand, the federal government may be more like non-Delaware states than Delaware in its managerialist bias, because it will not need to attract shareholders as a way of attracting incorporation in its jurisdiction. On the other hand, shareholders might be better able to organize at the federal level, and the SEC might set much federal law and be more pro-shareholder than Congress. 53 They argue that Congress is likely to be slow to innovate, but the SEC might be relatively quick to do so. 54 They think the net benefits of switching to a federal corporate law are unclear relative to the current situation.

Roberta Romano has already responded to some of these arguments that Bebchuk, Hamdani, Kahan, and Kamar make, and they, in turn, have responded to some of her responses. She argues that states other than Delaware engage in “defensive competition” to keep from losing firms already incorporated there. 55 Kahan and Kamar reply, though, that the gains from such competition are likely to be quite limited. 56 Romano also thinks the fact that corporate law reforms diffuse in a S-shaped cumulative distribution suggests competition. 57 Kahan and Kamar reply, though, that this diffusion pattern simply suggests transfer of information that can and does occur without competition. 58 Romano also questions whether network effects are truly significant, as differing laws may not be incompatible and there may be court congestion that leads to decreasing returns. 59 She also suggests that competing networks could develop to serve niche markets. 60

Mark Roe has made a final major recent contribution. 61 Roe argues that the major

49. Kahan & Kamar, supra note 5, at 736-38.
50. See id. at 739-41.
51. See id. at 741.
52. See JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM, AND DEMOCRACY 106 (3d ed. 1950) for the view that monopoly tends to promote innovation. Schumpeter’s hypothesis has lead to many efforts to test it and has been the subject of much debate. For overviews, see F.M. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 407-38 (2d ed. 1980) and Morton I. Kamien & Nancy L. Schwartz, Market Structure and Innovation: A Survey, 13 J. ECON. LIT. 1 (1975).
53. See Kahan & Kamar, supra note 5, at 743-45.
54. See id. at 747.
55. See Romano, supra note 19, at 509-10 (explaining the competition between states for retention of local corporations).
56. See Kahan & Kamar, supra note 5, at 699-700.
57. See Romano, supra note 19, at 511 (stating that the proportion of states adopting corporation code updates increases over time).
58. See Kahan & Kamar, supra note 5, at 715-16.
59. See Romano, supra note 19, at 517 (asserting that many provisions are similar even to Delaware and that docket congestion could lead to diminishing returns).
60. See id. (explaining that markets may develop where different rules are appropriate for different firms).
competition limiting the behavior of Delaware courts and legislature is the federal government, not other states. He points to a variety of ways in which federal actors (Congress, the SEC, and stock exchanges) have intervened in matters of corporate governance. The federal government has also frequently threatened to intervene, even though it eventually backed down.

The threat of federal intervention frequently affects what Delaware does. This makes empirical resolution of the race-to-the-bottom debate hopelessly indeterminate. Roe makes a convincing case that intervention by federal actors is an important factor to consider.62 His paper leads to two important questions: first, how much room do Delaware and other states have to act within the federal system?; second, does federal intervention tend to improve or worsen the final results of U.S. corporate law?

III. NICHES IN THE MARKET FOR CHARTERS

This Part considers the first goal of competition identified in the Introduction: providing varied legal rules for varied business organizations. Different corporations might have different preferences for corporate laws. If there were only one national law available, all would have to follow that law. With many states, corporations may sort themselves and choose the law that is closest to that which they most prefer.63

The existence of increasing returns complicates this point, however. Even if different corporations do have differing preferences as to corporate law, they may also want to incorporate in a state with many other corporations, to obtain the sorts of network effects discussed above.64 In the presence of such effects, will any states be able to follow a niche strategy and offer a corporate law that appeals to a group of corporations with different preferences than the mainstream Delaware companies? That is the question this Part addresses.

In fact, corporate law seems to vary little from state to state.65 However, a few states may have found ways to appeal to particular niches. Nevada is sometimes called the Delaware of the West.66 Nevada touts that it has no I.R.S. Information Sharing Agreement, minimal reporting and disclosure requirements, and that stockholders are not public record.67 As Kahan and Kamar suggest, this reflects a corporate law aimed mainly at certain closely held corporations, not the public corporations which dominate in

62. That the federal government helps set U.S. corporate law was a theme of my earlier paper on charter competition. See McDonnell, supra note 6, at 64-65. Roe has re-discovered a point made earlier by Melvin Eisenberg. See Melvin Aron Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1512 (1989) (explaining how the threat of federal action influences Delaware’s decisions).

63. See Romano, supra note 19, at 517 (advancing the concept of niche-filling); Barry D. Baysinger & Henry N. Butler, The Role of Corporate Law in the Theory of the Firm, 28 J.L. & ECON. 179 (1985) (asserting that firms select state laws that match their circumstances).

64. See supra notes 15-20 and accompanying text (suggesting that states with a large number of corporations may be more responsive to the needs of corporations).

65. See Romano, supra note 19, at 517 (observing that state codes do not vary much); Carney, supra note 12, at 731-34 (indicating that nearly 75% of states have adopted similar provisions).

66. See Keith Paul Bishop, The Delaware of the West: Does Nevada Offer Better Treatment for Directors?, 7 No. 3 INSIGHTS 20 (Mar. 1993) (stating that changes to Nevada corporate law offer directors greater protection from liability than is available under Delaware law).

Delaware. They argue that this shows that Nevada does not represent a serious threat to Delaware’s dominance of the core market. That is true, but it also suggests that some niche-filling does go on in the state competition, and such niche-filling can itself advance efficiency.

Another state which has found a niche is Maryland. It has attracted a number of investment companies. Between 1986 and 2001, 249 companies going public incorporated in Maryland; 193 of those were investment companies. Provisions that attract investment companies include a waiver of the requirement of annual shareholder meetings and giving boards the power to increase the number of authorized shares without shareholder approval. As with Nevada, Kahan and Kamar again argue that Maryland does not represent a threat to Delaware’s core market, which is correct, but they neglect to point out that filling a niche is itself a gain from state competition.

More variety appears if we look at business organization laws beyond corporate law. In recent decades there has been an explosion of types of business entities and the laws defining them. We now have corporations, partnerships, limited partnerships, limited liability partnerships, limited liability limited partnerships, limited liability companies, and business trusts, among others. These provide a wide range of choices for different kinds of businesses. I am not aware of any particular state coming to dominate in these areas, though. Rather, what seems to happen is that one state innovates a new form, and other states follow. Indeed, to the extent any state has become particularly strong in other legal entities, it appears to be Delaware, as is the case with business trusts and perhaps limited liability companies.

Thus, some states do seem to be following a niche strategy, but perhaps fewer, and with less success, than one might expect. What factors affect the ability of states to fill a niche in corporate law? I began to address that question in my previous paper. I presented a simple model in which corporations choose between two or more states which offer differing laws—I conceive the laws as arrayed along a continuum of possible laws; one way to think of this is that laws can vary from permissive to strict. Two factors affect the expected profits of a company from incorporating in a state: how close the state’s law is to the corporation’s preferred law, and how many corporations are incorporated in a state (reflecting network effects). The former factor means that there is

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68. See Kahan & Kamar, supra note 5, at 701-15 (challenging conventional wisdom that states compete for incorporations).
69. See id. at 718-20.
70. See id. at 721 n.147.
71. See id. at 721.
72. See id. at 721-22. One can argue that the Maryland and Nevada provisions are bad for shareholders, representing a race-to-the-bottom. I shall turn to the topic of state incentives to protect shareholders in Part VII.
73. For an overview, see Larry E. Ribstein, Unincorporated Business Entities (2d. ed. 2000).
74. See William H. Clark, Jr., Rationalizing Entity Laws, 58 BUS. LAW. 1005, 1005 (2003) (indicating that the enactment of statutes in Wyoming and Texas providing for the organization of LLPs and LLCs resulted in recognition by all fifty states and the District of Columbia).
75. See generally Tamar Frankel, The Delaware Business Trust Act Failure as the New Corporate Law, 23 CARDOZO L. REV. 325, 341 (2001) (proposing that those who traditionally use business trusts have reincorporated in Delaware to use the Delaware Business Trust Act, although other sorts of entities have not switched to using business trusts).
76. See McDonnell, supra note 6, at 722-23.
potentially a social gain from offering a variety of laws. The latter factor, though, tends to push to uniformity.

In that paper I examine whether and how one state may come to dominate the charter market. If network effects increase without bound then one state will come to dominate, with no other states able to fill different niches.\(^{77}\) On the other hand, if network effects are capped so that they do not increase beyond a certain number of corporations, the results may vary. If the network effects are capped at a low level, then no one state will come to dominate, and several states will offer laws which appeal to differing corporations.\(^{78}\) If the cap is higher, there are several possibilities. One is that one state will do well enough early on that it comes to be the dominant choice for all possible corporations. The other possibility is that several states may remain in the running and eventually achieve the maximum network effects, leading to a segmented market. This latter possibility is more efficient, as it allows corporations to get closer to their preferred laws while still achieving all available gains from network effects.\(^{79}\)

The question for this paper is what happens after one state has become dominant. In a model like that described in the last paragraph, is it possible that even if one state has become dominant, another state could enter the market by offering a quite different law that appeals to corporations with preferences for a law quite different from that offered by the dominant state? To explore this question I present a variant on the model from my earlier paper.

Once a system has come to rest, it takes some energy to move it from that equilibrium. One way to think about how easy it would be for a state to enter the market is to ask how much it would cost to successfully enter the market, and what factors affect that cost. I propose a simple way of thinking about that. Imagine an array of possible corporate laws along a continuum from 0 to 2d.\(^{80}\) One state dominates the market, and it offers a law in the middle of the continuum, at d.

Corporate profits depend on two factors: how close the law of the state in which they incorporate is to the law which they would most prefer, and how many other corporations are incorporated in that state, but with a cap on the size of the latter effect. Each corporation has a different most preferred law. In particular, the expected profit of corporation i if it incorporates in state j is

\[
\Pi_{ij} = 1 - (x_i - L_j)^2 + c(\min(N_j, N^*))
\]

where \(x_i\) is the ideal law of corporation i, \(L_j\) is the law offered by state j, \(c\) is a parameter which measures the strength of network effects, \(N_j\) is the number of corporations incorporated in state j, and \(N^*\) is the point at which network effects cease to increase. Corporations are arrayed along the line with \(x_1\) as the corporation with the lowest preferred law (which I normalize to \(x_1 = 0\)), \(x_2\) the next lowest, and so on.

Now suppose a state tries to enter this market by offering a law as far removed from the dominant law as possible, setting \(L_j = 0\). If \(N^*\) and the number of existing corporations in the dominant state are large enough, no corporation, not even \(x_1\), will prefer the new state to the dominant one. One way for the state to enter is to subsidize companies to induce them to switch. Suppose each corporation must pay a switching cost.
c to reincorporate. Then the subsidy the state must pay to induce corporations to switch can act as a measure of how easy entry by a new state would be.

What subsidy would the entering state have to pay the firm with value $x_1$ to switch? The answer is $S_1 = eN^* - d^2 + c$. Suppose that the state pays this to induce that corporation to switch. Now how much would it have to pay the corporation with the second-lowest value, $x_2$, to switch? The answer is $S_2 = 2x_2d - d^2 + e(N^* - 1) + c$. One can proceed in this way for each switching corporation. How much would it cost to induce the lowest $N^*$ firms to switch to the new state, so that the state realizes all available network externalities? The answer is:

$$ (1) \Sigma S = 2d \Sigma (x_i) - N^*d^2 + \Sigma e(N^* - i) + N^*c. $$

The payoff to this little exercise is asking how equation (1) changes as we vary different factors. A change that works to increase $\Sigma S$ makes entry into a new niche by a non-dominant state more difficult. What changes in this model increase $\Sigma S$?

Decreasing $d$ increases $\Sigma S$. That makes sense. Decreasing $d$ means that even companies with extreme legal preferences find that the dominant state’s law is less far from their ideal point. The companies thus have less reason to want to switch, and have to be paid more to induce them to do so. With a lower $d$, there is just less to gain from having diversity in corporate law.

Increasing $\Sigma x_i$ increases $\Sigma S$. $\Sigma x_i$ is a measure of how closely firms are clustered to the extreme edge away from the center where the dominant state’s law is located. The further firms are from the edge where the entering state is offering its law, the harder it is to induce firms to switch. With larger $\Sigma x_i$, there are not that many firms interested in leaving Delaware for a niche state.

Increasing $c$ increases $\Sigma S$. The more costly it is for firms to switch state of incorporation, the less likely it is that they will switch, and hence the harder it is for a new state to find a niche. Increasing $e$ increases $\Sigma S$.

81. Firm One’s profit from choosing the entering state is $1 - (0 - 0)^2 + e*0$, plus it incurs a cost $c$ from switching to that state, while its profit from the dominant state is $1 - d^2 + eN^*$. The two are set equal at the amount in the text.
82. Firm Two’s profit from choosing the entering state is $1 - (x_2 - 0)^2 + e$, plus it incurs cost $c$ to switch, while its profit from the dominant state is $1 - (x_2 - d)^2 + eN^*$. The two are set equal at the amount in the text.
83. Note that there might be more strategic ways for the entering state to proceed. If it could convince a number of companies to switch at once, rather than going one by one, it might incur a lower cost. The measure developed in the text assumes static expectations of corporations as to future market share for the states, a limiting assumption. However, the measure should still reflect the factors that influence how high the costs of inducing switches are likely to be.
84. Note that when one compares the benefits of gaining corporations with the costs, it might not be worth it for the state to proceed all the way to $N^*$.
85. The derivative of $\Sigma S$ with respect to $d$ is $2\Sigma x_i - 2N^*d$. Let us assume that all of the switching $x_i$ are less than $d$, which simply says that all of the states that switch to the new law of $0$ are below the law offered by the dominant state, $d$. It is a reasonable assumption that, network effects aside, a law of $0$ is better than a law of $d$ only for corporations with $x_i < 0.5d$. So long as $x_i < d$ for all $i$, then $2\Sigma x_i < N^*d$, and so $2\Sigma x_i - 2N^*d < 0$, i.e., $\Sigma S$ increases as $d$ decreases.
86. The derivative of $\Sigma S$ with respect to $\Sigma x_i$ is $2d > 0$.
87. The derivative of $\Sigma S$ with respect to $c$ is $N^* > 0$.
88. The derivative of $\Sigma S$ with respect to $e$ is $\Sigma(N^* - i) > 0$. 
the harder it is for a state to enter into a new niche.\(^89\)

The above only captures the costs of switching. Other variables are the benefits of switching, and the extent to which the state decision maker captures those benefits or takes them into account. The next Part will consider some related questions. Benefits, at least to in-state companies, are probably internalized by politicians well through lobbying. However, that may be less true for out-of-state companies, particularly when a state has not yet succeeded in attracting such companies. Once a state does start attracting a certain kind of company, though, such companies and the lawyers who support them may start lobbying the state legislature, creating a self-reinforcing process. Such a process seems to have occurred in Maryland. Maryland law apparently unintentionally began to attract investment companies because it had several attractive features. Once a number of investment companies had incorporated in Maryland, they became a political constituency within the state and pressed for further favorable changes.\(^90\)

Thus, a variety of factors influence how likely it is that states other than Delaware will be able to introduce a strategy of appealing to a niche of corporations with a corporate law tailored to their needs. Some of this does appear to happen, with Nevada and Maryland as leading examples, but not very frequently. Casual empirical observation suggests that there is not more because corporations do not differ all that much in their preferred corporate law,\(^91\) there is not a large cluster of corporations with preferences different from the mainstream,\(^92\) and the network effects to Delaware incorporation are fairly significant.\(^93\) However, corporate law specialization does currently provide some gains in the U.S., and if the gains to specialization were to increase in the future as a group of corporations found that Delaware law is quite far from their needs,\(^94\) the system could provide more specialization.

### IV. THE STALKING HORSE ARGUMENT

This and the next two Parts focus on the third goal of competition identified in the introduction: introducing innovation and adaptation.\(^95\) Can charter competition help induce innovation in the dominant law, either by having another state replace Delaware with a better law or by prodding Delaware to improve its law? In making this move, I now will focus, for the rest of the article, mainly on the law chosen by large public corporations, rather than on the larger range of business organizations considered in Part

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89. The other notable parameter is \(N^*\). The effect of a change in \(N^*\) is ambiguous. Since the number of firms is constrained to be an integer, we cannot take the derivative with respect to \(N^*\). We can, however, ask how \(\Sigma S\) changes as we move from \(N^*\) to \(N^* + 1\). The change is equal to \(2dx_{N^*+1} - d^2 + N^*e + c\). All but the \(d^2\) term in this expression are positive, so if the \(d^2\) does not outweigh the others, then \(\Sigma S\) will increase as \(N^*\) increases. This makes sense—it is more costly if one must induce more corporations to switch in order to achieve the maximum increasing returns. Remember, though, that a state contemplating entering into a niche need not necessarily attract as many corporations as \(N^*\) in order to find the strategy worthwhile.

90. See Kahan & Kamar, supra note 5, at 721 n.149.

91. That is, \(d\) is low.

92. \(\Sigma x_i\) is high.

93. That is, \(e\) is high.

94. I.e., if \(d\) were to increase and \(\Sigma x_i\) decrease.

95. I discuss the second goal, ensuring that a state that offers good corporate law becomes dominant in the first place, in an earlier article. See McDonnell supra note 6.
II. As described in Part I, Bebchuk and Hamdani have suggested that one major obstacle to competition inducing innovation is what they call the stalking horse problem. Suppose a state other than Delaware introduces a legal innovation that corporations find quite attractive. Delaware can, and often does, quickly choose to adopt that innovation for its own law. Romano shows that Delaware is a swift adopter of innovation in other states. This will prevent the innovating state from inducing corporations to choose it over Delaware as a result of the innovation. Anticipating this problem, if introducing the innovation is costly in the first place, a state considering such an innovation will not find it cost-justified. In this Part, I suggest a partial reply to this point, which argues that states get around the stalking horse problem for innovations that are not too costly—which includes many, if not most, innovations in substantive corporate law. Put simply, other states may have incentive to innovate, not to induce out-of-state corporations to incorporate under their law, but rather to service their own in-state corporations.

One possible response to the stalking horse problem would be to claim that the market for charters is a contestable market. That is, even though Delaware holds a quite dominant position in out-of-state incorporations, if entry into the market by other states is cheap and if after entry they (or the corporate lawyers who drive most innovation) could earn a decent profit on their innovation before Delaware responds, the threat of such innovation would significantly constrain Delaware. Bebchuk and Hamdani consider that response, though, and answer that Delaware can and does respond quite quickly, and it would take a relatively long time for a challenging state to attract a significant number of incorporations. Thus, the entrant is unlikely to profit, or even recover, the costs of innovation. I find their answer persuasive.

However, Bebchuk and Hamdani seem to have neglected a different response to the stalking horse problem. As they themselves emphasize, there is an important home state bias in firms’ choice of where to incorporate. As a result, every state in the U.S. has a relatively large number of corporations which continue to incorporate under their law, despite Delaware’s dominance. That being so, consider a state other than Delaware contemplating whether to introduce an innovation into its corporate law. Because of the stalking horse problem, it knows that if the innovation is successful it is unlikely to attract many new incorporations from out-of-state because Delaware will probably match the innovation.

However, the proposed innovation will still benefit those corporations that already incorporate in the state considering the innovation. State decision makers may well internalize that benefit, either because they capture some of it through taxation or because corporate managers and lawyers largely control state decision-making in corporate law through their lobbying and service on legal commissions. If the benefits to these in-state

96. See supra note 30 and accompanying text.
97. See Romano, supra note 13, at 240 (noting this attribute is present in Delaware). Delaware does not always follow other states, of course. See Carney, supra note 12, at 754.
98. See Bebchuk & Hamdani, supra note 4, at 593-95.
100. See Bebchuk & Hamdani, supra note 4, at 593-94.
101. See id. at 568-72.
corporations are great enough to outweigh the costs of innovation, then the state has incentive to innovate despite the stalking horse problem. Delaware may then have an incentive to respond to prevent companies from switching.

To test the logic of this point, I use a simple formal model. Imagine firms choosing between incorporating in a dominant state (D), a state with a decent-sized base of local firms (L), and a weak state with little in the way of local firms (W). Assume now that a firm’s profit depends on the quality of law offered by the state in which it incorporates, advantages offered by incorporating in the dominant state, advantages from incorporating in the home state, and the price charged by the state in which the firm incorporates. To start with, each state offers a corporate law with a value of Q to each firm. There are two types of firms. National firms (there are \( n_n \) of these) gain from incorporating in the dominant state, either because of network effects or because they value the dominant state’s installed infrastructure. Suppose the added value to national firms of incorporating in a state with that infrastructure is I. Local firms (there are \( n_l \) of these) have a home state bias towards incorporating in state L, and gain added value of H from doing so.\(^{102}\) Each state charges a price \( p_i \) (i equals D, L, or W). The gains to the two types of firm from choosing D, L, or W are thus:

<table>
<thead>
<tr>
<th>Firm type</th>
<th>Incorporate in D</th>
<th>Incorporate in L</th>
<th>Incorporate in W</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>( Q + I - p_D )</td>
<td>( Q - p_L )</td>
<td>( Q - p_W )</td>
</tr>
<tr>
<td>Local</td>
<td>( Q - p_D )</td>
<td>( Q + H - p_L )</td>
<td>( Q - p_W )</td>
</tr>
</tbody>
</table>

Each state gains profit \( N_i p_i \), where \( N_i \) is the number of firms which choose to incorporate in the state. Equilibrium prices are then as follows. State W sets \( p_W \) equal to 0 and gets no corporations. State D sets \( p_D \) equal to I and all national firms choose to incorporate in D, leading to a profit of \( I n_n \). State L sets \( p_L \) equal to H and all local firms choose to incorporate in L, leading to a profit of \( H n_l \).\(^{103}\)

\(^{102}\) Note that both here and in the previous Part I assume that there are different types of companies that prefer differing laws. I do not explain these differing preferences. A really adequate theory of American corporate law federalism would explain why some businesses choose Delaware and others do not. Bebchuk and Hamdani survey some reasons why some companies prefer their home state while others prefer Delaware. See Bebchuk & Hamdani, supra notes 37-39 and accompanying text. However, I think much work remains to be done in explaining the differences between firms, especially between large public firms. I thank Jill Fisch for pushing me on this point, and wish that I had a better answer.

\(^{103}\) To see that this is an equilibrium, note that the return to firms at those prices are:

<table>
<thead>
<tr>
<th>Firm type</th>
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<th>Incorporate in L</th>
<th>Incorporate in W</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>( Q )</td>
<td>( Q - H )</td>
<td>( Q )</td>
</tr>
<tr>
<td>Local</td>
<td>( Q - I )</td>
<td>( Q )</td>
<td>( Q )</td>
</tr>
</tbody>
</table>

National firms will thus incorporate in D and local firms in L if we add the tiebreaker assumption that given equally good returns in two states, national firms will choose D and local firms L. State W cannot profitably lower its price any further than the equilibrium to attract firms, since it has already set a price of 0, so a lower price, which would induce firms to switch to it, would lead to a loss. Raising its price is also pointless. If either state D or L were to raise its price above the equilibrium, it would lose all its firms to W. If either state D or L were to lower its price, it would lower the profit D or L receives from firms incorporated in it. In addition, D or L would not be able to induce any other firms to incorporate in it unless it set a price of 0, which would lead to 0 profit. Hence, all states and firms are making their best response given the behavior of the others, and the
Now, we want to ask about state L’s incentive to innovate in this situation. Suppose that state L can improve the quality of its law by $\Delta Q$ at cost $C$. Will it choose to do so? That depends on how one assumes the other states can react. I offer two versions of the model in which state L has some incentive to innovate, although less incentive than is optimal. In the first version, state L will be alone in offering this higher quality for some period, and afterward the other states can increase quality by $\Delta Q$ at no cost. Let $\delta$ be a discount factor that reflects how long state L will be the only state with higher quality—a higher $\delta$ means state L enjoys its advantage for a longer time. State L’s profit over time is $\delta$ times the profit it earns while it has the quality advantage plus $1 - \delta$ times the profit it earns after the other states have caught up.

Suppose that firms must incur a cost $s$ to switch state of incorporation, and that we start with the above equilibrium. If state L were to innovate and introduce a higher quality law, the advantages to firms to incorporation during the period of state L’s advantage would be:

<table>
<thead>
<tr>
<th>Firm type</th>
<th>Incorporate in D</th>
<th>Incorporate in L</th>
<th>Incorporate in W</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td>$Q + I - p_D$</td>
<td>$Q + \Delta Q - s - p_L$</td>
<td>$Q - s - p_W$</td>
</tr>
<tr>
<td>Local</td>
<td>$Q - s - p_D$</td>
<td>$Q + \Delta Q + H - p_L$</td>
<td>$Q - s - p_W$</td>
</tr>
</tbody>
</table>

State L has two possible pricing strategies. If it remains content with attracting only local firms, it can raise its price to $H + \Delta Q$ during this period, increasing its profit by $\Delta Q_nL$ during this period. Alternatively, it could try to attract national firms. To do so it would have to offer a price slightly below $\Delta Q - s$ (assuming that state D sticks to its former equilibrium price of I).\(^{104}\) If $s$ is larger than $\Delta Q$ that would require a negative price, and even if not, state L would lose profits received from its home firms by lowering the price. So long as that loss outweighs the gains from inducing national firms to switch,\(^{105}\) state L will not follow that strategy. Let us assume that state L will follow the high price strategy, and simply charge a higher price to its local firms while it has the quality advantage.\(^{106}\) Once the other states match the quality improvement, the original equilibrium will re-assert itself.\(^{107}\) Thus, state L gains from the innovation so long as $\delta \Delta Q_nL > C$.

The other variant of the model with potential innovation assumes that the other states can match the quality improvement immediately at no cost. Thus, the equilibrium prices will not change. It would seem then that state L has no incentive to innovate. But suppose, contrary to what we have assumed so far, that state L’s decision makers gain some fraction $q$ of the producers’ surplus enjoyed by firms locating in state L. This could be because state L can charge taxes on firms actually physically located in the state, and

\(^{104}\) At a price of $\Delta Q - s$, national firms receive $Q$ from incorporating in state L, the same that they receive from incorporating in either state d or state W at the original equilibrium. See id.

\(^{105}\) This holds if $H_n > (\Delta Q - s)n_L$.

\(^{106}\) This fits the point acknowledged above that this is not a contestable market. See Spence, supra note 99, at 981 and accompanying text.

\(^{107}\) Now each state has quality $Q + \Delta Q$, and the situation is identical to the original with this higher level of quality replacing the old $Q$.\n
Two Cheers for Corporate Law Federalism

hence faces no (or at least different) price competition from states D and W in setting those prices. Alternatively, state L decision makers may care about producers’ surplus of in-state firms because of lobbying by those firms’ managers and lawyers. Some combination of these factors seems to apply in the real world. The increase to producers’ surplus in state L from innovation is $\Delta Q_{nl}$. Thus, state L decision makers will choose to innovate if $q\Delta Q_{nl} > C$.

Thus, under either variant of the model, there is some incentive to innovate. However, the incentive to innovate is not optimal. Innovation is socially optimal if $\Delta Q(n_l + n_n) > C$. In both variants of the model, two factors make the incentives to innovate sub-optimal. One factor is the $\delta$ or $q$ term. State L does not fully internalize the benefits of innovation to its own firms, either because the state gains from the change only for a limited time (the first model) or because the state captures only a portion of the benefits to firms through taxes and lobbying (the second model). More significantly, state L does not internalize the benefits of innovation to firms that incorporate in other states. For instance, if there was a property right to innovations in corporate law then other states could license the right to improve a corporate law. However, there seems to be no such property right in the real world. Still, there is some incentive for state L to innovate so long as such innovation benefits firms incorporated in-state and so long as the state’s decision makers internalize that benefit to some degree in some way or another.

Note that the dominant state has a stronger incentive to innovate due to the extent that it has more incorporated firms and, thus, can internalize a greater proportion of the benefits of those changes. That particular point suggests that the more concentrated incorporation is in the dominant state, the better. This is a version of the traditional argument that monopoly creates a stronger incentive for innovation than competition. However, that overlooks the advantages of having a variety of actors experimenting with alternatives and the disciplining effects of competition. We shall consider these points in

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108. Firms would have to physically leave the state to avoid these taxes, generally a much costlier decision than simply reincorporating elsewhere.

109. That is true even in this model where states are generally unable to capture a high quality of corporate law by charging a higher price if other states offer a similarly high quality.

110. See Michael Abramowicz, Speeding Up the Crawl to the Top, 20 YALE J. ON REG. 139, 157 (2003) (stating that if there was protection for innovations, states would have incentives to innovate and investors would benefit); Ian Ayres, Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks, 43 U. KAN. L. REV. 541, 545-50 (1995) (stating that innovations in corporate law will occur at slow rates due to the lack of protection for the development of the innovations).

111. Michael Abramowicz suggests developing such rights. See Abramowicz, supra note 110, at 193-205. Daniel Greenwood suggests that private actors, such as law firms, may often be better able to offer corporate law innovations and capture a large share of the gains from them. The introduction of the poison pill is a leading example. Daniel J. H. Greenberg, Democracy and Delaware: The Puzzle of Corporate Law, available at http://ssrn.com/abstract_id=363480, at 62 (last visited Aug. 30, 2004).

112. That is, $n_n > n_l$. The dominant state, most of whose corporations are not physically located within the state, may not be able to internalize the benefits to corporations as well, that is, in the second variant of the model it may have a lower $q$. The dominant state, for instance, is certainly less able to capture profit through various forms of taxation other than the franchise tax. It is also possible that out-of-state corporations cannot lobby as effectively as in-state corporations. On the other hand, the centrality of attracting corporations to Delaware makes pleasing corporate decision makers of particular importance to Delaware politicians, suggesting perhaps a higher $q$ than for other states.

113. See supra note 52 and accompanying text.
the next section.

This model suggests that innovations that are not too costly, relative to their benefits, are still likely to be made within a system of state competition. A key question then becomes how costly the various legal innovations are. I would argue that most changes to corporate law statutes are of relatively low cost. Most corporate law reforms attract little political attention. In fact, in most states, the only well-organized groups that care about corporate law are corporate managers and corporate lawyers. The latter group dominates the lawmaking process and the state legislature often rubberstamps changes proposed by the corporate bar. The Model Business Corporation Act further reduces the costs of legal change by effectively pooling resources in the search for corporate law best practice. Occasional changes do attract substantial opposition and in such cases, state innovation is less likely.

One area where legal innovation may be relatively costly is changing the legal infrastructure. As noted above, Delaware’s Chancery Court may well be an important part of its advantage. A state wanting to seriously compete with Delaware might therefore want to introduce a similar court. However, the costs of doing so are plausibly relatively high. They are high enough, in fact, that the benefits to corporations already incorporated in-state are not great enough to justify the expense. In that case, the stalking horse problem might well prevent other states from introducing a Delaware-style court. Recently, some states have adopted specialized business courts, mimicking Delaware to an extent. Some argue that this shows that competition is indeed robust. Kahan and Kamar argue at least somewhat convincingly, however, that these courts focus more on commercial than corporate law and are mostly adapted to serving the interests of businesses based in-state, rather than attracting incorporation from out of state companies.

Another key issue suggested by the model is the extent to which states internalize the benefits from improved corporate law quality received by firms incorporated under their laws. To some extent that is a matter of how the state taxation system works, but of probably greater significance is how well lobbying is likely to induce legislators to care about the interests of in-state corporations. We shall turn to related questions in later parts.

This revised version of the stalking horse problem seems to fit casual empirical evidence fairly well. Both Delaware and other states do revise their corporate law relatively frequently. However, few states have tried to imitate Delaware’s judicial

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114. See Carney, supra note 12, at 737.
115. See infra Part VI.
116. Kahan and Kamar consider several cases of that sort. See Kahan & Kamar, supra note 5, at 730-35. They do not succeed in showing, in my view, that such cases are especially common.
117. See supra note 29 and accompanying text.
118. See Bebchuk & Hamdani, supra note 4, at 588; but see Kahan & Kamar, supra note 5, at 725.
120. See Kahan & Kamar, supra note 5, at 710-15.
121. See infra Parts V and VII.
122. For more on the patterns of legal innovation, see infra Part V. A difficulty here is in defining and measuring how frequently legal change occurs, particularly in relation to a counterfactual case of heavy state competition.
infrastructure. That is what the theory would predict. The story suggests that state charter competition does still encourage a significant amount of legal innovation. In the next section we will look at other issues affecting the incentive to innovate, and at some empirical evidence on innovation under state competition.

V. THE CHARTER MARKET AND MONOPOLY’S SLACK

As described above, Bebchuk and Hamdani argue that Delaware’s huge lead and the resulting lack of effective competition between states will create a large degree of monopoly slack. The core idea is that Delaware decision makers can offer laws that are sub-optimal and still not fear a significant loss of market share; they thus have weaker incentives to keep Delaware law fully up-to-date. Decision makers in other states have slack for a mirror reason: even if they worked hard to provide optimal laws, they would be unlikely to greatly increase their market share.

This use of an analogy to slackness in product market competition has much to recommend it. However, the idea has some limitations. This Part explores some of those limitations. First, it points out that monopoly may encourage product market innovation. Second, assuming that market competition does do better than monopoly at encouraging innovation and the supply of higher quality products, this Part considers why and how competition might do so, and asks how those arguments as to product markets translate into the different context of state political actors.

Some economists have argued that monopoly provides stronger incentives to innovate than competition. The core idea is that a monopolist, through monopoly profit, captures a significant portion of the social gain from innovation. Competition, by contrast, reduces profit and ensures that most of the gain from innovation is captured by consumers rather than suppliers. Thus, monopolists have better incentives to expend resources on innovation, as they are likely to capture more of the return from that expenditure. We saw in the last Part how this argument can easily be made in thinking about corporate charter competition. In this setting, the monopolist’s return could take the form of a high franchise tax fee to Delaware, or of high returns to Delaware lawyers. Recall that in the last model offered in that section, states had some incentive to innovate insofar as gains to corporations incorporated in the state could cover the costs of innovation. However, states do not have incentive to consider possible gains to corporations incorporated elsewhere. Thus, the more that one state succeeds in cornering the charter market, the more that state can succeed in internalizing the gains to legal innovation, and hence the better its incentive to innovate.

Thus, to the extent that one accepts the Schumpeterian story as to the relationship between monopoly and innovation, the product market/charter market analogy suggests

123. See Kahan & Kamar, supra note 5, at 708-15.
124. See supra notes 33-35 and accompanying text.
125. See SCHUPPER, supra note 52, at 87-91.
126. See Macey & Miller, supra note 12, at 472.
127. See supra notes 110-113 and accompanying text.
128. As noted above, Kahan and Kamar have briefly made the same basic point. See supra note 51 and accompanying text.
the opposite conclusion from that which Bebchuk and Hamdani draw. Before drawing such a conclusion, though, let us take a look at the reasons other economists give in favor of competition over monopoly, and see how well those reasons translate to charter competition. If one assumes that the decision makers within firms are unboundedly rational people who single-mindedly focus on maximizing the expected profit of their business, the Schumpeterian monopoly story seems pretty conclusive.

However, actual decision makers are quite a distance removed from that ideal. Corporate decision makers are quite bounded in their rationality. One implication is that they do not necessarily know what innovations would be best for customers in their market; indeed, they will not even think of many possible innovations. Corporate decision makers will also pursue ends other than maximizing their business’s expected profit. Their actual ends will include maximizing their own personal welfare, and the incentive structure within a firm will generally not guarantee that maximizing profits is necessarily best for the manager personally. These limitations of corporate managers help motivate two important functions for competition: product market competition can provide information as to what business is better serving consumers, and it can provide incentives to managers to do a better job. I shall examine each of these functions of competition, starting with the motivational.

It is well known that agency problems arise for managers in corporations, particularly for managers of large corporations with no controlling shareholder. With no shareholder having an incentive to closely monitor their behavior, managers may make decisions that pad their own pockets or that make their lives easier. A variety of mechanisms exist to limit these problems, including performance and equity-based compensation, the threat of hostile takeovers, managerial labor markets, and monitoring by large institutional shareholders. Product market competition is another important mechanism. If businesses in a competitive market offer unsatisfactory products, they are likely to quickly lose market share to better competitors. If they perform too badly, the businesses will go bankrupt and their managers lose their jobs. Even short of bankruptcy, product market competition may complement other disciplinary mechanisms. For example, where there is much competition, poor performance by managers may become apparent more quickly, leading to a quicker drop in stock value that hurts managers via equity compensation, increased risk of takeover, and worsened prospects in the managerial labor market. Harvey Leibenstein has suggested that such effects of product market competition are much more significant than the traditional focus on the

129. More precisely, half of an opposite conclusion. The Schumpeterian position does suggest, in agreement with Bebchuk and Hamdani, that states other than Delaware will have reduced incentive to innovate. This must be qualified by noting that other states do have incentive to make low-cost innovations. See supra Part IV.


131. For an overview, see Brett H. McDonnell, Convergence in Corporate Governance—Possible, But Not Desirable, 47 VILL. L. REV. 341, 353-54 (2002).

link between competition and allocative efficiency.\footnote{See Harvey Leibenstein, Allocative Efficiency vs. 'X-Efficiency', 56 Amer. Econ. Rev. 392 (1966) (arguing the importance of "non-allocative" efficiency).}

Even this very brief overview of how product market competition helps to discipline business managers suggests that we need to be careful before simply accepting an analogy between product market competition and the market for corporate charters. Product market competition works in good part because corporate managers fear bankruptcy, lowered stock prices, takeovers, and gaining a bad reputation in the job market. The decision makers we are concerned with disciplining in the charter market are state politicians—legislators and judges. They face no obvious analogues to these mechanisms. We must thus look more closely at the incentives facing state politicians and how charter competition and Delaware's dominance may affect those incentives.

Let us make the standard public choice assumption that legislators care mainly about maximizing their chances of being re-elected. To that end they seek to appeal to both voters and to those who will donate money to their campaigns.\footnote{For a good overview of public choice theory, see Daniel A. Farber & Philip P. Frickey, Law and Public Choice: A Critical Introduction (1991).} A standard argument is that this will frequently lead them to favor the interests of relatively smaller groups with large stakes in a matter, which groups are best able to overcome the free rider problem inherent in collective action.\footnote{See generally Mancur Olson, The Logic of Collective Action (1965).} The objectives of judges, on a public choice account, are more obscure and controversial.\footnote{See Richard A. Posner, Overcoming Law, 109-44 (1995) (discussing the appropriate role of judges).} For most potential changes to corporate law, the only interest group likely to have enough at stake to care about the changes are managers and the corporate lawyers who represent them.\footnote{See Macey & Miller, supra note 12, at 506-09; Carney, supra note 12, at 737.} Most state legislatures leave it to a bar committee dominated by corporate lawyers to suggest statutory changes, and most suggested changes are passed quickly and easily through the legislature because of the lack of any organized opposition.\footnote{This is not true for all corporate law changes, of course. Kahan and Kamar point to some examples of cases where corporate law has led to considerable political controversy. See Kahan & Kamar, supra note 5, at 73-78. I will discuss such cases shortly. See infra note 152 and accompanying text.}

How does the existence of state competition, which is constrained by Delaware's dominance, affect this political dynamic? The logic underlying Bebchuk and Hamdani's monopoly slack argument is that if effective competition existed, corporations could threaten to reincorporate elsewhere if a state did not make improvements in its law. These reincorporations would lower state revenue, hurting the ability of politicians to use those revenues to spread benefits to their constituents. However, the threat to reincorporate is an idle one, for the most part, because Delaware has such a great lead over all other states that even if it does not make the desired change, reincorporation anywhere else would still not be in the managers' interests.\footnote{See Bebchuk & Hamdani, supra note 4, at 598.} As for states other than Delaware, they have little incentive to compete for companies located in Delaware, and the companies located in their home state are unlikely to leave if the state does not offer a fully optimal\footnote{I mean "optimal" from the point of view of whatever interests dominate the process of choosing whether to incorporate. I shall address that issue in Part VII.} law,
so those states have significant slack as well.141

There is probably something to this argument, but perhaps not all that much. Consider first the state of affairs in Delaware. One can debate how credibly Delaware corporations can threaten to incorporate elsewhere if they are unhappy with a legal rule. There are reasons to think such threats are sometimes credible. Some companies may be on the margin, barely preferring Delaware to the next-best alternative. Moreover, an occasional legal issue may be important enough to give rise to a credible threat to go elsewhere on the part of many corporations. One relatively recent such instance may have been the anxiety and high insurance costs created by the Delaware Supreme Court’s decision in *Smith v. Van Gorkom.*142 The disturbance over that case quickly led to a statutory change that allowed corporations to waive personal liability of directors for violation of the duty of care.143 Let us assume with Bebchuk and Hamdani, though, that most Delaware corporations cannot credibly threaten to leave. Still, this very commitment to Delaware gives Delaware corporations incentive to make the investments needed to effectively monitor developments in Delaware and to lobby for changes where those developments are not satisfactory. Most lobbying for corporate interests occurs through the corporate bar.

Delaware’s dominance also affects political incentives within the state. Since the state gains a significant chunk of its revenue from franchise taxes, Delaware’s politicians have good reason to ensure that nothing threatens that revenue stream.144 The chances of corporations leaving Delaware are lower than if competition were more vigorous, but Delaware has much more at stake from that low risk of reincorporation than it would had it not achieved such dominance. Indeed, this commitment on the part of Delaware politicians to be responsive to corporate desires is probably one of the leading sources of network effects supporting Delaware’s dominance.145 Even more importantly, Delaware’s success has created an important in-state interest group reliant on Delaware’s preeminence, namely, its corporate bar and corporate service industry.146 The Delaware corporate bar is largely responsible for legislative changes to Delaware law. Additionally, it has a strong impact on judicial changes. If Delaware did not gain as much as it does from its charter mongering, then these factors would be weakened, and Delaware might well have weaker incentives to constantly update and improve its law.

Indeed, on occasion Delaware legislators have been quite open about their desire to update the law to ensure that Delaware maintains its dominance. In the 1960s, when Delaware’s position showed some signs of slippage, the legislature thoroughly overhauled the law, leading to the new Delaware General Corporation Law of 1967.147 The preamble to the law creating a commission to consider revisions is explicit about the law’s purpose:

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141. See Bebchuk & Hamdani, supra note 4, at 607.
142. 488 A.2d 858 (Del. 1985).
143. See James J. Hanks, Jr., *Evaluating Recent State Legislation on Director & Officer Liability Limitation and Indemnification,* 43 BUS. LAW. 1207 (1988).
144. See Romano, supra note 13, at 235.
145. See McDonnell, supra note 6, at 702-03.
146. See Klausner, supra note 2, at 845-46.
WHEREAS, the State of Delaware has a long and beneficial history as the
domicile of nationally known corporations; and

WHEREAS, the favorable climate which the State of Delaware has
traditionally provided for corporations has been a leading source of revenue for
the State; and

WHEREAS, many States have enacted new corporation laws in recent
years in an effort to compete with Delaware for corporate business; and

WHEREAS, there has been no comprehensive revision of the Delaware
Corporation Law since its enactment in 1898; and

WHEREAS, the General Assembly of the State of Delaware declares it to
be the public policy of the State to maintain a favorable business climate and to
courage corporations to make Delaware their domicile . . . .

Thus, although Delaware’s dominance reduces the ability of Delaware corporations
to achieve political gains by threatening to move elsewhere, it also increases the
incentives of those corporations and the lawyers who serve them to improve their ability
to lobby in Delaware, as that induces Delaware politicians to be quite friendly to those
lobbying efforts. It is not clear that there is a major monopoly slack problem here, nor
even that Delaware’s dominance tends to loosen the slack Delaware politicians enjoy
rather than tightening it.

Now consider states other than Delaware. As with Delaware, and as Bebchuk and
Hamdan themselves admit, the leading influence on the development of the state’s
corporate law is likely to be the corporate bar. Most of the corporations choosing to
incorporate in the state are likely to be committed to staying in that state because of the
home state bias. Thus, as with Delaware, it is probably true that most corporations will be
unable to credibly threaten to incorporate elsewhere. However, again as with Delaware,
this very commitment to the state gives in-state corporations strong incentive to develop
the ability to effectively lobby the state legislature. More importantly, local corporate
lawyers are specialized in their state’s law, and have a strong interest in ensuring that the
law remains responsive to the needs of their clients. Corporate managers are also an
important and effective lobbying group. Again, for most issues there is likely to be
little organized opposition to this lobbying, so the state legislators can cater to the wishes
of local corporations at a low cost. This should work to eliminate much slack in the
system. Unlike Delaware, though, maintaining an effective corporate law is not likely to
be as central a concern of state legislators and judges.

Thus, states other than Delaware are likely to be less responsive to corporate
requests for legal change, i.e., slack will be somewhat greater outside of Delaware.
Somewhat greater, but definitely limited—the political mechanism should give
politicians plenty of reason to make their local corporations happy. One way to put this

148. See id. at 280.
149. See Bebchuk & Hamdan, supra note 4, at 607.
150. See Carney, supra note 12, at 720.
151. See id. at 721.
point, for both Delaware and other states, is that although the possibility of exit is limited by Delaware’s network advantages and the home state bias, in the absence of effective exit, corporations can and do develop relatively effective mechanisms to exercise their voice in helping to determine state corporate law.152

A caveat to this argument is required. One part of the argument, for both Delaware and other states, is that on most corporate law issues there is likely to be little effective opposition to the voice of corporate managers and lawyers. There will be some exceptions, though, where other organized interest groups may be affected enough that they succeed in effectively organizing to oppose a law preferred by corporate managers and lawyers. Kahan and Kamar describe some such situations.153 They do not make a particularly strong case, though, that such situations are common. They are likely to be less common in Delaware, as most Delaware corporations are not physically located there, and so some groups affected by Delaware law, particularly employees and local communities, are likely to have less clout in Delaware. Of course, this raises possible race-to-the-bottom concerns about possible sub-optimal domination by corporate managers. For now I am putting such concerns aside, but I will return to them in Part VII.

A final point on the issue of how competition dominated by Delaware affects the motivation and slack facing political decision makers is to compare state politicians with federal politicians. Which are more likely to be responsive to the demands of corporations for changes in corporate law? It certainly seems that Delaware is likely to be much more responsive. Corporate law would be just one issue out of a huge agenda for the U.S. Congress, whereas Delaware’s very success in the state competition makes corporate law a much more central concern to Delaware politicians. The same also holds true for Delaware judges versus federal judges. This point is weakened somewhat if one considers that much federal regulation would likely be written by the SEC, which is focused on corporate governance issues. However, responsiveness to the needs of those they regulate is not a particularly salient characteristic of federal agencies, and the SEC, while probably better than most, is not a complete exception to that observation.154 The comparison of Congress with states other than Delaware is much more ambiguous, although even there closeness to local corporations combined with at least some fear of those corporations choosing to incorporate elsewhere may make state legislatures somewhat more responsive than Congress. Thus, even competition with Delaware dominating the scene still yields significant political mechanisms operating to keep state decision makers somewhat focused on corporate requests and motivated to keep that constituency happy. Now I turn to the second potential sort of gain from product market competition, the informational gain.155

As noted above, when it comes to providing high quality, and improving upon existing quality, competitive markets may have a significant informational advantage. If any one supplier of the product in question knew the optimal product design for all consumers in the market, this would not be so. However, if the product is at all complex

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152. See ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY (1970) (discussing how competition acts on deteriorating organizations causing either exit, voicing of dissatisfaction, or loyalty to the organization).
153. See Kahan & Kamar, supra note 5, at 730-35.
154. Once again, race-to-the-bottom concerns that Delaware is too responsive to corporate managers arise, and again I defer those questions to Part VI.
155. See supra text accompanying note 130.
Two Cheers for Corporate Law Federalism

(and corporate law is at least somewhat complex), no one supplier thinks of all possible product improvements or figures out which of the many possible versions of the product consumers most prefer. Suppliers, like all humans, have bounded rationality. There are limits to their imaginations and their ability to process information. If a market is monopolized by just one supplier protected by insurmountable barriers to entry, the product quality offered will be limited to what that one supplier is able to conceive, even if that supplier is motivated to provide the optimal combination of quality and cost.

In contrast, with a competitive market there will be many suppliers striving to figure out what version of the product most appeals to consumers. There will be experimentation with a variety of options which should increase the chances of finding improvements that differ significantly from the existing standard. When a change is found by one supplier, others will eventually adopt that change and it will spread through the whole market (setting aside possible intellectual property issues).

One might ask whether a monopoly supplier could still achieve innovation similar to that obtained in competition by hiring a number of persons to research possible improvements, then offering to the public the best options produced by that internal procedure. If the results of the research must be approved and brought to market through an internal bureaucracy, though, there will be a number of chances for various persons within the bureaucracy to veto an idea. Such a bureaucracy is more likely to veto even good ideas than a competitive, non-hierarchical market, although it is also less likely to waste resources on ideas that turn out to be bad ones. Where the costs of developing and testing new ideas are not too great, though, and the benefits from good innovations are relatively high, then competition will out-perform bureaucracy. The costs to states of developing most legal innovations are probably not all that great, and improved corporate law can have a significant positive effect on productivity, so the charter market is probably an area where competition makes more sense than monopoly, on informational grounds. Moreover, much innovation in corporate law comes from lawyers seeking to solve problems for clients. These lawyers probably find it easier to suggest changes to corporate law revision committee members located near them, rather than trying to contact members of a more remote national body.

What of Delaware’s dominance of the market? That does not seem to affect the informational argument. The home state effect guarantees that even states other than Delaware do continue to have a number of companies incorporated under their laws. So long as some of those states continue to experiment with their laws, other states, including Delaware, can learn from those experiments.

Note that this informational argument does not really rely on one feature of charter competition that is crucial to many other arguments for and against such competition, namely that corporations can choose what corporate law to be governed by (that is, where

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158. I thank William Carney for stressing this insight gained from his experience with the Georgia lawmaking process.
to incorporate) independent of their choice of physical location. The informational argument developed above would apply even without the internal affairs rule. Thus, this benefit to competition applies to any law that may be formulated differently in a variety of jurisdictions. However, the informational argument does distinguish our federal system of setting corporate law from a national system where all corporations are governed by one national corporation law. Indeed, the informational argument is a restatement of the old “laboratories of democracy” argument in favor of federalism.

This Part and the previous one have presented a variety of reasons why charter competition may still help encourage innovation in providing higher quality corporate law despite Delaware’s strong position. Although I have started with an analogy to the economics of product market competition, much of my argument has ultimately shown the advantages of federalism, rather than explicit intentional competition between policymakers in different states, although Delaware policymakers, at least, do seem to be consciously responding to what other states are doing. However, it is still true that Delaware’s advantages do weaken competition, and the benefits to innovation from having competition are probably on the whole somewhat lessened due to Delaware’s position as compared with the benefits from a more vigorous competition. Is there any empirical evidence available which might help us determine how much corporate law federalism encourages corporate law innovation? The remainder of this section considers a few pieces of evidence.

One relevant type of evidence is simply a bit of casual empiricism: a lot of innovation does seem to occur on a fairly regular basis in both Delaware and other states at the level of both statutes and case law. The Delaware General Corporation Law and the Model Business Corporation Act are both revised frequently. Of course, many changes are small and technical. However, fairly major developments also seem rather common. Over just the last several decades, major innovations in state corporate law include expanded indemnification provisions, optional waiver of personal liability for violations of the duty of care, antitakeover statutes, corporate constituency statutes, Van Gorkom’s weakening of business judgment rule protection.

160. See Newstate Ice Co. v. Leibman, 285 U.S. 262, 311 (1932) (Brandeis, J., dissenting) (disagreeing with the majority’s holding that a state cannot pass experimental laws designed to improve public welfare if those laws violate the 14th Amendment rights of its citizens).
162. In Delaware, courts now seem to be the source of most important innovation.
167. See Smith v. Van Gorkom, 488 A.2d. 858 (Del. 1985) (holding that business judgment rule protection does not extend to gross negligence in director decision-making).
proportionality review,168 and the Revlon standard.169 Outside corporate law itself, but in
the more general area of business organization law, there has been a proliferation of
whole new types of organization, including limited liability companies, limited liability
partnerships, limited liability limited partnerships, and the like.170

Another piece of noteworthy evidence is that Delaware has been a fast adopter of
most changes in corporate law—if it does not take the lead in innovating itself, then it
quickly follows after another state has done so.171 This fits with the discussion above.
Since a reputation for responsiveness is an important part of Delaware’s lead over other
states, and since that lead matters quite a bit to Delaware, we saw above that the slack
facing Delaware decision makers is probably less than that for those in other states.172
Furthermore, Romano also found through regression analysis that states that receive a
higher percentage of their revenues from incorporation fees tend to adopt corporate law
innovations more quickly.173 This fits with Romano’s theory that deriving a high portion
of state income from incorporation serves as a hostage and helps a state commit to being
more responsive.174

Of course, one might question how many of these innovations are really major and
how much innovation this actually represents compared with what one would experience
were there no state competition or were corporations not able to incorporate outside the
state in which they are physically located. One way of getting at the latter question is to
compare patterns of innovation diffusion in corporate law with patterns in other areas of
law. Roberta Romano found an S-shaped diffusion pattern between states for changes in
corporate law, and argues that this is consistent with vigorous competition among
states.175 Kahan and Kamar reply that such a pattern is also consistent with simple
information diffusion, rather than competition between states, and that a similar pattern
is found in other areas of the law.176 One response to Kahan and Kamar is that simple
information diffusion is itself valuable, as I have just argued, and that is a benefit
available from a federal system. But, does charter competition lead to a more rapid
diffusion of innovation than in other areas of the law?

Only a small amount of evidence is available for making that comparison. The
leading early study of diffusion in innovation among states found an average adoption
time of 22.9 years among the twenty states adopting an innovation during the period
1870-1899, with the average dropping to 20 years for the period between 1900-1929 and
18.4 years for the years 1930-1966.177 By contrast, Romano’s study of corporate law
adoptions indicates that twenty states adopted one of the four provisions well before 18

168. See Unocal Corp. v. Mesa Petroleum Co., 493 A.2d. 946, 955-56 (Del. 1985) (discussing the
proportionality requirement of defense mechanisms to the threat of a takeover).
the Revlon standard for defensive responses to corporate takeovers).
170. See Ribstein, supra note 73, at 289.
171. See Romano, supra note 13, at 240.
172. See supra notes 149-152 and accompanying text.
173. See Romano, supra note 13, at 240-42.
174. See id. at 235.
175. See id. at 233-35.
176. See Kahan & Kamar, supra note 5, at 682-84.
177. See Jack L. Walker, The Diffusion of Innovations Among the American States, 63 AM. POL. SCI. REV.
880, 895, 899 (1969) (reviewing the adoption of 88 programs).
years had passed.\footnote{See Romano, supra note 13, at 234; see also Carney, supra note 12, for more rapid recent changes.} This provides weak evidence that adoption rates have been quicker in corporate law than in other areas of law. One cannot readily conclude that this is the result of competition, however, as other factors could explain the difference. For instance, Walker’s study shows a trend for quicker adoption rates over time, and the corporate law changes Romano considers occurred later than the changes Walker studied.\footnote{See Romano, supra note 13, at 234 (stating that the first adoption for all four laws which Romano reports occurred in the sixties).} Also, corporate law changes may face less organized opposition than other sorts of legal changes.

Another comparison of interest is the pattern of innovation of corporate law in American states with that in other countries where there is no charter competition. Two interesting recent studies present evidence of this sort. Mark West compares the evolution of the Model Business Corporation Act with that of the post-World War II Japanese Commercial Code (JCC).\footnote{See Mark D. West, The Puzzling Divergence of Corporate Law: Evidence and Explanations from Japan and the United States, 150 U. PA. L. REV. 527 (2001) (comparing the Model Business Corporation Act with the modern JCC).} This is a quite interesting comparison as the two statutes started off the post-war period as quite similar, as both had been based on the Illinois Business Corporation Act.\footnote{See id. at 527.} Yet over time the statutes tended to diverge. West believes an important part of the explanation for the divergence is that the JCC tends to be changed only in reaction to exogenous shocks, while jurisdictional competition creates stronger endogenous pressures for change in the U.S.\footnote{See id. at 589-91.}

Another recent study, also by West along with Katharina Pistor, Yoram Keinan, and Jan Kleinheisterkamp, studies the evolution of corporate law in ten countries since the beginning of the 19th century.\footnote{See generally Katharina Pistor et al., The Evolution of Corporate Law: A Cross-Country Comparison, 23 U. PA. J. INT’L ECON. L. 791 (2002) (comparing corporate law in ten countries).} These authors conclude that continuous evolution is central to good corporate law, and that exposure to competitive pressure is a major prod to continuous evolution and innovation.\footnote{See id. at 793-94.} William Carney has argued that competition eliminates the interest group protections found in European law.\footnote{See William J. Carney, The Political Economy of Competition for Corporate Charters, 26 J. LEGAL STUD. 303 (1997) (discussing competition differences between Europe and the U.S.).}

Thus, the evidence seems to suggest that, despite Delaware’s dominant position, competition for corporate charters helps spur innovation in corporate law in the U.S. The competition is not perfect—the presence of significant network effects assures that. However, we should not let a theoretical vision of perfect competition obscure the real competition that still exists between the states, and the benefits gained from that competition.

VI. THE MODEL BUSINESS CORPORATION ACT

A majority of states within the U.S. have largely adopted a version of the Model
Business Corporation Act (MBCA). Thus, when a corporation is choosing whether to incorporate in its home state or in Delaware, it is usually choosing between a version of the MBCA and the Delaware General Corporation Law. An account of the charter competition process is thus not complete without an analysis of how the MBCA affects the process. This section argues that the MBCA has two main effects that work in opposite ways as to encouraging innovation in corporate law (our third goal of competition). On the one hand, the MBCA reduces the cost to states of changing the law, which makes change easier for the states to accomplish. On the other hand, the MBCA reduces the degree of variation and experimentation in corporate law, which tends to diminish the possible gains from innovation.

A committee of the American Bar Association (ABA) promulgates the MBCA. It was first created in 1950, and thoroughly overhauled in 1984. The ABA regularly revises the Act, and states fairly regularly incorporate those changes into their laws. Corporate lawyers dominate the committee that revises the Act, with a sprinkling of academics. The MBCA is generally similar to Delaware law, with some fairly notable differences. One overarching difference is that the MBCA tends to be written with rather more bright-line rules than Delaware law. The explanation for this seems to be that Delaware can rely on its courts to provide more guidance for corporations, whereas states adopting the MBCA tend to have less developed case law.

One major function of the MBCA is that it reduces the costs of legal change for states that follow it. Corporate law is somewhat technical, and in considering possible changes to one part of the law, one needs to think carefully about how those changes will fit with other areas of the law and with current standard corporate practice. Some expertise is required to do this well, and that expertise requires time commitments from professionals, namely corporate lawyers, whose time is worth quite a lot. If each state, even small ones with relatively few corporations and a small corporate bar, had to reinvent the wheel constantly, that would be a decently costly enterprise relative to the benefits of change in those states. As it is, states can take suggestions from the ABA and in most instances adopt them without too much further investigation. Of course, this shifts costs to the ABA, and the lawyers who serve on the ABA committee do devote valuable time to the MBCA revision process. However, serving on that national committee is a rather prestigious position, and the lawyers who do so are probably able to attract more and better clients as a result of their service.

We have seen, in Part IV, the importance of the costs of innovation in affecting the

186. At least 31 states have substantially adopted a version of the MBCA. See Michael P. Dooley & Michael D. Goldman, Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law, 56 BUS. LAW. 737, 738 (2001).
187. See MODEL BUS. CORP. ACT, supra note 161, at xxi-xxxi.
188. See id. at xx.
189. See id. at xx (listing members of the committee).
190. See Dooley & Goldman, supra note 186, for an analysis, and McDonnell, supra note 6, at 62 for a brief overview.
191. See Dooley & Goldman, supra note 186, at 765.
192. See Carney, supra note 12, at 724 (noting that bar associations are involved in legislation by lobbying for corporate law changes).
193. See id.
likelihood that innovation will occur. The argument there was that most changes in substantive law are relatively low cost, so that most states would find that the benefits of most changes outweigh the cost. The MBCA reinforces that point significantly. For matters which do not raise substantial political opposition—most proposed changes in corporate law fit this category—in a state which follows the MBCA a small local committee of corporate lawyers can, at quite low cost, take a recommended change from the ABA, examine the changes to see if there are any particular reasons why the change might not be good for the state, and if not pass the change on to the state legislature, which can adopt the changes with little investigation and debate.

Lowered costs of legal change are also relevant to part of the argument in Part V. In that Part, we considered the slackness of constraints on state decision makers. One variable in thinking about how constrained politicians are to cater to the interests of corporations is how costly it is to the politicians to do so. The less costly it is for politicians to make a legal change, the more likely they are to do so for any given level of political pressure which they face. By lowering the costs of legal change, the MBCA thus lowers the threshold of political pressure required to induce non-Delaware state politicians to respond to the wants of their corporate constituents.

This lowering of costs thus helps promote innovation in corporate law. However, another possible effect of the MBCA points in a different direction. Consider the informational benefits of competition analyzed in Part V. If many different states actively experiment with different laws, the system will explore a wide number of possible legal innovations. The chances of finding significant improvements that vary substantially from the status quo increases. However, with the MBCA, it may well be that many states choose not to actively experiment very much, but rather rely on following the MBCA, and thus introduce little innovation themselves. The system will explore fewer alternatives, reducing the amount of legal innovation. On the other hand, if legal innovation would be rather expensive for states with few corporations in the absence of the MBCA, then perhaps the Act does not cut down all that much on experiments that would be tried in its absence. Moreover, given the MBCA, when states do try experiments that succeed, the Act helps speed up the rate at which those successful innovations diffuse to other states.

Thus, the effects of the MBCA on legal innovation in corporate law are ambiguous. The Act lowers the costs to states of adopting innovations, and helps to diffuse information about successful experiments more quickly. On the other hand, the Act probably reduces the amount and variety of experimentation that occurs. It is thus an empirical question as to the net effect of the MBCA on legal innovation. Gathering the data to answer that question is a tough task, and it is not even clear what sort of data would help us answer the questions. I do not attempt that task here. My guess is that on balance the MBCA increases the amount of innovation that occurs, although it may make the innovation less drastic than it would otherwise be. At any rate, we can now see the various effects that the Act has on the process of corporate law innovation.

194. See supra notes 114-120 and accompanying text.
195. See supra notes 137-138 and accompanying text.
196. See supra notes 154-160 and accompanying text.
197. That is, the MBCA makes corporate law less varied and more standardized than it would be without the MBCA.
Now may be a convenient time to summarize the picture of charter competition that emerges thus far. For a variety of reasons, Delaware has a strong advantage in attracting large public corporations, and those advantages are self-reinforcing—Delaware’s past success attracts new corporations, which further cements Delaware’s position, thereby attracting yet more incorporations, and so on. Having a dominant state like Delaware helps businesses achieve network effects available in corporate law. Still, some corporations, especially smaller ones, prefer to incorporate in their home state. Part III argued that a few states, notably Nevada and Maryland, have appealed to particular niches of corporations. Such niche strategies are relatively rare because of Delaware’s advantages and because the optimal law probably does not vary that much for most corporations, but the niche strategy does provide some degree of useful diversity in business association law—the first goal to be achieved from state competition.

Part IV argued that all states do have some incentive to innovate in providing corporate law, to the extent that benefits, both to corporations which do incorporate in-state and to the state treasury, outweigh the costs of such innovation. Part V argues that a variety of political mechanisms work to keep Delaware politicians focused on providing satisfactory, up-to-date corporate law, precisely because of Delaware’s dominance. Politicians in other states also have fairly strong motivation to keep home corporations happy. The federal system creates and spreads information about varying approaches to corporate law. This Part argues that the MBCA helps lower the costs to states other than Delaware of updating their corporate laws, though it does reduce the degree of experimentation likely to occur.

Overall, the system of state charter competition provides a fair amount of impetus for our third goal, encouraging innovation in corporate law, despite Delaware’s dominance. Recall that the existence of significant network effects in corporate law creates a difficult balancing act. On the one hand, we want one law to become dominant so that the gains from network effects can be realized. On the other hand, we want to encourage both legal diversity and continuing adaptation and innovation in corporate law. These are in tension with each other, and it is probably impossible to fully realize both goals. However, our argument up to this point suggests that the U.S. federal system does a fairly good job of achieving network effects while still encouraging a little legal diversity and much innovation.

So far, I have largely ignored the traditional issue in the race-to-the-bottom/top debate. Namely, I have ignored whether corporate managers have proper incentives in choosing the state of incorporation. Thus, even someone who accepts most of the above arguments may remain skeptical about the benefits of corporate law federalism. After all, if charter competition does tend to induce state decision makers to constantly reform their laws to better suit the needs of corporation decision makers, but the managers who are expressing those needs are serving their own interests rather than those of their shareholders,198 then one could conclude that competition is only working to push the law more quickly to the bottom. Nothing I have written so far rules out that possibility in any way.

We must, then, go back to that traditional debate, and ask how possible mis-

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198. Managers are even more likely to ignore the needs of other corporate stakeholders or of society more generally.
incentives of corporate managers may affect the charter competition in a context where one state dominates that competition. We must, in other words, now consider our fourth goal, fairly balancing the interests of different corporate constituencies. Part VII compares the political pressures that will exist in a unified national system, a federal system with strong competition, and a federal system with weakened competition because one state dominates.

VII. STATE COMPETITION WITH SELFISH, UNDER-CONSTRAINED MANAGERS

Let us now suppose that market mechanisms do not adequately constrain corporate managers from pursuing their self-interest at the expense of the interests of shareholders and social efficiency. This is of course an endlessly disputed issue. A variety of market mechanisms operate to limit managerial self-dealing, but all of these mechanisms are highly imperfect.199 Thus, there may be at least some tendency for managers to choose state laws that sub-optimally favor managers over shareholders, i.e., a race-to-the-bottom. Even the pivotal Winter piece which set out the core logic of the race-to-the-top thesis allows that managers may have some incentive to adopt somewhat non-optimal law in the area of takeovers.200 This Part argues there are two strong reasons why Delaware may have a managerial bias. First, Delaware courts will be more subject to political pressure from corporations than federal courts or other state courts. Second, other corporate constituencies, such as employees and consumers, are less well-represented in Delaware than in other states or nationally. On the other hand, this Part concludes that our mixed federal system, with national actors also helping to set corporate law, helps prevent Delaware from heading off in too extreme a managerialist direction.

We want to consider the effects of insufficiently-constrained managers within three possible systems for setting corporate law: the traditional picture of heavily competing states, a system with more limited competition between states because one state has significant competitive advantages, and a nationalized system with just one jurisdiction available. Consider first the traditional picture of many states vigorously competing with each other. The standard race-to-the-bottom concern is that if managers control the choice of state of incorporation, then their ability to choose among states will give them much political strength in inducing states to adopt laws favoring managers. The threat of mass exit to another state helps keep state politicians attuned to the interests of corporate decision maker—managers (officers and directors), mainly. If that story is right, then a system where corporations are less able to effectively exit from a state’s law should reduce the ability of managers to distort the law in their favor. A system with just one national corporate law would make exit quite difficult.201 A system of competition with a dominant state and a home state bias for many corporations would be intermediate between the two—exit is easier than if there were just one national corporate law, but harder than with a system of vigorous state competition. Thus, imperfect competition would seem to imply an intermediate degree of managerialist distortion in corporate law.

199. For my own overview of this debate, see McDonnell, supra note 131, at 353-54, 360-61.

200. See Winter, supra note 10, at 288-89 (describing why management may not profit-maximize during a takeover).

201. However, it is not impossible. One could exit by moving operations to another country, or by choosing a non-corporate form of business organization. These moves both carry significant costs, however.
However, the picture is more complicated than that. As we saw in Part V, voice is an alternative to exit in influencing the making of corporate law. Managers and shareholders face different-sized obstacles in overcoming barriers to effective political organization, and these obstacles may look different in the different systems for making corporate law. Managers generally have more concentrated interests in lobbying for corporate law, and are aided by their ability to use corporate resources and especially through the solicitous attention of the corporate bar. Shareholders, in contrast, face more fully the difficulties of free riding when it comes to lobbying for corporate law.

Thus, any system—vigorous state competition, weakened state competition, or one national jurisdiction—is likely to face a managerialist tilt due to the more effective ability of managers and their lawyer allies to lobby. However, do the various systems differ in the likely strength of this tilt? Big institutional shareholders may be the best chance that shareholders have of overcoming free riding. Such shareholders might find it easier to lobby just one national legislature rather than fifty state legislatures. If so, then the case of weakened competition would again be an intermediate case—with one dominant state, institutional shareholders might find it worthwhile concentrating lobbying on that state. One would then expect to find the dominant state showing a less managerialist tilt than other states—Delaware’s relatively weak antitakeover statute could be an example.

This analysis of voice so far thus reinforces the exit analysis above. But, Kahan and Kamar argue that shareholders may be able to protect themselves relatively better with the exit option than with voice. Shareholders do have some say in the decision to reincorporate, as reincorporation typically requires shareholder approval. Rational shareholder apathy limits the effectiveness of shareholder voting, but that problem may be less severe than shareholder inability to organize politically. This consideration suggests that shareholders are likely to receive the most protection in the system where exit is most effective, i.e., vigorous state competition, and that the weakening of such competition due to Delaware’s dominance thus makes shareholders more vulnerable.

Another factor to consider is that managers may not have uniform interests in lobbying for laws. As Roberta Romano has argued, some corporations are more likely to engage in takeovers, while others are more likely to be targets. Thus, at least in the important area of takeover law, some managers will want strong legal protections against takeovers, and others will not. Romano uses this observation to argue that the dominant state, Delaware, will be less anti-takeover prone because it is more likely to have included in its corporate base a number of corporations which are likely to engage in takeovers. What does this suggest for a comparison of the three possible systems? Again, it suggests that a uniform national system is likely to be the most balanced. Not

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202. We are now assuming, remember, that non-market mechanisms do not give managers adequate incentive to consider the interests of shareholders.

203. See Romano, supra note 165, at 141.

204. See supra note 201 and accompanying text.

205. See Kahan & Kamar, supra note 5, at 737.

206. See id.

207. See Roberta Romano, The State Competition Debate in Corporate Law, 8 CARDOZO L. REV. 709, 730-31 (1987) (noting the desire of management and shareholders to adopt or reject takeover statutes).

208. See id.
only will the national legislature face lobbying from both types of managers, but neither type of manager will be able to threaten to leave the jurisdiction if they are unhappy with the law. With state competition, in contrast, even if a state has both types of managers, only those managers of potential target corporations can credibly threaten to leave. As it is the law of the target corporation’s state which governs the use of takeover defenses, if the managers of raider corporations are unhappy with Delaware’s law, incorporating elsewhere will do them no good. However, the less credible exit is as a threat due to Delaware’s competitive advantages, the less this point should matter. Thus, a fully competitive state system looks most prone to anti-takeover bias.

So far we have been largely thinking about how the different systems for making corporate law would differ in their likely impact on legislatures. There are other sorts of state decision makers though, most importantly courts and executive agencies. Does this consideration change how we evaluate which system is likely to have a more managerialist tilt?

Let us first consider courts. Judges in general are more difficult to lobby and influence politically than legislators. Indeed, law and economics scholars have long had some trouble figuring out what exactly it is that they should understand judges as maximizing. Of course, in the long run courts are influenced by who is appointed as judges, which in turn depends on which party controls the executive and legislative branches. However, for generalist courts it is unlikely that voting preferences in corporate law have much effect on which judges will get appointed; although general political ideology might influence likely voting in this as in most areas of law. Generalist judges at either the federal level or in non-dominant states are also unlikely to develop a pronounced personal philosophy of corporate law, as corporate law cases will not occupy a major part of their docket. That is not to say that none of them will ever develop such a philosophy, just that most will not.

Specialist judges like those on the Delaware Chancery Court look different. These judges are likely to be drawn from the corporate bar, and their philosophy in corporate law will matter more to those appointing them. They will also hear many corporate law cases, and have much interaction with the corporate bar, and to a lesser extent with corporate academics and others professionally interested in the area. Thus, to the extent that a managerialist bias affects the corporate bar and also those appointing such judges, one might expect more of a managerialist tilt among Delaware judges. I am not suggesting that Delaware judges deliberately favor managers over other constituencies. Rather, I argue that the milieu in which the typical Delaware judge has spent his career typically has been shaped by managerial interests, as is true for most corporate lawyers. Thus, competition with a dominant state may lead to a more managerialist bias in the courts of the dominant state than one would expect to find in non-dominant states or in federal courts. The tradeoff, of course, is that the Delaware courts offer greater expertise.

209. See RICHARD A. POSNER, OVERCOMING LAW (1995) (analyzing how the role of a judge is constrained in certain instances while freedom is allowed in others).

210. One might expect that conservative judges tend to be more likely to take a laissez-faire approach to corporate law, and hence to leave managers more room to operate. Note, however, that some notable academic conservatives have advocated a largely passive board response to takeovers. See 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, 1194-99 (1981).
The other major kind of political actor is executive agencies, notably the SEC. The SEC of course enters importantly into setting corporate law at the national level, while to my knowledge no executive agency is particularly influential in setting law in any state. Are agencies subject to bias in favor of the politically-organized legislatures and specialist courts, or more independent as with generalist courts? There are two competing tendencies. On the one hand, agencies are often subject to “capture” by the interests they are supposed to be regulating. This would suggest a managerialist tilt on the part of the SEC too, although it is unclear whether the tilt would be stronger than that of legislatures or of the Delaware courts. On the other hand, bureaucrats can expand their power by expanding their agency. This suggests a tendency to be heavily interventionist. The SEC has shown some of both tendencies at different times. However, the interventionist tendency seems more characteristic. Thus, the SEC probably operates to reduce the managerialist tilt of national law.

We must throw one last factor into this mix of political considerations. So far I have treated the political struggle as being only between managers and shareholders. However, corporate decisions also affect other groups, including bondholders, employees, customers, suppliers, and local communities. Although corporate law in the U.S. has come to focus largely on the relationship between managers and shareholders, that is far from inevitable, and could itself be the product of a flawed political process. Moreover, a variety of other types of laws—labor, employment, bankruptcy, commercial,

211. One can argue endlessly over whether particular Delaware cases or areas of cases do or do not display a managerialist tilt. The pattern seems to vary over time, in part due to responses to threatened federal action as described below. My own sense is that there is a managerialist bias when one looks to the substance. My point here, though, is to avoid the morass of looking to the cases and consider structural forces likely to affect the court’s outlook.

This tradeoff would appear typical of a general tradeoff between expertise and capture or bias in political institutions. It is precisely those specialized political institutions that are most able to develop expertise in a particular policy area which are also most subject to capture or bias. Both individual psychological factors and political factors are at work here. At the individual level, persons with a strong interest in a particular topic are most likely to want to work for an institution specializing in that topic, but those persons are also particularly likely to develop strongly held views on that topic. Even if they do not start their careers like that, they are likely to develop stronger views over time working for the institution. Indeed, that would seem to be an implication of Bayes’ Theorem: those with strong priors on a point will quite rationally give less weight to new information presented by a particular case or instance for rulemaking.

At the political level, institutions that deal repeatedly with a particular area are naturally more likely to be subject to political lobbying by interest groups especially interested in that area. They are thus especially prone to capture. This occurs both with lobbying of the institution itself (Delaware judges are repeatedly exposed to arguments from the corporate bar, and even outside of the courtroom will attend conferences and meetings dealing with questions of corporate law) and lobbying of those who appoint the leaders of the institution (corporate lobbyists will care much, much more about a new appointment to the Delaware Supreme Court than to the Montana Supreme Court).

These points would appear quite general and apply to all sorts of specialist courts, e.g., the Federal Circuit Court of Appeals, as well as specialist agencies. Among other things, they suggest that the perennial question of how much a general court should defer to an administrative agency is perennial precisely because a deep tradeoff is built in to the comparison between general and specialist political institutions. See McDonnell, supra note 8, for further discussion.

212. State Secretaries of State, however, do have some role in setting state corporate and securities laws.

213. See Homer Kripke, The SEC and Corporate Disclosure: Regulation in Search of a Purpose (1979) (arguing that the SEC tends to over-regulate).
environmental, tort, consumer safety, and so on—help protect other constituencies.\textsuperscript{214} Do the different possible systems for making corporate law differ in how well the political process is likely to represent such constituencies?\textsuperscript{215}

Some of these constituencies—consumers and those affected by the environment, for instance—are diffuse enough that they will have trouble organizing at any political level; although even these groups do manage to achieve some degree of political organization.\textsuperscript{216} Others, including employees, have enough at stake for each member of the group that they at least have a decent chance at being able to organize. At any rate, consumers, environmentalists, and employees all probably can organize with the least disadvantage relative to managers to lobby for laws set uniformly at the national level. Indeed, the most significant U.S. labor, consumer, and environmental laws are set at the national level.\textsuperscript{217}

As for law set at the state level, these other corporate constituencies are probably at the greatest disadvantage in Delaware.\textsuperscript{218} Delaware’s corporate laws affect employees, consumers, and communities which are almost all located outside of Delaware. In contrast, in states outside of Delaware, most corporations incorporated in-state do most, if not all, of their business within the state. As a result, many of the affected constituencies are within the state and are able to lobby state politicians. It thus appears to be no accident that a majority of states have corporate constituency statutes, albeit weak ones, while Delaware does not.\textsuperscript{219} Kahan and Kamar point to a variety of cases where other political groups have been able to stop or make legal changes promoted or opposed by corporate managers.\textsuperscript{220} It is, of course, a matter of much debate whether corporate law should take the interests of these other constituencies into account. I merely assert here that I believe they should.\textsuperscript{221}

In this Part, we have considered a variety of factors that affect the likely political success at various governmental levels under differing systems of managers, shareholders, and other groups. The factors point in various directions. However, on the whole they suggest to me some tendency for a system of state competition with one

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  \item \textsuperscript{214} See William J. Carney, \textit{Does Defining Constituencies Matter?}, 59 U. CIN. L. REV. 385 (1990) (discussing the general nature of markets in which contracting relationships are formed, the nature of contract formation, and post-contractual performance and agency costs of constituency representation).
  \item \textsuperscript{215} For a ‘yes’ answer, see Carney, supra note 185, at 306-09 (referencing differences in the shape of American and European corporate law).
  \item \textsuperscript{216} See MANCUR OLSON, \textit{THE LOGIC OF COLLECTIVE ACTION} 124 (1965) (“If the tariff proposed was excessive, presumably the consumers would organize a lobby that would oppose it.”).
  \item \textsuperscript{217} Which is not to deny the point made earlier that even at the national level managers are likely to be politically powerful. The Williams Act, for instance, is pro-manager. Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968).
  \item \textsuperscript{219} See Brett H. McDonnell, \textit{Corporate Constituency Statutes and Employee Governance}, 30 WM. MITCHELL L. REV. 1227 (2004); Springer, supra note 166. Constituency statutes generally help protect managers, but other constituency groups have supported them as well.
  \item \textsuperscript{220} See Kahan & Kamar, supra note 5, at 730-35.
  \item \textsuperscript{221} I explore this question more, concerning employees, in Brett H. McDonnell, \textit{Corporate Constituency Statutes and Employee Governance}, supra note 219; and Brett H. McDonnell, \textit{The Curious Incident of the Workers in the Boardroom}, 29 HOFSTRA L. REV. 503 (2000) (discussing the voice of employees in corporate governance).
\end{itemize}
dominant state to have a more managerialist tilt than when laws are set uniformly at a national level or by more vigorously competing states. In particular, the greater tendency of Delaware courts to be subject to capture and the lack of voice for non-managerial and non-shareholder constituencies in Delaware are strong factors that tend to make Delaware pro-manager. The degree of the problem and the difference between the two is often unclear and open to debate. It probably varies significantly over time and from issue to issue.

Note, too, that this Part has developed another tradeoff inherent in corporate lawmaking. A key advantage of the Delaware legislature and courts is that they are motivated to devote more attention to corporate law and develop additional expertise in the area. They have strong incentives to innovate in this area since innovation will benefit the people to whom they are accountable. And yet, this very desire to please corporate decision makers is likely to worsen Delaware’s bias in favor of managers. Other states and the federal government are likely to be less biased, but also less adept.

In this Part, I so far have considered three possible systems for setting corporate law: setting the law uniformly at the national level, setting it state by state with vigorous competition between states, or setting it state by state where one state has strong advantages in the competition to attract corporations. In fact, our system is something of a hybrid between the first and third of these possibilities. How does that affect the likely outcomes of our legal process?

As Part II discussed, Mark Roe recently argued that the federal government (and also national stock exchanges) effectively sets much of the corporate law in the United States today. The point becomes even stronger when one notes that federal laws in many other areas (bankruptcy, labor, employment, consumer protection, etc.) act to protect various corporate constituencies. Moreover, as the leading state, Delaware’s laws reflect the threat of federal intervention, either because Delaware decision makers consciously frame their law so as to avoid such intervention, or because the only state law that survives does so because it has not provoked such intervention. However, the structure of our federal system may still leave Delaware with much room to choose where to set the law. There are a variety of federal actors: the House, the Senate, the President, the SEC, federal courts at several levels, and the exchanges, to name the most obvious and important. The large number of federal actors may in some circumstances more tightly constrain Delaware, since if one federal actor is not inclined to intervene another may. However, in other circumstances the large number of federal actors may give Delaware more room to maneuver. Some federal actors may block action by other federal actors. A system of checks and balances may make it hard to change the status quo at the federal level. Since Delaware sets the status quo for most corporate law, this system often leaves it with much discretion as to where to set the law.

This system of federal actors, sometimes changing corporate law but still leaving Delaware much room to establish the law initially, makes a great deal of sense. As we have seen, state competition allows for much experimentation and Delaware has

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222. See supra note 210.
223. See supra notes 61–62 and accompanying text; Roe, supra note 61.
224. For further discussion, including a variety of examples where federal actors have blocked each other, see McDonnell, supra note 8.
developed great expertise. The law that emerges from the states is thus often better than federal actors could achieve on their own. However, competition with a dominant state also tends to lead to an over-representation of managerial interests in the dominant state and an under-representation of other non-shareholder constituencies. If Delaware set its law unchecked by possible federal intervention, that law would often be more managerialist than it currently is. The threat of federal intervention induces Delaware to curb its managerialist tendencies in order to avoid such intervention. We thereby gain many of the benefits of state competition with a leading state, while dampening the main negative effect of such a system.

I do not want to be too Panglossian about this. I give our system two cheers, not three. Even if one accepts my characterization, it only argues that the U.S. system makes sense in its broad contours. There could still be a number of real problems in the details. Do the federal actors tend to intervene often enough, and in the right sort of circumstances? There is much to debate as to how often they actually do intervene, and even more as to how often they should. This gives rise to a great variety of possible positions. Maybe states have a large zone of possible action but it should be narrowed, or maybe the zone is narrow but should be broadened. Or, perhaps, the zone of possible state action is broad and properly so, or narrow and properly so. Much room for such debate exists and we will have a hard time answering the questions that arise. However, at least we have an improved understanding of the general structure of the U.S. system and of the sorts of questions that one should consider in evaluating the performance of that system.

VIII. CONCLUSION: BENEFITS AND COSTS OF A MIXED FEDERAL SYSTEM

In a few years we have moved far from the old picture of states uniformly racing either uphill or downhill. We now know that for most corporations the choice of where to incorporate is effectively between their home state and Delaware. We have a fairly good understanding of the advantages Delaware has in competing against other states, and some limited sense of why corporations might prefer their home state. We have started to think about how these limits affect the incentives of states to regularly innovate and improve their law, and how it affects the relative political strength of different corporate constituencies. We have also begun to take more seriously the fact that important corporate law or related rules are set at the federal law and to think about how that affects the resulting law-making procedure and substantive law.

The end of the last Part sketches the picture that emerges. The presence of one dominant state allows companies to benefit from network effects in corporate law. A multiplicity of states offering corporate law provides for experimentation and some diversity in the law offered. Even with Delaware’s dominance reducing the incentive of other states to innovate in order to attract new corporations, they still have incentive to innovate in order to better serve their own home corporations, or in Delaware’s case, to

225. Within limits—overly-managerialist law would lower stock prices and cause corporations to incorporate elsewhere. State competition limits managerialism, but only somewhat.
226. See McDonnell, supra note 8, for further discussion.
227. The formal model developed in McDonnell, supra note 8, illustrates circumstances where federal actors may not adequately restrain Delaware.
maintain its reputation for responsiveness. Federalism allows each state to learn from the others. Delaware will have a greater managerialist tilt than the federal government though, so the threat of federal intervention, so long as it is not exercised too often, leaves room for state experimentation while serving as a brake if states go too far in protecting managers.228

Despite many remaining open questions, I think this picture does suggest that some of the more radical proposals for changing the American system of corporate lawmaking are not worth pursuing. Some suggest doing all corporate law at the national level.229 At the other extreme, some argue that securities law should be set by states competing with each other.230 Either extreme would result in a loss of the advantages of our current system. Full-fledged nationalization would lose the gains from diversity231 and experimentation.232 Full-fledged devolution to the states would eliminate the check on excessive managerialism that the various federal actors provide.233

However, more limited refinements of the current system may certainly be in order. The leading current academic proposal is that of Bebchuk and Ferrell for an optional national law regulating takeovers combined with a mandatory rule allowing shareholders to opt into that law without managerial approval.234 This proposal fits within the basic existing structure while responding to a real concern about possible bad incentives facing states in setting takeover law.235 The proposal still leaves corporations and states much flexibility. It is hard to argue against the proposal for having an optional federal law governing takeovers.236 The more controversial part of the proposal concerns the mandatory rule giving shareholders the ability to opt in. There is room to argue that this gives certain shareholders the ability to abuse the system,237 although there are some good responses to those concerns.238 Analysis of that debate goes beyond the scope of

228. See supra notes 223-226 and accompanying text.
229. See RALPH NADE ET AL., CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976) (proposing a federal charter system as a way in which to fundamentally change American corporate law to remedy, among other things, the collapse of state corporation law).
230. See Romano, supra note 19; Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 YALE L.J. 2359 (1998) (advocating a market-oriented approach of competitive federalism that is based on the success of state corporate law); see also Stephen J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 1 S. CAL. L. REV. 903 (1998) (recommending a regulatory structure that offers issues and investors a choice as to which law will govern their transactions).
231. See supra Part III.
232. See supra Part V.
233. See supra Part VII.
234. See Bebchuk & Ferrell, supra note 43, at 143-49.
235. A possibility recognized even by Winter in the seminal race to the top article. See Winter, supra note 10, at 288-89.
236. However, limiting the federal law opt-in only to takeovers does create potential confusion for where federal law ends and state law begins for corporations which choose to opt in.
238. See Lucian Arye Bebchuk & Allen Ferrell, Federal Intervention to Enhance Shareholder Choice, 87 VA. L. REV. 993 (2001) (acknowledging concerns but refusing to accept that the vote should be taken away from shareholders because of collective action and rational apathy concerns).
Beyond the Bebchuk and Ferrell proposal, there are a variety of other specific reforms floating around, especially in the wake of recent corporate scandals. A change to accounting rules requiring the expensing of employee stock options is one leading item of debate. Federal rules giving shareholders more of a chance to nominate directors is another. There are others. Acceptance of the basic structure of the current U.S. system, as advocated here, does not lead to any particular position on most of these specific reforms.

One can thus very well argue over a number of details of the U.S. system for making corporate law, including some very broad and important details. However, the basic structure seems to have roughly achieved a desirable balancing of goals. There is enough competition to promote legal diversity, innovation and adaptation, while the existence of a dominant state promotes expertise and predictability. Additionally, the federal government’s presence helps keep that state from swerving too far in favor of managers. We achieve each goal only imperfectly, and the goals are in tension. And yet, as a whole this mixed federal system of corporate law seems to work pretty well—at least as compared with any alternative on offer.