

DELAWARE AND WASHINGTON AS CORPORATE LAWMAKERS

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ABSTRACT

American corporate law scholars have long focused on state-to-state jurisdictional competition as a powerful engine in the making of American corporate law. Yet much corporate law is made in Washington, D.C. Federal authorities regularly make law governing the American corporation, typically via the securities law—from shareholder voting rules, to boardroom composition, to dual class stock, to Sarbanes-Oxley—and they could do even more. Properly conceived, the United States has two primary corporate lawmaking centers—the states (primarily Delaware) and Washington. We are beginning to better understand how they interact, as complements and substitutes, but the foundational fact of American corporate lawmaking during the past century is that whenever there has been a big issue—the kind of thing that could strongly affect capital costs—Washington acted or considered acting. Here I review the concepts of the vertical interaction, indicate what still needs to be examined, and examine one Washington-Delaware interaction in detail over time. Overall, we cannot understand the governmental structure of American corporate lawmaking well just by examining the nature, strength, and weaknesses of state-to-state jurisdictional competition.

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I. INTRODUCTION

The idea of jurisdictional competition—of a race—is deeply embedded in American corporate law scholarship, with its direction—to the top or bottom—having been one of American corporate law academics' enduring controversies. Only recently has sustained inquiry been made into how strong that race is and whether Washington is a de facto second American corporate lawmaker.

Here I first outline the state of our knowledge and indicate how and why the traditional horizontal state competition model needs updating to a multi-level triangular one. Then I discuss multi-level elements that need to be conceptualized further and, finally, I examine one vital Delaware-Washington interaction in depth, one whose import for understanding that interaction is contested—the going private developments of a few

decades ago. The detailed, sequential examination of the going-private rules illustrates that the United States has two parallel, at times interacting, systems of corporate law. One is state-made and one—incomplete but powerful—is federal.

II. THE TRADITIONAL MODEL: STATE-TO-STATE JURISDICTIONAL COMPETITION

For quite some time, the traditional model of state jurisdictional competition was that states compete to amass corporate charters, with the franchise tax motivating that competition. Collateral fees (to the state and to its corporate attorneys) also have been seen as motivating state players to compete. Views differed on the nature and directionality of the competition, but, as Figure 1 illustrates via two-headed arrows of states elbowing one another, the implicitly agreed upon concept was that states competed for franchise fees, and that those fees were critical to the competition.

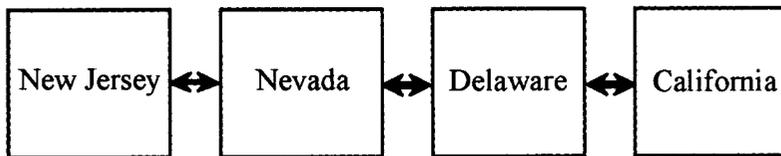


Figure 1. The Traditional Model

From that core of consensus that states compete for franchise fees, major disagreements flared. One camp viewed the race as more to the bottom than to the top. Early analysts, like Justice Brandeis, viewed the bottom as states' willingness to allow firms to grow large for managers' and shareholders' benefit.¹ Although Brandeis's view was premodern in that he focused on antitrust considerations, reflecting his animus against corporate size, it is his mechanism of state competition that matches the modern race-to-the-bottom view. He saw state competition as inducing states to capitulate to private corporate interests at the expense of the public interest, in order to garner incorporations and franchise revenue.

The modern race literature reconfigured Brandeis's perspective into an analysis of outside-shareholder and inside-manager authority within the firm.² William Cary finished his term as chair of the Securities and

¹See *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 548-65 (1933) (Brandeis, J., dissenting in part).

²For representative and classic arguments on the race to the bottom, see Lucian Arye

Exchange Commission, returned to academe, and concluded that the major threat to high-quality corporate law in the United States was what he saw to be Delaware's low-quality corporate lawmaking.³ In a prominent article, he concluded that Delaware case law gave far too much discretion to insiders, saw the franchise fees as motivating Delaware's favoring of insiders because insiders decided where the firm would buy its charter, and called on Congress to enact minimum corporate standards for large firms in the United States to remedy that race to the bottom: "The first step [for improving corporate law] is to escape from the present predicament *in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy* as an incentive to encourage incorporation within its borders"⁴

Powerful replies followed.⁵ Ralph Winter, then at Yale and subsequently on the U.S. Court of Appeals for the Second Circuit, said states could not systematically diminish their firms' efficiency.⁶ If a state did, product and capital market competition would degrade its firms' quality and profitability, while firms incorporated elsewhere would prosper. At the limit, firms in bad-corporate-law jurisdictions would be bought up by firms in good-corporate-law jurisdictions. (In his original formulation, he had state-made takeover laws not as part of the race itself.)⁷ Important expansions and empirical work followed.⁸

Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461 (1989); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32 (2004).

³See Cary, *supra* note 2, at 670-704.

⁴*Id.* at 701 (emphasis added).

⁵For representative and classic arguments on the race to the top, see ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* (2002); ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993); William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303 (1997); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

⁶Winter, *State Law*, *supra* note 5, at 256.

⁷For more on takeover laws in this context, see FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 218-23 (1991); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999); Mark J. Roe, *Takeover Politics*, in *THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE* 321 (Margaret M. Blair ed., 1993).

⁸See, e.g., ROMANO, *ADVANTAGE*, *supra* note 5; Barry D. Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J.

III. THE RECENT THINKING: HOW MUCH COMPETITION?

The heat in the race-to-the-top versus bottom exchanges obscured an essential agreement that there was a franchise-fee-motivated race. Even that foundation developed fissures in the past decade, as important recent thinking is skeptical that interjurisdictional competition is intense. Marcel Kahan and Ehud Kamar showed that other states are not now trying to garner franchise tax revenue.⁹ Most states have not invested in developing good business courts, they do not try to make the corporate law that managers and shareholders want, and their per-firm rate card for franchise fees does not have them charging enough to strongly motivate themselves to attract more incorporations. Delaware is alone in competing day-to-day for corporate charters and franchise fees.¹⁰ Lucian Bebchuk and Assaf Hamdani came to a similar conclusion through a complementary route,¹¹ as had Melvin Eisenberg nearly two decades ago.¹²

Figure 2 illustrates the concept that state competition for corporate charters is weak, with the bold double-headed competitive arrows from Figure 1 dissolving into dots, putting less (or no) interstate pressure on Delaware.

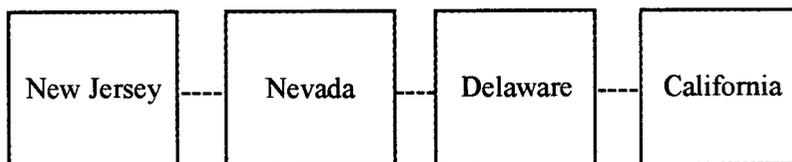


Figure 2. The Updated Model: Weak State Competition

The basic numbers support a view that immediate fee-based competition is weak: Firms incorporate, typically locally in their original place of business. Firms that grow decide whether to reincorporate, typically at crucial markers in their development, i.e., when they go public, when they begin buying up other firms, or when they seek major new financing. When they reincorporate, they do not, the new thinking runs, choose among several

CORP. L. 431 (1985); Daines, *supra* note 5.

⁹Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 724-35 (2002).

¹⁰*Id.* at 724.

¹¹Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 585-95 (2002) (economic and structural barriers to jurisdictional competition).

¹²Eisenberg, *supra* note 2, at 1511-12.

states. Overwhelmingly, they move to Delaware. As Kahan and Kamar show, no other state generates substantial franchise fees.¹³ Bebchuk and Hamdani argue that no other state can easily get started because any innovation they make can be quickly copied by Delaware.¹⁴

I have put forward the concept that constraints on Delaware in making corporate law have come as much, or more, from Washington as from the other states.¹⁵ When a big corporate business issue arises, Washington either takes the issue over or threatens to do so. Delaware sometimes reacts, but it sometimes watches as the lawmaking flows to Washington.¹⁶

Washington's presence is important on several levels. First and foundationally, it is just a big, direct presence in corporate governance law and it is not subject directly to interstate (as opposed to international) jurisdictional competition. Even if Delaware never pays attention to what Washington does, Washington at times takes over a major corporate law issue that could have been resolved at the state level. Moreover, because Washington often becomes the locus of corporate governance issues (consider Sarbanes-Oxley and recent years' proposals for shareholder access to the company's proxy statement), Delaware can avoid some controversial issues, providing a litigation forum and deference to directors. Without a Washington that takes on core corporate governance issues, Delaware's position would sometimes be made more difficult.

And, lastly and more controversially, sometimes Delaware does seem to formulate policy with an eye on Washington. When it does so, Delaware competes with Washington—not in issuing charters, but in making the law governing America's corporations—and that fact is underscored by the new analyses that conclude the other states are not tough competitors for corporate charters. Even if Washington's presence were weak (or just intermittent), its *relative* importance in Delaware lawmaking increases if state-to-state chartering competition is limited. Moreover, with critical

¹³Kahan & Kamar, *supra* note 9, at 687-92.

¹⁴Bebchuk & Hamdani, *supra* note 11, at 593-95.

¹⁵Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003); Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491 (2005).

¹⁶Roe, *Delaware's Competition*, *supra* note 15; Roe, *Delaware's Politics*, *supra* note 15. For related views, see Robert B. Ahdieh, *From "Federalization" to "Mixed Governance" in Corporate Law: A Defense of Sarbanes-Oxley*, 53 BUFF. L. REV. 721 (2005); William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401, 419 (1994); John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDOZO L. REV. 759 (1987); Eisenberg, *supra* note 2, at 1512; Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965); Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879 (2006).

elements of corporate law lodged in Washington, there is just much less to race over than there could be.

I extend this triangular, Washington view in the next part.

IV. WASHINGTON

States make merger law, they make the rules on how stock is voted, they authorize and control the rules governing the structure of the American boardroom, and they decide what duties shareholders and managers have. Washington also makes merger law, however; indeed, from the passage of the Williams Act in 1968,¹⁷ until 1987, Washington was a key player in merger law, especially in keeping the states from making strong antitakeover laws. The proxy rules in section 14 of the Exchange Act deeply affect corporate voting. Further, Washington can affect the structure and nature of the boardroom directly: stock-exchange rules that the SEC demanded determine key board structures by forcing an audit committee and requiring the independence of an increasing number of its members.

The United States is a federal system where Washington frequently takes over economic issues of national importance. The issues most likely to move into the national arena are those that could affect firm value so much that they would be central to state-to-state competition. That happened for securities trading during the Depression, takeovers in the 1970s and 1980s, and corporate governance after the Enron and WorldCom scandals. If fundamental issues of corporate governance often move into the federal arena, Delaware and the states are not deciding all key corporate law matters.

Vast areas of American corporate governance simply are not governed by the states alone. Since it is the mix that ultimately determines the effect of law on the economics of corporate governance, organization, and ownership, some portion—and it seems to be a very large portion—of the law governing the corporation is not made in a jurisdictional race but by a national political authority, such as Congress, the SEC, or the federal courts. With fewer aspects for the states to compete over, state competition is less central to corporate governance than has been conventionally understood. These are the central qualifications to the standard story, which Figure 3 illustrates.

¹⁷Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000)).

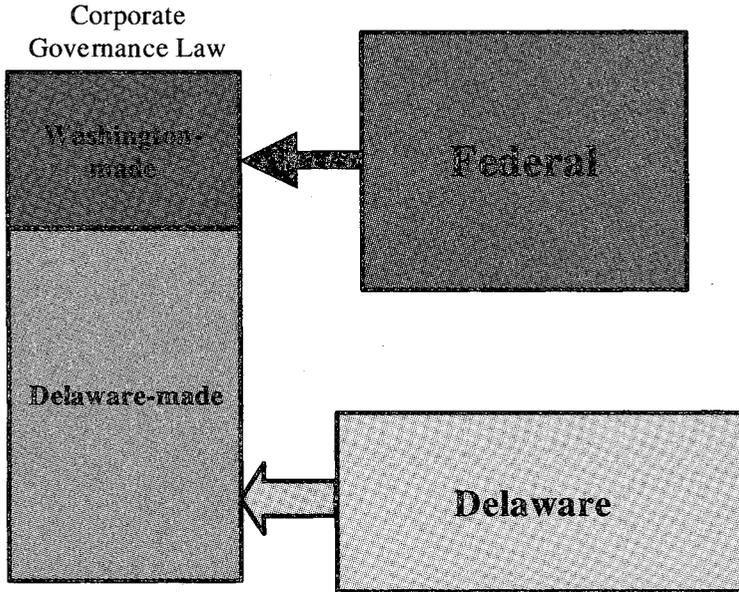


Figure 3. Washington, D.C., Making Corporate Law

Although federal authorities do leave the states a wide range to act, when scandals and economic reversals occur—when corporate transactions grab the attention of the American public and the U.S. Congress—Congress could, and often does, act. If the state results are grossly out of line with what a Washington consensus wants, Washington is more likely to act. Yes, Washington acts only sporadically, it is often divided, and it often has more important issues than corporate governance rules on its agenda. That inattention gives the states in general—and Delaware in particular—much room to maneuver. But that range, although quite wide, is not without limit.

That federal potential to act even more leads us to further qualify the conventional state competition story: Delaware players are not oblivious to the possibility that federal authorities can act. When the issue is big enough that it could attract Washington's attention, they have reason to consider what Washington would do, and they often have reason not to instigate Washington to displace them; they have said often enough that they are taking Washington into account. Figure 4 illustrates this point.

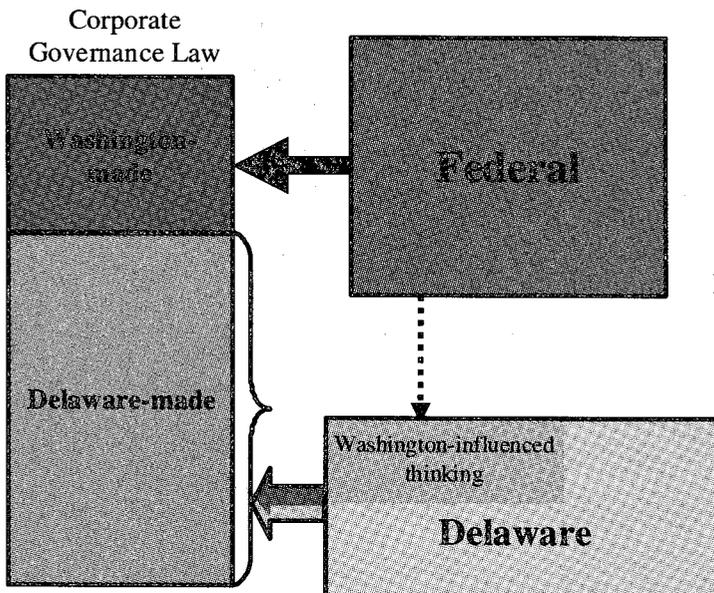


Figure 4. Washington, D.C., Affecting Delaware

Testing this model is not easy—we cannot rerun Delaware actions without Washington in the background to see which rules would differ if there were no Washington influence. Small rules on small matters would not command Washington's attention. There, states in general, and Delaware in particular, have a wide range to maneuver. But, in parallel contexts, we do have excellent theory and some data that other political units position themselves on major issues so as not to goad Congress into acting. The big gorilla of American economic lawmaking is the Congress which, when it wants to, can dwarf the Delaware Court of Chancery, the Delaware General Assembly, and the Delaware Corporate Law Council, which drafts Delaware's corporate law. They all have considerable freedom to act, but not on a corporate governance issue about which Washington has acted, and not if they upset those who can influence Washington.

Thus, we must reconceptualize who makes American corporate law and how it is made. Washington is not just a potential big player in corporate lawmaking, but an actual big player, usually always considering, and often acting, on the most important corporate governance issues of nearly every decade. And Washington could always do more. The American corporate regulatory structure is better conceptualized as having two major inputs, as in Figures 3 and 4, or as more triangular (states at the base, the federal authority at the top vertex) than just the horizontals in Figures 1 and 2.

Figure 5 illustrates the triangular structure. The upper horizontal arrow indicates the corporate governance law that Washington makes directly. The lower arrow indicates corporate law that Delaware makes in state competition—the traditional race structure; it is the product of states looking at one another, as the bracket pulling the states together illustrates. The middle horizontal arrow indicates corporate law that Delaware makes without state competition influencing it; some of that law is Washington-influenced and some discretionary with Delaware. It is discretionary in the sense that it is neither Washington-influenced nor honed in state competition.

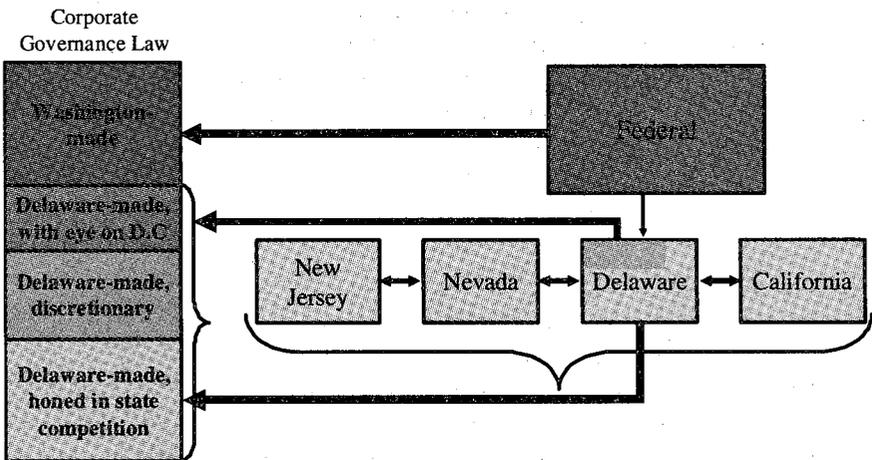


Figure 5. The Triangular Model

A. *Corporate Laws*

Washington makes corporate law. From 1933 to 2002, that is, from the passage of the securities laws to the passage of Sarbanes-Oxley, Washington has made rules governing the voting of stock and the solicitation of proxies to elect directors. It has made the main rules governing insider trading, stock buybacks, how institutional investors can interact in corporate governance, the structure of key board committees, board composition (how independent some board members must be), how far states could go in making merger law, how attentive institutional investors must be in voting their proxies, what business issues and transactional information public firms must disclose (which often affect the structure and duties of insiders and managers to shareholders in a myriad of transactions), the rules on dual class common stock recapitalizations, the duties and liabilities of gatekeepers like accountants and lawyers, and more. Even when the SEC cannot, or does

not, make the substantive rule, its capacity to force disclosure of numbers and transactions can turn a spotlight onto those transactions and numbers, thereby affecting whether or not they happen.

B. *Who Makes Them?*

There are four principal federal players. First is Congress, which passed the securities laws and approximately every ten years or so updates those laws. Second is the SEC, which promulgates regulations under the securities laws and often proposes changes to Congress. The courts are the third player, interpreting those laws. Finally, the fourth is the stock exchange, which, although it looks like a purely private actor, makes major corporate governance law, often when the SEC—a federal administrative agency created by Congress, which gave the SEC substantial power over the exchange—asks (or, perhaps for the stock exchange the better word is, directs) it to make those rules.

C. *Definitional Versus Functional: Is It Corporate Law?*

Traditionally, the American analyst correctly believes that since the states create corporations, the states initially make the law governing those corporations. So, one could formalistically say that only states make corporate law and not federal authorities, which do not charter American corporations. But this perspective would be far too formalistic today. If a rule affects the functioning of the firm, the relationship among shareholders, and the relationship between shareholders and managers, then it is functionally corporate law. Hence, any functional definition of corporate law would then bring in a huge amount of Washington-made law.

For better or worse, much corporate governance law is just not subject to a race; it is made in Washington, via disclosure rules, proxy rules, and general corporate regulation. So a mandate that there be an audit committee with independent directors is corporate law, rules governing the solicitation of votes for annual elections are corporate law, and insider trading rules are functionally corporate law rules as well. Each of these three is regulated primarily via federal effort, not via state corporate law.

D. *Washington Could Do More*

One also should not ignore Washington's potential power here, which is great. If Washington wanted to, it could take over all corporate law-making from the states, obliterating Delaware as a producer of state-made

corporate law. It is not irrelevant that Washington considered doing so at key points during the twentieth century.¹⁸

In this past decade, one of the more important proposals on the American corporate governance agenda has been the SEC's shareholder access proposal.¹⁹ It would, if promulgated, give dissident shareholders direct access to the company's proxy statement. As is fundamental to the American corporate structure, the company solicits votes for the incumbent board at the company's expense. Insurgents can run against the incumbents, but they must pay for their lawyers, proxy solicitors, and advertising fees—which run into the millions of dollars for there to be any chance of succeeding—out of their own pockets. The SEC proposal tilted toward insurgents.

The point here is not whether the proposal was a good one, or even whether it will be put in place. The point is that federal authorities think about making profound corporate governance changes, and sometimes they make them. Oftentimes, it is the Delaware players and their associated interest groups who are most opposed to federal action.

E. *State Awareness?*

State players are not oblivious to the possibility that Washington makes corporate law, could make more of it, and is not worth offending unnecessarily. Two examples from this decade follow.

1. Enron in 2002

Consider the views of Delaware's chief justice, Norman Veasey, at the time the Enron scandals broke and corporate observers expected federal action, an interaction that I have remarked upon previously.²⁰ He immediately acknowledges the federal-state framework for corporate lawmaking, saying that "the federal securities regulatory regime is a force in influencing the internal affairs of corporations."²¹ That is, the Delaware

¹⁸1 LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, *SECURITIES REGULATION* 238-44 (4th ed. 2006).

¹⁹In 2007, the SEC released, but did not thereafter adopt, two proposals regarding shareholder access for director elections and bylaw amendments. *See* Shareholder Proposals Relating to the Election of Directors, 72 Fed. Reg. 43,488 (Aug. 3, 2007); Shareholder Proposals, 72 Fed. Reg. 43,466 (Aug. 3, 2007).

²⁰*See* Roe, *Delaware's Competition*, *supra* note 15, at 596-97.

²¹E. Norman Veasey, *The Role of the Delaware Courts in United States Business Litigation*, Address Before ALI-ABA Advanced Course of Study on United States Domestic and International

chief justice is well aware that America has another major maker of corporate governance law besides Delaware. But he defends the state against the federal alternative: state-based corporate lawmaking has a long tradition and is the best locale, in his view, to begin the lawmaking reaction to a corporate problem like the Enron scandal. Yes, he said, federal preemption could end state-made rules at any time and much existing American securities law effectively regulates corporate internal affairs. But Delaware's regulatory apparatus, particularly its courts, provide a regulatory system superior to what the federal government offers. Although the Enron "foment has provoked debate about the effectiveness of [state law] standards governing directors," he argued, "the Delaware model works well overall, . . . and . . . one should be cautious in concluding that current events should dictate a new . . . regime of corporate governance."²² Nonetheless, he said elsewhere, "[i]f we don't fix [the scandal-related problems], Congress will, but I hope they've gone as far as they're going to have to go."²³

Veasey was not alone here: after Sarbanes-Oxley passed, the American Bar Association was warned at its annual meeting that "federal power was threatening Delaware corporate law. [Hence,] . . . lawyers opposed to federal encroachment into state law [should] persuade their corporate clients to institute best practices in shareholder nominations to 'help keep the system the way it is.'"²⁴ This seems to be astute advice, and it is time for the concept—of a federal overhang and that some corporate players' interests are to avoid it coming into play—to more deeply work its way into a fuller academic conception of American corporate lawmaking.

2. Delaware's Abstention in 2008: *Bear Stearns*

The pattern of Delaware avoiding stepping on federal toes could again be seen early in the current financial crisis, when federal officials engineered J.P. Morgan Chase's takeover of Bear Stearns, a large, failing investment bank. To prevent Bear Stearns from failing as a stand-alone bank, the U.S. Treasury and the Federal Reserve arranged for J.P. Morgan to buy Bear Stearns.²⁵ Shareholder approval would be needed and Bear's shareholders could have had reason to hold out for a better deal; but federal officials

Litigation and Dispute Resolution 1, 3 (Apr. 11, 2002).

²²E. Norman Veasey, *Reflections on Key Issues of the Professional Responsibilities of Corporate Lawyers in the Twenty-First Century*, 12 WASH. U. J.L. & POL'Y 1, 2-3 (2003).

²³Charles Elson, *What's Wrong with Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 77.

²⁴ABA Panel Weighing Possible Changes to Model Act on Voting for Directors, 20 CORP. COUNS. WKLY. 81, 81 (2005).

²⁵*In Bear Bailout, Fed Says It Tried to Avert Contagion*, N.Y. TIMES, June 28, 2008, at C4.

thought the systemic risks to the economy were too great to let the shareholders pursue their private interests. The federally-supported deal gave J.P. Morgan 39.5% of Bear's common stock, a number large enough to effectively preclude Bear's shareholders from rejecting the deal.²⁶

Consider Delaware's reaction. That high a level of deal protection would not ordinarily fly under Delaware law, which typically requires board and shareholder approval of such a transaction.²⁷ But Bear's board had effectively taken away the shareholders' statutory approval rights with 39.5% of the stock in merger-friendly hands, a preclusive merger structure that *Unitrin* and *Blasius* would ordinarily bar.²⁸ Delaware, though, abstained this time, stopping the shareholders' lawsuit in the Delaware courts, thereby avoiding any Delaware judicial challenge to federal authorities (or a judicial ruling inconsistent with the judiciary's prior rulings). As Edward Rock and Marcel Kahan state in a precise analysis of Delaware's dilemma here, "[I]f a Delaware court were to enjoin a deal pushed by the Federal Reserve and the Treasury[,] . . . it would invite just the sort of federal intervention that would undermine Delaware's role as the de facto provider of U.S. Corporate law."²⁹ Delaware did not enjoin the deal.³⁰

These two instances—Veasey's observations and *Bear Stearns'* abstention—are illustrations, not isolated occurrences. Delaware players regularly show their awareness of the federal potential.³¹ "Political officials have reacted to the Enron debacle with outrage," said a Delaware vice chancellor, "Congress may even [he wrote, after the Enron scandal but before Sarbanes-Oxley passed] be tempted to consider federalizing key elements of corporate law that have traditionally been the province of state law."³² Two on Delaware's Court of Chancery recently said that there is

²⁶Posting of Heidi N. Moore to Deal Journal, <http://blogs.wsj.com/deals/2008/05/28/how-to-buy-a-distressed-investment-bank-and-make-it-legal/> (May 28, 2008, 14:42 EST).

²⁷DEL. CODE ANN. tit. 8, § 251 (b)-(c) (2001).

²⁸*Unitrin, Inc. v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995); *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651 (Del. Ch. 1988).

²⁹Marcel Kahan & Edward Rock, *How to Prevent Hard Cases from Making Bad Law: Bear Stearns, Delaware and the Strategic Use of Comity*, 58 EMORY L.J. (forthcoming 2009).

³⁰*In re Bear Stearns Cos.*, S'holder Litig., No. 3643-VCP, 2008 WL 959992 (Del. Ch. Apr. 9, 2008) (Parsons, V.C.), reprinted in 33 DEL. J. CORP. L. 515 (2008). Delaware could have avoided conflict with Washington by directly holding that the business emergency—Bear Stearns was on the verge of bankruptcy—warranted extraordinary board action outside *Blasius'* doctrinal confines. Cf. *In re Bear Stearns Litig.*, No. 600780/08, 2008 WL 5220514 (N.Y. Sup. Ct. Dec. 4, 2008) (Cahn, J.) (business judgment rule insulates Bear's board).

³¹See Lawrence Hamermesh, *How We Make Law in Delaware, and What to Expect from Us in the Future*, 2 J. BUS. & TECH. L. 409, 412-13 (2007); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1767-68 (2006).

³²Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law*

a general, continuing, and, in their view, healthy interplay between federal and state corporate action:

This division of responsibilities [between state and federal authorities] has never been marked by bright borders. To the contrary, many federal disclosure requirements have had the natural and (presumably) intended consequence of influencing boardroom practices. Similarly, the state law of fiduciary duties has been an important tool in evolving better disclosure practices, particularly in the context of mergers and acquisitions requiring a stockholder vote or tendering decision. The tug-and-pull among the various policy actors has occurred in a civil manner³³

Vice Chancellor Strine goes on in a recent issue of the *Business Lawyer*:

[T]he capacious constitutional authority of Congress over interstate commerce is something that *Delaware and other state corporate lawmakers have constantly had to take into account* When state law appeared to substantial elements of the investment community to be insufficient to protect investor interests, calls for congressional action arose, calls that influenced state lawmakers to reexamine the balance of interests between managers and stockholders.³⁴

The point here, the most contestable one of the federal story I am selling, is surely not that Delaware responds marionette-like to every federal vibration, but that the large and looming federal overhang creates the potential for a large, broad, although not particularly fine-grained, and certainly not yet fully understood nor fully analyzed interplay between Washington and Delaware.³⁵

Implications of the Enron Debacle, 57 BUS. LAW. 1371, 1371-72 (2002).

³³William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 974 (2003).

³⁴Leo E. Strine, Jr., *Breaking the Corporate Governance Logjam in Washington: Some Constructive Thoughts on a Responsible Path Forward*, 63 BUS. LAW. 1079, 1081 (2008) (emphasis added).

³⁵See Roe, *Delaware's Competition*, *supra* note 15, at 592; Roe, *Delaware's Politics*, *supra* note 15.

V. CONSEQUENCES

A. *Descriptive: The Triangle Versus the Horizontal*

The most significant consequence is that the structure of American corporate law is more complex than a horizontal race between states, a relationship that by itself is sufficiently complex to have defied a full consensus in its academic conceptualization, even as to its directionality. In assessing how and why corporate law is made in America, we cannot rely on a market that we celebrate (because it races to the top) or denigrate (because it is captured by managers). Because federal authorities are big players, much of American corporate governance law is not made in the cauldron of state competition. States might be ready to give managers autonomy, but then federal authorities might tighten up. Or, states might get the balance needed in the relationship between managers and shareholders about right, but then Congress could upset the states' well-tuned balance with a hasty, populist intervention. Furthermore, we might conjecture that federal authorities leave to the states the issues that the national players—and American public opinion—care less about.

With this better picture of the structure of American corporate lawmaking in mind, we will be better able to reinterpret the race, the public choice structure of American corporate lawmaking, and why Delaware survives. In parallel work, I have sought to do so.³⁶

B. *The Basic Public Choice Structure of American Corporate Law*

There is a public choice structure to this divide. Because managers and investors jointly control the \$500 million franchise tax that Delaware gets for being the corporate law center, those are the main interests represented in Delaware's corporate lawmaking. This is simple, but should not be ignored, because it has public choice consequences. Delaware is often properly praised for its legislature's speedy reaction to corporate needs and its high-quality judiciary. And the franchise tax is usually seen as primarily Delaware's reward for being attractive. But more is going on here. The franchise tax is *also* a public choice bond, not just a qualitative bond. It is a public choice bond because the tax defines who directly influences

³⁶Roe, *Delaware's Competition*, *supra* note 15; Roe, *Delaware's Politics*, *supra* note 15; Mark J. Roe, *Is Delaware Too Big to Fail?*, 74 BROOK. L. REV. 75 (2009).

Delaware corporate law, i.e., the groups that bring the franchise tax to Delaware, namely shareholders and managers. Delaware's dependence on the tax excludes outsiders interested in state-made corporate law because they do not pay the tax. It excludes national public policymakers, whether for good or ill. Some policymakers in Washington are perhaps more likely than Delaware players to sympathize with an economist's goals in constructing strong capital markets.

And, when Washington acts on corporate law, it brings with it another strain of public policy: American populist sentiment and national public opinion, which are not always friendly to corporate productivity and corporate power. There are players in Washington—weak in recent years, but not always without power, and even recently influential in getting Sarbanes-Oxley passed and re-emerging in the recent financial rescues—who would like to regulate the corporation more, and who, if all corporate law were made in Washington, would have more reason to lobby lawmakers to make the corporation over in a way that would advance their agenda.

Figure 6 illustrates. At the bottom right are the main interests that bestow the franchise fee bonanza on Delaware, managers and shareholders. Delaware is in the first instance responsive to the two of them. Although the two are also influential at the federal level, an array of other interests and ideas also come into play, as the multiple arrows on the top right indicate. To the extent corporate law is made on the federal level, these interests dilute the impact of managers and investors. To the extent Delaware reaches its decisions with federal action in mind, these interests and ideas indirectly affect Delaware lawmaking.

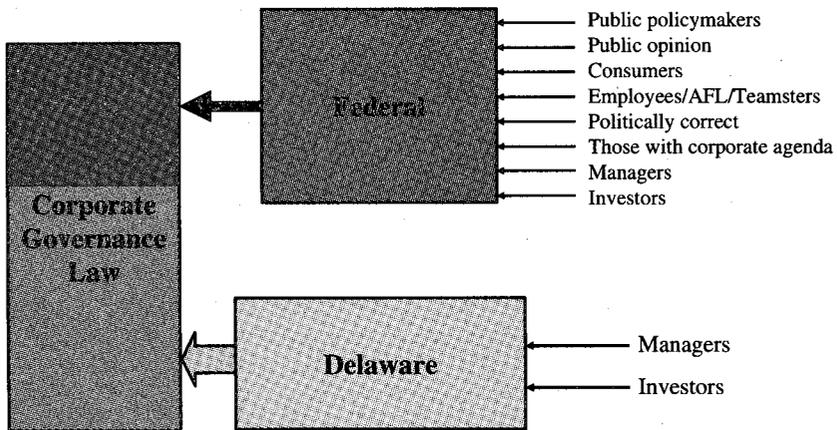


Figure 6. The Public Choice Inputs

Some capital-markets-oriented analysts would bemoan much of what Washington might do. They think, for example, that Sarbanes-Oxley, Congress's latest major corporate governance effort, was misguided and, hence, applaud little of what goes on in Washington. From a public choice perspective, the presence of the wider inputs in Washington gives Delaware's main players—managers, investors, and their lawyers—another reason for some to keep the decision making from Washington.³⁷ Others, beyond managers, shareholders, and their lawyers, with differing interests and views, would be involved if the corporate issue gets onto the congressional agenda.

VI. COUNTER-STORIES

The fact that Washington makes law governing the large American corporation is indisputable. But evaluating its weight is not immediately easy. How much Washington lawmaking is a lot? How much is a little? Even if there were agreement that Washington weighed in on the major issue of each decade (as I have argued, but others might dispute), assessing its importance is not obvious: Does that mean that the states "merely" deal with the residue, since (say) only one major issue is deeply consequential in every decade and Washington typically weighs in on that consequential issue? Or does that mean that once one issue is disposed of, Delaware then makes the rest of the—and the bulk of—day-to-day corporate law?

Let us look at how those views can differ. Roberta Romano has been, over the decades, a consistent and ingenious leader in arguing, testing, and extending the case that states race to the top, providing both compelling theoretical accounts and empirical evidence. She has regularly delivered a sustained, rich, and intellectually deep case for the race-to-the-top view.³⁸ So it is natural that Romano would disagree with a description that accords Washington a large role in regulating the relationships inside the corporation and would be acutely sensitive to countering any examples of federal action by denying their importance. She makes three major points: one is conceptual—that the theory of federal influence in corporate law is not testable as a positive theory and, hence, should be rejected; the second is

³⁷For how Delaware lawyers lose when corporate issues go federal, see Robert B. Thompson, *Defining the Shareholder's Role, Defining a Role for State Law: Folk at 40*, 33 DEL. J. CORP. L. 771 (2008). That potential for lawyer's loss could set up a dollar-based incentive similar to that attributed to the franchise fee.

³⁸ROMANO, ADVANTAGE, *supra* note 5; ROMANO, GENIUS, *supra* note 5; Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709 (1987).

mechanical, that the examples do not fit the model of federal action—Delaware is a fully free agent; and the third is definitional, that, properly defined, there just was not that much—or any—federal corporate lawmaking to speak of, until Sarbanes-Oxley came along.³⁹

A. Refutable Implications

Aspects of the Washington theory are indeed difficult to test. But difficult to test neither means failure as a positive theory nor indicates that we should ignore the phenomenon.⁴⁰ Academics will just have to work harder than otherwise to understand it.

The first Washington view that I have advanced is that Washington makes a large portion of the corporate law governing American firms. It is hard to contest this observation, and not much testing is needed, when we observe that there are two major securities laws, which govern not just broker-dealer relations, but voting in public corporations, disclosure of related-party transactions, aspects of tender offers, and more. The Williams Act,⁴¹ passed in 1968, regulates takeovers and, for nearly two decades, was used by American federal courts (i.e., Washington) to strike down most state-created antitakeover law. Stock exchange rules demanded an audit committee in the boardroom and increasing numbers of independent directors. These rules were put in place when the SEC insisted that the stock exchange so act. Washington makes law governing the corporation.⁴² Whether the SEC's influence on corporate governance since 1934 is a lot and important or a little and trivial is judgmental and, apparently, open to differing assessments.

³⁹Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?*, 21 OXFORD REV. ECON. POL'Y 212, 213-29 (2005).

⁴⁰KARL R. POPPER, *THE LOGIC OF SCIENTIFIC DISCOVERY* (Karl R. Popper trans., 1958). A little excursus on scientific logic: The statement that it will rain tomorrow is refutable. The statement that it will either rain or not rain tomorrow is not. The statement that it will rain if the weather front moves toward us but not rain if the front moves away from us is refutable. As a positive theory, it does not matter whether we can yet accurately observe the movements of the weather front. The statement that Delaware is more proshareholder (or more promanager) than its internal preferences if federal authorities are much more proshareholder (or more promanager) is refutable. It does not matter, as an issue of setting up a positive theory, whether we can yet precisely observe the true preferences of the relevant state and federal actors. A proposition may be testable in principle, but difficult to test. Policymakers need to make judgments when seeking to understand the phenomenon, judgments that need to be made without the benefit of full data.

⁴¹Pub. L. No. 90-439, 82 Stat. 454 (1968) (codified as amended at 15 U.S.C. §§ 78m(d)-(e), 78n(d)-(f) (2000)).

⁴²That is, for this prong of the Washington thesis to be important does not require that the states do anything at all, just that Washington affects core elements of corporate governance.

B. *Delaware as Free Agent?*

The element whose extent is particularly difficult to test is the hypothesis that Delaware at times has an eye on Washington in deciding what it should do. Whether it watches Washington is not always easy to detect, as players often have reasons to obscure their goals and influences. And, since there is still no obvious metric to measure the extent (must Delaware announce a change of mind for the influence to be judged substantial? or need it only announce that Washington's view entered the mix? or is it enough that Delaware appears to tilt in Washington's direction on some key issues and away from its own stance on other issues?), reasonable people could disagree on the importance of the influence. Because there is no rigorous, easy test to evaluate the strength of instances of federal action, we need for now to use our judgment as to its extent. But, since astute Delaware players—Chandler, Hamermesh, Sparks, Strine, and Veasey⁴³—say at key junctures that they are aware of the looming federal presence,⁴⁴ and since they, frequently and at key junctures, say that they are taking that federal presence into account, we should hesitate before rejecting their indications that Washington can, and does, influence them. And, since Washington players, such as SEC Commissioners (and sometime academics) like Grundfest and Ruder,⁴⁵ and the Council of Economic Advisors, seek to influence Delaware, they may well know what they are doing and do not think that there is just futility in their actions. Moreover, since the mechanics of state competition have Delaware being alert to innovations and trends in corporate lawmaking in other jurisdictions, it makes sense that they would pay careful attention to the corporate lawmaking in America's other large corporate lawmaker, the federal government. Perhaps we should just rest there with a core fact—Washington acts in corporate governance, and does so substantially and frequently—and what, for now, we can call a conjecture—that Delaware pays attention and at times incorporates Washington-based views into its own thinking.

⁴³William B. Chandler III is the sitting chancellor on the Delaware Court of Chancery; Lawrence A. Hamermesh is a law professor prominent in Delaware corporate law and a member of Delaware's Corporate Law Council, where most corporate legislative reforms begin; A. Gilchrist Sparks III is a prominent Delaware attorney and chaired the Delaware Corporate Law Council that drafted the 1988 merger law for the legislature; Leo E. Strine, Jr. is a sitting vice chancellor on the Delaware Court of Chancery; and E. Norman Veasey is former chief justice of the Delaware Supreme Court.

⁴⁴See *supra* notes 21-34 and accompanying text.

⁴⁵Joseph A. Grundfest, SEC commissioner during the 1980s and now a law professor at Stanford; and David S. Ruder, chair of the SEC during the 1980s and now a law professor at Northwestern.

1. Details and Specifics: Mergers in the 1980s

Of the dozen or so examples of federal action I provided in "Delaware's Competition," Romano expresses reservations as to whether the mergers and going-private transactions evidence that Delaware at times has its eye on Washington and seems to adjust for Washington's views. These two ought then to be further discussed.

By the late 1980s, the antitakeover forces were on the ascendancy in the states and, though not yet ascendant in every federal lawmaker, strong in Washington as well. Whether or not Delaware was extremely concerned with the other states is not in question. Surely it was. "[T]he interstate pressures on Delaware were powerful: the other states were passing powerful anti-takeover laws"⁴⁶ But the interesting and speculative issue is *why* Delaware did not *quickly* match the other states in the severity of their antitakeover output. Perhaps we can ignore the possibility that Delaware players were aware of, and considered in deciding what to do, the takeover bill proposed by Representative John D. Dingell—the chair of the House Energy and Commerce Committee and a wily congressional actor—that contained provisions that the SEC supported. But it is just not likely that Delaware players neither knew directly that a federal takeover law was potentially in play nor read the *New York Times* report of a bill that would curb takeover tactics, an article entitled "Dingell Bill Would Curb Takeover Tactics."⁴⁷ That bill would have eliminated many offeror tactics, like the two-tiered bid, but it would have instructed the SEC to eliminate the poison pill.⁴⁸ The *New York Times* reported that Edward Markey, who cosponsored the bill, said that the sponsors did not design the bill to stop mergers but to stabilize financial markets by "curbing abuse and unfair tactics employed by both raiders and managements."⁴⁹ The bill had both antitakeover and protakeover provisions, perhaps more of the former than the latter. But, although antitakeover overall, its totality was less antitakeover than the state antitakeover legislation then emerging. In the end, Representative Dingell would have lost, we are told,⁵⁰ and the SEC would have been ignored. The

⁴⁶Roe, *Delaware's Competition*, *supra* note 15, at 625; *cf.* Romano, *supra* note 39, at 229.

⁴⁷Nathaniel C. Nash, *Dingell Bill Would Curb Takeover Tactics*, N.Y. TIMES, Apr. 27, 1987, at D6.

⁴⁸*Id.* (reporting that Representative Dingell's bill "would outlaw or restrict a host of tactics frequently used in hostile takeovers, including 'greenmail,' 'golden parachutes,' 'poison pills,' and open market purchases of a target's stock").

⁴⁹*Id.*

⁵⁰Romano, *supra* note 39, at 228 & n.24 ("[T]here was never any chance.").

more antitakeover-focused Senate bill had a better chance of being enacted (although it, too, we must observe, never passed).

But this is not the right way to look at the lawmaking process. Even if there is good reason to think *now* that no enactment was in the cards then, *at that time* such inaction appeared uncertain to the relevant actors. Delaware players said *then* they were paying attention to the SEC, and the federal players were pushing Delaware (SEC commissioners were sending Delaware tough letters, one commissioner came to Delaware to testify, the Council of Economic Advisors weighed in, and the Delaware drafters actively solicited the SEC's and other federal actors' views). After all, the year—1988—was the last one of the Reagan administration, during which the executive branch was stunningly protakeover. Federal courts had, until 1987, regularly struck down state antitakeover statutes, while the SEC had sought even more protakeover rules. The SEC had regularly told Delaware lawmakers that it disliked Delaware's proposed antitakeover legislation and would seek to preempt it. As the *New York Times* indicated about the Dingell takeover bill, which Markey cosponsored: "Mr. Dingell and Mr. Markey are considered the most influential members of the House on securities matters, since they preside over the committees responsible for all securities legislation."⁵¹ Delaware players said that more severe Delaware legislation would be more likely to incur the federal players' ire. Presumably they had in mind what Dingell and Markey were doing and were reluctant to provoke them to make a deal with the SEC and the administration.

The Delaware players on the ground then probably had more rounded judgments than we do now. They had reason—or they perceived themselves as having reason in protecting their franchise—not to provoke Congress. The business press was more in line with the natural import of the Delaware players' cautious words than is the academic hindsight belief that Washington would not have acted on takeovers. Consider the title to a contemporaneous *Business Week* article from August 1987: "States vs. Raiders: Will Washington Step In?"⁵²

Washington acts sporadically and oftentimes unpredictably. As insightful analysis has shown, when the substance of the Sarbanes-Oxley Act first reached the Washington agenda, it was getting nowhere in Congress.⁵³

⁵¹Nash, *supra* note 47.

⁵²Vicky Cahan, *States vs. Raiders: Will Washington Step In?*, BUS. WK., Aug. 31, 1987, at 56.

⁵³Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1563 & n.117 (2005). As Roberta Romano states insightfully about Congress's attention span in passing Sarbanes-Oxley: the bill hung around in committee without moving much and was intermittently pronounced dead. When WorldCom collapsed, the bill

It needed one last catalyst—the WorldCom scandal—and then the bill raced through Congress into law.⁵⁴ Without WorldCom's failure having induced Congress to pass Sarbanes-Oxley, 20-20 hindsight might have led *later* analysts to mistakenly conclude that Washington just was not going to do anything about the Enron scandal. Hence, the astute Delaware players who clearly were sensitive to the possibility of federal action, a later critic might say, were overreacting when they worried that Congress would legislate in reaction to Enron.⁵⁵ But that kind of confident hindsight thinking would be incorrect: the situation was volatile and in the end Congress *did* pass a massive corporate governance statute. The same might be said for after-the-fact views of 1980s merger legislation. We know *now* that Congress did not act in the 1980s on pending bills, so we might mistakenly conclude that Delaware then had nothing to worry about. But that would be incorrect from the perspective of what was happening at the time. State players who took Washington seriously in the late 1980s quite possibly also assessed the *ex ante* probabilities of federal action as plausibly as did those who feared that Congress would enact something like Sarbanes-Oxley—unlikely perhaps, but not a possibility they could afford to ignore.

From 1968 to 1987, Washington made much of America's takeover law, much of it by blocking the states from making very strong antitakeover law. In 1988, states were new to the game of making strong law that they thought could stick. In that environment, a *hindsight* analysis—that the state players did not need to have kept a wary eye on the federal players to avoid federal repercussion—seems correct now but could mislead us from understanding what the actual setting was back then. In that hindsight view, the Delaware Corporate Law Council could have ignored the SEC. Gilchrist Sparks, its chair, with the benefit of hindsight need not have been so defensive about federal action when he told the Delaware legislature that his council had taken into account federal views, and that he had personally FedExed their first copy of a draft bill, right off the press, to the SEC.⁵⁶ He

moved though Congress with astonishing haste. That is the way it would likely have happened in the 1980s with a congressional takeover bill if one eventually passed: a *mélange* of provisions hanging around in committee, then a catalyst that induced rapid action, and a bill containing perhaps both proshareholder (no pills, no greenmail, no defensive recapitalizations) and promanager (more process before the offer, only any and all offers, no two-tiered takeovers) provisions.

⁵⁴*Id.*

⁵⁵See Chandler & Strine, *supra* note 33, at 956-57; Strine, *supra* note 32, at 1371.

⁵⁶"[The draft] is the product of a series of compromises which both preceded and followed the *nationwide* circulation in late November for comment to attorneys, academics, corporations, pension funds, *federal officials*, and others of an earlier draft of the statute." And, he further reports: "I personally sent the very first day that the draft [of the antitakeover law] had been prepared, the very first copy off by Federal Express to Commissioner Ruder at the Securities and Exchange Commission." Audio tape: Hearing on H.B. 396 Before the Del. H.R., 134th Gen. Assem., held by

did not ignore the SEC back then and perhaps his judgment at the time was sound as a matter of what actions and considerations were useful to protect Delaware's turf. Curtis Alva summarizes the merger bar's perspective, concluding that it was not just Sparks who had his eye on Washington but many of the corporate lawyers whose input was critical to Delaware's merger statute. Alva said: "[P]assing this proposal [they feared] would be the proverbial camel-back-breaking straw that would force Congress to enact national corporate chartering . . ."⁵⁷ Even though Delaware was intensely concerned with what other states were doing, possibly even more so than it looked to Washington, it still *also* kept its eye on Washington and, it is plausible to conjecture, tempered the legislation accordingly. That is what they said they did. Why not believe them?

2. Details and Specifics: Going Private in the 1970s

In the 1960s and 1970s, going-private transactions were common. A controlling shareholder could, in effect, throw minority stockholders out from a public company by merging it with a private firm that the controller owned completely. Running legal battles were fought over when the controller could go private and how much the controller had to pay the outside stockholders.

SEC action on going-private transactions first exemplifies how federal authorities can, and have, partially displaced the state authorities.⁵⁸ When the SEC became upset at what it saw as lax state action (and what going private proponents might think of as flexibility), it forced stringent disclosure rules to govern the transaction. Their effect would be to give stockholders some litigation rights if the controllers misstated the company's worth. The upgraded disclosure might also embarrass state authorities, or

the Delaware House of Representatives (Jan. 26, 1988) (testimony of A. Gilchrist Sparks III, Chairman of the Corporation Law Council, Delaware Bar Association) (on file with author) (emphasis added). Sparks said further:

Why don't we want to pass the most restrictive thing that we can pass? And the reason for that is that to the extent that our legislation is viewed either in the short run or the long run as unbalanced and unreasonable, we all know that ultimately somewhere down the road we might have to pay the price for that in the context of the federal government coming in and taking [over] some portion of that privilege from us.

Kahan & Kamar, *supra* note 9, at 740-41 n.230; Romano, *supra* note 39, at 224 n.17.

⁵⁷Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 908 (1990). As long as Delaware takes Washington into account when Delaware makes its law, regardless of whether Washington is pro, anti, or confused—and even if Delaware decides to be low key so not to awaken and focus a confused and divided Congress—the Washington influence prong of the federal thesis holds up.

⁵⁸Roe, *Delaware's Competition*, *supra* note 15, at 616-17.

bankers giving financial opinions in the transactions, or even controllers who expected to go to market again, if they set a price lower than the value stated in the disclosure documents. The SEC made its proposal and, in time, promulgated rules. These SEC rules are still, today, in 2009, the law in the United States. While it is still possible for a firm to disclose that it is worth \$100 per share and offer only \$50 per share, and still possible, although less likely, for states to say that only \$50 is fair value in an appraisal proceeding—there have been cases doing similar things, including one that reached the Supreme Court, *Santa Fe Industries, Inc. v. Green*⁵⁹—it is harder to engineer such a transaction past shareholders and judges if strong disclosure rules govern the transaction. State law governs the going-private transaction, yes—and so does federal law.

That is enough to make out the claim that going-private transactions are governed not just by state law but also by federal law—the first prong of the Washington thesis I have offered. Federal law has muscled into an important part of the otherwise state-made rules governing going-private transactions. The SEC promulgated the rules and they still are central to the rules governing going-private transactions.

But there is more. A case can be made that the federal thrust here affected Delaware—the most controversial prong of the Washington thesis. It is debatable and judgmental, but the conventional wisdom is that the SEC and related federal players brought great force to bear on Delaware—and Delaware blinked.

It is correct to note, as Professor Romano does, that the SEC formally proposed and adopted its going-private rules after Delaware reversed its prior standard in going private.⁶⁰ Hence, neither the SEC's *final* actions nor its *formal* proposal can be used as evidence to suggest that SEC pressure might have affected Delaware's 1977 decisions.

But we will not understand the full federal-state interplay by focusing on the SEC's final rules and not the SEC's proposals. The SEC had first proposed going-private regulations in 1975, *before* Delaware acted in favor of minority shareholders in 1977.⁶¹ The SEC announced its proposal in a 1975 draft of its proposed rule, which focused on means to get good value

⁵⁹430 U.S. 462 (1977).

⁶⁰Romano correctly points out that the SEC's final adoption of the going-private rule occurred after Delaware's *Magnavox* reversal. Romano, *supra* note 39, at 227. This sequencing might have been raised to imply that Delaware was not affected by the SEC here. But, if so, that would be an incorrect implication of the full timing story, as I show in the text.

⁶¹*Singer v. Magnavox Co.*, 380 A.2d 969 (Del. 1977), *overruled in part by* *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983).

into the hands of the minority shareholders.⁶² The SEC's 1975 proposal was quite prominent in corporate law circles.

Individual SEC commissioners criticized Delaware and its rulings on going-private transactions, sometimes quite brutally. SEC Commissioner A.A. Sommer recited the terms of a going-private transaction in which the dominant shareholder would gain 400% "without a single dime of additional investment [from] her" and concluded that "there is something wrong with that."⁶³ He then said, "We are enjoined by Congress under the statutes which we administer to protect investors [T]he tactics I have discussed in order to freeze out minority stockholders [do not protect investors] . . . or contribute anything to the integrity of the market place."⁶⁴ Keeping the heat on, the SEC in 1976 brought a well-publicized case in federal district court to upset a going-private transaction (albeit of a New York company, not a Delaware company)—its first direct attack on going private.⁶⁵ *The Washington Post* headline was "Move to Go Private Challenged by SEC";⁶⁶ *The Wall Street Journal's* was "Parklane Hosiery is Charged in SEC Suit With Cheating Holders in Going Private."⁶⁷

This SEC pressure came at a time when the Supreme Court both helped and hurt Delaware, but either way clearly signaled to Delaware that the state's corporate rulemaking was under federal scrutiny.⁶⁸ The U.S. Supreme Court cut back the expansion of federal actions into fiduciary duty areas in *Santa Fe*,⁶⁹ but the Court said that it was doing so not because the federal presence was a bad idea, but because the existing securities statute did not cover the transactions being attacked. Then the Court cited the

⁶²See "Going Private" Transactions by Public Companies or Their Affiliates, 40 Fed. Reg. 7947 (proposed Feb. 24, 1975).

⁶³A.A. Sommer, Jr., "Going Private": A Lesson in Corporate Responsibility, [1974-1975 Transfer Binder] Sec. Reg. & L. Rep. (BNA) No. 278, at D-3 (Nov. 20, 1974).

⁶⁴See *id.* at D-4.

⁶⁵SEC v. Parklane Hosiery Co., Inc., 422 F. Supp. 477 (S.D.N.Y. 1976), *aff'd*, 558 F.2d 1083 (2d Cir. 1977).

⁶⁶John F. Berry, *Move to Go Private Challenged by SEC*, WASH. POST, May 6, 1976, at D45.

⁶⁷*Parklane Hosiery is Charged in SEC Suit With Cheating Holders in Going Private*, WALL ST. J., May 6, 1976, at 15.

⁶⁸*Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977).

⁶⁹*Id.* at 477. Robert Thompson and Hillary Sale have shown convincingly that it is back. That is, fiduciary breaches are normally covered by state law, and failures to disclose by federal law. Stockholders who are unhappy with state law remedies have successfully recast their lawsuits as federal disclosure suits, along the lines of: the company and its controllers did not disclose that they had a plan to divert value to themselves when they sold the stock. The diversion is not just a fiduciary violation under state law, but a securities law failure-to-disclose violation. See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections upon Federalism*, 56 VAND. L. REV. 859, 861-64 (2003).

famous William Cary article (recall: Delaware is a pygmy, yet it misdirects American corporate law) and raised the possibility of Congress acting on the matter.⁷⁰ This all happened before the Delaware Supreme Court reversed the lower court's going-private decision with a protective minority shareholder decision of the type Commissioner Sommer would presumably have approved.⁷¹

We will never know for sure whether the Delaware court blinked because of the repeated federal pressure: nasty criticism from current and former SEC commissioners, a prominent proposed SEC rule, and the Supreme Court calling on Congress to act. One has to make a judgment. A judgment that the Delaware court was oblivious to what was happening in Washington and the federal courts may indeed be correct, but it is not the conventional wisdom. Years before this current federal debate started, Ronald Gilson and Bernard Black summarized in their casebook the conventional view of corporate players of the federal-state interplay with this passage:

The history of state law limitations on the ability of an acquiring company to freeze out minority shareholders [(the going-private transaction)] . . . reflects, among other influences, the impact of political forces on judicial opinions, the opening shots of an ongoing debate over the appropriate role of the federal and state governments in setting corporate law standards, and [important policy decisions]

At the same time as federal law was making litigation inroads into areas previously the exclusive domain of state law, political activity developed in response to the same perceived problem—insufficient protection of shareholders, especially minority shareholders, under state law. This activity sought the same end as the litigation efforts—"federalizing" areas of state corporate law—but through Congressional, rather than judicial action. . . . In an influential article, Professor William Cary accused the Delaware legislature and judiciary of pandering to

⁷⁰*Santa Fe*, 430 U.S. at 477-80 & n.17. How loudly the Court's suggestion would be heard probably depended on who the listener was. Congress's attention, one expects, would have been mild, but Delaware lawyers (and judges) could well have been much more alert to the passage and its potential consequences.

⁷¹See *Singer v. Magnavox Co.*, 380 A.2d 969, 978-80 (Del. 1977), *overruled in part by* *Weinberger v. UOP, Inc.*, 457 A.2d 701, 715 (Del. 1983).

corporate management by leading a "race to the bottom" in fiduciary standards Cary . . . propose[d] a "Federal Corporate Uniformity Act" that would override state law on critical fiduciary issues

[Then came] the United States Supreme Court's reversal of the . . . [lower court's aggressive federalization] in *Santa Fe*. From Delaware's perspective, the Supreme Court's opinion contained both good and bad news. The good news [for Delaware] was that the Supreme Court slowed the expansion of federal securities law into state corporate law The Court stated that "[a]bsent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations . . . where established state policies of corporate regulation would be overridden." The bad news was that the opinion could also be read as giving support to the political effort to displace state law by the adoption of federal chartering or minimum standards legislation. Citing Professor Cary's article, the Court also noted that "[t]here may well be a need for uniform federal fiduciary standards to govern mergers such as that challenged in this complaint" ⁷²

I summarize the going-private sequence in Table 1. There was a percolating federal presence, which resulted in a significant federal rule. Moreover, when the SEC announced its final rules, it talked about going further. It noted some doubts as to where it had authority to act, and then said that it would wait to act further until it saw how its own rules worked out and then, vividly indicating the Washington-Delaware interaction in making corporate law, it added: "Further developments in the remedies provided by state law for unfairness in going private transactions will also be important."⁷³ That further history has had ups and downs, but a few years later the Delaware Supreme Court upgraded the way it calculated the value that insiders had to give the outside shareholders.⁷⁴ That SEC comment shows the SEC saying that it then planned to keep a policeman's eye on state

⁷²RONALD J. GILSON & BERNARD S. BLACK, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 1254-56 (2d ed. 1995) (citations omitted). Much of this was in Gilson's earlier, 1986 edition; i.e., the view is a long-standing one. RONALD J. GILSON, *THE LAW AND FINANCE OF CORPORATE ACQUISITIONS* 887 (1986).

⁷³Going Private Transactions by Public Companies or Their Affiliates, 44 Fed. Reg. 46,736 (Aug. 8, 1979) (codified at 17 C.F.R. pt. 240).

⁷⁴See *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).

law in this domain; one could readily infer that it sought to influence state lawmaking. It looks like the SEC thought someone in Delaware would be listening. Respected Delaware corporate players—Chandler, Hamermesh, Sparks, Strine, and Veasey—say they do listen.

Table 1. Timetable of SEC Attacks on Going Private

Action or statement	Date	Source
Former SEC Chair Cary attacks Delaware corporate lawmaking generally	Mar. 1974	Cary, <i>supra</i> note 2, at 663.
SEC Commissioner Sommer excoriates going-private transactions and state law	Nov. 20, 1974	A.A. Sommer, Jr., "Going Private: A Lesson in Corporate Responsibility," [1974-1975 Transfer Binder] Sec. Reg. & L. Rep. (BNA) No. 278, at D-3 (Nov. 20, 1974).
Commissioner Sommer attacks them again, suggests expanding federal remedies	Mar. 19, 1975	A.A. Sommer, Jr., <i>Further Thoughts on "Going Private"</i> , Sec. Reg. & L. Rep. (BNA) No. 294, at D-2 (Mar. 19, 1975).
SEC announces formal inquiry into going private	Feb. 6, 1975	"Going Private" Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 14,185, 42 Fed. Reg. 60,090, 60,091 (Nov. 23, 1977) (proposing SEC Rule 13e-3).
SEC proposes rules for comment	Feb. 6, 1975	Notice of Public Fact-Finding Investigation and Rulemaking Proceeding in the Matter of "Going Private" Transactions by Public Companies or Their Affiliates, Securities Act Release No. 5567, Exchange Act Release No. 11,231, Investment Company Act Release No. 8665, [1974-1975 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 80,104, at 85,089 (Feb. 6, 1975).
SEC publicly attacks going-private transaction	May 6, 1976	Berry, <i>supra</i> note 66; SEC v. Parklane Hosiery Co., Inc., 422 F. Supp. 477 (S.D.N.Y. 1976), <i>aff'd</i> , 558 F.2d 1083 (2d Cir. 1977).
<i>Singer v. Magnavox</i> under submission	Mar. 14, 1977	<i>Singer v. Magnavox Co.</i> , 380 A.2d 969 (Del. 1977).
Supreme Court decides <i>Santa Fe</i> , confining securities laws and speaking favorably of federal legislation	Mar. 23, 1977	<i>Santa Fe Indus., Inc. v. Green</i> , 430 U.S. 462, 479 (1977).
Delaware Supreme Court reverses <i>Singer v. Magnavox</i>	Sept. 23, 1977	<i>Singer v. Magnavox Co.</i> , 380 A.2d 969 (Del. 1977).
SEC formally proposes Rule 13e-3	Nov. 17, 1977	Going Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 14,185, [1977-1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 81,366, at 88,737-38 (Nov. 17, 1977).
SEC adopts Rule 13e-3, says it will look at state developments before acting next	Aug. 2, 1979	Going Private Transactions by Public Companies or Their Affiliates, Exchange Act Release No. 16,075, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 82,166 (Aug. 2, 1979).
Delaware expands protections to minority shareholders in going-private transactions	Feb. 1, 1983	<i>Weinberger v. UOP, Inc.</i> , 457 A.2d 701 (Del. 1983).

Table 1 suggests quite a bit of federal action on going-private transactions. The conventional wisdom is that it ended with minority stockholders better off than they were before it all started. Delaware eventually

developed fair dealing and fair price protections that are generally considered more substantial than the abandoned test.⁷⁵

These examples, out of the dozen others I provided, show, as do the others, both a Washington that acts (stopping much state antitakeover law until 1987, making much of it in Washington, actively making key components of the going-private rules, and so on), and a Delaware that is, at least at times, paying attention.

VII. REFUTABLE HYPOTHESES AGAIN: CONCEPTUALIZATION

The fact that we must assess the Washington-Delaware dynamics without having deep, wide evidence that allows for precise, controlled regressions, shows us the limits of what we can know.⁷⁶ The conceptual problem of refutability, which has been brought forward as undermining the view of federal-state interaction,⁷⁷ however, is not whether the available data is already sufficient to test it out,⁷⁸ but whether the concept can be falsified if we had the data. Much legal discourse would be preempted if such territory—where the complete data is not yet available—could not be entered.

But, if we could measure the position and intensity of preferences in Congress, the SEC, and Delaware, I hypothesize that we would find a relationship. If Washington's preference is to be much tougher on managers than Delaware's initial preference, then Delaware would tend to adjust in the same direction. We would detect, I hypothesize, a tilt in Delaware toward Washington. The problem is the measurement, not the concept.

Parallel political science research exemplifies the testable nature of the concept. The U.S. Supreme Court is usually seen to be an independent actor. Nevertheless, political scientists have hypothesized that the Court, when interpreting legislation, tilts toward Congress's preferences and away

⁷⁵GILSON & BLACK, *supra* note 72, at 1286. Federal authorities at first sought (and then dropped) a business purpose test—no going private unless there was a business purpose stated—and the states *also* used but eventually dropped this requirement. Romano, *supra* note 39, at 226-27. The requirement proved unworkable, because a business purpose can always be stated (i.e., to avoid securities filing expenses, to operate without disclosure to our competitors), and the players understood that money was more important than purpose. GILSON & BLACK, *supra* note 72, at 1286. What counted was not purpose, but compensation, as the SEC, and then Delaware, concluded.

⁷⁶See Romano, *supra* note 39, at 223.

⁷⁷*Id.*

⁷⁸Contra, though, see *id.*

from its own.⁷⁹ They so hypothesize despite the Court's strength: the Court is independent of Congress and its members have lifetime appointments, unlike agencies over which Congress has budget control. The justices do not have to report to Congress. None of the major controls Congress has over the federal agencies—budget, compelled testimony, etc.—are in play, save one: Congress can legislate. If the Supreme Court interprets legislation in a way that Congress finds offensive, Congress can rewrite that legislation.

Yet Congress rarely does so. Does that mean that Congress—simply by existing with that potential to write legislation—fails to influence the Supreme Court? Since Congress can overturn what the Supreme Court does, when the Supreme Court interprets statutes (as opposed to when it interprets the Constitution), it is plausible that the Court takes congressional power into account. Hence, a Supreme Court seeking to further its agenda would move just far enough to keep Congress quiet.

Pablo Spiller and Rafael Gely found exactly that.

[T]he [Supreme] Court is restricted [because] . . . Congress [can] . . . overturn its decisions. The Court, then, cannot deviate too much from what Congress's independent legislative outcome would be without facing a reversal. So even though Congress may not be actively legislating, it does not follow that it has actually relinquished legislative responsibility to the Court, or that the Court is dictatorial.⁸⁰

They have enough Supreme Court decisions and congressional indicators to get a handle on a testable confirmation. While we do not have that density of data yet for Delaware, that does not mean we do not have a positive, testable theory—nor does it mean that we never will have that data.

We have here a challenge and for now are in the realm of considered judgments, about which people will disagree. But I suspect in time clever work may well appear that tests the triangular hypothesis: first, that Washington is a major player in making American corporate law and,

⁷⁹See Mario Bergara, Barak Richman & Pablo T. Spiller, *Modeling Supreme Court Strategic Decision Making: The Congressional Constraint*, 28 LEGIS. STUD. Q. 247 (2003).

⁸⁰Pablo T. Spiller & Rafael Gely, *Congressional Control or Judicial Independence: The Determinants of U.S. Supreme Court Labor-Relations Decisions, 1949-1988*, 23 RAND J. ECON. 463, 465 (1992). For a similar model, see John A. Ferejohn & Barry R. Weingast, *A Positive Theory of Statutory Interpretation*, 12 INT'L REV. L. & ECON. 263 (1992). Government inter-actions and overlaps are in play in multiple lawmaking areas. See Robert B. Ahdieh, *Dialectical Regulation*, 38 CONN. L. REV. 863 (2006).

second, that Delaware at times adjusts its own preferences in light of Washington's.⁸¹

VIII. CONCLUSION: THE SHARP LIMITS TO THE AMERICAN RACE

Is it mostly a market of competing states that produces American corporate law? A market, we might think, produced American corporate law, and markets hone efficiency. A market may well have produced American corporate law, but that widely believed conclusion is harder to assess than is commonly thought. One reason is that Delaware is the only state actively competing for chartering revenues, as Kahan and Kamar have shown.⁸² Another is that there is a vast federal presence in the law governing the American corporation and that federal presence affects state-based jurisdictional competition.

Properly conceived, the movement from a state to a federal forum need not even involve the identical issue. Consider this: we can array the rules on a continuum of managerial autonomy versus shareholder control. States might, say, shut down the takeover market with strong antitakeover laws. But then shareholders might go federal and induce the SEC to loosen up restrictions on shareholders in policing management. A case can be made that this sequence describes main moves in American corporate governance during the late 1980s and early 1990s; states put antitakeover law in place, then institutional investors asked the SEC to loosen up restrictions on their organizing to toss out directors. And the SEC then did so. We are only beginning to scratch the surface conceptually and empirically on how this vertical interplay works, but we have to realize that there is a major federal legal presence in the governance of the American public corporation. The complementarity, substitutability, and interaction of federal and state corporate law are all in play, and they still need to be better analyzed.

American corporate lawmaking should be seen not as purely horizontal regulatory competition, but as triangular. Firms arise in their home states, then decide whether to stay put or move to Delaware, usually

⁸¹ Anna Harvey and Barry Friedman ingeniously measure the Supreme Court's sensitivity to Congress by looking at the type of cases that never make it to the Court's docket, to see if they correspond to congressional ideological indicators. Barry Friedman & Anna L. Harvey, *Electing the Supreme Court*, 78 IND. L.J. 123 (2003); Anna Harvey & Barry Friedman, *Ducking Trouble: Congressionally-Induced Selection Bias in the Supreme Court's Agenda*, 71 J. POL. (forthcoming 2009); Anna Harvey & Barry Friedman, *Pulling Punches: Congressional Constraints on the Supreme Court's Constitutional Rulings, 1987-2000*, 31 LEG. STUD. Q. 533 (2006).

⁸² Kahan & Kamar, *supra* note 9, at 687-90.

when they take on a big transaction, such as an initial public offering or a merger. So on the lower left-hand corner of that triangle is the home state, on the right-hand corner is Delaware, and in between are the other states. Sitting atop the triangle, though—and thereby giving the structure verticality—is Washington, which sporadically enters the world of corporate governance, often in reaction to a scandal, as with Sarbanes-Oxley, or an economic downturn—and could always do more.

The play of interest groups and ideas differs between Delaware and Congress. Delaware's interest groups are narrow, basically consisting of shareholders, managers, and their advisors. Congress has more interest groups, and broader ideas of efficiency, fairness, and sometimes power leveling are in play in Washington. These differences give Delaware's interest groups a powerful reason to have Delaware solve corporate issues before the issues get onto a federal agenda, something they have been less able to do in recent years. Depending on one's view of the importance and relevance of social policy to corporate law, these considerations induce analysts to applaud Delaware—because it minimizes such considerations—or induce critics to be wary of it, if their policy preference is to keep social considerations in play in making corporate law.

Thus, the mechanisms that would make for a pure interstate race are absent in the federal system we have. Yes, there is interstate mobility for corporations. That mobility is not in multiple directions, but mainly from the home state to Delaware, with no third state today actively competing for chartering revenues. But the strength or absence of state-to-state interactions is not the only governmental structure issue that is important here for understanding the governmental structure for corporate lawmaking. Hardly a decade has gone by in which the federal government did not consider taking over the major corporate issue of the time, and often at times it did. Thus, Delaware's strongest competitor, and possibly the strongest constraint it faces, has been, and probably still is, Washington, making it necessary to take the interplay between the horizontal movement and the vertical authority into account for any full conceptualizing of the governmental structure for making American corporate law. This federal reality weakens the mechanisms of a strong race. If the issue is important, it often becomes a federal one. The race analysis, therefore, must yield to a wider perspective on what is, and who makes, corporate law.

There is a large federal presence in corporate law. In nearly every decade of the twentieth century, the major corporate issue either went federal or threatened to go federal. Delaware has a great deal of discretion, especially on technical matters, but that discretion is not without limit. When the corporate issue is big enough, Washington is often where American corporate law is made.

