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The Future of Corporate Federalism: State Competition and the New Trend toward De Facto Federal Minimum Standards

John C. Coffee Jr.
Columbia Law School, jcoffee@law.columbia.edu

THE FUTURE OF CORPORATE FEDERALISM: STATE COMPETITION AND THE NEW TREND TOWARD DE FACTO FEDERAL MINIMUM STANDARDS

John C. Coffee, Jr. *

What sensible compromise can be struck between Bill Cary's and Ralph Winter's views of the competition among states for corporate charters? This is the relevant question to ask in response to Professor Romano's stimulating paper, because if one ends in an intermediate position between Cary and Winter (as she does and as I do), then one needs to focus on the protections shareholders should be accorded both to protect them from exploitation at the hands of a state pursuing tax revenues and from excessive regulation by a state whose regulatory efforts are intended in fact to realize ulterior objectives unrelated to shareholder wealth maximization. In this response, I will suggest one approach that attempts to update a reform proposed by Bill Cary in his famous article on Federalism and Corporate Law,[1] but does so in order to accommodate the rival insights offered by Ralph Winter. While I would not defend everything Bill Cary said in his influential article, I find it ironic that in a quiet, low-visibility way we are today witnessing the promulgation of new types of federal minimum standards that significantly regulate public corporations and constrain state law. Although no political program is less likely to be attained than federal chartering, Bill Cary's alternative—federal minimum standards—appears to be succeeding even as it is being ignored.

What evidence supports my very counterintuitive announcement of victory for Bill Cary's vision? I have two distinct and significant events in mind: First, last summer, the SEC adopted rule 14d-10, the all holders rule, which bans tender offers that exclude some holders of the class of securities sought.[2] In effect, this rule has trivialized an important 1984 decision of the Delaware Supreme Court, *Unocal Corp. v. Mesa Petroleum Co.*,[3] which legitimized discriminatory self-

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* Adolf A. Berle Professor of Law, Columbia University School of Law; B.A., 1966, Amherst College; LL.B., 1969, Yale Law School; LL.M., 1976, New York University.

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

[2] See Amendments to Tender Offer Rules—All-Holders and Best-Price, Exchange Act Release No. 33-6653, Fed. Sec. L. Rep. (CCH) No. 1186 (July 16, 1986).

[3] 493 A.2d 946 (Del. 1985).

tenders as an antitakeover defense. Similarly, last summer the Seventh Circuit, in an important decision by the redoubtable Judge Posner, invalidated a "poison pill" plan adopted by CTS Corporation. Although other decisions have also struck down poison pill plans,[4] the distinctive element in *Dynamics Corp. of America v. CTS Corp.*[5] was Judge Posner's statement, arguably in dicta, that the plan would be invalid even if authorized by Delaware corporate law because it impermissibly burdened interstate commerce and was preempted by the Williams Act. Going further than other recent decisions, *CTS* also stated that even the time-honored "internal affairs" rule, which makes dispositive the law of the jurisdiction of incorporation, would not be respected where it interfered with the free operation of the market for corporate control and this impact was "direct, intended, and substantial."[6] This decision casts a serious cloud over the continuing force of an important recent Delaware decision, *Moran v. Household International, Inc.*[7] Hence, since last summer, we have seen the certain downfall of *Unocal* and the possible eclipse of *Moran* by federal law.

Delaware is not the only state to have suffered this fate. A number of other recent decisions have invalidated second generation antitakeover statutes,[8] even though these statutes purport to apply only to firms incorporated within the state's jurisdiction and, thus, do not have any more extraterritorial effect than does a Delaware statute that, for example, defines whether Delaware corporation shareholders have preemptive rights or can commence a derivative suit without making a demand on the board. The issue thus framed is significant: If poison pills and certain supermajority voting provisions triggered by a controlling shares acquisition are constitutionally invalid, what about special appraisal rights or a simple majority voting approval requirement for a partial bid? Are such provisions similarly invalid? If so, the reach of Judge Posner's theory is intrusive indeed, and the

[4] See, e.g., Amalgamated Sugar Co. v. NL Indus., Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶ 92,857 (S.D.N.Y. 1986); Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y. 1985); Minstar Acquiring Corp. v. AMF, Inc., [1984-1985 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 92,066 (S.D.N.Y. 1985); Asarco Inc. v. Court, 611 F. Supp. 468 (D.N.J. 1985).

[5] 794 F.2d 250 (7th Cir.), cert. granted, 107 S. Ct. 258 (1986); see also Fleet Aerospace Corp. v. Holderman, 796 F.2d 135 (6th Cir.), appeal docketed, No. 86-344 (U.S. Sept. 2, 1986) (Ohio statute making it easier for incumbent management to defend against takeover held unconstitutional).

[6] Id. at 264.

[7] 500 A.2d 1346 (Del. 1985).

[8] See, e.g., Terry v. Yamashita, 643 F. Supp. 161 (D. Haw. 1986); APL Ltd. Partnership v. Van Dusen Air, Inc., 622 F. Supp. 1216 (D. Minn. 1985); Icahn v. Blunt, 612 F. Supp. 1400 (W.D. Mo. 1985).

stability of our two-tier system of corporate law may be seriously challenged. The prospect is that the statement in *Santa Fe Industries v. Green*[9] that "corporations are creatures of state law"[10] may be in the process of being overshadowed by the statement in *Edgar v. MITE Corp.* that the market for control may not be chilled by state regulation.[11] To report the death of *Santa Fe* is highly premature, but it is timely to suggest that its health as a precedent has declined.

Here, at last, I come into serious contact with the themes discussed in Professor Romano's incisive paper. If one believes that multistate competition is value maximizing for shareholders, then it seems to follow that the new constraints represented by rule 14d-10 and the *CTS* decision should logically reduce shareholder wealth. From a neoclassical perspective, "bad" state law decisions will, in time, be reversed, because corporations would otherwise migrate from them. That is, if cases such as *Unocal* and *Moran* were unwise, corporations would simply reincorporate elsewhere, at least until the Delaware legislature reversed these decisions. Of course, no such movement away from Delaware is visible, since corporate managers were delighted with *Unocal* and *Moran*. Does this mean that these decisions were sound? At least among corporate scholars, they elicited a uniquely broad condemnation. Perhaps, then, the theory has problems. As I will ultimately suggest, the greatest problems may lie with who has control over the reincorporation decision. Initially, however, a closer examination of Professor Romano's reasoning is warranted. While I next propose a different way to understand Delaware's current hegemony, I do not mean to reject Professor Romano's interpretation, but rather to suggest that the data on which she relies are ambiguous and can support quite different interpretations.

I. Interstate Competition: The Significance of Fixed Investments in Human Capital

Professor Romano characterizes all commentators, including herself, as believing that states are principally seeking tax revenues when they compete for corporate charters. This seems overstated. If Delaware corporate franchise taxes were repealed or invalidated tomorrow, I believe little would change. My view is that the political

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9 430 U.S. 462 (1977).

10 Id. at 479.

11 457 U.S. 624, 643-45 (1982) (noting that tender offers do not regulate the internal affairs of a corporation and that a state has no legitimate claim to regulate market transactions between nonresident shareholders). I have criticized this firm/market distinction. See Coffee, Shareholders Versus Managers: The Strain in the Corporate Web, 85 Mich. L. Rev. 1 (1986).

dynamics and interest-group politics are far more important than this relatively crude form of economic determinism.

A. *The Political Context*

A simple story begins as follows: Once Delaware obtained its current oligopolistic position, powerful lobbies arose that had a strong interest in maintaining Delaware's status as the preeminent authority on corporate-law matters. Because any loss in Delaware's preeminence implied a loss of revenues for the legal profession there, that state's highly specialized corporate bar organized to preserve its status in order to protect its investment in transaction specific human capital. Lawyers are a powerful lobby, as the medical profession and the insurance industry have recently learned in their largely unsuccessful efforts to secure the "reform" of medical malpractice or products liability doctrines. Although in most states it is the trial bar that is the most politically active, Delaware's success in the charter competition implies that it has a uniquely high percentage of corporate lawyers. Moreover, this group constitutes a sophisticated elite within the bar of an otherwise small, agrarian state. I do not mean to decry this fact. Lawyers are as much entitled to lobby for protection as are farmers for subsidies or domestic manufacturers for high tariffs. But what is best for lawyers is not always best for shareholders.

More generally, even without lobbying, it is predictable that any state or political unit will seek to protect the interests of an important constituency in the absence of countervailing pressures. Nor is it only lawyers who are affected. Delaware's corporate preeminence supports satellite industries. For example, Wilmington hotels are filled with out-of-state litigators preparing to argue in the Chancery Court. Additionally, Delaware residents are employed by corporate service firms, and in a host of other ways, Delaware's "gross state product" is enhanced by this commerce, even apart from its effect on tax revenues.

Another distinctive fact about Delaware as a jurisdiction is the relative absence of countervailing lobbies. In California, which probably has the most "activist," least lax body of corporate law, the lawmaking process may involve a number of contending groups: labor, environmentalists, public-interest lobbies, etc. But Delaware is sparsely populated and hence resembles a relative vacuum in terms of interest groups. It is interesting to note that Delaware shares this characteristic with Nevada (the "Delaware of the West"), which also has competed successfully for charters. The common denominator is that both states can concentrate on marketing their corporate law to consumers because there is little inherent interest in the topic among its citizens. In contrast, the labor unions have had a clear impact on the New York Business Corporation Law, as evidenced by its unique provision for large-shareholder liability for wages.[12] The ironic implications of this point are that if one truly believes that competition for charters is desirable, the optimal solution would appear to be a fifty-first state without citizens, whose corporate law would be drafted, for example, by the ABA's Corporate Laws Committee. Such a hypothetical jurisdiction could market a purely consumer-oriented body of law, rather than one affected (or "distorted") by the preferences of its citizens.

One advantage of this interest group explanation is that it can explain some features of Delaware law that a pure tax revenue maximization story cannot. Initially, for example, it seems anomalous that it is easier procedurally to sue the directors of a Delaware corporation in a derivative suit than those of corporations incorporated in many other jurisdictions. This relative ease exists because Delaware does not require a securities-for-expenses bond, because it permits beneficial holders to bring suit, and because it has a very broad consent-to-service statute that makes it comparatively simple to obtain jurisdiction over nonresident directors.[13] What explains this? These legal rules do not appear to be motivated by a desire to maximize tax revenues; rather, this prolitigation stance maximizes revenues for a powerful interest group—lawyers. Similarly, Delaware law authorizes substantial fee awards for a plaintiff's attorneys under a more liberal fee award statute than that used in federal courts, and Delaware has virtually institutionalized the nonpecuniary settlement which permits the defendants in a derivative suit to enter into a collusive settlement with the plaintiff's attorneys. This, in effect, trades a high fee award for a small to nonexistent recovery. Were Bill Cary alive today, I suspect *Polk v. Good*,[14] a recent Delaware decision that employs a much looser standard of settlement review than governs in federal court and that permits high fees to be paid in return for largely cosmetic relief, would make the updated version of his "dirty dozen"

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12 See N.Y. Bus. Corp. Law § 630 (McKinney 1986).

13 Del. Code Ann. tit. 10, § 3114 (1986 Supp.); Pestolite, Inc. v. Cordura Corp., 449 A.2d 263, 265-66 (Del. Super. Ct. 1982).

14 507 A.2d 531 (Del. 1986). One recent survey of securities and derivative actions found that in roughly 30% of the settlements analyzed, no monetary relief appeared to have been received by the corporation. See Garth, Nagel, & Plager, Empirical Research and the Shareholder Derivative Suit: Toward A Better-Informed Debate, 48 L. & Contemp. Probs. 137, 146 (Summer 1985). Presumably, in another significant proportion of the cases, the monetary relief received was less than, or approximately equal to, the fee awarded.

list. Although Delaware's tolerance for collusive settlements may also be in the interest of management, it is almost certainly not optimal from the shareholders' perspective. Because the ability to pay bribery to the plaintiff's attorney ultimately invites extortion, such judicial benign neglect should encourage the filing of frivolous suits and an excessive rate of litigation.

This view that the legal profession's self-interest shapes some of the contours of Delaware law is subject to the obvious limitation that, if the Delaware law were made unattractive to corporations, the corporate migration to Delaware will end. Thus, it is primarily the procedural law, not the substantive law, that lawyer self-interest appears to have influenced most, probably because this body of law has lower visibility to those making the choice of jurisdiction decision. Even if corporate lawyers make this decision, they seldom understand all the subtleties in this litigation area.

Ultimately, my point is a simple one. Forces are at work, even within the relatively simple political context of Delaware, that are distinct from the desire to maximize the marketability of Delaware corporate law to the relevant consumer (whether that consumer is a shareholder or manager). As a result, the shape of the law will be more indeterminate than a simple revenue maximization model would suggest. Most importantly, the Delaware bar, having a large fixed investment in human capital, may be relatively risk-averse about the prospect of federal intervention. Hence, it may resist opportunities to maximize the attractiveness of its law to the consumer (whether that consumer is the shareholder or the manager) if acceptance of such opportunities might increase the prospect of federal intervention. During the 1970's, this was a real prospect, and hence it becomes understandable that a number of Delaware decisions took a more proshareholder stance during this period.

B. *The Relevant Decisionmaker*

If any major law firm in Manhattan is asked why it recommends Delaware incorporation to its corporate clients, the answer will probably be the stability and the certainty of Delaware law and the expertise of its bench. This has long been the conventional wisdom, and it differs from the neoclassical model which assumes that states compete by developing legal innovations. The problem with this innovation model is that it is hard to come up with a substantial list of Delaware innovations that have more than housekeeping significance. Undeniably, however, Delaware does have more precedents, thereby giving greater certainty, and its judges have more expertise and time to concentrate on corporate law issues. Hence, it is not surprising that Delaware has a more attractive body of decisional law. The critical fact, then, is Delaware's "first mover" advantage in the development of precedents, which Professor Romano correctly mentions but to which I would ascribe even greater weight. One cannot manufacture precedents, because they require both time and an existing supply of litigants.

But here a paradox arises. It is now a commonplace observation that Delaware's decisional law has become volatile and unpredictable over the last decade. Important precedents, such as *Singer v. Magnavox Co.*,[15] *Weinberger v. UOP, Inc.*,[16] *Zapata Corp. v. Maldonado*,[17] *Unocal, Inc. v. Mesa Petroleum*,[18] and *Smith v. Van Gorkom*,[19] have surprised most observers.

Why has Delaware law so recently become unstable if certainty was its selling point? One answer involves Bill Cary's legacy. By raising the issue of Delaware's legal integrity, he may well have made Delaware judges more sensitive, at least for a time, to issues of fairness.[20] A body of socio-psychological research suggests that the desire to be perceived as fair may significantly influence a judge's behavior, even when that judge is biased in favor of one side.[21] This does not mean that Delaware judges were necessaily unfair or biased before Bill Cary wrote, but only that an increased desire to be perceived as fair can change our behavior.

More generally, economic models are on thin ice when they try to predict judges' attitudes and preferences. With life tenure, or at least the expectation of long-term employment, judges need not be as sensitive or responsive to political attitudes and pressures as does the legislature. While Delaware judges were socialized within the Dela-

[15] 380 A.2d 969 (Del. 1977).

[16] 457 A.2d 701 (Del. 1983).

[17] 430 A.2d 779 (Del. 1981).

[18] 493 A.2d 946 (Del. 1985).

[19] 488 A.2d 858 (Del. 1985).

[20] Emphasizing this apparent reversal in direction and attributing it to the influence of the Cary article, Professor Fischel has criticized these recent Delaware decisions as producing a new "race to the bottom" that has reduced shareholders' wealth. See Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U.L. Rev. 913 (1982). For an effective empirical critique of his assertion that these decisions have reduced shareholder wealth, see E. Weiss & L. White, Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" In Corporate Law (available at Cardozo Law Library).

[21] Social scientists have developed a theory, known as "attribution theory," which finds that legal decisionmakers are under strong "role pressures" to avoid any manifestation of bias. See Thibaut, Walker & Lind, Adversary Presentation and Bias in Legal Decisionmaking, 86 Harv. L. Rev. 386, 390-401 (1972).

ware bar and thus probably shared its outlook, this generalization is not an iron law. Most lawyers know of a defense lawyer who became a "hanging judge" when appointed to the bench. As a result, to the extent that the key element of Delaware law is its case law, there is little reason to expect this body of law to be as stable as its statutory law. This observation that judges are human and not always predictable will not excite the model builder, but it does suggest limits on his craft and skill.

Historically, a factor that further explains this volatility is the recent ebb and flow of pressure for federal fiduciary standards. Prior to the Supreme Court's 1977 decision in *Santa Fe Industries v. Green*,[22] there was a realistic possibility that federal fiduciary standards would emerge from the circuit courts of appeals, especially the Second Circuit. This factor may have influenced Delaware courts, particularly in cases such as *Singer*.[23] As this prospect of federal judicial oversight fades, however, the case law could shift again in the opposite direction—perhaps explaining in small part *Singer*'s reversal in *Weinberger*.[24] The volatility of Delaware's law is, in this view, the product of the ebb and flow of the federal threat to Delaware's hegemony and, thus, to the human capital of its bar.

In evaluating Delaware's attractions, Professor Romano seems to take it as a given that greater legal predictability is always a virtue. In contrast, I view legal certainty as more problematic. Of course, certainty is usually beneficial, but it can sometimes be manipulated by management in those areas where its interests conflict with those of the shareholders. Good corporate lawyers can predict the response of a Delaware court to a greenmail repurchase or to a leveraged buyout by management at a low premium, and they can structure their transaction accordingly. It is doubtful, however, that they could be as confident of the response of a California court and, in particular, that they could be as certain of the legal weight that would be given to procedural measures, such as independent director approval or investment banker opinions. This ambiguous evaluation forces me next to come to grips with Professor Romano's central argument: if Delaware law was unfavorable to shareholder interests, why wouldn't stock price studies reveal this in the form of a negative reaction to Delaware reincorporations?

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22 430 U.S. 462 (1977).

23 380 A.2d 969 (Del. 1977).

24 457 A.2d 701 (Del. 1983). Still, a further change of direction back in the direction of Singer v. Magnavox Co., 380 A.2d 969 (Del. 1977) is discernible in Rabkin v. Philip A. Hunt Chem. Corp., 498 A.2d 1099 (Del. 1985). This author agrees with the line drawn by *Rabkin*.

C. *The Stock-Price-Study Evidence*

Professor Romano discounts the Cary thesis because, as she reviews the evidence, stock price studies of corporate migrations to Delaware do not show a decline in share value upon the announcement of such a move. As she realizes, the problem with this evidence is that it is potentially confounded by the market's anticipation of, or reaction to, transactions it believes the bidder will undertake once it has migrated. If the market believes that the corporation is migrating to Delaware in order to reduce the transaction costs associated with effectuating profitable mergers and acquisitions, then the value of the firm's shares may rise in contemplation of such acquisitions, even though shareholders might also believe that Delaware law gives them less legal protection. Professor Romano acknowledges this problem, but responds that in her research she was able to differentiate among corporations "according to the reasons for which reincorporation was undertaken." In the case of firms reincorporating to embark on acquisitions, there was a statistically significant positive stock market reaction to the reincorporation; we may infer this to be a response to the anticipation of profitable acquisitions. For other groups, however, the market reaction was statistically insignificant (although still positive). This latter noisy signal might be interpreted to mean that because there was no decline in share value even when acquisitions were not the motive for reincorporation, shareholders saw no injury from an adoption of the legal regime offered by Delaware.

I do not see this as the logical inference to draw from statistical noise. In my view, noise is the predictable market reaction, given the significant informational asymmetry that exists between shareholders and managers. At the moment of reincorporation, managers know what their motive is, but shareholders typically do not. In general, shareholders understand that corporate acts may signal future developments that have not been explicitly announced. Thus, stock dividends tend to elicit a positive market reaction, possibly on the grounds that shareholders see them as a sign of future improved earnings or cash flow. But the interpretation of such management signals involves much shareholder inference. When management decides to reincorporate in Delaware, shareholders may read this as a signal of favorable impending developments, even when none are in fact contemplated. Or, they may fear that management is contemplating greenmail or a poison pill takeover defense, which Delaware law facilitates. Either way, they may overreact, and the result could be statistical noise if other shareholders view the reincorporation differently. Two points here are central and distinguish my views from those of

Professor Romano: First, we are dealing with a skewed sample because firms that do reincorporate have disproportionately experienced high growth and earnings that have made them ambitious and acquisition oriented. Thus, I doubt we can compare two samples of corporations and state that the market reaction in one case, but not in the other, is influenced by the anticipation of future transactions. Both samples may be influenced by such shareholder inference, but to different degrees. Second, the magnitude of the shareholder reaction to expected corporate developments—whether real or imagined, whether favorable or adverse—should drown out any response to the difference between legal regimes. This is because the discounted value of the transaction cost savings that Delaware's more flexible legal regime offers is essentially trivial on a per share basis. Even the value of its greater legal certainty must be discounted by the limited prospect of litigation arising in the near future. In short, what counts is the corporate motive, and noise results when it cannot be clearly identified.

Other reasons are even more important to my belief that stock price data can tell us little about the merits of competing legal regimes. First, it must be recognized that in the competition among states, the race is always fairly close. Whether the race is to the top or bottom (or sideways and more erratic, as I tend to believe), the competitors are seldom that far apart. Thus, we cannot measure Delaware's real impact by looking only to the margin at any given time that separates it from its nearest rival, but rather we must consider the total distance that this competition has taken us. Stock price studies at best can only measure this margin, and cannot estimate the total distance that this state competition took us from the legal regime that would result absent such competition.

A second difficulty involves the earlier noted volatility of recent Delaware precedents. I suspect that Bill Cary's legacy is most clearly to be found here. Decisions like *Singer* may owe much to the heightened concern for fiduciary standards that his article helped arouse. As a result, during the early 1980's, I heard some corporate lawyers recommend against Delaware incorporation (in favor of Texas, incidentally) on the grounds that Delaware's judiciary was too "moralistic." Hence, any stock price study that uses this period for comparison is confounded by the fact that during this period Delaware's decisional law appeared "tough," even if its statutory law was "lax."

Another subtle problem with interjurisdictional comparisons involves the fact that Delaware's decisional law is automatically adopted by many other jurisdictions. Precedents in both Indiana and Michigan, for example, hold that their highest courts will normally follow the Delaware corporate law decisions.[25] In theory, automatic adoption of the Delaware decisional law represents a means by which other states can compete against Delaware's "first mover" advantage, because it enables those states with little decisional law on corporate issues to "bond" themselves to follow the mainstream and avoid novel or erratic decisions (unless Delaware announces them first). In effect, other jurisdictions can free ride on Delaware's substantial investment in specialized courts and judicial expertise, thus leaving Delaware with a comparative advantage only with respect to novel issues. This pattern confounds the ability of a stock price study to measure Delaware's overall impact, because a new Delaware decision thus affects the law of many states and through them the stock market as a whole. Hence, no comparison is possible, because the whole universe of corporations is impacted.

D. *Analogous Forms of Regulatory Competition*

The basic economic model which sees different states or agencies as producing different brands of regulation that consumers (i.e., corporations) choose among applies not only to corporate charter competition, but also to other forms of regulatory competition. Professor Scott has used this model to examine the dual banking system in which banks can elect to obtain (or switch between) either a federal or state charter and thus be subject to different regulatory agencies.[26] Others have debated the significance of the current competition among the stock exchanges, which recently resulted in the New York Stock Exchange's abandonment of its longstanding one-share, one-vote rule—an event that I do not see as benefiting shareholders.[27] In these other fields, close observers, such as Professors Scott and Selig-

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25 See Genzer v. Cunningham, 498 F. Supp. 682 (E.D. Mich. 1980) (Michigan courts will normally follow Delaware law); Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 253 (7th Cir. 1986) ("Indiana takes its cues in matters of corporation law from the Delaware courts, which are more experienced in such matters . . . .").

26 Scott, The Dual Banking System: A Model of Competition in Regulation, 30 Stan. L. Rev. 1 (1977).

27 See Seligman, Equal Protection in Shareholder Voting Rights: The One Common Share, One Vote Controversy, 54 Geo. Wash. L. Rev. 687 (1986). A study by the SEC's chief economist has also found statistically significant negative changes in issuer's stock prices following the announcement by an issuer of a proposal to issue dual-voting class stock that effectively consolidated control with insiders. See Jarrell, The Stock Price Effects of NYSE Delisting for Violating Corporate Governance Rules (available from Office of the Chief Economist, Securities and Exchange Commission). Of course, some portion of this loss may have been attributable to the likely prospect of NYSE delisting for violation of its one-share, one-vote rule.

man, have had doubts about whether this competition really followed the same rules as the competition among private firms in a market. Whether for good or ill, the general pattern has been that competition among regulators reduces the agency's authority. The unique fact about the corporate context is that some states are seeking to maximize their law's appeal to consumers (i.e., corporations), while others are seeking to respond to powerful internal lobbies within the state. For example, states within the Rust Belt have been the most aggressive in passing the new second generation of antitakeover laws to respond to powerful internal coalitions of local firms, unions, and their satellite constituencies (including local law firms) that fear management ouster, plant closings, and the firm's physical departure from the state. Professor Romano disagrees with this Rust Belt hypothesis and cites statistical evidence and one case history to refute it.[28] Put simply, I believe her methodology suffers from her disregard for the "softer" social sciences. Historians, political scientists, and sociologists could add much to our understanding of these political dynamics, but for the time being I persist in seeing a particular distaste for the hostile takeover in those Northeast and Midwestern states that are losing population, experiencing high unemployment, and lack any significant population who are employed in merger and acquisition activities. Surely, it is more than coincidental that the current leader of the antitakeover forces in the U.S. Senate is Senator Proxmire from Wisconsin.

In any event, on the assumption that a state antitakeover statute may be politically responsive to the local majority, it may still be thought "unfair" to noncitizen shareholders who are thus denied lucrative takeover premiums. In principle, state competition could enable firms to escape this form of inefficient regulatory control—if firms were willing to migrate to Delaware to escape restrictive antitakeover legislation. Unfortunately, I know of no unambiguous instances of migration away from statutes that excessively protected the incumbent management.[29] If I am correct, this fact is like Sherlock Holmes' dog that did not bark in the night; it suggests that the market

28 In her paper, Professor Romano assesses the Connecticut experience and finds that no such coalition of labor and business formed to lobby for the Connecticut statute, which was passed largely in response to the efforts of one corporation. Whatever the experience in Connecticut, the New York experience was emphatically different and fits the above described Rust Belt pattern. Section 912 of the New York Business Corporation Law was a direct descendant of a more sweeping proposed statute that was strongly supported by both the AFL-CIO and the New York State Business Council. The Governor's Counsel, Mr. Evan Davis, so indicated at an ALI-ABA forum held in October, 1986.

29 Some state antitakeover statutes permit a corporation to "opt out" from their application, and some corporations have done so. However, the motive for such decisions appears to

for charters is affected by a promanagerial bias. In rebuttal, some may point to Professor Romano's event study of second generation takeover statutes which found no effect. Again, I have trouble with what this study should be taken to demonstrate. Possibly, this is because such statutes may produce a wash: that is, higher premiums result, but there are fewer bids.[30] If so, shareholders are not injured as a class, although there may be wealth transfer effects within the shareholder class as institutional investors lose their comparative advantage over smaller shareholders. Another more likely possibility involves the high discount rates that rational individuals may apply to remote or speculative events. Since relatively few of the incorporated companies in any state will be actual takeover targets within the near future (i.e., five years or so), shareholders may focus on the prospect of a takeover only once there is distinct evidence that the company is "in play."

II. A Policy Evaluation

State antitakeover legislation forces us to view Delaware in a new light. Its decisional law, at least as expressed in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[31] strikes me as sound and sensible. Given the current empirical debate over whether defensive tactics enhance shareholder wealth (at least to the extent such tactics promote an auction), *Revlon*'s rule that the board's response must be "reasonable in relation to the threat posed"[32] seems congruent with the present state of our knowledge, because it authorizes an ex post judicial inquiry that is unconstrained by the usual limitations of the business judgment rule. Absent Delaware, the majority of today's largest corporations might be subject to the kind of antitakeover regulation that Rust Belt legislatures would happily adopt.[33] Modern "public choice" theory suggests that such forms of regulation are often driven by covert interests and can be seriously adverse to the shareholders' interests that they purport to protect.

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have been that the statute, if applicable, would have seriously impeded the corporation's ability to undertake acquisitions as an acquirer.

30 See Coffee, Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance, 84 Colum. L. Rev. 1145, 1181-83 (1984).

31 506 A.2d 173 (Del. 1986).

32 Id. at 180.

33 Of course, much of this legislation might be found invalid under the commerce clause. But these issues remain to be resolved when the Supreme Court decides the *CTS* and *Fleet Aerospace* cases. See supra note 5. It is no accident that these two cases involve statutes from Ohio and Indiana, which are quintessential Rust Belt states. Minnesota and Wisconsin have been equally hostile to takeovers. These states differ in their political complexion, but not in their fears of migrating jobs and plant closings.

Thus, a balanced evaluation of Delaware's position must consider the alternative: What would happen if Delaware did not exist? Would we need to invent it? Absent charter competition, local state interests might often (perhaps usually) produce an inefficient body of corporate law. This conclusion leads me to a problematic assessment. On the one hand, one may respond that charter competition weakens state power and so has an antidemocratic effect. In this view, the real problem with endorsing Professor Winter's market model is that it seemingly deprives citizens of the ability to determine the legal regime under which corporations in their jurisdiction shall operate. This result may be acceptable, however, if we believe corporate law has few "third party" effects and essentially sets forth a model form contract for use by shareholders. Although I do not fully subscribe to this view, it suggests that shareholder welfare may suffer if a single state can regulate the corporation when the corporation's interests and span of activities transcend those of the state. The state may prefer its local interests to those of the shareholders (as in the case of antitakeover legislation motivated by a desire to prevent plant closings or out-of-state relocations). This is the opposite concern from the usual race to the bottom thesis because it fears excessive state regulation in order to favor local interests rather than excessive friendliness. Charter competition reduces this former danger, even as it aggravates the latter.

The bottom line is an uncertain trade-off. One can continue to believe that Delaware may be excessively partial to management, notwithstanding the stock-price-study evidence. Yet, one must recognize that local control by the state that has the primary contacts (other than the fact of incorporation) may also be inefficient. Such a trade-off compels us to consider the federal government's role. Neither the tax revenue hypothesis nor the local capture theory apply to it. Of course, it too could be excessively regulatory, but not because of any local imbalance of interests and lobbies.

The real problem with federal minimum standards is not that the federal government is the wrong body to regulate, but that the optimal substantive content of such standards is very hard to determine. Yet, if we do not know what is best, we may still know what is bad. Bill Cary's idea of minimum standards did not necessarily freeze the evolution of law, or prevent competition; rather, it simply put some limits on that competition. From my perspective, the attraction of the minimum standards approach is that it would apply equally to the state that is aggressively seeking charters and the state aggressively seeking to protect local industries, both of which may have "managerialist" biases. From this perspective, the operative policy question becomes: What is the least restrictive "minimum" standard that can prevent externalities without unduly intruding on the values of federalism or authorizing excess federal regulation? To explain my answer to this question, some background is useful.

At the outset of this paper, I noted that although federal legislation was unthinkable in the current climate, something that much resembled federal minimum standards seemed to be overtaking the market for corporate control. Personally, although I would applaud the SEC for adopting rules 14d-10 and 13c-4, I believe that the logical consequence of Judge Posner's statements in *CTS*[34] is not competition, but anarchy. Arguably, Judge Posner's test might wholly preclude state competition in the field of takeover regulation. This problem is aggravated by the fact that in *Schreiber v. Burlington Northern, Inc.*,[35] the Supreme Court largely drained federal law of any substantive content.[36] Thus, we face the paradox of the Supreme Court refusing to extend federal law in deference to the states in *Schreiber*, while lower federal courts invalidate state regulatory efforts under the commerce clause in deference to the federal government's exclusive right to regulate interstate commerce. The net result is a vacuum.

What should be the standard? Professor Romano makes the intriguing compromise suggestion that state takeover regulation should contain an "opt-in" provision so that it would apply only if adopted by shareholders. This answer is on the right track, but stops well short of the optimal solution. Opt-in provisions still limit the range of shareholder choice and typically require board approval. Indeed, the commerce clause could be read to mandate an answer not significantly different than her suggestion. On the theory that a state law which burdens interstate commerce is presumptively invalid if less restrictive alternatives are available for achieving the same legitimate goals of regulation, the commerce clause could be interpreted to invalidate state statutes regulating takeovers that do not permit opting in or out.[37] What less restrictive alternative is available? The simplest

34 794 F.2d at 264. See supra note 6 and accompanying text.

35 472 U.S. 1 (1985).

36 In *Schreiber,* the Court held that the Williams Act is a disclosure statute, which does not authorize the substantive regulation of tender offers, except as expressly provided. Specifically, it found that the term "manipulative" as used in § 14(e) of the Williams Act did not authorize a court to enjoin conduct that frustrated a tender offer, if it was fully disclosed. 472 U.S. at 11-12.

37 Commerce clause analysis has frequently looked to the availability of less restrictive alternatives and has basically sought to balance the benefits of regulations having a valid local purpose against their burden on interstate commerce. See Dean Milk Co. v. City of Madison,

answer is that the state could instead have adopted enabling legislation that would not be mandatory but under which shareholders could approve charter provisions blocking or chilling takeovers.[38] Action taken by shareholders pursuant to enabling legislation is private action which neither offends the commerce clause nor is preempted by the Williams Act.[39] In contrast, mandatory legislation sweeps too broadly because no showing has been made to explain why shareholders will not adopt a beneficial provision voluntarily if it is presented by management. While opt-in statutes would, of course, be permissible under this interpretation, they are not optimal because they constrain the range of shareholder choice to "yes" or "no."

Another approach has been suggested recently by the SEC in its Concept Release on Takeovers and Contests for Corporate Control ("Concept Release").[40] In this Release, the SEC seeks comments on whether it should authorize "self-governance exemptions to specific tender offer rules."[41] For example, a charter amendment might waive the Commission's all holders rule that requires a tender offer to be made to all shareholders in a class.[42] Or, such a "self-governance exemption" might adopt specific takeover rules such as the Bebchuk proposal to require shareholder approval of a hostile takeover.[43] This proposal also entails a problematic evaluation because of the tendency for state takeover regulation to be protarget and antibidder.

What conditions should be placed upon this power to adopt "self-governance exemptions"? Many could be sensibly proposed—e.g., sunset provisions, supermajorities, appraisal remedies, shareholder initiatives to make counterproposals[44]—but possibly the most

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340 U.S. 349 (1951). See also G. Gunther, Constitutional Law 276-78 (11th ed. 1985) (distinguishing between discriminatory "effect" and "purpose" when the statute is not discriminatory on its face).

38 A few states, most notably New York, permit direct shareholder amendment of the Certificate of Incorporation. See N.Y. Bus. Corp. Law § 803(a) (McKinney 1986). This provision seems preferable to an opt-in provision since it outflanks a managerial veto at the board level and gives shareholders a freer range of choice.

39 For cases holding that private action taken pursuant to enabling state authority is not state action, see Blum v. Yaretsky, 457 U.S. 991, 1002-05 (1982); Rendell-Baker v. Kohn, 457 U.S. 830, 839-43 (1982); Flagg Bros., Inc. v. Brooks, 436 U.S. 149, 164-66 (1978); Moose Lodge No. 107 v. Irvis, 407 U.S. 163, 171-77 (1972).

40 Exchange Act Release No. 34-23486, 51 Fed. Reg. 28,096 (August 5, 1986).

41 Id. at 28,097.

42 See Rule 14d-10, 51 Fed. Reg. 25873 (1986) (to be codified at 17 C.F.R. § 240.14d-10 (applicable to third-party offers) and Rule 13e-4, 17 C.F.R. § 240.13e-4 (1986) (applicable to self-tenders by an issuer). See supra note 2 and accompanying text.

43 See Bebchuk, Toward Undistorted Choice and Equal Treatment in Corporate Takeovers, 98 Harv. L. Rev. 1693, 1747-49 (1985).

44 With regard to the desirability of such protections, see American Law Institute, Principles of Corporate Governance: Analysis and Recommendations, Advisory Group Draft No. 7,

important condition should be one that generalizes this ability to adopt exemptions and extends it to state antitakeover regulation as well. Shareholders should not face a restricted agenda in their ability to opt out. Put simply, the Williams Act chiefly regulates and protects the bidder from more restrictive state legislation or decisional law. By setting time limits, the Williams Act precludes dilatory or burdensome state regulation. The best example of the protective shelter afforded the bidder is the SEC's all holders rule, which now protects the bidder from a discriminatory self-tender by the target that excludes the bidder.[45] If the target is permitted to opt out from the all holders rule (or any similar provision), basic considerations of equity and evenhandedness suggest that there should be an equivalent right to opt out from state statutes that, for example, require a vote before a "controlling share acquisition" or trigger a right to redemption once a specified threshold is crossed. In short, if shareholders are to be asked to determine their own legal regime, they should be enfranchised to relax not only the regulations that bind the target's hands but also those that bind the bidder's. Opting out from federal legal rules is a particularly risky concept to legitimatize,[46] but, if it is to be done, the target's management should not be able to select the legal rules to be waived. Instead, shareholders should be permitted to use the proxy system to make counterproposals to opt out of state rules. To be sure, many state statutes do not permit shareholders to opt out, but in these cases waiver of the federal rules should be prohibited. Over the long run, this reciprocal policy may encourage states to permit greater opting out.

To sum up, two routes to enhanced and meaningful shareholder choice are open: SEC action and constitutional decision under the commerce clause. The traditional criteria used in commerce clause analysis—namely, the less restrictive alternative test—should not stop at the edge of the "internal affairs" rule, but should be applied so as to place a heavy burden on a state seeking to justify mandatory, rather than enabling, legislation to protect shareholders.[47]

§§ 6.01-6.04 (September 17, 1986) (proposing some such protections, including in some cases sunset provisions and appraisal remedy). The author has served as one of the Reporters to this Project.

45 See Rule 13e-4, 17 C.F.R. § 240.13e-4 (1986); see supra note 2.

46 In particular, shareholders cannot estimate accurately how management will utilize a provision authorizing discrimination within a class. It may be that a provision intended to authorize a selective self-tender or poison pill could be used instead to favor institutional investors over small shareholders. For example, management might decide to buy out arbitrageurs and institutional investors holding its stock (and not smaller investors) pursuant to a self-tender in order to take the firm "out of play."

47 I have suggested at greater length that private action undertaken by shareholders pursu-

Still, it is speculative to predict that the commerce clause will be stretched this far. Indeed, it is even possible (although unlikely) that the Supreme Court might reverse the Seventh Circuit in *Dynamics Corp. of America v. CTS Corp.*[48] on the grounds that *Santa Fe* permits a state to regulate internal corporate governance (even if in so doing it chills the market for corporate control). In this event, a host of statutes similar to the Indiana and Ohio statutes seem foreseeable. Moreover, there would be little prospect of federal legislation overruling such state legislation. What I would suggest at this juncture would be a new kind of federal minimum standard: namely, a federally guaranteed right of shareholder initiative. Because it is unlikely that all states would enact similar antitakeover legislation and because, as Professor Romano argues, Delaware is among the states least likely to enact strongly protectionist antitakeover legislation, the most important federal minimum standard may be an effective shareholder right to exit a particular state regulatory regime. That is, if shareholders had an effective right to reincorporate their corporation in another jurisdiction by direct shareholder initiative, they could escape protectionist state statutes and rely on the "market for charters" to provide them with at least some safe havens to which they could flee. Thus, they could escape the managerial veto that today inheres in the fact that in most jurisdictions all mergers and charter amendments first must be proposed by the board. Designing an effective right to "exit" for the corporation is no small problem, given the inherent difficulties in collective shareholder action. But in a marketplace increasingly dominated by institutional investors, it is not unthinkable.[49] In principle, a federally-created right to exit would be a federal minimum standard of a kind Bill Cary did not foresee—one that protects shareholders by activating, not restricting, the market for charters. Ironically, my proposal implements Ralph Winter's view of the market for charters by using Bill Cary's technique for implementation. Ultimately, a federal right guaranteeing shareholder choice among state legal regimes is a minimalist safeguard that protects the interstate

ant to a charter (which might be specifically authorized by an enabling statute) should offend neither the commerce clause nor be preempted by the Williams Act. See Coffee, supra note 11, at 93-103.

48 794 F.2d 250 (7th Cir.), cert. granted, 55 U.S.L.W. 3198 (U.S. Oct. 7, 1986) (No. 86-71).

49 Any federally created right to change the jurisdiction of incorporation by shareholder initiative would not necessarily overrule shareholder-approved shark repellents, which might still require a supermajority before the firm could reincorporate elsewhere. Alternatively, there could be a "sunset review" at regular intervals (say, every five years) so that a supermajority requirement adopted in one era would not forever block reincorporation if the applicable state law subsequently changed. I do no more here than sketch the barest outlines of such a proposal.

market for charters and, may make it meaningful. Such a reform is not a panacea, but its impact could become significant in future years if the trend toward greater activism on the part of institutional shareholders continues.

This conference is about the future of corporate law. The SEC Release and the *CTS* decision do indeed hint at the dawn of a new era—a brave new world of "roll your own" law regimes. But if we are to enter this new world, the guiding principle that I would offer is that shareholder choice should not be constrained by the existence of managerial control over the shareholders' agenda. Shareholders should be given equivalent autonomy to repeal or revise the legal rules applicable to both sides in corporate control contests because it is a false deference to the ideal of shareholder autonomy to allow them to waive only the federal regulatory structure or only those provisions that managers ask them to waive. Similarly, my suggestion that shareholders should be accorded a direct shareholder initiative to reincorporate in another jurisdiction represents, I believe, a new way—one that does not intrude on the values of federalism—to implement some aspects of Bill Cary's idea of minimum standards. Bill Cary's legacy is still with us.