Paper on which the presentation by Mark Roe, David Burg Professor of Law, Harvard Law School; ECGI Fellow is based

The nature of state competition for corporate charters — is it a race to the top or to the bottom? — has been one of American corporate law's enduring issues, one that dates back to the early twentieth-century origins of the modern American corporation and that has persisted since then in policy debates touched off by the SEC, the Supreme Court, and academic analysis.

Even today, new data is brought forth to support the contention that the race is to the top (see note 1 below), while other data is assembled to support the contention that the race is to the bottom(see note 2 below). Politicians, judges, and commentators wonder whether the scandals at Enron and WorldCom were produced by a race to the bottom, and whether similar ones can be prevented by a race to the top.

Here I argue that this debate is misconceived — and badly so. Whether or not the states are racing (see note 3 below), and whether they are racing to the top (see note 4 below) or to the bottom (see note 5 below), the United States is a federal system where Washington can, and often does, take over economic issues of national importance. The issues most likely to move into the national arena are precisely 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 early 1980s, and corporate governance after the Enron and WorldCom scandals. And if fundamental issues of corporate governance often move into the federal arena, then Delaware is not deciding all key corporate law matters. Moreover, even when those matters formally remain matters of Delaware law, if the risk of federal action heavily influences Delaware, it follows that even when federal authorities do not take the issue away, federal power may make Delaware law.

Even when, as now, the federal government does not threaten to take away Delaware's chartering business in its entirety — something it seriously threatened to do three times in the twentieth century — Delaware players know that the federal government can take away their corporate lawmaking power in whole or in part, because it has acted often enough. Because Delaware players can never be oblivious to the possibility of being displaced, we have never had, and we never could have had, a full state-to-state race in corporate law. Delaware's competition in making corporate law thus comes not just — and at times not even primarily — from other states, but also from the federal government: It comes from Congress and the SEC, not just California, Nevada, Ohio, or New York. It comes from the Second Circuit Court of Appeals when that court interprets the scope of the securities laws, not just from a new or threatened commercial court in another state. And it comes from the New York Stock Exchange, which itself is often prodded to act by the SEC or Congress. Even if Delaware had all the chartering business, it might not make all (or, at the limit, any) corporate law.

And even if Delaware never acted with the risk of federal intervention in mind, Delaware corporate law would still effectively have a large federal component. Federal authorities reverse state corporate law that they dislike and leave standing laws that they tolerate. State power is to jigger the rules in the middle by adopting those rules that Washington does not gear up to reverse, even if the federal authorities would not have enacted them exactly as the states did.

My point here is not that every twitch in Delaware is determined by the prevailing tilt in Washington. Because Congress moves sporadically, because courts need a case or controversy, and because the SEC's power is incomplete, states often have room to maneuver. Nevertheless, federal authorities set the broad boundaries — of an uncertain and changing demarcation — within which the states can move. These boundaries both determine who really makes corporate law in the United States, and, when tight, weaken the mechanisms of the state-to-state race.

This federal-state interaction then has deep implications for the race debate: Even if empirical evidence showed incontrovertibly that Delaware was racing to the bottom, we would not know whether the state reluctantly dropped down because of state-to-state competition or because it feared that congressional politics, errant judicial decisions, or an out-of-control SEC would have ousted Delaware had it risen to the top. And conversely, even if empirical evidence incontrovertibly showed the contrary — that Delaware was racing to the top — we would not know whether it was state-to-state competition or the threat of federal ouster that pulled Delaware up. Moreover, even if we knew which way states have raced thus far, we would not know whether the race would persist in that direction and with the same intensity if we sharply altered the domain of state corporate lawmaking.

That is, if Delaware in fact makes efficient law that looks to have been honed in a vigorous race to the top, it would be unclear what mechanism produced that efficiency. It could not be pure state-to-state competition, because the potential for federalization can influence Delaware. Good Delaware law could have arisen instead from a vertical mechanism, one that resembles the separation of proposal and ratification in management theory. States act, but they act subject to another authority's power to override them.

If state corporate law is efficient, then some variety of a proposal-ratification theory could be the basis for a theory of good corporate lawmaking. But more likely, corporate law, like other law, would have to be recast as an amalgam of efficiency, trial and error, attempts to do the right thing, interest group pressures, and happenstance. The result may be less glamorous than the racing engines corporate law scholars have designed — but more realistic.

A few examples can illustrate. When the SEC attacked Delaware's lax regulation of the going private transactions of the 1970s — the quintessential corporate transactions of their time — the Delaware courts, although lax initially, reversed themselves mid-stream and got tougher. In the 1980s, Delaware was slow in making antitakeover law, when many of its sister states were often falling over one another to pass tougher antitakeover rules. While there are other explanations for Delaware's slowness and relative moderation (see note 6 below), consider this statement from the prime drafter of Delaware's antitakeover statute in 1988 when pressed by the legislature as to why he didn't write up a tougher, more antitakeover statute:

[W]hy … moderate …? Why [not] the most restrictive thing that we can pass? … [T]o 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 … we might have to pay the price … of the federal government coming in and taking … the privilege from us (see note 7 below).

Or consider this more recent statement from Delaware's Chief Justice after the Enron scandals broke and corporate observers expected federal action. He immediately sees, more clearly than most, "the federal securities regulatory regime is a force in influencing the internal affairs of corporations." (see note 8 below) And "the New York Stock Exchange . . . impose[s] . . . internal standards . . . [like] minimum standards for audit committees." (see note 9 below)

But the state as the locale for corporate lawmaking has a long tradition, the Chief Justice pleads, albeit one that federal preemption could end at any time (see note 10 below). The Enron debacle and the ensuing corporate governance controversy could precipitously end that tradition; indeed, by the time he spoke, the controversy had already induced congressional and SEC proposals to regulate corporate internal affairs (see note 11 below). But the tradition should continue, he says, selling the idea that due to Delaware courts' "integrity, expertise, diligence, good faith, independence and professionalism," Delaware still provides a regulatory system superior to what the federal government could offer. Although "the Enron foment has provoked debate about the effectiveness of [state law] standards governing directors," he argues, "[m]y thesis is that the Delaware model works well, over all, . . . and that one should be cautious in concluding that current events dictate a new . . . regime of corporate governance." (see note 12 below) Nonetheless, says the Chief Justice elsewhere, "[i]f we don't fix it, Congress will, but I hope they've gone as far as they're going to have to go." (see note 13 below) (Congress thereafter passed Sarbanes-Oxley.)

American corporate lawmaking should be seen, not as horizontal regulatory competition, but as triangular. Firms arise in their home state, corresponding roughly to an EU "real" seat. Then they decide whether to stay put or move to Delaware, usually when they take on a big transaction — such as an IPO or a merger. When firms move, few move anywhere other than to Delaware. Hence, day-to-day competition, whether to the top or to the bottom, is not intense: Although Delaware is trying to garner reincorporations, and hence is "competing," no other state is seriously taking reincorporations away from Delaware. So on the left hand corner of that triangle is the home state; on the right hand corner is Delaware. Sitting atop the triangle though — and thereby giving the structure some 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 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 (see note 14 below). In the EU, these might roughly translate as social policy considerations. Depending on one's view of the importance and relevance of social policy to corporate law, these considerations might militate analysts to applaud Delaware — because it minimizes such considerations — or critics to be wary of it — if one's 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 a true federal system such as America's. Hardly a decade has gone by in which the federal government did not consider taking over the major corporate issue of the time. Thus, Delaware's strongest competitor has been, and probably still is, Washington. This reality renders the mechanisms of a strong race implausible or indeterminate. If the issue is important, it usually becomes a federal one. The race analysis therefore must yield to a wider perspective on what, and who, makes corporate law. And in understanding whether jurisdictional competition would be valuable for the EU or not, one must keep in mind that it's not just the state-to-state, or nation-to-nation, relationships that count, but also the strength, effectiveness, play of interests, and good sense at the center — in Washington in the United States, and in Brussels in the EU.

Notes:

1. See, e.g., Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. FIN. ECON. 525, 533 (2001) (finding that Delaware law enhances shareholder value by as much as five percent).

2. See, e.g., Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. PA. L. REV. 1795, 1872 (2002).

3. See Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 STAN. L. REV. 679, 748 (2002) (states do not compete; Delaware has a monopoly); cf. Lucian Bebchuk, Alma Cohen & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law?, 90 CAL. L. REV. 1775, 1820–21 (2002) (no).
4. See Ralph K. Winter, Jr., State Law, Shareholder Protection and the Theory of the Corporation, 6 J. LEGAL STUD. 251, 289–92 (1977); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–24 (1993).
5. See William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 YALE L.J. 663, 705 (1974); Louis K. Liggett Co. v. Lee, 288 U.S. 517, 558 n.34 (1933) (Brandeis, J., dissenting in part); Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1437, 1509 (1992); see also ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1933).
6. Delaware's constituency consisted of both large offering firms and smaller target firms. And its main policy players were probably genuinely uncertain as to what the best policy was.
7. Hearing on H.B. 396 Before the Delaware H.R., 134th Gen. Assembly (Jan. 26, 1988) (testimony of A. Gilchrist Sparks III, chairman of the Delaware Bar Ass'n Corp. Law Council), audiotape, as reported in Kahan & Kamar, supra note 3, at 741 n.230 (emphasis added).
8. E. 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 Litigation and Dispute Resolution 1, 3 (Apr. 11, 2002). The Chief Justice delivered his speech in April 2002 at an American Bar Association function.
9. Id. The NYSE audit committee requirements came about under federal pressure.
10. Veasey, supra note 8, at 3. He then concedes that a healthy chunk of securities law effectively regulates internal affairs. Id.
11. Id. at 9. Veasey worried about federal overreaction, which not only could be detrimental to the corporation, but also would take control of critical elements of corporate governance away from Delaware and vest it elsewhere. Id. at 10–11. "[W]e do not take for granted our responsibilities or our reputation. . . . [W]e try harder, because life would be much less interesting without the corporate activity that engenders all this . . . interesting work." Id. at 33.
12. Id. at 4-5.
13. Charles Elson, What's Wrong with Executive Compensation?, HARV. BUS. REV., Jan. 2003, at 68, 77 (comments of Chief Justice Veasey) (emphasis added); see also William 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. (forthcoming 2003) (manuscript at 33) ("[P]roblems could arise if the federal government . . . [is] not sensitive to the states' primary role in the formulation of substantive corporation law."); id. (manuscript at 75) ("[T]he 2002 Reforms . . . generate creative friction with state corporate law . . . .); id. (manuscript at 69) (Delaware[] . . . was perhaps slower than ideal in adapting to the new realities [of executive compensation]."); Leo E. Strine, Jr., Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle, 57 BUS. LAW. 1371, 1371–72 (2002). Strine observes: "Political officials have reacted to the Enron debacle with outrage. . . . Congress may even be tempted to consider federalizing key elements of corporate law that have traditionally been the province of state law . . . ." Id. Chandler is Delaware's sitting Chancellor; Strine is a Delaware Vice Chancellor.
14. See Roe, Delaware's Politics (working paper 2004).