Democracy and Delaware: The Mysterious Race to the Bottom/Top

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I. INTRODUCTION

Corporate law scholarship has focused on the role of the states as competitive actors in producing corporate law. The standard story is that states compete to provide corporate law options for businesses, producing a race to the top or a race to the bottom in which corporate law is created by market rather than political processes. This story is deeply implausible: Though states are constrained, they are far from powerless. There can be no escape from politics in determining law.

In this Article, I attempt to determine what is viable in the story of the race to the top or bottom. In Part II, I first restate the conventional debate as a set of simple game theory models focusing on the behavior of incorporators, rather than states. These simple models assume a range of options and focus on the corporate managers who choose among them. Race theorists moved from a simple one-period game (yielding a race to the bottom) to an equally simple infinitely-repeating game (yielding a race to the top). More recently, they have begun to face the complexities and indeterminacy of a finitely-repeating game played by human managers often close to retirement age and always tempted to defect in a final period. The corporation-centered game theory models focus on one important truth: Managers choosing corporate law within their firm role constraints have neither the incentives nor the right to consider the full range of factors citizens might. The public interest is explicitly not part of the game; rather, managers will choose law that promotes their self-interest and the interest of their firms, narrowly construed. Whether this pursuit of private interests will lead to a desirable public result is entirely a function of how well

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the invisible hand works within the constraints of the particular legal structure we have created.

Second, I shift the focus to the states themselves and consider a series of conceptual problems underlying the game theoretical model. The race to the bottom/top depoliticizes corporate law: It presents corporate law as the result of market forces rather than political ones. This transformation endows corporate law with an air of sanctity, inevitability and virtue: Markets, notwithstanding a century of critique, continue to have an aura of blessedness in American theology. But states are semi-sovereign actors, not passive price-takers unable to influence a market. Unlike ordinary competitors in a market, states can change the terms of the game they are playing should they dislike the competitive results. There can be no escape from politics and the need for a political justification of the structure and results of the particular pseudo-market we've created.

In Part III, then, I seek to repoliticize corporate law: to make visible the political decisions that structure the race to the bottom/top. First, I examine the basic implausibility of the entire race story. In the usual story, the states are being exploited by Delaware. But if this were the whole picture, states could simply stop playing Delaware's game. States, unlike the classic price-takers of ideal markets, are entitled to change the rules under which they compete. More concretely: If the race consists of Delaware appropriating tax revenues from other states, the other states could simply reject the essential doctrinal underpinnings of Delaware's success, the internal affairs doctrine.

The race-to-the-bottom/top theories portray states as helpless, passive price-takers in a market beyond their control. This image depends intimately on an equally implausible view of the internal affairs doctrine as inevitable. In fact, as I suggest in Subsection III.B.2, the internal affairs doctrine is quite the opposite. Far from a natural, unchangeable element of the order of things, it is something of an anomaly in our law. First, it is quite contrary to ordinary choice of law rules. Second, it seems on its face to violate fundamental principles of state sovereignty in a federalist system. Third, as a doctrinal matter, its boundaries are contested and contestable and its ideological foundations largely unexamined. Not only has the political system retained the ability to intervene when the legally structured market for law turns out politically unacceptable results, but it has in fact done so in major ways.

Further consideration of the underpinnings of race-to-the-bottom/top theory shows another oddity. Race theorists model corporate law as an agency cost problem: Shareholders hire managers who then are tempted to defect, acting for themselves rather than for their principals. But shareholders are not principals and managers are not their agents, and in a free-market economy, the fiduciary concepts underlying agency are counterbalanced by an equally fundamental market/contract notion that there is nothing wrong with actors looking out for

their own self-interest. The agency picture is flawed not only as a legal description but as an economic metaphor: The economic model suggests that managers could be imagined to be hiring shareholders just as easily as the other way around. The claim that managers are agents of shareholders is not a legal analysis so much as an attempt to tap into the highly asymmetrical fiduciary model rather than the equally-available symmetrical contract model. Calling shareholders "principals" is potent—but analytically empty—rhetoric seeking to strengthen dubious shareholder claims to corporate surplus.

In Part IV, I briefly outline the political consequences of our pretense of depoliticizing corporate law. State acceptance of the internal affairs doctrine creates market processes of law selection that in turn demand that corporate decision-makers seek to subvert other law and norms of good citizenship. Under the current regime, corporate managers are commanded to treat all corporate participants (indeed, all their fellow citizens and all other values) as outsiders and competitors, mere tools to be exploited as much as possible within the effective limits of the law. If Kant held that one should always treat fellow humans as ends rather than means, the corporate law that results from the race enacts the anti-Kantian principle: Treat us all as means, never ends.

A more political conception of corporate law, made possible by abolishing the internal affairs doctrine and therefore the race to the bottom/top, might seek, instead, to import some republican virtue into corporate decision-making. Instead of treating law, morality, and human values as mere constraints in the pursuit of profit, managers might be commanded to take other roles or values as ends as well. Regulatory law would look quite different if corporate managers were told to treat the law's ends as their own, rather than to see the law merely as an external constraint to be complied with or evaded as the search for increased share value directs.

The race theories, then, serve a heavily ideological function, obscuring the peculiar political decisions we've made in corporate law. By portraying the political process that creates corporate law as a market, they suggest that no political choice has been or need be made. But in fact, our race, like most markets, is a heavily structured competition with rules determined by political processes (even if not consciously) and subject to change by political processes should the states decide that either the current process or its results are unattractive.

Several rounds of critics, beginning with Berle and Means, have advocated federalization of corporate law (or parts of it) as a solution to the race to the bottom.[1] This Article suggests an alternative to both the race and federalization:

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1. *See, e.g.*, RALPH NADER ET AL., TAMING THE GIANT CORPORATION (1976) (calling for federal corporate law); Adolf A. Berle, *Property, Production, and Revolution: A Preface to the Revised Edition* of ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION & PRIVATE PROPERTY (Transaction Publishers 1991) (1932), at xix (stating that the book was causative in creating the

a genuine federalism, in which different states may enforce differing views of corporate law on businesses doing business in their territory. No state is required to sacrifice its sovereignty to Delaware, and ordinary democratic theory suggests that no state should.[2] Neither law, market, nor democracy demands that states allow the constitutive law of their most important economic actors to continue to be determined outside of normal political processes.[3]

II. GAMING THE RACE TO THE BOTTOM/TOP

Scholars and practitioners are largely agreed on the non-democratic process that creates American corporations law.[4] Corporate law, the standard account goes, is created by a process of competition between the states. Each state has an incentive to entice out-of-state corporations to incorporate under its law because it derives tax revenue from the corporation.[5]

Securities and Exchange Commission). More recently, Mark Roe has suggested that the possibility of federalization restrains Delaware and thus the race. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

2. An exploration of that democratic theory will be the next installment of this project.

3. The modern literature contains few objections to the internal affairs doctrine either on the democratic ground that it denies the rights of citizens affected by corporations to control them (although this was an important part of the nineteenth century debate) or the doctrinal ground that it is incompatible with ordinary choice of law rules. The prominent exceptions are Kent Greenfield, *Democracy and the Dominance of Delaware in Corporate Law*, LAW & CONTEMP. PROBS., Autumn 2004, at 135; P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 DUKE L.J. 1; Jack L. Goldsmith III, *Interest Analysis Applied to Corporations: The Unprincipled Use of a Choice of Law Method*, 98 YALE L.J. 597 (1988); and Daniel J.H. Greenwood, *Democracy and Delaware: The Puzzle of Corporate Law* (Geo. Wash. L. Sch., Public Law Research Paper No. 55, 2002), *available at* http://www.law.utah.edu/greenwood/pdf/PuzzleofCorporateLaw.PDF.

4. The standard accounts setting up the race and the dispute about whether it is to the bottom or the top are William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (race to the bottom); and Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEG. STUD. 251, 271 (1977) (race to the top). Dozens of more recent articles include many studies seeking to correlate stock price changes with reincorporation in Delaware. *See, e.g.*, ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 21 (Ann Petty ed., 1993) (discussing event studies); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992) (same). However, since the decision to reincorporate is, in practice if not in law, under control of incumbent management, it is hard to understand why investors would not price all companies, regardless of where they are currently incorporated, as if they were already incorporated in the most manager-friendly jurisdiction: Rational investors should assume that whenever law matters, the firm will be incorporated where managers want it to be. In this market for lemons, any price effects at reincorporation should not be the result of the changes in the applicable law, but rather due to secondary signaling effects, if investors determine that this particular management is more (or less) assiduous in protecting shareholder (or manager) interests than they previously suspected.

5. Lucian Bebchuk has recently questioned the strength of this incentive for states other than Delaware, arguing that the "market" for corporate law has significant barriers to entry, so that states other than Delaware have little prospect of seizing significant tax revenues. *See* Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 563, 570-71, 581 (2002) (showing that, overwhelmingly, major firms are incorporated either in the state of their headquarters or in Delaware, and concluding that states other than Delaware do not appear to be seeking revenue from incorporation). Bebchuk's empirical evidence strongly suggests that lawyer-advisors typically see no need to go beyond a binary home-or-Delaware choice (limited rationality might restrict them to that in any event: one would need strong reason to

In the case of a corporation with business operations (including employees, customers, suppliers, and shareholders) largely located out-of-state, the state of incorporation may have no interest in the firm except as a tax source.[6] When a corporation pays taxes, it is never entirely clear which human beings are bearing the ultimate costs; but for the taxes, the corporation might increase its dividends, its wages, or what it pays to other suppliers of inputs, or it might increase its investments, or, alternatively, it might decrease the prices it charges to customers. However, when the business, and thus all the relevant people, is located out-of-state, it is clear that taxes on the corporation are not borne by voters in the taxing jurisdiction. Thus, states seek to have out-of-state corporations incorporate locally in order to externalize local costs onto non-citizens.[7] States competing for revenues in this way will seek to offer corporations corporate law that reflects precisely what corporate decision-makers seek—any negative costs of such leniency will in any case be borne by the firm's customers, employees, etc., all of them, by hypothesis, out-of-staters.

One might expect that the corporation's home state—that is, the one where the business and/or shareholders are located—would seek to resist this exploitative behavior. Indeed, one might even imagine that basic federalism concerns would bar one state from raising much of its revenue by taxing citizens of other states. We fought a revolution to establish the principle of no taxation without representation.

However, our legal doctrine developed differently.[8] Unlike the practice in

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suspect that another state had significantly better law to develop a third expertise). Still, so long as Delaware seeks to maximize its tax revenues, it must continue to offer a competitive product. Bebchuk's race may be less vigorous than the hyper-competitive market Romano, *supra* note 4, imagines, but it should act in largely similar ways. Delaware will still seek to offer law that is attractive to corporate managers (even if it does have some room to extract something for itself—mainly tax revenues—which it would not have in a more competitive market). Managers will still opt to use Delaware law only if they or their advisors find it attractive. *See* Bebchuk & Hamdani, *supra*, at 600-01. Large companies, in particular, have the option of lobbying their local legislatures for custom rules, and other small states may change the way they act should Delaware become overly rigid. Nevada, for example, has significant numbers of out-of-state incorporations. *Id.* at 570-71 (showing that in Bebchuk's data set, Nevada has 45 local incorporations and 172 out-of-state ones). Even that shadow competition should be enough to keep Delaware responsive to managerial needs.

6. Alternatively, the state may take interest in the firm to protect the interests of the local bar. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

7. Under Macey & Miller's analysis, states may also desire the local incorporation of out-of-state corporations as a source of out-of-state work for the local bar. *See id.* The goal of externalizing tax costs—Delaware taxing New Yorkers without giving them the vote—is facially improper in a federalist system. In contrast, despite some protectionism concerns, the goal of creating demand for the services of local lawyers doesn't seem nearly so improper.

8. The puzzle of why states allowed the race to develop and whether there is any doctrinal reason preventing them from simply opting out, I will discuss separately in a future paper. *See also* William Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEG. STUD. 303, 313 (1997) (emphasizing political difficulties confronting 'interest groups' that might seek 'rents' through changes in the internal affairs doctrine); Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, LAW & CONTEMP. PROBS., Summer 1985, at 161 (describing the internal affairs doctrine). Carney views any law that imposes "higher" costs on investors—by which he means

some European countries, a corporation incorporated in any American state is presumed to exist in every American state, without any need to create a separate subsidiary or sister corporation in each jurisdiction, or (as some early railroads did) to obtain federal incorporation. Indeed, states do not require even purely domestic businesses to organize themselves under domestic law: California does not require that California citizens doing business in California apply California law to their businesses.[9] Thus, a corporation may choose to be governed by the law of any state, regardless of where it is headquartered, operates, or does business.

Given this competition between the states, or more precisely given the willingness of states to allow corporations to choose their own constitutive law without regard to normal principles of territorial sovereignty, the conventional account demonstrates that corporate law develops rapidly to meet the perceived needs of corporations. Corporations will reincorporate in the state that offers them the law they seek; states that attempt to respond to other interests or ideologies in their corporate law will find that their corporations (though not

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higher than under that law which would allow investors the greatest ability to extract value from other corporate participants—as creating "rents" without justifying or even articulating any baseline of permissible exploitation.

9. California has come closer, however, to imposing its own law upon its own citizens than do most states. *See* CAL. CONST. art. XII, § 15 (1879) (repealed 1972) ("No corporation organized outside the limits of this state shall be allowed to transact business within this state on more favorable conditions than are prescribed by law to similar corporations organized under the laws of this state."); CAL. CIV. CODE § 322 (Deering 1886) (repealed 1931) ("Each stockholder of a corporation is individually and personally liable for such proportion of its debts and liabilities as the amount of stock or shares owned by him bears to the whole of the subscribed capital stock or shares of the corporation, and for a like proportion only of each debt or claim against the corporation. Any creditor of the corporation may institute joint or several actions against any of its stockholders for the proportion of his claim, payable by each, and in such action the court must ascertain the proportion of the claim or debt for which each defendant is liable, and a several judgment must be rendered against each, in conformity therewith. . . . The liability of each stockholder of a corporation formed under the laws of any other state or territory of the United States, or of any foreign country, and doing business within this state, shall be the same as the liability of a stockholder of a corporation created under the Constitution and laws of this state."); Thomas v. Matthiessen, 232 U.S. 221 (1914) (holding that under the California statute a shareholder of an Arizona corporation formed to build a hotel in California was a "primary obligor" on a note created by the corporation in California and accordingly the judgment against shareholder must be enforced in any court); Pinney v. Nelson, 183 U.S. 144 (1901) (similar).

California continues to impose some aspects of its corporation law upon certain corporations that are not listed on a national exchange and have extensive contacts with California. See CAL. CORP. CODE § 2115 (West 1990); Michael J. Halloran and Douglas L. Hammer, *Section 2115 of the New California General Corporation Law—The Application of California Corporation Law to Foreign Corporations*, 23 UCLA L. REV. 1282, 1294 (1976) (observing that where a corporation with a substantial presence in California is not listed on the NYSE or Amex, California courts will apply California law and recognizing that other jurisdictions are unlikely to do so); for additional discussion, see Carney, *supra* note 8, at 303, 314; Stephen R. Ginger, *Regulation of Quasi-Foreign Corporations in California: Reflections on Section 2115 after* Wilson v. Louisiana-Pacific Resources, Inc., 14 SW. U. L. REV. 665 (1984); J. Thomas Oldham, *California Regulates Pseudo-Foreign Corporations—Trampling Upon the Tramp?*, 17 SANTA CLARA L. REV. 85 (1977); J. Thomas Oldham, *Regulating the Regulators: Limitations Upon a State's Ability To Regulate Corporations with Multi-State Contacts*, 57 DENV. L.J. 345 (1980); and John Hugh Newman, Note, *The Pseudo-Foreign Corporation in California*, 28 HASTINGS L.J. 119 (1976).

necessarily the associated business) migrate elsewhere.

The story is not simply theoretical; history shows the competition in action. At the end of the last century, states offered substantially differing models of corporate law. When New Jersey offered a corporate law designed to appeal solely to corporate management it quickly attracted so many incorporators that the associated tax—imposed almost completely on out-of-staters—obviated any need to tax its own citizens.[10]

However, a reform movement in New Jersey under Governor Woodrow Wilson amended the New Jersey corporate law to impose various restrictions that the Progressive movement endorsed but which weren't necessarily attractive to corporations. Shortly thereafter, Delaware, blessed with a small size, central location, and minimal countervailing interests, outdid the original New Jersey law and obtained the distinction of creating American corporate law. Because Delaware is small and not a major industrial state, its local politics are relatively free of the type of reformist politics that made New Jersey unattractive to firms. Delaware corporations are likely to be physically located elsewhere; thus, politicians and citizens have little relationship with the corporations that incorporate there except as legal entities. Moreover, Delaware remains heavily dependent on tax revenues from its sale of the privileges of incorporation. Accordingly, Delaware is relatively unconstrained in its pursuit of corporate franchise taxes. Together with its sophisticated institutional structures to support its corporate law (including special courts, a dedicated bar, and specialized legislative committee mechanisms), this creates a reasonable assurance that Delaware will seek to keep its corporate law attractive to corporations. Indeed, should any other state find an attractive corporate law innovation, Delaware will match if not better it.[11]

Within the self-imposed constraints of the principles of free incorporation and the internal affairs doctrine, other states then faced a limited number of possible approaches to corporate law. They could imitate Delaware, in the hope that at least some of their local corporations would not find it worthwhile to reincorporate in Delaware, perhaps with an occasional special twist for a large local company with idiosyncratic needs more difficult for Delaware to fulfill. They could attempt to out-"Delaware" Delaware—but that was a difficult prospect once it became clear that the Delaware citizenry was willing to sacrifice its views, if any, on proper corporate law in order to obtain the tax

10. HERBERT HOVENKAMP, ENTERPRISE AND AMERICAN LAW, 1836-1937, at 257-59 (1991) (reporting history of the "Traitor State" New Jersey's corporate law reforms).

11. ROMANO, *supra* note 4; *cf.* Bebchuk, *supra* note 5, at 613 (arguing that states other than Delaware may not innovate since they might "find [themselves] operating as a stalking horse that produced an improvement [sic] in corporate law but did not capture any benefit for itself"). I speak of "attractive" rather than "improved" since I see no reason to assume a priori that law that is adopted by corporate managers will be "improved."

advantages of being the incorporation center of the nation, and that Delaware's specialized institutions worked well enough to assure that it kept its law the most attractive (to incorporators) in the country. Or they could attempt regulation—and see all significant local business reincorporate in Delaware. Whichever course the states took, the result would be the same: All important corporate law is made in Delaware. And regardless of where it is made, state corporate law either is directed to the perceived needs of corporate management or is empty, "rusted girders, internally welded together and containing nothing but wind,"[12] because all management need do to avoid unwanted regulation is to reincorporate in Delaware.

The general agreement on this story of how corporate law is made is somewhat hidden by a continuing controversy over whether the process is good or bad, reflected in claims that the process should be seen either as a race to the bottom or a race to the top. The argument, in somewhat simplified terms, is over the appropriate time frame in which to understand managerial strategy.

A. *Race to the Bottom as a One Time Game*

The early race-to-the-bottom theorists modeled a simple one-period game. This formulation assumes that self-interested managers[13] prefer law that does not restrain them, so that they are free to use their position to appropriate corporate surplus. In particular, race-to-the-bottom theorists assume that management will choose corporate law that allows it to exploit shareholders and other corporate participants. In game theory terminology, managers look for rules that allow them to defect: to enter into mutually advantageous arrangements with shareholders but then to renege on the agreement and take a larger than anticipated share. On this view, the radical simplicity of Delaware's corporate law and its general permissiveness are little more than legalized theft.

In the early liberalization, Delaware eliminated compulsory regulation of minimum capitalization,[14] par value,[15] preemptive rights,[16] and ultra vires rules,[17] universalized perpetual existence and limited liability,[18] permitted

12. Bayless Manning, *The Shareholder's Appraisal Remedy: An Essay for Frank Coker*, 72 YALE L.J. 223, 245 n.37 (1962).

13. Both race-to-the-top and race-to-the-bottom theorists generally assume that top managers are closely allied with and in the ordinary course control the directors. Accordingly, I refer to managers and management in the following discussion even though Delaware law generally vests authority to make the decisions in question in the board of directors.

14. DEL. CODE ANN. tit. 8, § 154 (2005) (eliminating most capitalization and anti-dilution rules); § 162(d) (eliminating most shareholder liability for violation of anti-watered stock rules); § 170 (eliminating most limits on declaration of dividends out of capital).

15. § 153(b) (authorizing no par value stock).

16. § 102(b)(3) (providing for no preemptive rights unless explicitly granted in corporate charter).

17. § 121 (reversing the rule that a corporation has only powers explicitly granted); § 124 (eliminating ultra vires action).

18. § 122(1) (perpetual existence); §102(b)(6) (limited liability).

corporations to hold the stock of other corporations and eliminated other restrictions on corporate behavior common in early codes,[19] and drastically limited the powers of shareholders, placing governance in the board of directors instead.[20] It completely failed to develop a doctrine limiting monopoly or anti-competitive mergers and combinations.[21] More recently, it has reduced compulsory fiduciary duties almost to the vanishing point.[22] The race-to-the-bottom theorists interpret this general reduction in regulation straightforwardly as simple pandering to managers.

Similarly, Delaware's general acceptance of limits on hostile takeovers fits nicely into the basic picture: Managers get the law they want. So-called hostile takeovers are transactions in which a target company's shareholders agree to sell their shares (and thus the company) over the objections of the target's incumbent management. Such transactions were rare until Milken's invention of the new-issue junk bond revolutionized their financing. Junk bonds briefly made the hostile takeover a key part of our market for corporate control. Within a few years, however, the poison pill offered managers a new technique to prevent shareholders from acting without managerial permission.[23] Delaware was quick to correct courts that saw poison pills as a violation of its equality-of-shares principle,[24] and later enacted a statutory pill,[25] both of which have the general effect of requiring target board approval before a tender offer is consummated. Delaware case law has generally upheld the right of

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19. §§ 122(4), (10)-(11), 160 (permitting a corporation to buy and hold its own stock); § 251 (permitting mergers); *cf.* HOVENKAMP, *supra* note 10, at 248 (reporting that in 1890 most states forbade corporations from owning stock of other corporations or transferring their operations to other corporations, thus making merger difficult). The trust was an attempt to evade this restrictive early corporate law, thus leading to the oddity that our anti-monopoly law is called antitrust law. *Id.* at 249.

20. *See* DEL. CODE ANN. tit. 8, § 141 (2005) (stating that the business of a corporation is managed by the board, not shareholders); *cf.* § 228 (allowing corporations to eliminate the right of shareholders to act by written consent without a meeting); § 211(d) (allowing directors, via bylaws, to authorize a person to call a special meeting).

21. *See* HOVENKAMP, *supra* note 10, at 245 (reporting that state regulators first assumed that corporate law would provide the vehicle for anti-monopoly policy).

22. Pursuant to § 102(b)(7), a corporation may eliminate personal liability of directors for most breaches of the duty of care. Section 145 generally allows the corporation to indemnify officers and directors against expenses in connection with suits, including for breach of duty to the corporation, so long as the indemnified person acted in good faith and in a manner the person believed not opposed to the best interests of the corporation.

23. Poison pills are special rights generally structured so that they may be put in place (and removed) by directors acting unilaterally without shareholder consent. Unless redeemed by the board (or by order of a court), the pill makes completion of a tender offer financial suicide. The result is that acquisitions by tender offer, like acquisitions by merger or sale of all assets, cannot proceed without approval of the target's directors before shareholder action. Of course, if directors are in favor of the transaction, pills are no impediment.

24. *Compare* Unilever Acquisition Corp. v. Richardson-Vicks, Inc., 618 F. Supp. 407 (S.D.N.Y 1985) (finding pill to be a violation of the equality of shares), *with* Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (upholding poison pill over opposition by, inter alia, the SEC).

25. *See* DEL. CODE ANN. tit. 8, § 203 (2005) (barring most business combinations with interested shareholders unless the board or a super-majority of disinterested shareholders approve the transaction).

management to refuse to put the company up for sale even against strong shareholder opposition and has allowed managers to defend against breach of duty actions by contending that actions seemingly taken without regard for shareholder interests were motivated by concern for other corporate participants, such as employees, creditors or customers, or even for the product itself or the process of making it (e.g., Time Culture).[26] The net result is that takeovers are now effectively impossible without the consent of incumbent management.

Race-to-the-bottom views also easily explain another aspect of takeover regulation: While state law restricting hostile takeovers appears to invoke values of stability or other stakeholder interests, these concerns disappear when managers support the takeover. *Paramount v. Time* is the most-famous Delaware statement of a phenomenon enshrined in most state laws in so-called "constituency statutes"—in the takeover context directors are free to define the interests of the corporation to include values and participants the stock market would exclude. But this shield is no sword. As a general rule, directors are not required to consider those other participants should they wish to act contrary to their interests.[27] Moreover, no corporate participant other than the fictional shareholder has standing or a cause of action with respect to director decisions. Accordingly, directors are entirely free to ignore all non-shareholder interests and values except in the most extraordinary circumstances (and they would risk suit from shareholders if they were to explicitly consider those other concerns).[28] It would be peculiar in most areas of the law to find rules

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26. *See* Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1143 n.4, 1145-48 (Del. 1989).

27. The Connecticut constituency statute appears to be an exception: It does require directors to consider stakeholder interests before approving a takeover. CONN. GEN. STAT. § 33-756(d) (2005). However, it provides no way for those supposed beneficiaries to enforce this rule: Only shareholders have a right of action.

28. In the few cases where directors have openly stated that they were not running the corporation in the interests of fictional shareholders, courts have disapproved. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (barring directors from considering actual interests of owners of shares—who were also owners of bonds—and requiring that they instead pretend that share owners have no interests other than share value maximization); Smith v. Van Gorkum, 488 A.2d 858 (Del. 1985) (holding that directors may not abdicate their fiduciary duties in favor of a shareholder vote); Dodge v. Ford Motor Co., 170 N.W. 668 (Mich. 1919) (holding improper a corporation's decision to act according to the political views of the holder of a majority of its shares, despite evidence that the course was in fact profit-maximizing). It is true that, as noted in the prior footnote, review of shareholder suits is extremely deferential, and outside of the limited "*Revlon* Mode," the Delaware courts do not searchingly examine directorial action to determine if they are considering non-share interests. On the contrary, they generally allow such consideration, so long as the directors claim that the non-share interests are in some fashion congruent with share interests, an argument that should always be available to a properly-advised board regardless of what it does. *See generally Paramount*, 571 A.2d 1140 (accepting seemingly implausible explanation of share interests); *Revlon*, 506 A.2d 173 (setting forth limited circumstances in which directors must consider only share interests).

Nonetheless, the basic asymmetry seems clear. Whenever directors consider non-share interests, a potentially litigable issue arises. In contrast, only in the most extraordinary circumstances are directors under any judicial pressure, however mild, to consider non-share interests. The one exception is a line of

permitting decision-makers to simply ignore the interests and values of those most intimately affected by their decisions. But if state law is simply pandering to managers, as the race-to-the-bottom view contends, it is not surprising that state corporate law generally permits but never requires management to invoke non-shareholder interests in takeover contests.[29]

In the ordinary course, non-share corporate participants and claimants have only contract law to protect them; that is, as a matter of corporate law, managers are invited to treat corporate participants as badly as their contracts permit. Contract law, however, more often than not instead protects the autonomy of the corporation to defect or not as it pleases.

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cases holding that when a company is near insolvency, the directors may have some fiduciary duties to protect bondholders. *See* William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 733 (discussing limits on debtor's activities near insolvency). I know of no cases extending that duty outside the immediate insolvency situation—although, as the bondholders of RJR Nabisco graphically learned, bondholders are injured anytime a company decides to radically increase the risk of insolvency, even if the gamble turns out well. *See* Lawrence E. Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. REV. 1165, 1167-68 (1990) (objecting to the absence of protections for bondholders); William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 94-96 & n.10 & 102 n.26 (discussing 1988 RJR Nabisco refinancing as wealth transfer from bonds to equity, lack of fiduciary duty to creditors and advocating development of such a duty). Nor am I aware of any cases extending fiduciary protection to other corporate claimants who may need it near insolvency even more than bondholders. Employees, suppliers, or customers with firm-specific investments are less likely to be diversified and (in the case of employees) more likely to be hurt beyond the pocketbook than are bondholders.

29. Roughly speaking, if an action (or inaction) that directors support does not amount to a sale of the company, shareholders may bring an action contesting the board's decision on grounds of breach of a duty of care to the company, but review will be under the lenient business judgment rule standard, which presumes "that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company," Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984), and generally precludes complainants from proving negligence, *Smith*, 488 A.2d at 874 (requiring proof of gross negligence). The business judgment rule protects actions the directors take to prevent losing control, such as enacting a pill, so long as they are not done in the context of a particular threat. Kahn v. Roberts, 679 A.2d 460 (Del. 1996) (refusing to apply heightened scrutiny to a share repurchase program).

In conflict of interest transactions, the business judgment rule does not apply, Cede & Co. v. Technicolor, Inc., 634 A.2d 345, 363 (Del. 1993) (director's material financial interest or evidence of disloyalty lifts the presumptions of the business judgment rule), but review remains quite lenient: Directors may defend by demonstrating the "entire fairness" of the transaction, which has generally turned out to be fairly easy.

Where directors are defending against a transaction they oppose, which could be understood as a conflict of interest transaction, the business judgment rule doesn't apply unless the directors demonstrate a threat to the corporation or incumbent management's vision of it, and demonstrate that their response was proportionate; this too has not proven an unduly difficulty burden. Amanda Acquisition Corp. v. Universal Foods Corp., 708 F. Supp. 984, 1010-14 (E.D. Wis. 1989) (upholding "just say no" defense); Unitrin, Inc. v. Am. Gen. Corp., 651 A.2d 1361 (Del. 1995) (when defensive actions are not "coercive or preclusive" review is limited to whether they are within a "range of reasonableness"); *Paramount*, 571 A.2d 1140 (allowing directors opposed to an all-cash tender offer supported overwhelmingly by shares to defend their actions as in the interests of non-shareholder constituencies and a general concept of the corporation's purpose); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (upholding discriminatory treatment of shareholder who sought to make unwanted tender offer).

However, once the directors decide on a transfer of control, the courts apply a stricter standard of review. *Revlon*, 506 A.2d 173 (when company is to be sold, directors must maximize price shares will receive). *See generally* McMullin v. Beran, 765 A.2d 910 (Del. 2000) (reviewing the multi-tier standards of review).

Thus, for example, under the standard analysis of bond, pension and employment contracts, directors and managers are free to take any action not explicitly barred by the contract. But it is a trivial matter for a firm to radically change the likelihood that the company will perform its future contractual obligations to long-term debtors, such as unsecured bondholders, long-term employees and pensioners.[30] Anytime the firm unexpectedly increases its risk level, it reduces the value of all its long-term contracts, because it reduces the odds that it will fulfill its obligations. Indeed, every time the firm pays a dividend, it reduces the security of its long-term contracting counterparties. Except in the most egregious situations, neither contract nor corporate law offer any meaningful remedy.[31]

Even more dramatically, employment contracts are interpreted against background rules assuming that the employer has the unilateral right to set and control working conditions, including the unfettered discretion to organize or reorganize the business in any fashion without consideration of employee interests or desires, that employees have waived any right to internal termination proceedings (whether for cause or not), that employee work products (including inter-employee relationships) are the property of the employer to be disposed of as the employer sees fit, and even that (except where ERISA changes state law) pension promises create at most a junior unsecured claim to whatever assets the employer chooses to have available.

Contract law, thus, offers cold comfort for corporate participants. Corporations will be held to the terms of their contracts but are free to reorganize in ways that make those terms worth less or worthless. Corporate law offers non-shareholders even less: Corporations can deliberately take maximum advantage of non-shareholder participants in the firm to the fullest extent permitted by other law without violating any corporate law duty whatsoever and, indeed, such an action is liable to be interpreted as a commendable concern for fictional shareholder interests.[32]

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30. *See supra* note 28. Some courts recognize that when the company is close to insolvency, managers may be tempted to gamble with what is effectively bondholders' investment, and therefore impose a fiduciary duty to respect bond interests. However, as RJR Nabisco demonstrated, the temptation to gamble with non-shareholder investments is not limited to near-insolvency circumstances.

31. In extreme cases, the fraudulent transfer acts or their corporate law equivalents, the statutory limits on dividends, may prevent debtors from actually giving away the assets they need to meet their obligations. But it is not a violation of any legal principle I am aware of for the firm to deliberately increase the risk of insolvency. *See, e.g.*, Metro. Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y. 1989) (upholding corporate issuance of enormous new debt, even though the effect was to radically reduce, without compensation, the value of pre-existing bonds).

32. Some managers have taken this general attitude that corporations should always do what is in the interest of fictional shareholders so far that they have caused their corporations to violate the law in the name of share profit maximization. Courts have generally not fully endorsed this extreme position. *See, e.g.*, Miller v. Am. Tel. & Tel. Co., 507 F.2d 759, 763 (3d Cir. 1974) (holding violation of federal campaign finance laws sufficient to state a claim for breach of corporate law fiduciary duty because shareholders were within the class protected by federal law). But as a matter of corporate law, only shareholders can sue in this circumstance, and as a rule, they will be understood to have no damages and

In short, for race-to-the-bottom theorists, corporate law is mostly about freeing managers to do as they please, most dramatically in hostile takeover law—which allows managers to prevent shareholders from selling the company, even though buying and selling would seem to be the core area of shareholder expertise—and with respect to non-shareholder corporate interests—who have virtually no standing at corporate law.

B. *Race to the Top as a Repeating Game*

Race-to-the-top theorists, in contrast, contend that managers and shareholders should be seen as playing a repeating game. If shareholders fear that managers will appropriate gains that shareholders anticipated would go to them—that is, if shareholders fear managerial defection in the way that race-to-the-bottom theorists predict—they can easily defend themselves by charging for the defections ex ante. In other words, if shareholders think managers are going to steal, they will reduce the returns they expect to earn by the amount available to be stolen. If stealing were entirely unrestrained, the result would be that only the naïve would invest in the public stock markets: Rational investors would not expect any returns except perhaps by accident.

The race-to-the-top point is that in this repeating game, managers have a potential common interest with shareholders. Managers who convince the financial market that they will work for shareholders, not themselves or other corporate participants, will be able to obtain investment capital at far lower cost than competitors who do not. For companies that raise capital in the IPO market, rational investors should discount the amounts they are willing to pay for the company's stock to reflect their view of the likelihood of managers working for shareholders and the adequacy of protection against future changes of heart. Since the value of stock is dependent on its future returns, rational IPO investors should price protections that will inure to the benefit of later secondary market investors as well. But even a company that relies principally on retained earnings for investment capital will be better able to compete if its stock is highly valued; it can use stock as a currency to purchase other companies, compensate employees, and so on. This should give share-oriented managers a major advantage in the product market by allowing them to produce products at a lower cost and underbid their competitors.

Moreover, if there is an active market for corporate control (that is, if hostile takeovers are possible), managers who are percieved by the stock market as not acting in shareholder interests will quickly find themselves out of a job. If the stock market bids a company's stock below what would be the

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therefore no action if they have not been injured in their role as shareholders. Without some change in the standing and damages rules, corporate law is structurally incapable of protecting non-share interests, even in the case of criminal violations.

company's value if it were run in the interests of shareholders, it is a clear takeover target. Any manager who makes the shift should be rewarded with an immediate jump in share price. Nor is the pool of managers who could make the change limited. Shifting corporate surplus to shareholders is not rocket science—because it doesn't require improving the product or production processes, outsiders should be able to redirect a company's surplus to its shareholders even with no particular knowledge of the industry. Moreover, Wall Street should have no trouble understanding the profit potential here, so financing for hostile takeovers should be readily available. Thus, both incumbent management and outsiders have both the means and powerful incentives to do what the stock market wants.[33]

In short, managers who appear to be running the company for the benefit of shares will be rewarded with a lower cost of capital; those who don't will be penalized and their firms targeted for takeovers. Accordingly, the race-to-the-top analysis contends that race to the bottom has it backwards: Far from looking for ways to abuse shareholders, managers should be searching for ways to prove that they have only the best interests of shareholders in mind.

Although race-to-the-top theorists do not always emphasize the point, precisely the same argument can be made with respect to all other corporate participants.[34] If bondholders or employees fear defection in a rational game, they will charge ex ante as well. Bondholders, after RJR Reynolds, should demand additional protection (causing drag on the firm's flexibility) or charge higher interest to compensate for the risk the firm will later change its risk profile to their detriment. Employees who fear that they will be treated unfairly are more likely to spend their time resume padding, loafing, or even stealing than those who view the firm as on their side.[35] Thus, managers who can persuade bondholders, employees, suppliers, or customers that management is acting in their interests will also gain a competitive advantage in the product marketplace.

In this best of all possible worlds, managers should search for the corporate

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33. Race-to-the-top theorists can deal with the legal impediments to hostile takeover by assuming that if the target's stock is sufficiently cheap, the acquiror will be able to bribe incumbent management into ceasing active opposition.

34. *See generally* Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999) (discussing corporate governance as a potential solution to problems of coordinating production); Daniel J.H. Greenwood, *Enronitis: Why Good Corporations Go Bad*, 2004 COLUM. BUS. L. REV. 773, 827-34, *available at* http://www.law.utah.edu/greenwood/html/Enronitis.htm (discussing the contradictory demands on managers to induce employees to trust them while simultaneously being prepared to betray them).

35. *See generally* SCOTT ADAMS, THE DILBERT PRINCIPLE (1996) (detailing many ways in which employees who perceive themselves as mistreated can extract revenge). Allan Lind and Tom Tyler have documented the close connection between employee behavior and perceived firm trustworthiness. *See, e.g.*, E. ALLAN LIND & TOM R. TYLER, THE SOCIAL PSYCHOLOGY OF PROCEDURAL JUSTICE (1988). The old U.S.S.R. reduced the process to a well-known joke: "They pretend to pay us and we pretend to work."

law that most clearly assures *all* corporate constituents of managerial good will, whether by restraint or alignment of interests. Since, on the assumptions of rational actors and competitive markets, every participant can make every other participant internalize the costs of all attempted impositions, no one has any interest except to work for the common good.

1. *The Complexities of Finite Repeating Games: The End-Game Problem in the Race to the Top*

The race to the top can exist only if managers can demonstrate to potential investors that managerial and investor interests are aligned. There are two basic ways to do this: reputation or external regulation. This Subsection discusses reputation.

In an infinitely repeating game without external regulation, only managers with a reputation for not stealing would be able to sell their services, and those who had a reputation for focusing on shareholder value would obtain the lowest-cost capital. Accordingly, managers would seek to develop a favorable reputation, as the race to the top contends.

But there is a final period problem with this optimistic story. CEOs are typically near retirement age, and a retiring CEO may find it attractive to cash-in on a hard-acquired reputation for honesty: Now that he has his hands on the cookie jar, why not help himself and sacrifice his reputation? If a CEO of a large public company can seize enough corporate assets (via salary and perks, stock or option grants, an MBO, or golden parachutes) to make future employability or company success an irrelevant consideration, he may do so. A large piece of even a much smaller pie may be more attractive to a self-interested individual than a smaller share of a larger pie. Even if his company suffers from a sudden jump in its cost of capital, the CEO himself will be both rich and retired.

Moreover, the simple model of dishonest defection omits other, perhaps even more common, situations in which managers may act as if they were stealing from the company—even without any bad intent. Most people find it easy to assume that their personal self-interest is aligned with their responsibilities, and in this case, an entire army of academics and consultants has spent two decades explaining that managers cannot be expected to do a good job unless they are paid very well. Any reasonably optimistic and self-confident manager is likely to decide that the theorists are right: He would do a better job (tomorrow) if he were given a significant chunk of the company today. That is, even non-defecting managers may act as if they were defecting.

Generalized, this end-game problem presents a very serious problem indeed. If potential shareholders take these possibilities into account ex ante, the public market may decide that reputation is not reliable. Kenneth Lay, after all, had a fine reputation until it was too late; Enron was run according to the

best advice of the consultants. At this point, the situation appears to be a market for lemons.[36] Investors should refuse to pay for quality that they cannot verify. Moreover, since the odds are entirely under the control of the managers themselves, the risk should be essentially uninsurable. Investors in an impersonal market would invest in companies on the assumption that top managers will steal, which suggests very low multiples of expected earnings indeed. Since honest managers would not be paid for their honesty, they would disappear.

As in any market for lemons, willing buyers of a high quality (or honest) investment product and willing sellers would be unable to make a bargain; all that would be available would be high risk at low cost. But investors are not like car buyers who simply suffered with poor-quality cars until foreign manufacturers figured out how to escape the lemons trap. Americans can't live without cars, but investors can easily shift out of the stock market. If CEOs can determine unilaterally whether and how much to steal, investors cannot price future returns in any rational way. When the risk is under the control of the insured, insurance companies refuse to sell; the financial markets should act no differently.

The implications then are dire. If investors were to conclude that managers are freely able to appropriate corporate assets, the public financial markets might largely close down or, at a minimum, would charge extraordinarily high risk premiums. (How do you price the risk of someone defecting when the defector can change the odds unilaterally?)

Reputation, then, is unlikely to work as a disciplining mechanism in a finitely repeating game where the key players (CEOs) are inevitably near the final period. Investors should fear that CEOs will find the temptation to cash in on their reputations too hard to resist, and acting on their fear, they should treat all CEOs, even ones with good reputations, as likely defectors. A reputation-based race to the top should quickly collapse into a market for lemons.

A market for lemons is not the end of the world—even a total collapse of the public stock markets wouldn't necessarily cripple the economy permanently. Most investment by major corporations is financed by retained earnings and most of the rest by debt. Moreover, private financing transactions (for example, intra-family financing, where other methods of preventing defection are possible) would pick up some of the slack, as they do in countries with less developed public finance markets.

Still, *any* loss of finance capital should result in lower growth and flexibility in the economy, to the detriment of all of us. Moreover, were

36. *See* George A. Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970), *reprinted in* GEORGE AKERLOF, AN ECONOMIC THEORIST'S BOOK OF TALES (1984) (describing market-for-lemons problem).

investors to withdraw from the stock market due to suspicion of self-dealing managers, it seems somewhat implausible that they would entirely put aside those suspicions in the bond market. Bond markets suffer from their own problems: After RJR Nabisco, bondholders should be quite aware of the possibility that they too may be taking unquantifiable risks of defection. Accordingly, the net result of greater suspicion of the public finance market ought to be both lower stock prices (perhaps dramatically lower) *and* higher interest rates, each leading to slower growth directly (especially of smaller companies less able to generate investment capital internally) and indirectly, as managers use higher "hurdle rates" to determine the desirability of investment opportunities.

In addition to a slowing of growth, we'd see a reduction in social mobility. Public markets depend on trust between strangers and on the actuarial calculation of the odds of success. When the odds are controlled by one party, public markets must fail. Instead, people will rely on less impersonal methods of determining on whom to rely. With the public markets less useful, we would likely see a dramatic increase in influence of banks, large corporations, and wealthy families able to escape the market for lemons by personal relationships. In general, investments would be more determined by both "connections" and bureaucratic processes—large firms and banks deciding to support a business plan based either on old-boys networks or on Weberian rationality—and less by markets. Personal connections, status and background, and the ability to articulate a plan to a peer group would became more important relative to raw market smarts, the common touch, and pure luck, leading to a closing of the elite.

2. *Corporate Law as the "Credible Commitment"*

What is needed, then, is a different way out of the end-game problem: some device, more reliable than reputation, that managers can use as a "credible commitment" that they will not defect. That device could be corporate law.

If managers can find law that allows them to prove to investors that they won't defect, some managers should seize on it as a way out of the market-for-lemons problem. If they can demonstrate that the law requires them to keep their agreements, they should be able to attract lower-cost financing by eliminating the fear of last-period defection. Lower financing costs, in turn, should allow them to beat their competitors. Accordingly, race-to-the-top theorists propose that managers acting in their own private interest will choose law that prevents them from defecting, thus solving the end-game problem in a beneficial race to the top.

On this story, managers and shareholders unite in choosing the law that is in their mutual best interests. Since they are the ones most intimately involved in the process, it seems reasonable to assume that they will do a good job of

defining those interests and the law that will support them. It follows, then, that corporate law, like contract law, must be about enforcing voluntary agreements.

Oddly, however, Delaware's law doesn't actually look like the law this story would predict. If choice of corporate law is driven by the need to find a credible commitment that managers will not defect in an ever-imminent end-game, one might expect to see legal regulation obviously preventing defection. Such a law would solve the market-for-lemons problem by enabling CEOs to credibly claim that an outside enforcer will force them to keep their promises.

This credible commitment model is a plausible explanation for the extensive regulatory apparatus of our federal securities laws: Free markets work best when players are not free to break their commitments. Markets are more likely to rely on disclosure and reputation when those who lie or cheat go straight to jail or are subject to suit by highly motivated private attorneys general under generous class action rules. But this isn't Delaware law, at least in any obvious way. The usual story of Delaware law is one of increasing permissiveness, not careful elucidation of minimum standards of behavior and effective joint government/private enforcement. Race-to-the-top theorists, accordingly, have some explaining to do.

If Delaware law is, as it seems to be, centrally about permissiveness, the implication is that a market for lemons, not a race to the top, is the most likely result of our corporate finance regime. On this analysis, current investment in the financial markets must be based on (irrational?) faith in the honesty of managers who have every incentive to cheat. The limits of that trust limit our market. Were the trust to break down further, we might see a major collapse of stock prices.[37]

Moreover, accepting this story of Delaware's loose regulation of a market with strong tendencies to collapse suggests that more investment capital would be available were corporate law more regulatory. At the peak of the boom, several best-selling authors suggested that the stock market "ought" to be priced much higher because the risk premium for holding common stock is inappropriately high.[38] Here, the claim is inverse: Were corporate law able to eliminate more of the risk of defection than it does, the appropriate risk premium indeed would be lower, and a good deal of cash now under mattresses would shift to the finance markets. As it is, the risk premium is as *low* as it is only because investors are puzzlingly confident that managers will place honor over self-interest and will not defect even where they might well get away with

37. For more on the importance of trust in economic activities, see, for example, ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY 321 (2000) (stating that people prefer to buy and sell with people they know); *id.* at 324-25 (describing the importance of trust in creating the economic growth of Silicon Valley).

38. *See, e.g.*, DAVID ELIAS, DOW 40,000 (1999); CHARLES W. KADLEC, DOW 100,000 (1999).

it.[39]

Race-to-the-top theorists contend, however, that the markets are driven by rationality, not faith. Accordingly, they are driven to explain that appearances mislead. Delaware law—they must say—is not permissively pandering to managerial temptations to renege or leaving investors undefended against dishonesty. Rather, if the race is to the top, Delaware's apparent *permissiveness* actually must be *flexibility*. It must be that the older regulatory regime imposed costs that were not to the advantage of either shareholders or managers, simple deadweight costs that the efficient processes of competition for law have eliminated. Shareholders, after all, require managers who can freely and quickly adapt to the rapidly changing environment of a capitalist marketplace; the old law must have clogged up the works. Perhaps defection is not as large a problem as the game theory model might suggest, or at least it is a smaller problem than the problem of excess rigidity resulting from the older rules (even race to the top only assumes that managers will choose the best of the proffered compromises, not that an ideal legal solution exists). Maybe, for example, managers are less rationally self-interested than extremely honest, professional and selfless.[40] What is absolutely clear, however, is that if the race-to-the-top analysis is correct, the law must be mutually-beneficial for shareholders and managers (relative to real alternatives), appearances to the contrary notwithstanding.

C. *Lifting the Race-to-the-Top Assumptions: The Potential for Lemons*

Race-to-the-top analysis, however, is not pure Dr. Pangloss.[41] Our world comes with no guarantees. Most fundamentally, it is always possible that no reasonable solution to the corporate law problem has yet been proposed.[42] If the

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39. Ordinary market risk can be estimated, or so conventional market analysis contends, and therefore priced, much as an insurance market prices risk. *But see* BENOIT B. MANDELBROT & RICHARD L. HUDSON, THE (MIS)BEHAVIOR OF MARKETS (2004) (contending that markets are far riskier than ordinarily understood, because conventional risk analysis uses mathematics appropriate to bell curves rather than fractal, chaotic systems). In contrast, the odds of managerial defection cannot be predicted actuarially at all. When the odds are dependent on the honesty of the insured, insurance companies see moral hazard and decline coverage. Rational investors should act in the same way. Insurance companies cannot insure against the insured's arson, and public stock markets cannot insure against (or price a risk premium for) managerial theft.

40. In *Enronitis*, *supra* note 34, I contend that much of the current understanding of corporate law is based on this semi-concealed paradox. Managers are expected to be simultaneously selfish and selfless, ruthlessly exploitative of opportunities to extract value from fellow employees (and themselves) but willing to turn over these ill-gotten gains to shareholders, motivated by their own gain but faithful agents working for their principals even against their principles.

41. VOLTAIRE, CANDIDE 12 (Henry Morley & Lauren Walsh trans., Barnes & Noble Classics 2003) (1759) ("In this best of all possible worlds . . . [all things] must necessarily be created for the best end.")

42. The analogous problem in evolutionary biology is famously associated with Stephen Jay Gould and the panda's thumb: Even intense evolutionary pressure will only result in "solutions" that emerge from the materials at hand. An engineer working from a blank slate would have proposed a different solution than the panda's thumb. *See* STEPHEN JAY GOULD, THE PANDA'S THUMB (1980). Human

only available choices are either to allow defection or to so hamstring managers that they cannot manage in the first place, race to the top predicts only that managers will choose the lesser evil, not that their choice will be attractive.

But even within a restricted set of possibilities, evolution by market selection need not reach the best one. Under some realistic scenarios, even in a repeating game, managers will choose law that is not the best available from a collective perspective. So long as they can fool some of the people some of the time, some managers will conclude that it is more profitable (for them, if not for their companies) to choose law that appears to be shareholder-protective, but still allows room to defect. Race-to-the-top theory assumes that these managers will be penalized by a higher cost of capital which will, in turn, penalize them in the product and takeover markets to such an extent that, as a practical matter, we need not worry about the problem. This prediction's plausibility depends on a number of assumptions that aren't necessarily correct.

First, for shareholder-oriented managers to prevail over those who would like to retain the option to defect, both the product and the finance market must be thoroughly competitive. Most American companies finance most of their expansion through internally-generated funds (retained earnings). Most of the rest is financed through debt. Accordingly, we cannot simply assume that companies that suffer in the stock market will quickly be competed into insolvency. Especially in a rapidly changing economy, other factors (including not only past success but also current product innovation, fashions and luck) may overpower the marginal effects of even clearly counterproductive corporate governance.[43] Similarly, the takeover market is marked by high

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affairs, of course, can be changed by acts of conscious design that may take larger jumps than biological evolution. Still, market pressure only selects the most successful of the available solutions in the particular environment—it offers no guarantees that useful innovations will appear as needed. And the importance of path dependence in human affairs should not be underestimated. *See, e.g.*, Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

43. For example, the Google IPO was highly successful despite Google's explicit rejection of several standard good governance procedures. In particular, Google's founders retained super-voting shares leaving public shareholders with even less than the usual limited governance rights and, in particular, virtually no possibility of hostile takeover. Moreover, Google's disclosure was notably uninformative.

There are two possible rational explanations. First, perhaps the stock market understands (and conventional commentary does not) that these governance provisions are in fact in the shareholders' interest. Lynn Stout has made convincing arguments along these lines. *See, e.g.*, Lynn A. Stout & Iman Anabtawi, *Sometimes Democracy Isn't Desirable*, WALL ST. J., Aug. 10, 2004, at B2. Alternatively, the stock market might see these provisions as unmitigatedly bad, but not nearly as important in valuing the company as Google's business prospects. After all, Google makes money selling advertising, not corporate governance. If their business model is sound, it might be so successful that leakage—even massive leakage to the founders or other insiders—will not matter. Even a smaller share of a large enough, fast growing enough pie is quite attractive.

Nor is the market price necessarily a reflection of Google's fundamental prospects, as the last Internet bubble made clear. If investors using rationally recursive valuation models conclude that Google's business plan and governance structure are bad bets, but that other investors are likely to want to purchase its stock, they will expect to make a profit buying the stock and selling it to one of those

transaction costs: We can't assume that every company that *could* be run with shareholder interests more front and center quickly *will* be.

Even if these markets are competitive enough so that they will have their way in the long run, managers may not take a long term perspective: As suggested above, it often will be wealth maximizing for any individual CEO to defect even at the cost of substantial long term damage to the company. If the markets are only imperfectly competitive, the costs are likely not to hit home until after the CEO has retired.

Moreover, CEOs—being an optimistic group—may be likely to overestimate the odds that any shenanigans can be put right at the next upturn before ever being discovered, or to use the powerful tools of self-deception and cognitive dissonance to convince themselves that what they are doing is good for the company in any event. If CEOs convince themselves that it is in the company's best interest to be in a jurisdiction with rules that give CEOs great discretion, imperfectly-competitive markets may not be powerful enough to convince them of their error.

Second, the race-to-the-top thesis assumes that investors can incorporate their views of different corporate law into share prices. While this seems a plausible assumption, it too is by no means certain. Current corporate law leaves companies entirely free to determine their state of incorporation. Reincorporation in a new state typically requires approval of both the board of directors and the shareholders but otherwise is unrestricted. The shareholder vote, however, is largely a formality in practice—perhaps because investors take the sensible view that if you can't trust managers, who are the experts in running the company day to day, then you shouldn't be a shareholder in the first place, with the result that the electorate at any given time consists of those who have faith in current management. If the shareholder vote is a formality, then managers are largely in control of the reincorporation decision.

But if managers can change the state of incorporation pretty much at will, we are back in a market for lemons. Rational shareholders will assume that, whenever it matters, the corporation will be incorporated in the state that is most advantageous to managers. Paradoxically, that could well mean that regardless of where the company is incorporated, the stock market will price it as if it were in the least shareholder-friendly jurisdiction.[44] There isn't much

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deluded fools. In short, the connection between efficient corporate governance and stock market price (let alone business success) is loose at best. Where selection pressure is this weak, there is no reason to think that the results we see are the best we could have even with no innovation.

44. Extensive empirical research on the effects of reincorporation on stock market price have yielded what, to my eyes, look like remarkably inconclusive results. *See, e.g.*, Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002) (reviewing literature). The research is, thus, compatible with the interpretation I offer in the text. Of course, it is equally compatible with most of the alternative explanations. For example, markets generally tend to converge on one or two quite similar products (think of Coke and Pepsi); if state laws

point in paying for protection from rapacious managers if managers can choose to eliminate the protection whenever they please; the commitment simply isn't credible. On this story, the market price for shares would not include any bonus for corporate law protection—and the race-to-the-top mechanism would collapse.[45]

Third, much depends on the interpretation investors place on any given share-friendly or unfriendly situation. Rational investors are forward-looking, valuing investments based on predictions about future returns, not based on sunk costs. Accordingly, past problems are important only if they are predictors of future ones. If investors interpret past defections as the result of anomalous bad actors, a few arrests may convince them to view the problem as over and done with and not as predicting anything about the future. After all, Kenneth Lay, the disgraced CEO of Enron, is unlikely to have another chance to sink a public company. This understanding would break the link between past bad acts and stock price, thus eliminating both the market for lemons and the pressure towards a race to the top.

So too, if investors see the problem as one of a particular technique—the junk-bond-financed two-tier takeover, or improper accounting for off-balance sheet entities, for example—overcoming those particular problems may satisfy them. If problems are isolated and resolved, there is no reason to bid down the price of the stock, and (new) managers will not be penalized for the sins of the past or, for that matter, rewarded for choosing law that prevents them from defecting in new and unprecedented ways.

The race-to-the-top mechanism, in this instance, would be limited to eliminating specific known and identified problems after they have become well-known to the investor community. But if investors take these views, then so long as managers continue to turn over on a regular basis and can command the services of clever lawyers and bankers to find new (legal) distortions, we can expect to see regular crises, each dismissed by the market as an isolated case.

On this story, we will never see a race to the top, but we will not necessarily see a full market for lemons either. Americans are pretty trusting. Whether because a sucker is born every minute or because Charlie Brown-like

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are generally fairly similar (which is how they look to me), one would not expect to see dramatic pricing differences from changes. Alternatively, a thorough-going race-to-the-top theory might argue the exact opposite of my claim: Whenever it matters, corporations will choose the most pro-shareholder law, so one should price stock as if the firm had already reincorporated, much as the stock price of potential takeover targets often seems to reflect a view that it is inappropriate to pay now for pro-shareholder management that one expects to be installed later.

45. Of course, managers might still choose law that is attractive to shareholders, if shareholder and managerial interests are aligned. But the race-to-the-top theory says that those interests are aligned precisely because shareholders will pay managers to choose pro-shareholder law (or charge them for the reverse). This mechanism breaks down if shareholders will not pay extra for protection because they view it as ineffective.

investors keep believing that their Lucy-like managers will keep the faith this time, enough capital should continue to flow into the market to allow reasonable, if not optimal, function. Presumably, however, finance capital is more expensive than it could be were corporate law better able to convince more skeptical investors.

In contrast, if investors begin to conclude that what they suffer is a pattern, not isolated instances, matters are different. If defection appears to be routine, then it will seem reasonable to conclude that the problem is that the law is not powerful enough to control it. Corporate law, investors may conclude, puts managers in charge of investors' money and leaves it to them to decide whether to keep it or not. On this view, the stock market has a serious moral hazard problem and rational investors should avoid it.

For the race to the top to work, investors must conclude that managerial defection is predictable, systematically controllable, and differentially affected by different state corporate law. If they view defection as just a problem of isolated bad actors, they will not reward companies that provide systemic safeguards against it. Conversely, if they conclude that clever corporate lawyers, bankers and managers will always find a new (and as yet unpreventable) way to defect—so that corporate law will constantly be solving last year's problem—closing barn doors after the horses are gone, they will again not discriminate among companies based on choice of law. Investors who conclude that corporate law cannot help them should, in a self-fulfilling prophecy, destroy the very race-to-the-top mechanism that is supposed to save them. In short, if investors do not distinguish carefully between different legal regimes, concluding that some but not all can prevent defection, the incentives of the race to the top fail: Investors and honest managers will simply be caught in the low value trap of a market for lemons.

Fourth, "excess volatility" can destroy the race-to-the-top mechanism.[46] Many investors specialize in predicting not future returns but rather investor sentiment regarding future returns.[47] These "momentum" investors should have the effect of amplifying and distorting any changes they discern in underlying views, making the market more herd-like than it might otherwise be. Herds need to be where the grass is, but for each individual the safest place to be at any given time is the center of the herd. This combination of some need to be where food is and a more immediate need not to *be* food results in the difficult-

46. On volatility and its problems, see generally ROBERT J. SHILLER, IRRATIONAL EXUBERANCE (2000); ROBERT J. SHILLER, MARKET VOLATILITY (1989) (discussing excess volatility and its implications); GEORGE SOROS, GEORGE SOROS ON GLOBALIZATION (2002) (arguing that markets are inherently unstable).

47. JOHN MAYNARD KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 154-56 (1953) (describing stock market investors who pick not those stocks that they think will do best, but those that they think others will think that others will think will do best).

to-predict movements and sudden changes of direction of stampedes. In the market, fundamental value plays the same role as grass: In the long run, fundamental value is the nutrient that keeps investors alive, but in the meantime you can get killed by unexpected movements of the market, changes in liquidity, or simple trampling. A surer way to make money, if you can manage it, is to be in the front of the herd (or at least not at the back), an inherently competitive contest much like that created by the need of each wildebeest to be in the center of its herd. The result ought to be a market characterized by great volatility, lurching stampede-like from crisis to crisis.

But if market pricing is highly volatile and often based on herd movements rather than fundamental underpinnings, the race-to-the-top mechanism will not work. Any reasonably optimistic or Machiavellian CEO with a short time before retirement should be willing to gamble that the reduction of share value associated with his making himself rich by defection will be lost in the general noise of the market. Note that it doesn't even matter if he is right: So long as enough managers make this calculation or enough investors fear that managers will make this calculation—even if they are all wrong—we will not see a race to the top. Rational investors, fearing this type of miscalculation, will withdraw from the market or assume possible defections in their calculations, leading to low valuations.

Fifth, limited rationality could also interfere with the simple race-to-the-top story in another way: Investors may not be able to tell the difference between abuse and brilliant management. Indeed, there may not even be a difference. Over the last couple of decades, CEO compensation has increased to a truly extraordinary degree. CEOs are now taking a historically-unprecedented share of the corporate pie. But it is not clear, even post-Enron, that shareholders have necessarily suffered; they, too, seem to have done rather well. High CEO compensation, even if it is not closely tied to company results, likely has the effect of changing CEO class solidarity: They are now among the ultra-rich, not mere upper middle class working stiffs.[48] This should make it easier for CEOs

48. On the magnitude of recent CEO salary increases, see, for example, Susan J. Stabile, *One for A, Two for B, and Four Hundred for C: The Widening Gap in Pay Between Executives and Rank and File Workers*, 36 U. MICH. J.L. REFORM 115, 116 n.4 (2002) (stating that in 2000, average CEO compensation was 531 times the pay of the average blue collar worker). On the prior regime, in which CEOs were much closer in both wages and outlook to the middle managers they supervise, see, for example, JOHN K. GALBRAITH, THE NEW INDUSTRIAL STATE (1967) (describing an alliance of managers and organized labor in which the CEO role is as chief bureaucrat, not as an agent for shares). *See also* LAWRENCE MISHEL ET AL., STATE OF WORKING AMERICA 2004/2005, at 212-16 & fig. 2Y (2005) (stating that CEO compensation has risen from roughly 24 times average employee pay in 1965 to 300 times in 2000); *id.* at 113 tbl. 2.1 & 213 tbl. 2.46 (showing that while average real hourly wages increased by roughly 10% between 1989 and 2000, average CEO compensation increased by 342%). While twenty-times-average wages is quite generous compensation, it is still within the range of a successful doctor or other professional. Just as important, it is middle class in the basic sense that the recipient can maintain his lifestyle only by continuing to work. In contrast, at 300-plus times average pay, a CEO should quickly be able to live as well as the best-paid professional from investments alone.

to identify with shareholders and reduce any tendency to think of the "corporation" as those who work for it. And I need not rehearse the simpler financial incentives of massive stock and, even larger stock-option grants: A shareholding CEO has a powerful incentive to keep the stock price up at least until he can make a graceful exit.

If the stock market believes wealthy CEOs have similar interests to shareholders, then it has no need to demand credible commitments. Rather, shareholders may view their shareholding interests as best served by allowing top managers the maximum freedom of maneuver to work on behalf of themselves and their teammates, the shareholders (much as bondholders before junk bonds assumed that few contractual covenants were necessary; managers were likely to use any discretion in their mutual interest anyway). If the finance market bought this story, it would be likely to see little need for protection from managers and therefore to support managerial flexibility and discretion. Race to the top, then, would mean race to permissive, non-regulatory law.

But the story about the joint interests of managers and shareholders could very well be generally true and still a gross oversimplification. If the story of beneficent managers working for shareholders has a significant place in the collective Wall Street heart, there should be plenty of room for CEOs to abuse their positions without the market noticing.[49] So long as shareholders were making the extraordinary returns of the 1980s and 1990s, they were unlikely to look too closely at what managers were taking home. Indeed, before the late 1990s, it might even have seemed likely that the amount a top manager could possibly appropriate was trivial by comparison with the gains to shareholders of having managers firmly allied with capital against labor. Even if managers were grossly overpaid, there weren't enough of them to matter, or so investors might have imagined until quite near the end.

Thus, it is at least possible that the stock market could press for deregulation during boom times only to be astonished by the resulting abuses (which will not be highly visible until the next bust), accentuating market volatility without approaching any equilibrium level of regulatory restraint. This is particularly true because the end-game problem is endemic on Wall Street as well as in the CEO offices: In an industry where most players have very short expected job tenure, many may prefer to overlook known abuses, hoping to make their own pile before the house of cards collapses.[50]

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49. *See generally* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE (2004) (describing high managerial pay as a result of excessive managerial power).

50. There may also be lock-in effects resulting from the advantages of using Delaware law simply because everyone else uses and understands it. To the extent that corporations are locked in to Delaware, the race-to-the-bottom/top picture is weakened, since Delaware will have greater ability to change its law in directions that might not be attractive to corporate decision-makers. *Cf.* Bebchuk, *supra* note 5 (describing evidence that 'market' for competitive law is not very competitive). Delaware has little relationship to most of "its" corporations other than as sources for taxes and fees for the local bar;

D. *Summary: Gaming the Race to the Bottom/Top*

In summary, the race-to-the-bottom and race-to-the-top theories are closely related models of competition between managers and shareholders. Race-to-the-bottom theorists assume that management is relatively free to choose corporate law that allows it to exploit shareholders and other corporate participants. Race-to-the-top theorists contend, in contrast, that the market for shares and/or corporate control is sufficiently competitive to assure that shareholders can force managers to internalize the costs of any possible exploitation of shareholders, thus giving managers an incentive to choose corporate law that bars such exploitation (except, of course, where the benefits to managers outweigh the costs to shareholders).

Race to the bottom is easily generated in a one-shot game, race to the top in an infinitely repeating one. In the more complicated finite repeated game, however, the models can lead to potential races to the top, races to the bottom, or to market-for-lemon traps depending on relatively minor changes in the assumptions about market competitiveness and participant motives and rationality. Shareholders may be less rational than race-to-the-top theorists have assumed, unable to see the potential defections in advance and thus regularly surprised when managers find new ways to increase their share of the corporate pie. Or credible commitments may not be available: The very restrictions that would protect shareholders from managers would also make it impossible for managers to manage, so there is no value-maximizing choice. Empirical studies have found little evidence that share prices suffer when companies reincorporate in Delaware,[51] suggesting, perhaps, that Delaware law is no worse for shareholders than any other or, if the decision to reincorporate is largely in the hands of management, that the prospect of future reincorporation is already priced in, leaving little further price change for researchers to find. Finally, the empirical contingency of the assumptions necessary to generate a race to the top suggests little basis for an *a priori* conclusion that free choice of corporate law will drive the law towards any equilibrium, let alone optimality.

III. SITUATING THE RACE TO THE BOTTOM/TOP: CONCEPTUAL PROBLEMS

The agreement between proponents of the race-to-the-bottom and race-to-the-top theories far outweighs any disagreement. It is nearly universally acknowledged, first, that corporate law's evolution is relatively free of normal political processes; second, that the ability of corporate management to choose

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accordingly, lock-in, if it exists, seems most likely to produce higher Delaware incorporation fees. It is hard to imagine a Delaware political movement or lobbying group pressuring to move Delaware corporate law in some ideologically motivated direction. On the other hand, lock-in does create room for drift in corporate law based on intellectual fashions or Brownian motion in the Delaware courts.

51. *See, e.g.*, Bebchuk, *supra* note 5, at 592.

where the corporation will incorporate is virtually without extra-corporate law consequences; third, that corporate management is the proximate decision-maker and should be modeled as self-interestedly considering which corporate law will best promote managerial interests narrowly understood;[52] fourth, that states have effectively no ability to regulate management in ways that management perceives not to be in its self-interest; and fifth, that Delaware has created an effective mechanism for giving management what it seeks.

Most importantly for democratic theory, both sides of the race-to-the-bottom/top debate agree that it is effectively impossible for the voters of a particular state—or even every state—to introduce substantive regulation into corporate law. State voters cannot use corporate law, for example, to regulate friendly mergers; to limit limited liability; to make corporate managers politically answerable to line employees or customers; to demand that corporations replace or limit maximization of share value with other possible goals such as maximization of product quality or value, respect for status quo economic relations, improvement of employee quality of life or creditor or environmental protection; to require minimum capitalization; or the like (unless, of course, management finds such regulation attractive for some reason).

Only by overcoming the race to the bottom/top—generally by federalizing aspects of corporate law—has such regulation occurred. Thus, for example, ERISA changes limited liability and fiduciary duty rules;[53] bankruptcy law shifts fiduciary duties to non-shareholder participants;[54] Superfund modifies the usual rules for piercing the corporate veil;[55] the Wagner Act originally granted

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52. *But see* LAWRENCE MITCHELL, CORPORATE IRRESPONSIBILITY (2002) (contending, in the managerialist tradition, that managers granted sufficient discretion do, or would, consider the interests of the corporation broadly defined and society generally); Daniel J.H. Greenwood, Book Review, 12 LAW & POL. BK. REV. 201 (2002), http://www.bsos.umd.edu/gvpt/lpbr/subpages/reviews/mitchellci.html (reviewing MITCHELL, *supra*) (agreeing with Mitchell's analysis of the corporate governance problem but expressing some skepticism about his proposed solution).

53. 29 U.S.C. §§ 1100-1461 (2000). ERISA separates the pension plan from other corporate assets and then creates a trustee who owes a fiduciary duty as a matter of federal law to the "plan's participants and beneficiaries" rather than to the corporation and its shareholders. *Id.* § 1132 (creating entity liability for pension funds); *id.* § 1103(a) (requiring that plan assets be held in trust); *id.* § 1104 (setting out fiduciary standards).

ERISA also creates standards for contribution liability to a plan that differ from usual state corporate law rules, extending to a broadly defined control group that would not be liable under ordinary state corporate law doctrine. I.R.C. §§ 414(b), (c), 1563 (defining control group). Moreover, if a principal purpose of a merger or similar transaction is to evade contribution liability, any person participating in the transaction may be held to be a contributing employer liable for contributions if the plan is terminated within five years of the transaction, even though there would be no liability under state corporate law. 29 U.S.C. § 1369. In each case, the internal affairs doctrine is ignored.

54. 5 MATTHEW BENDER & CO., COLLIER BANKRUPTCY PRACTICE GUIDE ¶ 84.02 (2004) ("the fiduciary duties of a trustee [including a debtor in possession under Code § 1107] will run primarily to the debtor's creditors"); *id.* ¶ 84.03[1] ("debtor in possession becomes a fiduciary of the estate . . . exercising its powers in the best interest of creditors").

55. Superfund, CERCLA, 42 U.S.C. §§ 9601-75, has its own standards for veil-piercing that disregard state law standards that would be applicable under the internal affairs doctrine. CERCLA

substantial employee rights in corporate governance,[56] and so on. Indeed, even basic protection of shares against defecting managers, more often than not, has occurred outside of the race—basic information rights necessary to any exercise of control are found in the federal securities regime rather than the state laws, and it is the Williams Act, not the state laws, that primarily structures shareholder voting rights.[57]

Within this broad agreement, the debate is over whether in determining where to incorporate, corporate managements seek to maximize the freedom of action corporate law will give them vis-à-vis shareholders, or rather seek to publicly renounce that freedom in order to avoid having shareholders charge them for it. Common sense, and the contingency and complexity of the assumptions necessary to generate a determinate result in a finitely repeating game, suggest the same conclusion: No doubt, both happen.

In this Part, I raise three problems with the theory of the race to the bottom/top as a whole. Each addresses, from a different angle, the quasi-empirical claim that the race theorists agree upon: that our law is a product of market-like forces leading to a largely inevitable result (at least so long as the federal government fails to intervene). Although I will not fully develop any of these objections in this Article, they point the way toward a deeper understanding of the process.

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§ 107, 42 U.S.C. § 9607. While many courts interpret these standards to be largely similar to the usual state law rules, others do not. *See, e.g.*, Nurad, Inc. v. William E. Hooper & Sons Co., 966 F.2d 837, 842 (4th Cir. 1992) (holding the parent liable for a subsidiary corporation's actions even in the absence of actual control); United States v. Nicolet, Inc., 712 F. Supp. 1193, 1200-02 (E.D. Pa. 1989) (disregarding a parent's separate corporate existence under CERCLA without regard to corporate law doctrines); Vermont v. Staco, Inc., 684 F. Supp. 822, 831-32 (D. Vt. 1988) (holding, contrary to corporate law, that a parent is always liable for its subsidiary's CERCLA violations); *In re* Acushnet River Proceedings, 675 F. Supp. 22, 31 (D. Mass. 1987) (holding that CERCLA veil piercing does not implicate the "internal affairs" doctrine because veil piercing involves third-party rights). Similarly, CERCLA applies its own standards for successor liability, which some courts view as significantly different from the otherwise applicable state law standards. La. Pac. Corp. v. Asarco, Inc., 909 F.2d 1260 (9th Cir. 1990) (using federal "continuity of enterprise" approach); Gould, Inc. v. A & M Battery & Tire Serv., 950 F. Supp. 653, 657 (M.D. Pa. 1997) (setting out federal "substantial continuity" test); Allied Corp. v. Acme Solvents Reclaiming, Inc., 812 F. Supp. 124, 129 (N.D. Ill. 1993) (contrasting CERCLA approach to state law standards); *cf.* ELIZABETH GLASS GELTMAN, ENVIRONMENTAL LAW AND BUSINESS 670 (1994) (noting "almost irreconcilable tension between state corporation law and federal environmental statutes"). Even those courts that apply traditional doctrine do so as a matter of federal law without regard for the internal affairs doctrine. *See, e.g.*, United States v. W. Processing Co., 751 F. Supp. 902 (W.D. Wash. 1990) (applying traditional successor liability rules as a matter of federal law).

56. LMRA, 29 U.S.C. § 157 (guaranteeing employees certain governance rights in corporation, principally right to bargain collectively). The original intent of the Act, according to its sponsor, Senator Wagner, was to "promote 'democracy in industry.'" SAMUEL ESTREICHER & MICHAEL C. HARPER, CASES AND MATERIALS ON THE LAW GOVERNING THE EMPLOYMENT RELATIONSHIP 520 (2d ed. 1992).

57. This assumes—and it does not seem to be controversial—that the securities regulatory regime indeed has succeeded in enhancing the mutual interests of shareholders and managers by aiding the "maintenance of fair and honest markets [in securities]." Securities Exchange Act of 1934 § 2, 15 U.S.C. § 78b; *see, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78mm; *id.* § 14, 15 U.S.C. § 78n (regulating proxy solicitation); *id.* § 21A, 15 U.S.C. § 78u-1 (regulating insider trading).

A. *The Helpless States*

Both of the competition-between-the-states theories portray the states as largely passive participants in a system that is beyond their control. They are price-takers in the market for law. That is, they simply offer law and then sit back and see whether corporations will accept it. But this is deeply implausible: Markets exist only within a set of legal rules, and states typically make those rules.

In the standard accounts, the states are competing for tax revenues. When Delaware wins that competition, it is supporting its internal tax requirements by funds raised from corporations that exist out of state. When a corporation pays taxes, it is not always clear which human beings ultimately bear the burden of those taxes: Depending on the relative competitiveness of the various markets in which the corporation is active, the taxes could result in lower dividends, lower wages, higher product prices, or lower payments to lenders or suppliers. What is clear is that in the case of the typical Delaware corporation, few of those people will be Delaware citizens. Accordingly, Delaware is exporting its tax burden onto non-citizens.

This country fought a revolution on the issue of taxation without representation, so there is something more than slightly surprising about a model that gives Delaware the right and ability to tax the rest of us.[58] The issue of whether Delaware should have that right in a geographically-based federalist system I develop elsewhere. In this Section, I wish to focus not on the right but on the ability.

The race to the bottom/top immediately raises this question: Why do the other states put up with it? Why don't they simply opt out of the race by changing the rules? For example, they could take the civil law approach, deciding that corporations headquartered domestically, or with their principal places of business located in state, will be subject to domestic law.[59] Or they

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58. The ultimate burden of a tax on a corporation is a highly fact-dependent issue, contingent on the relative competitiveness of the various markets in which the corporation participates and the relative market power of its various factors of production. Delaware's tax may be something like a sales tax on products sold out of state, if it is ultimately borne by consumers (as would be the case in competitive market equilibrium). It may be an income tax on out-of-state employment, if it results in lower wages. It may be a capital tax on out-of-state investors, if it results in lower returns to bondholders or shareholders. In any event, to the extent that Delaware corporations are not in fact in Delaware, Delaware is successfully taxing Americans who have no vote in Delaware on economic activity that takes place outside of Delaware's borders. This is clearly in violation of the purpose, if not necessarily the doctrine, of the Interstate Commerce Clause.

59. *See* Kozyris, *supra* note 3, at 46-55 (describing the real seat doctrine); Alfred F. Conard, *The European Alternative to Uniformity in Corporation Laws*, 89 MICH. L. REV. 2150 (1991). The EU has largely sought to avoid the race to the bottom/top by focusing harmonization attempts on the creation of a unified corporate law at the EU level rather than on the mutual recognition of corporations organized under the disparate law of individual member-states. *See* David Charny, *Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 HARV. INT'L L.J. 423 (1991) (contrasting EU and American

could simply bar foreign corporations from doing business domestically, as current American law apparently permits them to do.[60] That might result in a system like some of the aspects of American banking law, with state-chartered subsidiaries of national parent companies, or perhaps federal incorporation for national firms. Or the states might have stuck to the early American view that a corporation has the citizenship of its shareholders and concluded that it ought to be governed by their law as well. Indeed, some states have refused to grant full recognition to foreign law with respect to corporations composed entirely of domestic citizens but incorporated elsewhere (so-called tramp corporations);[61] the arguments used in those cases could easily be extended to include any instance where the incorporating state has only a minimal connection with the firm.

One claim might be that states are economically too weak to impose their own law on corporations. The race to the bottom operates in many areas beyond corporate law—usually by means of capital flight or physical movement. Even in a counterfactual world without the internal affairs doctrine, corporations might still be able to choose their law by changing physical domiciles. But the tradeoff would be quite different. Under current law, a firm can determine its state of incorporation independent of such business decisions. High-tech firms may need to be in Silicon Valley or publishers in New York, but any corporation can incorporate in Delaware. Were law tied to location, most firms, most of the time, would find that legal regulation was insufficiently salient to determine their location. No doubt, if California law was vastly less attractive than Delaware's, some firms might physically move to Delaware, but in most cases, relocation would simply not be worth the costs.

Moreover, our economy is dominated by large firms operating in many different markets, or, more accurately in a single national American market that does not respect state boundaries. With respect to these firms, at least the large commercial states would have great ability to impose law were they to reject

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doctrine).

60. *Bank of Augusta v. Earle*, 38 U.S. (13 Pet.) 519 (1839), established that states may exclude foreign corporations from doing business or acquiring or holding property within their borders. After the enactment of the Fourteenth Amendment, the principle was reaffirmed in *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1869), which extended it to a broader doctrine that states could impose even discriminatory burdens on out-of-state corporations for the privilege of doing business. *Id.* at 181-82 (emphasizing that states must retain the right to limit the number and operation of corporations). This specific extension was rejected in *Southern Railway Co. v. Greene*, 216 U.S. 400 (1910) (barring discriminatory taxes as against foreign corporations already lawfully doing business in the state), although it seems to have been applied later in *Lincoln National Life Insurance Co. v. Read*, 325 U.S. 673 (1945). In any event, that line of cases does not question the underlying rule that a state may exclude foreign corporations altogether. *See, e.g.*, Metro. Life Ins. Co. v. Ward, 470 U.S. 869, 874-75 (1985). Modern equal protection doctrine and Dormant Commerce Clause doctrine might well bar a discriminatory rule applying different standards to out-of-state corporations than in-state ones. *See, e.g.*, Gen'l Motors v. Tracy, 519 U.S. 278, 298 n.12 & 299 (1997). But there is nothing discriminatory about requiring an out-of-state corporation to follow the same rules as domestic corporations.

61. *See supra* note 9.

the internal affairs doctrine. Car companies surely would not refuse to do business in New York, Illinois, or California just because their managers preferred some aspect of Delaware corporate law to the New York, Illinois, or California equivalent.

In short, capital flight no doubt would restrain a small and radical state to some degree. When Massachusetts's taxes get too high, a certain part of Boston's suburbs crosses the New Hampshire border; Utah's willingness to allow businesses to operate as they please similarly allows it to serve as a refuge from perceived excesses in California's more aggressive regulatory regimes. But this type of interstate competition operates at a vastly different level than current corporate law competition, where corporations choose their law with virtually no collateral costs at all. Even weaker states should have enough freedom of maneuver to abandon the race to Delaware without seeing significant parts of their economy decamp to Wilmington.

Alternatively, there could be some legal bar to abandoning the race to the bottom/top. This claim also seems incorrect. The doctrinal core of the race to the bottom/top is the internal affairs doctrine, which holds that a state will apply the corporate law of a corporation's state of incorporation, regardless of ordinary choice of law considerations. Under ordinary choice of law doctrine, it might be difficult to determine which state's law ought to apply to questions relating to national enterprises.[62] But generally it would be crystal clear that under no possible analysis would Delaware have the weightiest interest in enterprises that operate almost completely elsewhere. The issue, then, is whether the internal affairs doctrine bars states from opting out of the race. This it could do only if it were written in stone, in some sense unchangeable. It is not.

In general, modern versions of the internal affairs doctrine appeared near the turn of the twentieth century as common law, later codified. For example, the R.M.B.C.A. enacts the doctrine by defining "corporation" to exclude "foreign corporation"[63] and "foreign corporation" to mean "a corporation for profit incorporated under a law other than the law of this state."[64] The effect of these definitions is that every corporation incorporated in the enacting state is covered by that state's R.M.B.C.A. regardless of whether it is located or doing business there; conversely, all corporations incorporated elsewhere, regardless of whether they are located or doing business in the enacting state are foreign

62. *See infra* Subsection III.B.1.

63. REV. MODEL BUS. CORP. ACT [R.M.B.C.A.] § 1.40(4) (2002). The R.M.B.C.A. has been enacted more or less verbatim in a number of states and is closely followed in others. *See, e.g.*, Utah Revised Business Corporations Act, UTAH CODE ANN. ch. 16-10a (closely paralleling R.M.B.C.A.). The Uniform Limited Liability Act has almost precisely parallel structure: Each LLC is regulated by the law of the state in which its principals choose to organize.

64. R.M.B.C.A. § 1.40(10).

corporations not subject to the enacting state's R.M.B.C.A. In case the implications were not clear, the statute states it explicitly: "This Act does not authorize this state to regulate the organization or internal affairs of a foreign corporation authorized to transact business in this state."[65]

The very fact that the internal affairs doctrine is a product of statute or judge-made common law suggests that any state could reject it by simple legislation. And of course, no state can force another state to allow it to legislate extra-territorially simply by asserting that right in its corporations code. The internal affairs doctrine exists, then, only because each state enacts it, by common law or statute, and only so long as the state continues to accept it.

Some states have explicitly restated this limitation on the doctrine even as they have accepted it. Thus, for example, New York affirmatively asserts the right to legislate with respect to foreign corporations: "This chapter [i.e., the N.Y.B.C.L.] applies to every domestic corporation and to every foreign corporation which is authorized or does business in this state."[66] To be sure, having asserted the right to regulate, New York doesn't actually do so: Most provisions of the N.Y.B.C.L. apply only to corporations organized under the statute. Even where the language could be interpreted otherwise, New York courts consistently refer to the internal affairs doctrine. For example, section 626 of the N.Y.B.C.L. explicitly authorizes derivative actions with respect to foreign corporations, but most New York courts view this as a jurisdictional grant that does not affect the choice of law question.[67] The point remains: The internal affairs doctrine applies in New York to non-New York corporations only by the grace of the New York legislature and the acquiescence of the New York courts. There is nothing inevitable about New York's participation in the race to the bottom/top.

Even the more restrained language of the R.M.B.C.A. appears to recognize that the internal affairs doctrine is a matter for the host state's legislature: The

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65. *Id.* § 15.05(c).

66. N.Y. BUS. CORP. L. [N.Y.B.C.L.] § 103(a). (McKinney 2003).

67. *See, e.g.*, Miller v. Quincy, 72 N.E. 116 (N.Y. 1904) (holding that a derivative action against directors of a foreign corporation doing business in New York may be maintained in New York, in part out of fear that no other court would have personal jurisdiction over the directors, and rejecting the internal affairs doctrine—understood as a jurisdictional limitation, not a choice of law principle—as to actions that injure a citizen of New York); Miller v. Schreyer, 606 N.Y.S. 2d 642 (App. Div. 1994) (applying Delaware law to determine demand requirements in a derivative action, despite the explicit language of N.Y.B.C.L. § 626, which authorizes derivative actions with respect to foreign corporations); Pessin v. Chris-Craft Indus., Inc., 586 N.Y.S.2d 584 (App. Div. 1992) (acknowledging the doctrine while applying New York law to the question of whether shareholders of a Delaware corporation acquired their shares by operation of law in order to allow them to bring a derivative action under N.Y.B.C.L. § 626, which explicitly refers to foreign corporations); Hart v. Gen. Motors Corp., 517 N.Y.S.2d 490 (App. Div. 1987) (discussing the "fundamental" principle of the internal affairs doctrine); Tarlow v. Archbell, 47 N.Y.S.2d 3 (Sup. Ct. 1943) (holding that derivative action claiming that directors breached duty to corporation is not an internal affair, and applying New York law to demand requirement).

statement that "this Act does not authorize the state to regulate the organization or internal affairs of a foreign corporation"[68] clearly acknowledges the possibility that another chapter, or a differing statutory text, might so regulate.

Delaware has asserted that the internal affairs doctrine, and thus the race to the bottom/top, is constitutionally-mandated, a necessary consequence of our federal system and the commerce clause's bar on interstate discrimination.[69] Dicta in some Supreme Court decisions suggests the same thing (although the older opinions located the right in a different constitutional clause).[70] Full discussion of the Constitutional cases would require another article.[71]

Here, suffice it to note that the argument requires believing that federalist principles require states to allow Delaware to legislate with regard to matters entirely outside its borders. Surely this is a deeply implausible claim.

First, ordinary notions of sovereignty, even the limited variety we give our states, begin with the territorial principle that a state has primary authority over matters of economics, politics, and law occuring within its boundaries.

Second, ordinary notions of democracy require that the people affected by a law—here, clearly all those whose economic relations are determined by the existence, boundaries, governance rules, and policies of the corporation, and only rarely Delaware voters—have the ultimate say over it. If in fact "internal affairs" affected only shareholders and managers who had contractually agreed to adopt Delaware law, perhaps this would not be a concern. But, as Jed Rubenfeld puts it, "the problem with the internal affairs doctrine is essentially the same as the problem with John Stuart Mill's doctrine of self-regarding acts: There are none. No corporate affairs are ever exclusively 'internal'; they will always have consequences of greater or lesser magnitude on the 'outside' world."[72]

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68. R.M.B.C.A. § 15.05(c).

69. McDermott Inc. v. Lewis, 531 A.2d 206, 217 (Del. 1987) (holding that "application of the internal affairs doctrine is mandated by constitutional principles, except in 'the rarest situations'"). Delaware relied principally on the Commerce Clause, although it suggested that despite *Alaska Packers Ass'n v. Indus. Accident Comm'n*, 294 U.S. 532 (1935), the Full Faith and Credit clause might also support its argument. *McDermott*, 531 A.2d at 218.

70. Edgar v. MITE Corp., 457 U.S. 624, 645-46 (1982) (stating that the host state "has no interest in regulating the internal affairs of foreign corporations"); *cf.* Carney, *supra* note 8, at 312 (1997) (summarizing constitutional argument). The nineteenth-century cases analyzed the problem as one of comity rather than the Dormant Commerce Clause, perhaps because commerce was understood in its original narrow meaning of buying and selling. *Compare* Paul v. Virginia, 75 U.S. (8 Wall.) 168, 181 (1869) (holding that the Commerce Clause gave a corporation no right to do business in another state), *with* W. Union v. Kansas, 216 U.S. 1, 45 (1910) (first holding that the Commerce Clause might limit regulation of entry of foreign corporations). For further discussion, see the companion piece, EDWIN MERRICK DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860, at 157 n.11 (1954) (remarking that antebellum courts would not have found the Commerce Clause applicable).

71. *See* Jed Rubenfeld, *State Takeover Legislation and the Commerce Clause: The "Foreign" Corporations Problem*, 36 CLEV. ST. L. REV. 355 (1988) (demolishing claims that the Constitution enacts the internal affairs doctrine).

72. *See* Rubenfeld, *supra* note 71, at 376-77.

Finally, giving constitutional status to the internal affairs doctrine requires believing that this strange understanding of federalism is so fundamental that it is enshrined in a Constitution that, in all relevant parts, pre-dates the origin of the modern corporation and, of course, is absolutely silent on the subject.

Corporate law creates the corporation as an economic and legal actor, giving it the right to hold funds and other property, enter into contracts, author intellectual property, and commit torts. It determines which human beings speak for, represent, or make decisions for the corporation, by determining the authority of the board and its electors. Perhaps most important, it determines whom corporate decision-makers should view as the corporation and whom as outsiders. When fiduciary duty law (or accounting principles) state that profits are reduced by wages, interest, or price reductions but not by dividends, the message to corporate decision-makers is clear. Employees are outsiders, to be given as little as possible in arms-length market bargaining. Shares, in contrast, are insiders; transferring corporate funds to them does not make the corporation worse off. It is corporate fiduciary duty rules, not anything in the nature of the firm, that directs managers to consider giving money to shares fulfillment of their professional duty but providing value to consumers or wages to employees merely a tool to the end of profit.

Corporate law determines the responsibilities of the people who work for the corporation and influences whether they, in their jobs, will act as citizens thinking of the good of society or will view social norms merely as restraints to be avoided whenever convenient. It thus determines the ways in which the corporation will use the great discretion granted to it under general law, for whose benefit it will act, and how it will fulfill its role in our society. Legal personality and limited liability rules, in turn, determine the extent to which property and the humans responsible for it will or will not be available to respond to claims against the corporation.

Given this broad reach, constitutional minimum contacts jurisprudence clearly would put all corporate law within the reach of any state in which a corporation has business operations.[73] Thus, in the case of disputes about limited liability, states clearly could impose state law any time they can impose state law regarding the underlying contract or tort dispute. More broadly, however, ordinary minimum cnontacts jurisprudence would allow a state to impose local law regarding corporate decision-making whenever local jobs, factories, environmental regulation, financial investments or other local interests are impacted.

Finally, it could be argued that abolishing the internal affairs doctine, even if legally possible, would be completely impractical. If each state were to

73. *See* World-Wide Volkswagen Corp. v. Woodson, 444 U.S. 286 (1980) (setting out constitutionally-required minimum contacts necessary for state to assert jurisdiction).

impose its own law on corporations acting within its borders, certain complications would arise that are absent in the internal affairs system. More than under current corporate law, corporations existing and operating in different states would be subject to multiple and possibly inconsistent corporate law regulations. For example, corporate investors might be secondarily liable for corporate obligations in one state but not in another.[74] Similarly, one state might require that corporation decisions be made by a board elected by proportional representation of shares while others might bar such voting.[75] Connecticut already requires corporations to consider non-shareholder interests under some circumstances (although it provides no effective remedy for violations).[76] More radically, some states might decide to follow European norms and require representation of non-shareholder interests, while others no doubt would bar such systems.

But multistate businesses face such inconsistency in many areas, from state Blue Sky laws to environmental and labor laws. Dealing with the inconsistencies wouldn't be impossible. Presumably, most firms would find it possible to meet most regulatory regimes most of the time, just as they do in other regulatory areas today. For example, if one state were to limit limited liability for environmental torts in its jurisdiction, corporations would simply adjust their business plans to compensate, increasing precautions or holding larger insurance reserves in that state, for example. Or investors could adjust, holding firms that operate in the high liability state only in diversified portfolios or demanding higher compensation or greater supervisory rights due to the higher risk. Similarly, if one state followed Germany's lead and required employee representation on the corporate board, corporations doing business there could comply with that regulation without violating any provision of the generally quite flexible R.M.B.C.A. or Delaware codes.

Other types of inconsistencies might be more difficult for corporations. For example, different states in fact have had incompatible voting regimes for corporate boards. Different American states have both mandated and barred cumulative voting; a corporation would find it challenging to both have and not have cumulative voting.

But this type of inconsistent regulation is also not unknown. If compliance with differing state regimes was impossible or unduly difficult, corporations could create independently incorporated subsidiaries in each jurisdiction in

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74. *See infra* Subsection III.B.2.b (discussing historical variation in state definitions of limited liability).

75. *See infra* note 94 (discussing historical variation in state rules regarding cumulative voting).

76. *See supra* note 27 (discussing Connecticut constituency statute); *cf.* Norfolk S. Corp. v. Conrail, Inc., Nos. CIV.A. 96-7167, 96-7350, 1997 WL 33463657 (E.D. Pa Jan. 9, 1997) (interpreting Pennsylvania constituency statute to allow directors to place employee (and CEO!) interests ahead of shareholder interests in takeover context).

which they did business (as banks did as the ban on interstate banking began to break down and as insurance companies often do to comply with disparate state regulatory regimes). This would give us the advantages of federalism without the free choice of law, leading to a lack of legal restraints on power; tax exporting; and anti-democratic aspects of the current regime.

Alternatively, firms could seek a uniform state corporation code through the usual mechanisms. This is the regime under which multi-state law firms and other large partnerships exist; each state applies its own law, but most states apply something quite close to the Uniform Partnership Act or the Revised Uniform Partnership Act. We might then end up with a single state corporate law, but with the critical difference that every state legislature, not just Delaware's, would have the opportunity to vote on it.

Finally, multi-state corporations unwilling to operate through state-based subsidiaries could pressure for a federal incorporation law (as early railroads did, and as is the German model, where incorporation is considered a federal rather than a state responsibility).[77] We already have federal chartering for banks, so this would not be a radical innovation.

In short, neither economics, the nature of law, nor inconsistency problems prevent states from simply opting out of the race to the bottom/top and reclaiming both their sovereignty over difficult issues of social planning and over taxation of their citizens. A fuller account of the race to the bottom/top, then, must explain why states have not fought harder to retain their right to legislate. This Article does not explore that historical question, but it does argue that the time has come for states to reassert the rights they have abandoned. The race is not some inevitable aspect of federalism but rather an accidental byproduct of particular contingent facts. Were the major industrial states to conclude that the race is no longer in their interests or not in accord with their political or moral beliefs, they could simply and unilaterally put an end to it. Indeed, as we see in the next section, at the margins they have ignored it.

B. *The Inevitable Internal Affairs Doctrine*

If the first problem with the race to the bottom/top is that it is hard to understand why states don't simply opt out, the second is that the doctrinal basis for the race is extremely peculiar. Given that states have choice, the question here is the coherence of state law. The choice of law rule for corporations—that corporations choose their law by determining where to incorporate—is anomalous. Under ordinary doctrine, a forum state applying a comparative interests analysis would be hard pressed to conclude that Delaware

77. On railroads, see HOVENKAMP, *supra* note 10, at 247, 370 n.15; and GABRIEL KOLKO, RAILROADS AND REGULATION, 1877-1916, at 14 (1965).

had a stronger interest than the forum state in corporate actions taking place in the forum or affecting the citizens of the forum state. Courts and legislatures interested in making the law a consistent whole ought to question why we abandon the usual rules for corporations.

1. *An Anomalous Choice of Law Rule*

Ordinary choice of law doctrine presumes that the law of the forum state applies unless the weight of interests is clearly elsewhere.[78] In the usual course, courts would consider factors such as where the dispute arose, where the relevant agreements were made or carried out, which state's citizens would be most impacted by the adjudication or rule of law, where the parties are domiciled, and so on. In a case where the corporation's only contact with Delaware is its incorporation (with the statutorily required registered office and agent), none of these factors points to Delaware.

Conflicts analysis generally begins with the legal issue at stake. Were corporate "internal affairs" considered under the usual doctrine, the first issue would be characterizing particular disputes as tort, contract, or status—a difficult task, considering that corporate law partakes of all of these while borrowing most heavily from the law of limited sovereignty and self-government.

Some corporate law disputes seem to be obviously in the tort category: The most common "internal affairs" litigations probably are derivative actions for breach of duty of care or duty of loyalty, which are clearly negligence-type actions. Similarly, the "internal affairs" matter of limited liability also affects, at least implicitly, every tort action involving a corporation.

In a tort action, courts will look first to the interests of the states involved. The tort law of conflicts focuses on which state "has the most significant relationship to the occurrence and the parties," by looking to "(a) the place where the injury occurred, (b) the place where the conduct causing the injury occurred, (c) the domicil, residence, nationality, place of incorporation and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered."[79] Courts ask such questions as where the allegedly tortious conduct occurred—in most cases the state where the tort occurred is the state that will have the strongest interest in deterring such conduct or balancing deterrence against other values—or where the victim is domiciled or was injured—that state, or those states, will have the strongest interest in compensating the injured party or balancing the interests of

78. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 6 cmt. f (1971) ("In general, it is fitting that the state whose interests are most deeply affected should have its local law applied.").

79. *Id.* § 145(2).

compensation against competing interests of furthering economic activity.[80] Since these torts involve a relationship between the parties at least formally, the location or center of that relationship will also be important under ordinary tort conflict of law principles.[81] When a corporation doing business in New York injures a New Yorker, whether as a shareholder or in any other role, Delaware has no obvious interest in whether New York concludes that accurate pricing, compensating victims, deterring wrongdoers, or subsidizing accident-causing entrepreneurs is the most important tort value. Those are issues for the citizens of New York to decide, not Delaware (or the firm's managers).

Other corporate law internal affairs actions might be analyzed as contract disputes. For example, contract conflicts principles would apply when limited liability affects the performance of a contract. Disputes among shareholders or between shareholders and directors over the election of the board, for example, might be analyzed as closer to contract than tort, on the theory that corporate governance, at least as to shareholders and managers, can be analogized to a consensual, negotiated contractual agreement. Like many contracts, this agreement implicates both individuals and policies beyond its four corners, including the effects it has on corporate participants who are not participants in the "agreement." Usually, then, if corporate law were analyzed as contract, it would be analyzed as contract imbued with social significance. Contract conflict rules are more complicated than tort rules but again ultimately rest on the relative interests of the states involved.

In contract disputes, courts will give substantial weight to the law chosen by the parties (although never the dispositive weight of the internal affairs doctrine) to the extent that the parties could have determined the issue explicitly in their private agreement.[82] This is clearly the point where the internal affairs doctrine looks most like normal conflicts law: If corporate law were purely private contract law, the only relevant parties were shareholders and managers, and incorporation were equivalent to a private agreement with no public-policy implications, ordinary choice of law would reach a conclusion not unlike the internal affairs doctrine. But those qualifications are critical.

Absent the internal affairs doctrine, parties could not privately agree to grant themselves limited liability or to create a corporate enterprise with governance centered in an elected board and transferable voting rights. (At a minimum, that would require consent of each shareholder or perhaps each corporate participant, converting a corporation into something much more like a partnership.) The very creation of a corporation, then, should take corporate law out of the purely private sphere in which parties are allowed to choose their

80. *See id.* § 145 cmt. e.
81. *See id.* § 146.
82. *Id.* § 187(1).

own law without regard for state sovereignty or policies.

Beyond that fundamental limit on the right of the disputants to choose their own law, other conflicts principles significantly limit contracting parties' right to specify their own law outside of normal political processes. First, contracting parties may not specify a state that "lacks a substantial relationship to the parties or the transaction," which would exclude Delaware in most instances of Delaware corporations. Second, the forum state should ignore the parties' specification if "application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest."[83] As in tort, courts place great weight on location in determining the interests of the various states. The Restatement lists such factors as place of contracting, negotiation, and performance; location of the subject matter of the contract; and the same domicil-related factors important in tort.[84]

A court might also understand the issue not as a dispute between human beings located in specific places but as an issue of the existence or status of the corporation itself. Corporate law, then, would be closely analagous to other status relationships, and corporate choice of law might look like family choice of law. Like families, corporations are semi-autonomous, internally governed units in our law, where the state overtly intervenes mainly when something has gone seriously wrong or the usual internal dispute resolution mechanisms (operating in the shadow of state-created background rules) are malfunctioning.

Status relationships—principally divorce—have yet a third set of conflicts rules; here, the most important jurisdictional factor is domicil, but states may choose to hear disputes involving mere residents as well. Importantly for the corporate analogy, it is accepted that the "the fact that the spouses were married in the state should not of itself provide an adequate jurisdictional basis."[85] Moreover, a domiciliary state will apply its own local law to determine the right to a divorce.[86] The net result is that the key factor is domicil—which in the corporate context would more naturally mean the real location of the actual organization, rather than the legal formality of incorporation, which would be more analogous to the state that created the marriage.

Neither in tort nor in contract do these principles lead automatically to an obvious result in all corporate law disputes. But they point in a consistent direction away from Delaware. Disputes about how the company is run ought to be subject to the law of a state *where* the company is run, or a state that is affected by *how* the company is run, or a state where the *people* who run the company are located, or a state where the disputants' *relationship* is centered.

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83. *Id.* § 187(2)(b).
84. *Id.* § 188(2).
85. *Id.* § 72 cmt. b.
86. *Id.* § 285.

In the ordinary course, the choice under these principles would be among states where the corporation is headquartered (presumably the location of any breach by its managers or directors) or where its principal activities are located. Sometimes, the key factor arguably might be the state where the relationships were commenced—for disputes involving shareholders of publicly held corporations, presumably either New York where the stock exchange is located or the shareholders' home state where they initiated the relationship, or, again, the headquarters of the corporation where the relationship was consummated and centered. In any event, the state of incorporation is nearly irrelevant to any of these issues. If the corporate law issue is seen as a dispute between managers and shareholders (or indeed any other corporate participants), the key point ought to be where the human parties are located.

Similarly, a court applying status rules in the absence of the internal affairs doctrine to determine what law should apply to an issue of corporate existence or internal corporate decision-making (for example, who has the power to act on behalf of the corporation) might ask (as European courts do) where the corporation or its headquarters is physically located.[87] It might explore where the relevant agreements were made or were intended to be performed—where, for example, the relevant by-laws or corporate resolutions were negotiated or enacted. Presumably, it would ask which states' citizens were likely to be affected by the dispute or its resolution. It would then inquire whether fundamental policies of those states—including values of self-governance, employee protection and self-determination, economic growth and quality, responsibility for legal liabilities under tort, environmental protection law and (with a rather different set of issues) contract law, and so on—are implicated.

In short, under standard conflicts law, there might not be a single, clear answer to where the weight of the interests might be in disputes involving a national corporation. But usually it would be clear that Delaware has no interest at all because so few of the relevant human beings live in Delaware. When Delaware determines to whom corporate managers owe fiduciary duties, what the scope of limited liability is, whether shareholders should be imagined to be diversified portfolios as interested in a company's competitors' success as in its own, or whether Delaware corporations may vote their own stock, the humans affected by the decision—shareholders, managers, bondholders, employees, customers, suppliers, competitors, downwinders, or economic neighbors affected by the corporation—are almost certain to be located elsewhere.

Under the internal affairs doctrine as currently understood, of course, none of this is relevant. Choice of law is not an issue for courts to determine by comparing the interests of the forum state with that of other possible sovereign claimants. Instead, courts simply defer to the choices made by corporate

87. *See supra* text accompanying note 59.

decision-makers. Without that deference, the race to the bottom/top would not exist in its current form: States, no longer passive but active participants in a regulatory enterprise, would have to make decisions about which state is entitled to regulate which business enterprises (or, in the case of regional or national ones, which parts of them). Corporations unhappy with the corporate law of their host states would be forced to respond just as ordinary citizens respond to law they are unhappy with—by attempting to mobilize political forces to change the rules, by relocating to a different state, or by convincing the federal government to impose a uniform national standard.

2. *Defining "Internal"*

The gap between ordinary choice of law rules—which would not lead to the race—and the internal affairs doctrine means that the race to the bottom/top as we know it in corporate law depends intimately on the line created by the internal affairs doctrine. The boundary between internal affairs and ordinary choice of law is the boundary between ordinary politics and the "market for law" that distinguishes the race-to-the-bottom/top theories. If the distinction collapses, then either the race must turn into ordinary politics or vice versa. For without the internal/external distinction, any state could opt out of the race by declaring a particular regulation "external," or corporations could argue that any regulation was "internal" and ought to be binding only if chosen. Thus, the race to the bottom/top relies on strong agreement on which matters are "internal" and which are not.

Legal boundaries are places of conflict and dispute as a rule; maintaining distinctions, tweaking, pushing, and destroying them is most of what lawyers do. The internal affairs/conflict of law distinction is no different than the other famous distinctions around which legal debate centers: It is not only essential but debatable, contestable, and ultimately quite fragile. Current law cannot live without it, but it cannot depend on it either.

At first glance, there appears to be general agreement on what is covered by the internal affairs doctrine—the sorts of things that appear in the Revised Model Business Corporations Law, matters relating to the internal power relationships between shareholders, directors and managers. The R.M.B.C.A., for example, invokes this understanding of the doctrine in its reference to "organization or internal affairs of a foreign corporation." It then effectively defines internal affairs as "whatever matters are covered in the R.M.B.C.A."[88] by excluding foreign corporations from the scope of its regulation. But, appearances notwithstanding, there is no principled line that explains what is or

88. See the discussion of the way in which the R.M.B.C.A. enacts the doctrine, *supra* text accompanying notes 63-65.

is not part of corporations law nor what is or is not internal.[89]

If, as this Subsection demonstrates, the boundary of the internal affairs doctrine is contested and, ultimately, political, then it follows that the race to the bottom/top is not a natural feature of American law but rather a hidden political decision. Covert action is generally not a healthy way to make law in a democracy. The decision to abandon the task of determining the content of corporate law to corporate managers and Delaware voters is an intensely political decision that, to be justifiable, requires strong arguments against normal law, as we have seen in several areas. That decision ought to be made, if at all, only after a true political debate. But first we must establish that there is something to debate about—that the internal affairs doctrine is not simply a background fact of life.

a. Internal Corporate Law/External Securities Law

Many issues that seemingly relate to the relationship between shareholders and managers have been taken out of the race to the bottom/top by being declared something other than corporate law. Most importantly, perhaps, is the unusual American distinction between corporate and securities law. In most countries, securities regulation is considered part of companies law, and of course our corporations laws regulate many aspects of the rights and duties associated with corporate securities. However, we have removed large parts of securities law from the race to the bottom/top by simple reclassification. On the one hand, the federal government, through securities law, regulates most issues of shareholder rights to learn about internal corporate affairs ("disclosure")[90] including minimum accounting standards,[91] as well as many aspects of rights to sell the corporation or change the composition of its board of directors (tender offer and proxy solicitations).[92] On the other hand, states simultaneously regulate disclosure and other sale of securities issues without concern for the internal affairs rules by declaring Blue Sky law subject to ordinary choice of law doctrine.

Corporate law and federal securities law conceptualize the regulatory problem in largely distinct ways. In general, federal securities law conceives of shareholders as outsiders to the corporation. In effect, under federal law,

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89. *See* Rubenfeld, *supra* note 71, at 375-80 (pointing out the "fundamental incoherence in the internal affairs doctrine").

90. *See generally* Securities Act of 1933, 15 U.S.C. § 77 (2000); Securities Exchange Act of 1934, 15 U.S.C. § 78 (mandating various forms of disclosure, including of information that must be produced specifically in order to disclose it).

91. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. § 77m(b)(2)(A) (requiring books that "accurately and fairly reflect the transactions and dispositions of the assets of the issuer").

92. *See, e.g.*, *id.* § 77m(d) (requiring holder of beneficial interest in more than five percent of class of securities to publicly disclose such ownership and intentions); *id.* § 77n (regulating proxy solicitations in connection with corporate elections and tender offers).

shareholders are consumers of a product (securities) that is seen as particularly difficult to evaluate, so that consumers need a special type of truth-in-labeling protection. In contrast, state law more often treats shares as insiders—voter-citizens of a peculiar kind of limited republic.

Both regimes use the rhetoric of ownership, but in the federal regime, what shareholders own are shares, while in the state regime, they are sometimes spoken of as owning the corporation itself (although they generally have political rights rather than the rights normally associated with ownership). But even this distinction is not entirely clear. The federal Williams Act, for example, regulates that most-political of shareholder rights, the proxy contest to overthrow incumbent governors, in ways that go well beyond the usual federal conception of shareholders as benighted consumers in need of elaborate warning labels.[93]

Notwithstanding the differing rhetoric and metaphors of state and federal law, the line between corporate and securities law is basically arbitrary. Nothing in the nature of the corporation determines when public shareholders will be seen as consumers, entitled to protection without races to the bottom/top, or when as voters and owners under a state regime of voluntary law.

Similarly, some states have unilaterally declared particular issues not "internal." Thus, for example, California has mandated (while other states have banned) cumulative voting for directors without closely following the internal affairs doctrine.[94] New York and other states impose domestic rules regarding disclosure of the shareholders list—important mainly for the purely internal purpose of contesting the control of the corporation's decision-making machinery—on foreign corporations using ordinary choice of law analysis.[95]

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93. *See, e.g.*, Securities Exchange Act of 1934, 15 U.S.C. § 77n(d) (regulating the number of days a tender offer must be left open under various circumstances).

94. Currently, every state permits cumulative voting and two (Nebraska and Arkansas) mandate it. *See* Jeffrey N. Gordon, *Institutions as Relational Investors: A New Look at Cumulative Voting*, 94 COLUM. L. REV. 124 app. I (1994) (listing dates when each state first permitted or mandated cumulative voting). At various times in the past, twenty-five states have *mandated* cumulative voting. *Id.* (listing Alaska, Arizona, Arkansas, California, Colorado, Hawaii, Idaho, Illinois, Kansas, Kentucky, Michigan, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, North Carolina, North Dakota, Ohio, South Carolina, South Dakota, Washington, West Virginia and Wyoming as having mandated cumulative voting at some point). At common law, shareholders had one vote per person. State *ex rel.* Baumgardner v. Stockley, 13 N.E. 279, 281 (Ohio 1887) (holding that cumulative voting could exist only by statute). Accordingly, it appears that most or all states have also *barred* cumulative voting at some point in their history. During the period when California mandated cumulative voting, it applied its law to some corporations incorporated elsewhere, in disregard of the internal affairs doctrine. W. Air Lines v. Sobieski, 12 Cal. Rptr. 719 (Ct. App. 1961) (applying California's mandatory cumulative voting rule to a Delaware corporation); *see* DeMott, *supra* note 8, at 163 (discussing the internal affairs doctrine and its exceptions).

95. Sadler v. NCR Corp., 928 F.2d 48, 53-56 (2d Cir. 1991) (upholding New York's application of its shareholder disclosure list rules to a Maryland corporation). See DeMott, *supra* note 8, for further discussion. *See also* Jefferson Indus. Bank v. First Golden Bancorp., 762 P.2d 768, 769-70 (Colo. Ct. App. 1988) (applying Colorado's shareholder inspection rights statute to Delaware corporation);

New Jersey, in a famous case read in many introductory business organizations courses, imposed its own law of fiduciary obligation on a New York corporation existing in New Jersey.[96] New York did the same in a Cardozo decision.[97] Other states have also ignored the internal affairs doctrine from time to time.[98] Finally, nearly every state determines most managerial (as opposed to directorial) duties at least in part by agency law, following ordinary choice of law rules rather than the internal affairs doctrine.

b. Externalizing Internal Law

Conversely, some parts of the R.M.B.C.A. are "internal" only by the

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Havlicek v. Coast-to-Coast Analytical Servs., 46 Cal. Rptr. 2d 696, 699, 701 (Ct. App. 1995) (applying California Business Corporations Law § 1602 to a Delaware corporation to grant inspection rights).

96. Francis v. United Jersey Bank, 432 A.2d 814, 820 (N.J. 1981).

97. German-Am. Coffee Co. v. Diehl, 109 N.E. 875, 877 (N.Y. 1915) (allowing a New Jersey corporation to sue its directors for violating New York law by declaring an improper dividend, even though New Jersey law provided for no such suit: "Even if the prohibited act is done in the home state it may be so bound up in its results with the business in this state that we cannot view it with indifference."). As Professor Rubenfeld points out, allowing a corporation to sue its own directors is about as "internal" as affairs get. Rubenfeld, *supra* note 71, at 377 n.77.

98. *See, e.g.*, CAL. CORP. CODE § 2115 (West 2005) (regulating aspects of certain foreign corporations' internal affairs including selection, removal, fiduciary duties, liability and indemnification of directors; distribution of dividends; shareholder meetings; cumulative voting; rules regarding mergers, reorganizations, dissenters' rights, records and inspections; etc.); N.Y.B.C.L. §§ 1315-19 (regulating aspects of certain foreign corporations' internal affairs including dividend issuance, share repurchases, directorial loans, shareholder lists, mergers, derivative actions, and indemnification policies); *Sadler*, 928 F.2d at 53-56 (upholding N.Y.B.C.L. § 1315); Mansfield Hardwood Lumber Co. v. Johnson, 268 F.2d 317 (5th Cir. 1959) (rejecting internal affairs doctrine and applying Louisiana law of fiduciary duty to Delaware corporation); Norlin Corp. v. Rooney, Pace Inc. 744 F.2d 255 (2d Cir. 1984) (applying N.Y.B.C.L. provisions regarding derivative actions to a Panama corporation); Blazer v. Black, 196 F.2d 139, 146 (10th Cir. 1952) (applying Kansas law to a breach of fiduciary duty claim against directors of a dissolved Illinois corporation, without discussion of internal affairs doctrine); Int'l Ticket Scale Corp. v. United States, 165 F.2d 358, 359 (2d Cir. 1948) (applying New York law regarding improper dividends to a foreign corporation); Coyer v. Hemmer, 901 F. Supp. 872, 882 (D.N.J. 1995) (applying New Jersey law to pierce limited liability of a Delaware corporation while applying Delaware law to determine the need for demand in a derivative action); Tankersley v. Albright, 374 F. Supp. 538, 550 (N.D. Ill. 1974) (applying Illinois law to analyze the voting trust in a Delaware corporation); Stephenson v. Landegger, 337 F. Supp. 591, 593 (S.D.N.Y. 1971) (applying N.Y.B.C.L. provision regarding derivative actions to an Ohio corporation); Wilson v. La.-Pac. Res., Inc., 187 Cal. Rptr. 852 (Ct. App. 1982) (upholding against a constitutional challenge California Corporations Code provision governing cumulative voting in a Utah corporation); *W. Air Lines*, 12 Cal. Rptr. 719; Ficor, Inc. v. McHugh, 639 P.2d 385, 391 (Colo. 1982) (applying Colorado law to the dissolution of a D.C. corporation); Edwards v. Schillinger, 91 N.E. 1048, 1053 (Ill. 1910) (excluding "cheating creditors" from the internal affairs doctrine in connection with an improper dividend); State *ex rel.* Weede v. Bechtel, 31 N.W.2d 853, 864-65 (Iowa 1948) (applying Iowa law to a dispute regarding the voting rights of shareholders of a Delaware corporation); Booth v. Scott, 205 S.W. 633, 643 (Mo. 1918) (determining that an Arizona corporation did not exist in Missouri on the ground that Missouri corporate law required greater paid-in capital than Arizona, and holding purported incorporators liable as partners); Greenspun v. Lindley, 330 N.E.2d 79, 81 (N.Y. 1975) (rejecting "any automatic application of the so-called 'internal affairs' choice-of-law rule"); Joncas v. Krueger, 213 N.W.2d 1, 3-5 (Wis. 1973) (applying Wisconsin law to pierce the veil of foreign corporations in order to require a shareholder to pay unpaid back wages and noting that a similar New York statute was applied only to domestic corporations). For further discussion of these cases, see Jennifer J. Johnson, *Risky Business: Choice-of-Law and the Unincorporated Entity*, 1 J. SMALL & EMERGING BUS. L. 249, 272-75 nn.90-96 (1997); Elvin R. Latty, *Pseudo-Foreign Corporations*, 65 YALE L.J. 137, 150-55 (1955); and Rubenfeld, *supra* note 71, at 378.

wispiest of legal fictions.

i. *Limited Liability: Determining When There Is a "There" There*

The law of limited liability, usually found in business corporations laws, determines whether and to what extent the people associated with a corporation will be personally responsible for the contracts they enter into or the damages they cause while operating as a firm. In turn, that determines whether other "external" regulatory law has any meaning at all. If a corporation can be set up with no capital and only the corporation is liable for "its" contracts, torts, or environmental disasters, then nobody is liable at all. Limited liability, that is, determines if there is a "there" there, and thus whether the host state (not the incorporating state) will be able to effectively control its economic and other actors. For this reason, no doubt, both ERISA and Superfund ignore the internal affairs doctrine—to be effective, those statutes had to have their own rules of limited liability.[99] California, similarly, for many years refused to recognize full limited liability even when it was granted by the incorporating state.[100] Most states impose minimum capitalization rules on insurance companies operating domestically without regard to the internal affairs doctrine (which would leave that decision to the incorporating state); this too is a clear limitation of limited liability.

In general, the states have abandoned limited liability law to Delaware under the banner of the internal affairs doctrine, but there is nothing in the doctrine itself that explains why limited liability is an internal affair. After all, Delaware law generally treats corporate creditors as external, outsiders to a corporation conceived of as consisting, at least in the first instance, of its shareholders. Why should Delaware be allowed to determine the conditions under which investors in a business operating outside of the state should be allowed to decline responsibility for its torts and contracts?

ii. *The External Reach of Fiduciary Duty*

Similarly, fiduciary duty is hardly an "internal affair." Everyone, not just shareholders, is affected by how national businesses are run. The law of fiduciary obligation (and the rules of voting) determine to whom directors owe loyalty and for whom they manage the corporation. This "internal" rule

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99. See *supra* notes 53, 55 and accompanying text. These federal laws abrogate the internal affairs doctrine using Congressional Commerce Clause powers and the Supremacy Clause. States could reach the same end simply by repudiating the internal affairs doctrine or limiting its scope: As I demonstrate in the companion piece, the doctrine itself has no history or purpose that gives it Constitutional standing.

100. CAL. CIV. CODE § 322 (Deering 1886) (repealed 1931) (providing that shareholders are liable for pro rata portion of corporation's debts without regard to state of incorporation); Pinney v. Nelson, 183 U.S. 144 (1901) (upholding statute against shareholders of non-California corporation); *see* PHILLIP BLUMBERG, THE MULTINATIONAL CHALLENGE TO CORPORATION LAW 12-14 (1993) (discussing history of California exceptionalism).

determines how the corporation relates to its various participants—whether, for example, employees are seen as part of the enterprise or as outsiders to be exploited.[101]

Delaware corporate law instructs managers that their duty is to act in the best interests of the corporation and its shareholders but offers little guidance as to what interests the corporation might have apart from share value maximization.[102] However, Delaware law is quite clear that no non-shareholder has a claim on the loyalty of directors, since it grants no non-shareholder either standing or votes to influence those actions or represent those interests. Moreover, when the company is for sale, shareholders have an enforceable claim to exclusive loyalty.[103]

While we call these matters "internal," they hardly affect only shareholder/manager relations. Whether or not what is good for General Motors is good for America, it is definitely the case that what General Motors views as good for General Motors will affect every American. Fiduciary duty law tells General Motors decision-makers what they should view as "General Motors" and what they should view as "good" for General Motors. If it directed them to view global weather patterns as part of General Motors, or if it directed them to consider General Motors customers as constituents (as shareholders are) rather than outsiders (as employees are), perhaps General Motors would take a different view of mass transit. If it directed Wal-Mart to view its employees (or the employees of the factories that produce the products it sells) as as much a part of Wal-Mart as its shareholders are, surely the company would be quite different. The point is not that these changes in fiduciary duty would be sensible; some would not be. The point is that fiduciary duty affects the citizenry—it is not an "internal" affair.

At the margins, the law accepts the claim it ignores at the core. Thus, recognizing the arbitrariness of the claim that fiduciary duty is "internal" and private, of concern only to those who chose the applicable state law, federal bankruptcy law ignores the internal affairs doctrine and constructs its own, rather different, view of fiduciary obligation, in which bondholders—explicitly excluded from the corporation under *Revlon*—may demand that directors of insolvent or almost-insolvent corporations run the firm in their interests.[104]

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101. For further discussion of the significance of the insider/outsider line, see Greenwood, *supra* note 34, at 8, 15.

102. *See supra* text accompanying notes 24-30.

103. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (holding that when company is for sale, sole duty of directors is to maximize price at which shares will be sold); *see supra* note 28.

104. *See supra* note 54. The important point is that federal law ignores the internal affairs doctrine, not its substantive difference from otherwise applicable Delaware law. Delaware also accepts a similar shift in fiduciary duty even before insolvency, under the "troubled" company doctrine. *See, e.g.*, Geyer v. Ingersoll Publications Co., 621 A.2d 784, 787 (Del. 1992) (noting change of fiduciary duty near insolvency). *See generally* Gregory V. Varallo & Jesse A. Finkelstein, *Fiduciary Obligations of*

Fiduciary duty, in short, determines what a corporation's managers should view as "its" interests. That, in turn, should affect how it acts in the world—not merely relation to shares "internally" but in every aspect of its operations. External regulatory laws—such as environmental, civil rights, consumer protection, labor, tort or criminal law, or even contract rules requiring contracting parties to fulfill their promises—impose more-effective or less-effective external constraints on corporate decision-makers. Corporate law, in contrast, charges the decision-makers with a duty to use their freedom of action within those constraints to a particular end.

One key justification of the internal affairs doctrine is that it is simply a convenient rule of interpretation of a private contract—by incorporating in a particular state, shareholders and managers clearly signal their intent to be governed by the law of that state, and other states have little reason not to respect their choice. But that justification only works if the internal affairs are in fact internal in the sense of being important primarily to shareholders and managers. Because it determines these role obligations, fiduciary duty is not "internal" in that way. Rather, changes in corporate law change the basic decision-making process itself, a potentially far more powerful tool than changing the "external" regulatory constraints within which it functions.

iii. *Harnessing Fiduciary Duty: Who Is a Means and What Is an End?*

Under current norms, conscientious managers are likely to see a conflict between their role responsibilities and larger social duties: To be a good professional, one must set aside one's views as a citizen. The role of manager currently requires professionals to maximize share returns even at the expense of social good (although it probably does not require the manager to adopt any particular view of how best to maximize shareholder value and certainly does not require adopting the false view that share value is always best pursued by disregarding everyone else's interests). Indeed, Delaware norms suggest that managers "ought" to exploit loopholes, take advantage of non-shareholder corporate participants, and evade or perhaps even violate the law whenever doing so is profit-maximizing.

Within the professional managerial role, the argument must be about whether criminality or excessive decency is profit maximizing, not over whether Kantian imperatives require one to act morally even if the result is going to hurt the firm. Thus, corporate ethics debates center on whether it might not be profit enhancing to treat employees better or whether pollution is costly.[105] Optimistic theorists suggest that consumers might be able to

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Directors of the Financially Troubled Company, 48 BUS. L. 239 (1992).

105. For a recent example, see THE CORPORATION (Big Picture Media Corp. 2003) (highlighting, inter alia, the work of a CEO who is convinced that pollution control can be profitable).

overcome the limits of constrained rationality to purchase products based on their politics.[106] Less persuasively, ethicists even argue that shareholders might avoid the stock of companies that act contrary to their values, although most shareholders are institutions that would be in violation of their own fiduciary duties if they chose stock on any basis other than potential profit, and even a few such shareholders should be enough to ensure that stock prices reflect only perceived profit potential.

All these approaches accept the basic premise of current fiduciary law: Doing good is permitted only when profitable. Conversely, the share-centered profit norm of corporate law demands that managers cause the corporation to free-ride whenever profitable, even if they see and agree that it is wrong to do so.[107] Delaware corporate law, that is, encourages decent managers to act indecently.[108]

Thus, for example, under current corporate law, corporate funds expended to help the environment or the employees are classified as costs to the corporation. Conscientious managers are directed to minimize such costs. Corporate law tells them to do no more for the environment or employees than regulatory law (interpreted narrowly) requires, unless benefiting those outsiders would effectively increase gains for shares. In contrast, current corporate law counts a gain to the value of shares as a gain to the corporation: Corporate law directs managers to maximize, not minimize, this share value within regulatory constraints. If corporate law has any effect at all, it must be to urge managers to use their discretion to increase shareholder gains at the expense of environmental or other values whenever they conflict. Share value is an end, while all other participants and values are merely means to that end or legally imposed constraints on pursuing it.

Accordingly, a state serious about its environmental, consumer protection, tort, or contract law—or indeed any value that potentially conflicts with maximum returns to shares—might consider making one or more of those corporate claimants into beneficiaries of a corporate fiduciary duty or voting constituents of a corporate governing board. This change would dramatically

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106. Clearly, anything that makes it easier for consumers to do this would mitigate the problems of corporate law, even if it seems unlikely to do so fully. *See* Douglas A. Kysar, *Preferences for Processes: The Process/Product Distinction and the Regulation of Consumer Choice*, 118 HARV. L. REV. 525 (2004) (proposing informational labelling as an important part of merging citizen and consumer preference).

107. *See generally* MITCHELL, *supra* note 52 (describing public corporations as "externalizing machines").

108. This principle is usually put in nicer language, of course: A manager's first duty is to the owners of the business, who are assumed to want to make as much money as possible, and so the manager ought to put aside any personal views. *See, e.g.*, Bell v. Maryland, 378 U.S. 226 (1964) (discussed in Daniel J.H. Greenwood, *Fictional Shareholders: For Whom Are Corporate Managers Trustees, Revisited*, 69 S. CAL. L. REV. 1021, 1090 (1996) (generalizing from the problem of manager who claims that he must set aside his personal beliefs and discriminate in the interests of the corporation)).

change the decision-making process of conscientious professional managers. Fulfilling the spirit, not just the letter, of non-corporate law would now be their duty, rather than an arguable violation of fiduciary responsibilities to fictional shareholders. Conscientious managers, under this alternate corporate law regime, would seek to maximize, rather than minimize, the corporate resources going to these constituents. If the beneficiaries of this new duty had the right to enforce it in court or to politically oust directors who ignored it, even non-conscientious managers might find their role-demands radically changed. One cannot simply exploit a party who has a right to sue for breach of duty or an effective power to remove the exploiter from office. Thus, by opting out of the race to the bottom/top, states could harness the powerful incentives of corporate law to work for, rather than against, other legal norms.

iv. *The Limits of Law*

To be clear, it is important to note the limits of corporate law, including radically different corporate law that states might consider. In the end, the market constrains every firm. At equilibrium, where there is no firm surplus and firms must sell precisely at cost, corporate law fiduciary duties are largely irrelevant, for the simple reason that there is no difference between maximizing and minimizing: To sell anything at all, managers must sell at the lowest cost they can, which means they must minimize resources given to all corporate claimants, including shares or any alternative object of their fiduciary duty. Even when a corporation has some flexibility—where there is a corporate surplus to argue about—the basic market constraint limits any attempt to obey corporate law's mandate that managers exercise their discretion in the interests of one corporate claimant rather than another. If, under current law, a corporation gives too much to shares in the short run, its expenses will be too high for it to continue in existence in the long run.

Even were the object of corporate fiduciary duty to change, this constraint would not. Managers directed to maximize (for example) environmental values could do so only to the limited extent that the market did not penalize their product for having, for instance, higher costs or reduced quality and other corporate claimants lacked market power to increase their own take (just as managers directed under current law to maximize share value can do so only to the limited extent that the market does not penalize the product for higher costs, employees or the CEO do not succeed in taking higher wages or dilutive stock options, and so on).

Only the corporate surplus is at issue here. Markets are not usually at equilibrium, and successful corporations often have surplus; corporate law is not entirely empty.

The race to the bottom/top exists only so long as states accept the internal affairs doctrine and give it coherent meaning. But states have a choice about whether to accept the doctrine in the first place, and having accepted it, they

must interpret it. This Section has argued that almost every issue that could be considered "internal" has been declared "external" by some court at some point, for the simple reason that almost any issue involving corporate law impacts large and diverse groups of individuals beyond the ones empowered by corporate law or impacts public policy beyond corporate law itself. Corporate law helps define the job of those who run our economy; how could it be anything other than central to political concerns and public policy? Thus, the internal affairs doctrine, far from being inevitable, should be seen as an unfortunate, but reversible, delegation of state sovereignty to corporate managers.[109]

C. *The Thinness of the Race-to-the-Bottom/Top Analysis*

According to the conventional analysis, states compete in order to maximize tax revenues, but at the same time, they voluntarily accept the internal affairs doctrine as binding on themselves even though it allows Delaware to steal their tax revenues. This analysis is problematic. It make some sense for Delaware, which has no reason to care about other states' economic enterprises except as sources of tax revenue from non-voters. But as to other states, the race, if it exists, cannot be the simple competition for tax revenues the models postulate. Were the states as mutually exploitative as the model suggests, and were the race in fact about taxes, New York would simply pass a law requiring corporations doing business in New York to incorporate in New York, and that would be the end of Delaware's dominance. Something else is going on here that is not properly modeled in the rational game theory approach.

I do not propose to offer a full alternative motivation for the states' general acquiescence in Delaware's rules of the incorporation game. My best guess is that the states have not resisted the race to the bottom/top more vigorously for reasons that are not entirely rational—a perception that the internal affairs doctrine is more coherent and more fundamental than it is, a failure to think clearly about alternatives—and for reasons that are related to the difficulties American politics often has with controversial issues.

Were states to opt out of the race to the bottom/top, they would need to have controversial debates about the proper content and purpose of corporate law. Why, for example, does our democratic system allow massively important enterprises to operate in an entirely undemocratic way, in which most

109. I set aside for another day the interesting question of whether the internal affairs doctrine is itself unconstitutional as a violation of federalism or republican form of government principles. Were a state explicitly to delegate law-making power either to Delaware or to corporate managers answerable to the stock market but not to the state's voters, the courts would have no trouble finding a constitutional violation. Our legislatures are supposed to be elected, not purchased. The internal affairs doctrine is in effect the same delegation, but concealed and therefore even more suspect.

participants have no vote at all, and the shareholders, who do, vote based not on equality of citizenship but on pure wealth?[110] Why do we tell administrators of major institutions that they are free to seek ways to evade the law—environmental law, tax law, health law, tort law—rather than requiring them to find ways to meet not only its letter but its spirit? There are answers to these questions, and in some cases, the status quo may well be more defensible than any available alternative. But a democratic republic of self-governing citizens will have varying views.

And that is the rub. These are divisive issues. It may well be that state politicians are just as happy to avoid the whole debate by pretending that they have no choice anyway. Alternatively, and more cynically, perhaps the problem is that powerful and wealthy corporations and their lobbyists have every reason to defend the internal affairs doctrine, which places corporate governance beyond the law, while no comparably wealthy and organized group presses the issue on the other side.

In either case, however, the race to the bottom/top, with its image of helpless states unable to do anything but offer corporate managers what they want, is radically incomplete. The states are complicit in this loss of their sovereignty, not just victims.

D. *Do Shareholders Hire Managers?*

The final puzzle with respect to the race to the bottom/top is the image of the corporation that seems to underpin it.

The race-to-the-bottom/top theories assume a model of the corporation in which shareholders "hire" directors and managers as their agents. On this view, the key problem for the law is whether management is acting as a faithful agent of shareholders: The race is to the "top" when managers work for shareholders and to the "bottom" when they do not. Similarly, the bottom/top debate depends in large part on whether shareholders, as the principals, are effectively able to police managers or whether they need additional legal assistance to do so.

Modern finance theory, however, suggests that there is no particular reason to conceptualize shareholders as hiring managers. One could equally-well think of the process as the other way around: managers hiring investors. In a competitive market at equilibrium, the characterization should not matter.

1. *The Asymmetry of Agency*

For lawyers (as opposed to economists), it makes an enormous difference

110. So-called "shareholder democracy" is more properly "share plutocracy." The governing principle is not one shareholder one vote, but one share one vote.

who is hiring whom. Stating that one party hires another invokes a clear set of radically asymmetric default rules. Hiring creates an employer/employee relationship, which is a type of principal/agent relationship. The basic elements of an agency relationship are that the principal has the right to direct the agent;[111] the agent can bind the principal;[112] the agent has a duty to act on behalf of the principal;[113] and the relationship is terminable at will by either party regardless of contractual agreement to the contrary.[114] The first three are each asymmetric in principle; the last is asymmetric in fact.

Because of these basic rules of agency, an employment relationship will be interpreted to grant the employer/principal the right to control and direct its employees/agents and the conditions under which work is performed, but not the reverse.[115] The employer/principal will be bound by acts of its employees/agents (contract making and tortfeasing within the scope of the relationship), but not the other way around.[116] Each employee/agent will be understood to have assumed the obligation to act on behalf of and in the interests of the employer/principal, and the reverse will not be true.[117] Employers have presumptive rights to retain trade secrets after termination of the relationship; employees do not.[118] The employer will own things employees make and have at least a claim to employees' ideas, thoughts, and knowledge—never the reverse.[119] The employer will have the right to inspect employees' work, read their correspondence, snoop in their work areas, and monitor their conversations; the reverse will not be true.[120] In Europe and in the unionized

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111. RESTATEMENT (SECOND) OF AGENCY §§ 1(1), 14 (1958).

112. *Id.* §§ 1(1), 12.

113. *Id.* § 13.

114. *Id.* § 118; RESTATEMENT (THIRD) OF AGENCY § 1.01 (Tentative Draft No. 1, 2000).

115. Eyerman v. MaryKay Cosmetics, Inc., 967 F.2d 213, 219 (6th Cir. 1992) (discussing an employer's right of control over its employee as opposed to lack of control over contractors). No legal doctrine would give an employee control over the employer.

116. Meyer v. Holley, 537 U.S. 280, 285-86 (2003) (holding real estate company liable under "traditional agency principals" for acts of sales agent who obstructed the sale of a house to racially mixed couple). Agents, of course, are not liable for the acts of the master. *See, e.g.*, Corpus Christi Dev. Co. v. Carlton, 644 S.W.2d 521, 523 (Tex. App. 1982) (noting the general rule that a disclosed agent is not liable for contracts entered into on behalf of a principal).

117. AGA Aktiebolog v. ABA Optical Corp., 441 F. Supp. 747, 754 (E.D.N.Y. 1977) ("[Employee] owed a fiduciary duty to his employer and was prohibited while employed from acting in any manner inconsistent with the agency or trust relationship. He was at all times bound to exercise the utmost good faith and loyalty in the performance of his duties."). Employers owe no fiduciary duty to employees. *See* RESTATEMENT (THIRD) OF AGENCY § 1.01 (stating that the obligations that a principal owes an agent are not fiduciary).

118. N. Atl. Instruments, Inc. v. Haber, 188 F.3d 38, 47 (2d Cir. 1999) ("As explained below, New York law imposes a duty not to use trade secrets in competition with a former employer, and the Employment Agreement clearly reinforces this duty, requiring that Haber keep all trade secrets and client lists strictly confidential. Accordingly, we affirm on this point . . . .").

119. *See* Eaton Corp. v. Geire, 971 F.2d 136 (8th Cir. 1992) (barring an employee, even in absence of a trade secret agreement, from showing his design drawings to his own potential future clients).

120. Smyth v. Pillsbury Co., 914 F. Supp. 97 (E.D. Pa. 1996) (holding that an employer did not violate an employee's privacy by reading the employee's e-mail).

sector of America, even the formal symmetry of agency termination may not extend to employment relations: The employer often will be restricted in its ability to terminate the relationship, but the reverse normally will not be the case.[121] Similarly, civil rights concepts usually will restrict the employer's freedom of action in hiring and firing but not that of employees (for example, there is no civil rights action against an employee who quits out of racial animus).[122]

To be sure, many of these are only default rules, and in theory one could draft a contract that would vary them. But lawyers assume that default rules that go with a status will normally govern large parts of the relationship. Smart lawyers who are unhappy with the results a set of default rules generates usually will begin by attempting to find an alternative status relationship to enter into rather than attempting to shift the default rules radically; courts are likely to read the default rules back into the relationship even when contracts are drafted to keep them out.[123] If you don't like the asymmetry of the employee/employer relationship, ordinarily you are better off thinking about partnership than trying to draft around the default rules.[124] Thus, the claim that

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121. Union agreements, of course, often restrict the employer's ability to fire without cause and may provide that wrongfully discharged employees can regain their position. *See, e.g.*, Note, *Protecting Employees at Will Against Wrongful Discharge: The Public Policy Exception*, 96 HARV. L. REV. 1931, 1934 (1983) (noting that union agreements often prohibit the firing of unionized employees except for cause). Employees, however, remain free to quit, even in violation of their contract and the sole remedy an employer will be given is damages; forcing an employee to work might well raise Thirteenth Amendment issues. *Cf.* Stevens v. G.L. Rugo & Sons, 209 F.2d 135, 142 (1st Cir. 1954) (upholding a "permanent employment contract" while noting that the employee remained free to quit at will). On European norms, see, for example, Bob Hepple, *European Rules on Dismissal Law?*, 18 COMP. LAB. L.J. 204 (1997).

122. Thomas v. Eastman Kodak Co., 183 F.3d 38 (1st Cir. 1999) (holding that employer's disparate treatment of employees based on race can be based on an unconscious bias). Employees, of course, are free to quit even based on conscious bias. Similarly, discharged employees who prevail on a discrimination claim may be entitled to injunctive relief restoring them to their jobs. Even were employee discrimination against the employer actionable and were an employer to prove "discriminatory quitting," injunctive relief is inconceivable.

123. *See, e.g.*, Morris Oil v. Rainbow Oilfield Trucking Inc, 741 P.2d 840 (N.M. 1987) (finding principal liable for debts of undisclosed agent despite contractual terms); Rapoport v. 55 Perry Co., 376 N.Y.S.2d 147 (App. Div. 1975) (reading contractual terms in light of background UPA rule); Donahue v. Rodd Electrotype, 328 N.E.2d 505 (Mass. 1975) (imposing fiduciary duties on controlling shareholders despite formal legality of challenged actions), McQuade v. Stoneham, 189 N.E. 234 (N.Y. 1934) (refusing to enforce shareholders' contractual agreement to appoint one of them as treasurer). *But see* Martin v. Peyton, 158 N.E. 77 (N.Y. 1927) (rejecting creditors' claim that standard partnership terms should be imposed where contractual agreement was not framed as a partnership). Indeed, the power of the default rules is so strong that courts read them back into even statutory attempts at reform: Consider, for example, the power of the termination-at-will rule in interpretation of the civil rights statutes. *See, e.g.*, Chad Derum & Karen Engle, *The Rise of the Personal Animosity Presumption in Title VII and the Return to "No Cause" Employment*, 81 TEX. L. REV. 1177 (2003) (demonstrating influence of termination-at-will rule on civil rights jurisprudence).

124. "Ordinarily" and "normally" are strong words here. Highly paid lawyers are highly paid precisely because they spend most of their time in the non-ordinary and non-normal circumstance, where there are other constraints, for example regulatory or tax rules that depend on being in one box rather than another, that make fighting the law's categories fun and profitable.

shareholders hire managers is for lawyers a claim that, unless otherwise agreed, shareholders will have the right to order managers around, that managers have a fiduciary duty to work for shareholders, and so on.

2. *Economic Symmetry*

In contrast, for economists thinking about ideally competitive markets, managers and shareholders are each parties to a "contract" the terms of which are set by market processes. In the frictionless world at equilibrium, all terms are negotiable and both parties must agree to them. Each side is equally free and default rules have no special weight: As Coase demonstrated, they'll simply be changed to put the costs on the party best able to bear them.[125]

Thus, for economists describing competitive market equilibrium, "contracts" are necessarily symmetrical. If investors and managers are negotiating the terms of a relationship, there is no a priori reason to assume that they must agree that investors should control managers rather than the other way around. Since all contract terms are up for grabs, the agreement may well have aspects of both managers hiring capital and the other way around—or it may be simply arbitrary which way we choose to describe it.[126] Indeed, ordinary language is almost as equivocal as the economists' theory: We speak of shareholders "owning" the company, but also of companies "selling" stock—which suggests either that shareholders are mere consumers (and thus outsiders, in an arms-length non-fiduciary relationship) buying a corporate product, or that management (on behalf of the corporation) is renting or buying capital for its use. In this view, management can be seen as hiring shareholders.

3. *Metaphors and the Law: Is There Any Agency Here?*

Of course, neither shareholders hiring managers nor the reverse image bears much resemblance to actual corporate law.[127] Corporate lawyers speak loosely in metaphors of ownership, agency, and trust to discuss the manager/shareholder relationship, but at least with respect to public corporations, the relationship has virtually none of the characteristics of ownership, agency or trust. Managers, of course, are agents of the corporation in the full sense of the legal term: They are subject to the corporation's control, they can bind the corporation, they have a duty to act on behalf of the

125. For my complaints about Coase, see Daniel J.H. Greenwood, *Beyond the Counter-Majoritarian Difficulty*, 53 RUTGERS L. REV. 781 (2001).

126. *See, e.g.*, HENRY HANSMANN, THE OWNERSHIP OF ENTERPRISE 83 (1996) (describing why workers might choose to hire a boss rather than be self-governing); Blair & Stout, *supra* note 34 (offering a different set of reasons for workers to hire a boss); Stephen A. Marglin, *What Do Bosses Do?: The Origins and Functions of Hierarchy in Capitalist Production*, 6 REV. RADICAL POL. ECON. 60 (1974) (providing a similar account characterized as a power struggle).

127. For further discussion, see Greenwood, *supra* note 108.

corporation, and they can quit or be terminated at will regardless of contract. But the principal in this agency relationship is the corporation as a legal entity and the only party that can act as the corporation directly (rather than as its agent) is its board of directors.

Shareholders, on the other hand, are not in an agency relationship with either the firm or its directors and managers. First, the relationship lacks the basic agency element of control. It is blackletter law in Delaware and elsewhere that the directors have original, undelegated power to run public corporations.[128] Shareholders have no right to direct or control the corporation, its board or its managers; the populist devices of instruction and referendum have no corporate law equivalent. Indeed, even with respect to issues on which shareholders have the collective right to vote, it is a derogation of duty for directors to allow a proposal to go to the shareholders until the board has made an independent, informed business judgment that the proposal is in the best interests of the corporation and its shareholders.[129] Conversely, the managers, the directors, and the corporation have no right to direct or control shareholders.

Second, shareholders have no right to bind a public corporation, its directors, or its managers. And conversely, the corporation, its directors, and its managers have no power to bind shareholders—that is the key point of both legal personality and limited liability. To be sure, the managers, as agents of the corporation, may bind the corporation, and the board of directors may act as the corporation, and if the corporation fails, shareholders will suffer too. But all corporate participants are at risk of losing the investment they have made in the corporation. In this respect, bondholders are only quantitatively different from shareholders: The corporation has to fail more thoroughly to hurt them. Employees and even customers or suppliers are likely to have made specific investments in a given firm that are at risk if the firm fails. An employee will lose the economic value of firm-specific skills (for example, explicit privileges of intra-firm seniority or the implicit value of increased productivity resulting from understanding the best ways to manage the strengths and weaknesses of particular organizations), while customers and suppliers may have firm specific investments at risk. If Microsoft were to fail, everyone who depends on Windows and Windows-based programs or on the Seattle real estate market

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128. DEL. CODE ANN. tit. 8, § 141(a) (2001) ("The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors . . . .").

129. Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (holding that directors may not allow shareholders to vote on proposed fundamental change without directors' first exercising independent judgment and concluding that proposal should be approved). Closely held corporations operate under a different legal regime in which shareholders have more of the rights of owners and directors are closer to their agents. *See, e.g.*, Galler v. Galler, 203 N.E.2d 577 (Ill. 1964) (upholding shareholder agreement in close corporation that would be void in a public one due to close shareholder's status as "more than a mere investor").

would suffer, not just Microsoft's shareholders.[130]

Indeed, given the ease with which shareholders can diversify, it seems likely that other firm participants will often suffer more than shareholders. So long as the corporation is separate from its shareholders, there is no reason to jump from the fact that directors bind the corporation to the unsupportable claim that they bind shareholders.[131]

Third, unlike agents or employees, shareholders of public corporations have no duty to consider the interests of the corporation, let alone its directors or managers, either in their shareholder role or outside it. Ordinarily, for example, they are perfectly free to compete with the firm. Indeed, a minority shareholder invested in a competitor would breach no duty if it voted in favor of a directorial candidate who promised to destroy the firm (although if elected, the candidate would breach her duty if she kept the promise).

Less obviously perhaps, the reverse is also true. The duty of the board and managers to act in the interests of the corporation and its shareholders bears little similarity to the duty they would owe shareholders were they the shareholders' agents. First, the business judgment rule ordinarily precludes judicial investigation of most directorial action. Even beyond the business judgment rule, most courts clearly understand the duty to the "corporation" to be something different from the duty to "shareholders," so that except in the limited sphere of *Revlon* duties, directors may defend actions that are not in the interest of shares as nonetheless in the interests of the corporation.[132]

Finally, even in the limited circumstances where courts do require directors to act in "shareholder" interests, they never treat shareholders as principals or even trust beneficiaries. Instead, the interests to which they hold managers are pure legal constructs, determined by legally stripping shareholders (or the human beings behind corporate shareholders) of every aspect of their individual personalities, individual interests, and individual will, beliefs, desires, and needs, and even of their actual investment portfolios, leaving only undiversified share ownership. That is, the duty is owed to the corporation and its "shares," not its shareholders.[133] It is no defense to a breach-of-duty claim for managers to establish that their shareholders are, in fact, more heavily invested in the firm

130. On the importance of firm-specific investments as justification for the distinctive rights of shareholders, see OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 33, 53 (1985). Contrary to Williamson, however, shareholders are rarely the corporate participant most subject to lock-in. Indeed, since shareholders can diversify more easily than other corporate participants, they are often the least susceptible to opportunistic expropriation.

131. *See, e.g.*, Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1, 25 n.101 (1996) (noting that no court has ever disregarded the entity of a publicly held corporation).

132. Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (creating duty to maximize share value in narrow circumstances); Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989) (using an extremely broad understanding of the interests of the corporation to defeat claims that managers where not acting in interests of shares).

133. *See* Greenwood, *supra* note 108 (discussing implications of the fictionality of shareholders).

as employees so that they would prefer high wages to high dividends or that they have portfolios so heavily invested in the firm's competitors that running the company into the ground would benefit them. Indeed, the facts in *Revlon* itself suggest that most of the shareholders must also have been bondholders. The case normally cited as the strongest support for a shareholder-centered view of the corporation therefore stands for the proposition that directors must work for *share* interests even if *shareholders* might prefer otherwise.[134] Shareholders are disempowered.

Finally, the last basic element of agency is missing as well. Neither shareholders nor directors can terminate the relationship at will. An individual shareholder can exit without permission, but only by finding another shareholder to replace it: The share (and the limited duty owed to it) remains unchanged. Collectively, shareholders cannot exit the firm without a resolution of the directors approving dissolution, merger, or reorganization and recapitalization.[135] Similarly, the directors have no right to "terminate" shareholders without their vote: Squeeze-outs are frowned upon and never available without approval of the majority of the shares. Thus, the shares can neither exit nor be forced out without consent of both sides. In the other direction, shareholders have no power to terminate directors except as provided by the articles of incorporation—quite unlike the principal of an agent, who may terminate regardless of any contract to the contrary.[136]

In sum, the board acting collectively, not shareholders, has the sole right to manage the firm and to act for it directly rather than as an agent; managers are hired by and are agents of the corporation, not of shareholders; shareholders

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134. *Revlon*, 506 A.2d 173.

135. *See, e.g.*, R.M.B.C.A. § 10.03 (amendment to articles of incorporation requires approval of board); *id.* § 11.04 (plan of merger or share exchange must be approved by board); *id.* § 12.02(b) (disposition of substantially all assets must be initiated by resolution of board); *id.* § 14.02(b) (proposal to dissolve must be recommended by board). Formerly, there was one exception to the general rule that shareholders may not initiate any action that would fundamentally change the shareholder/firm relationship: Shareholders could sell their shares to a single owner who would thereby be able to move the company from the public to the close category. The poison pill and its statutory equivalents, *see, e.g.*, DEL. CODE ANN., tit. 8, § 203 (2001), eliminate that exception in practice by making it prohibitively expensive for a potential acquirer to purchase the shares without prior consent of the target company's board.

136. Under the default rules, shareholders may terminate a director without cause at the end of her term, typically one year, except where the corporation has a staggered board. But they may do so only at an annual meeting, a special meeting called for that purpose, or by unanimous consent in lieu of meeting, and corporations are authorized to restrict the manners in which shareholders may call for special meetings. R.M.B.C.A. § 8.03(c) (providing for terms of directors); *id.* § 8.08(d) (limiting shareholder removal of directors to action at an annual meeting or a meeting called for that purpose); *id.* § 7.02 (regulating shareholders' ability to call special meetings). *Cf.* DEL. CODE ANN., tit. 8, § 211 (permitting special meetings only at discretion of board). All this is quite different from agency law, where the relationship is terminable at will at any time and contractual limitations only create an action for damages. *See* RESTATEMENT (THIRD) OF AGENCY § 3.06 (Tentative Draft No. 2, 2001) (absolute right to terminate agency relationship); UNIF. P'SHIP ACT § 31 (1914) (noting the absolute right of a partner to dissolve a partnership, even in contravention of an agreement).

cannot act for the corporation, dispose of its property in any way, or direct the board to take any action; shareholders do not have any contractual rights against the firm; and the fiduciary duty owed by directors to shareholders bears only the loosest resemblance to that in a trust or agency relationship. The shareholder-director relationship has little resemblance to agency, let alone employment, in either direction.

Under state business organization laws, shareholders are the electorate in a largely political (but not democratic) relationship, not contracting parties, principals in an agency relationship, owners of a property interest in the firm, or beneficiaries of a trust. In contrast, federal securities law borrows heavily from consumer protection concepts, typically treating shareholders as customers of the firm who have purchased a product (a security) about which they need information.

4. *Economic Theory vs. Legal Categories*

Nonetheless, the conceptual heuristic of imagining shareholders and directors as "hiring" each other is useful in pointing out aspects of the relationship that may be harder to see in conventional legal terms.

At equilibrium in a competitive market, each party to a contract is paid its marginal cost, which equals its marginal product. Thus, if shareholders are viewed as hiring managers, they will pay managers a salary equal to the cost of producing managers and to the benefit the managers bring to the company. Were the managerial salaries higher than the cost of production, other managers would bid them down; were salaries lower than the managerial product, shareholders would bid them up.

Conversely, if we view managers as hiring shareholders, at equilibrium shareholders will be paid no more than the marginal cost of the investment capital and risk-bearing services the shareholders provide. Any investor that attempted to charge more for its services would find itself without customers, and any manager who attempted to pay less would be unable to find financing.

At full equilibrium, there is no difference between these points of view. The corporation, as a nexus of markets, will pay each corporate participant (including shareholders) precisely the marginal cost of producing the supplies or services she sells to the corporation. It will then sell its own product to consumers for, once again, precisely the marginal cost of production, including all the payments it made to corporate participants. Moreover, supply will match demand at the point where these marginal costs are equal to the marginal values produced.

Shareholders are no different from anyone else in this model. They will receive the marginal cost of money—normal profit—and not a bit more, and the payment they receive will precisely match the marginal value of the

contribution they make to the enterprise. At this imaginary point, there is no difference between shareholders who hire managers and managers who hire shareholders. Indeed, for that matter, we could equally well describe the corporation as employees hiring customers, managers, and shareholders.[137] Moreover, at equilibrium, each party is paid precisely what it contributes. If we were to see shareholders earning eighteen percent per annum or managers earning hundreds of times the wages of line workers, according to the model it would be because they were contributing precisely that much more as well.

But the interesting problems arise in disequilibrium and non-ideal worlds. In non-equilibrium situations, by definition, someone is receiving more (or less) than her marginal product and marginal cost of production. The questions are who and why.

In the ordinary course, a company could be thought of as an ongoing competitive struggle between participants in different markets: shareholders, managers, employees, consumers, suppliers, and lenders, each attempting to charge the others more than their own marginal cost of production. Successful companies will produce a product that has more value than the minimum costs of its components. That is, they will generate an economic profit that cannot exist at equilibrium, a profit above the cost of capital and other factors of production. This producer's surplus is then available to be divided among the various factors of production (at least until a competing company underbids and shifts the surplus to consumers). A priori, there is no reason to simply assume that one party will get it rather than another; that is a question to be negotiated in the various markets in which the corporation participates or legislated by political conflict.

The legal label of who hires whom is a way of signaling the results of the negotiation. At law, the "owner," "principal," or "employer" is presumptively entitled to producer's surplus. In the corporate context, where the corporation is the employer, this label hardly settles the question—the issue is what is going to happen to the corporation's funds. Depending on market power and the legal agreements that result, the producer's surplus could be paid out to shareholders in dividends. But it could also be paid to employees in the form of higher wages or salaries, better working conditions, higher levels of employment, or executive stock options. The surplus could go to the general public in the form of lower prices or higher-quality, charitable contributions, a more attractive plant, general research and innovation expenses, advertising that does not increase profits, or improved environmental or safety performance. It could go to suppliers, subcontractors, bondholders, taxing authorities, or landlords in higher payments or less-aggressive negotiating tactics. And so on. Only if the surplus remains unclaimed in the corporation's coffers and the firm dissolves

137. *See, e.g.*, HANSMANN, *supra* note 126, at 83 (describing employees as hiring managers).

do the shareholders have any *legal* claim to it. If other participants succeed in obtaining the surplus—for example, if unionized employees command an above-market wage—the law will not call that illegitimate.[138]

Now the ideological power of the agency theory of the corporation should be clear. Calling the shareholders "owners" or "principals" of the corporation is a (misleading) claim that the shareholders are entitled to the producer's surplus as a matter of law—that they alone of all the factors of production should be paid more than their marginal cost or marginal product.

In contrast, the economic model re-emphasizes that any notion of share entitlement is conclusory bosh. Everything is up for negotiation here. The producer's surplus will go to whomever has the negotiating power to take it. Saying that we could think of managers as hiring shareholders or the other way around is a metaphorical gloss on the underlying economic claim: In a free market, no one has an a priori superior claim, morally or legally, to the surplus. Shareholders have no particular claim to the assistance of the law (or the rhetoric of "ownership" or "agency" metaphors) in tipping the balance of negotiation in their favor. If the market is truly free, they will be required to negotiate based on the merits or accidents of their position, and it will be difficult to predict the results. If we can think of managers as hiring shareholders, we can contemplate the possibility that the corporate surplus might end up "belonging" to managers rather than the shares. If, following Hansmann, we imagine employees hiring their bosses, then the surplus "should" go to the employees.[139]

5. *Shares in the Economic Model*

But we do know one thing: The closer any given market is to the ideal frictionless competitive ideal, the less likely its participants are to be able to negotiate for more than their cost of production. In a competitive market for fungible goods, a producer who attempts to charge more than marginal cost will be underbid immediately.

Managers are not particularly fungible and do not operate in an obviously competitive equilibrium market. At equilibrium, managers, like all firm participants, ought to be paid both their marginal product and their marginal cost. But surely it is unlikely, to say the least, that while in 1960 top managers were thirty times as productive as average workers and cost thirty times as much to produce, over the next generation they suddenly became 500 times more productive and costly in the United States (but much less so in apparently

138. Politically motivated economists may call it inefficient, however. Above-market wages are inefficient, but no more or less so than if the "owner" seizes the surplus: Were the system efficient, there would be no surplus to seize.

139. *See supra* note 126.

equally successful economies elsewhere).[140] Rather, a more plausible explanation is not increase in managerial productivity or production costs, but disequilibrium, imperfect competition, or some other market failure. Presumably, managers have simply succeeded in appropriating a large and growing share of firm surplus in a far from perfect market.

Shareholders, however, are a different story. This, then, is the key economic point: Shareholders are purely fungible providers of a purely fungible commodity—cash—in what is surely our most competitive market.[141] Accordingly, shareholders should rarely be able to obtain anything more than their marginal cost of production, the normal cost of capital. Rather, economic profit or producer's surplus should go to some more monopolistic or monopsonistic corporate participant who is less fungible, or provides a less fungible service or product, than shareholders. Thus, we should expect to see corporate surplus—what otherwise would be excess corporate profits—going to employees in the form of higher wages or more comfortable working conditions, to managers in the form of stock options and compensation plans that more closely resemble claims on economic profit than payments based on marginal cost or marginal product, or to debt-holders and other fixed claimants (including employees) in the form of retained capital (which reduces the risk borne by non-shareholder firm participants), or to suppliers and customers in the form of higher or lower prices.[142] While lawyers often refer to shareholders metaphorically as "owners," the economic theory emphasizes what careful legal thinkers know: Shareholders have no particular claim to corporate assets (except in special circumstances) and are rarely likely to win the competition to control them without special legal intervention.

The economic model, then, presents a puzzle. If it were correct, that is, if pricing in markets were determined by cost of production, public shareholders would not earn excess returns even in ordinary, disequilibrium, times. Not only would they not be "owners" in any strict legal sense, they could not be owners

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140. *See, e.g.*, Stabile, *supra* note 48.

141. The discussion in the text applies only to publicly traded corporations and their shareholders. In the start-up world, shareholders are not fungible at all. There, the specific information, relationship, or peculiar beliefs about the future state of the world that induce one investor to invest in a firm are unlikely to be replaced easily. Non-fungible venture capitalists should be able to negotiate spectacular deals when there are many more good ideas around than cash to finance them. Conversely, when as in the late 1990s there is more venture capital than there are good investments, the negotiation is between bilateral monopolists and the results are completely open.

142. The claim in the text suggests that returns to public investors ought to be largely independent of the success of particular firms. This is the same factual prediction made by proponents of the efficient capital market hypothesis and index investing (although the theoretical basis differs). In contrast, employees (who, being less fungible, may sometimes be able to command more firm surplus) ought to be paid more when they work for successful firms than when they work for less successful ones, even though neither their productivity nor their replaceability varies with employer. Any lawyer or indeed secretary who has left a large coastal firm is aware of this phenomenon, which contradicts standard explanations of how wage levels are set.

in the limited law-and-economics sense of "residual risk bearers" entitled to the producer's surplus. Surplus (which in a competitive market ought to be fairly limited anyway) would always go elsewhere. Shareholders, in short, should be compensated much like bondholders. And, oddly for lawyers familiar with the metaphors of corporate law, shares and the finance capital they represent—as the most fungible inputs into the corporation—would have the weakest claim to being called "owners," "principals," or beneficiaries of a fiduciary trust. Like the hamburger flippers at a fast food chain, capital is just a fungible, disposable, commodity that, left to a competitive equilibrium market, will earn little indeed.

Because shares are fully fungible participants in a highly competitive market, it would be irrational to pay them more than their cost of reproduction or the value they add. This suggests that the large shareholder returns we have seen in the last generation are more plausibly rents rather than competitive market returns—more likely the result of power, particularly due to the relative mobility of finance capital over other corporate factors of production, than to contribution to the firm's success.

6. *Expanding the Legal Categories: The Implications of Economic Theory.*

We are left then with this unhappy theoretical state of affairs. The empirical predictions of economic modeling seem quite implausible. It is hard to square twenty-five years of double digit returns in the stock market, or the far larger increases in managerial compensation, with a theory that is based on marginal cost and marginal product.

On the other hand, the theory remains quite useful for the nonchalant way in which it destabilizes ordinary understanding of legal categories. If managers can be thought of as hiring shareholders as easily as the other way around (and if both of them might be hired by the line workers), then the common political acceptance of the notion that extraordinary profits "belong" to shareholders is left floating unsupported in the air. On a market view, shareholders are fungible and disposable and should expect to be treated as such.

The first key implication of the economic theory, then, is that as between shareholders and managers, there is little reason to think that shareholders will often win, and no particular reason to suspect some subversion of the market if they do not. The century-old obsession of corporate law with protecting shareholders from rapacious managers seems to be contrary to the injunctions of the free market. On this view, shareholder advocates are just rent-seekers. Prophets of double-digit returns to share owners are fools at best, if not dangerous or (if people reasonably rely on them) fraudulent manipulators.

Paradoxically, to the extent that the economic theory is right, the extraordinary returns to share ownership over the last several decades must come from something that the economic theory does not explain. That is, either

equilibrium modeling is seriously wrong or shareholder returns must come from law and culture, not a free market.

Similarly, with respect to managers, the simple economic theory has them paid according to marginal cost and marginal product. The cost of a business education has increased in the last generation, no doubt. But surely there are still fine managers who would be willing to run great companies even if they only earned 25 times the nation's median wage. We fill far less-pleasant jobs and equally demanding ones with lower wages than that. And it simply makes no sense that Kenneth Lay earned so much because he was so much more productive than his American counterparts of a generation ago or his European equivalents today.[143] Managerial pricing must be the result of something not picked up in this model of the competitive market at equilibrium.

The second implication, then, is that shareholder and managerial returns alike are a result of something other than competitive markets. The economic model, paradoxically, re-emphasizes the power and importance of cultural and legal constraints on the market. Just as we saw that the market metaphor was inadequate to explain the behavior of the states in the race—something other than a drive to profit-maximize (or externalize taxes) must be motivating New York's willingness to accept the anomalous internal affairs doctrine—so too something other than marginal cost and marginal product pricing at equilibrium is necessary to explain the joint success of managers and shareholders.

The final implication of the economic model is perhaps the most important for the race to the bottom/top: The number of characters in this story must be increased. Legal thought has concentrated on the relationship between shareholders and managers, often characterized as one of owners and agents. This conceptual box is reinforced by the divisions of the law and the law school curriculum: Business organization laws, like business organization courses, are centrally about the shareholder/director relationship, with managers appearing both as subordinates to the directors and the puppetmasters pulling their strings.

The economic view, however, removes shareholders and directors from their central place. The business is not just shareholders and directors but all the other participants in the sociological organization and the other parties dependent on it. The conflicts are not just between shareholders and managers but among all the participants in the corporation. No participant has an a priori claim to the proceeds of cooperation. Rather, assuming that cooperation indeed produces gains, the corporation's gains could end up anywhere: as lower prices to customers, higher prices to suppliers, higher returns to capital (not just stock, but bonds, banks, or brokers), higher wages or salaries, or more expensive

143. *See, e.g.*, Roger Lowenstein, *Heads I Win, Tails I Win*, N.Y. TIMES, June 9, 2002, § 6 (Magazine), at 102 (describing one CEO's vast pay increases precisely as his company began to stumble).

buildings.

Moreover, the theory predicts that the gains to cooperation will—if the market has its way—end up in the hands of those with some kind of market power. If this were true, it would suggest that we should not be cheerleading visible success so much as worrying about whether it is an antitrust violation. If, on the other hand, returns are going to shareholders, who seem unlikely to have monopoly power, we need to think harder about why they are winning, who is losing, and whether this market result is one we find politically attractive.

As we have seen, the theory that shareholders "own" the firm or that they "hire" managers seems to have little connection with either legal or economic theory. Nonetheless, it remains quite powerful ideologically.

Popular discourse appears to accept the notion that shares have a stronger claim to windfall gains than do other corporate participants. Although economically, income is income, legally and socially salary appears quite different from profit on shares. Very large salaries are in bad taste. Moreover they are almost automatically somewhat legally suspect—agents and employees are supposed to work for their principals, not themselves. If you pay yourself that much, it seems facially implausible that you have set aside your own interests.

In contrast, vast profits on stock ownership look like rewards for the sort of heroic entrepreneurship that keeps our economy moving. In contrast to the faint reek of high salary with its hints of breach of duty, high stock profits smell only of roses: Owners are supposed to be looking out for themselves. It was Michael Milken's downfall that he failed to understand the distinction between owning one quarter of the company he built (which would have made him a hero and potential presidential candidate) and taking a salary worth one quarter of the profits of the company he built (which made him an overpaid employee greedy beyond all comprehension and, perhaps just as bad in some circles, a mark paying vast amounts of avoidable income tax).

The rhetorical and political lesson is simple. Managers interested in making lots of money are well advised to do it with modest salaries and large stock grants (even leaving aside the tax implications). Shareholder, employee, or customer advocates concerned that managers are taking too big a share of the corporate pie should be working to eliminate the tax subsidization of stock and option grants: Managers who are paid by salary will take home far less. And anyone attempting to understand the system should admire the category-breaking rhetoric of economics—and approach it with caution. For economists, income is income and shareholders might be hired by employees. At law and in politics, the categories take on a life of their own.

IV. Revising the Competition Between the States

The conventional story of the race to the bottom/top is unsustainable. The states are not passive victims of a system beyond their control, driven by lust for taxes into deregulating corporations for the greater bad or good of society. Were they motivated by taxes alone, it is hard to imagine why they wouldn't have abandoned the internal affairs doctrine long ago. Accordingly, politics must reenter our explanations. Were the political coalitions right, nothing in the nature of the world or our legal system would stand in the way of states reasserting their sovereignty.

If the race is not inevitable, we must confront the political question: Is it good? Should individual states opt out? Who benefits when states voluntarily abandon law-making to corporations? Is this a fair or a democratic way to decide our corporate law?

Here, the agreement between the race-to-the-bottom and the race-to-the-top analyses is probably more important than the difference. Both sides agree that the proximate decision-maker is management and that management makes the decision in its perceived self-interest. As we have seen, changing the underlying assumptions of the model slightly generates significantly different predictions regarding the degree to which managers will see their self-interest as closely tied to shareholders. But in the final analysis, corporate practice seems to have mooted the race-to-the-bottom/top debate.

The debate assumes that shares and managers are on opposite sides of a conflict and that shares ought to win. In the world (Enron and the accounting scandals to come notwithstanding), that battle is muted if not over. Both have won.

Moreover, as we've seen, neither shares nor managers have a pre-political claim to victory. Rather, we have the right and obligation to use ordinary political processes to consider whether our corporations ought to be run on behalf of this sometimes fractious managerial-share coalition, or whether we'd live in a better society if other interests were reflected as well in internal corporate debates.

A. *Managerial Victory and Defection*

In a blow to the race-to-the-top theorists, managers have won many important skirmishes in ways that are hard to rationalize as gains for the shares. First, managers have tamed the hostile takeover market. Since the poison pill was upheld and universalized, managers have usually been able to resist unwanted takeovers, at least to the extent that the cheapest strategy for the other

side usually is to buy their support.[144] In the end-game, successful hostile takeovers nearly all become friendly takeovers and the exiting managers, in conceding defeat, become even more exceedingly rich.

Second, managers need not wait for takeovers to amass great wealth. Top management has increased its compensation over the past three decades to such a degree as to lead all but the most credulous to suspect that perhaps they have not entirely set aside their own self-interest. Perhaps top management wasn't fully motivated to work for the shares when it was paid barely more than an ordinarily successful doctor. But somewhere in the last thirty or forty years, that magic moment must have arrived. Modern CEO salaries cannot plausibly be explained as no more than is necessary to extract a full working day out of their recipients and ensure that ambitious youngsters seek to take their place.

Third, accounting conventions continue to be manipulated in ways that are indefensible from a shareholder perspective. It is not yet clear that we have conclusively reversed the rules that allowed companies to account for stock option grants to managers as if they were cost-free, an accounting convention that would be fraudulent were it not so transparently false. More generally, shares have suffered from defecting managers using faulty or fraudulent accounting, producing accounting profits without actual returns to shareholders.[145]

It is too early to tell what accounting reforms will be adopted in the wake of the 2000-02 market melt-down or how many of them will result from race-to-the-top market-like processes. In the abstract, accounting seems to be subject to a relative of Say's Law or a market for lemons: Bad accounting drives out good. Assuming that shareholders are influenced by reported numbers, any firm that does not present its results in the most favorable (even deceptive) way permissible (or acceptable in the market) will be at a disadvantage relative to its peers. In an unregulated market, the standard presumably would steadily march downward, as less aggressive companies feel pressured to adopt the current norm and more aggressive ones push beyond it.

Companies that would prefer to use honest accounting have only a limited number of escape routes. In the mode of the race to the top, they could seek a clear signal to the market that they are using better accounting and should be rewarded for it, for example by reincorporating in a state with stricter controls. Alternatively, and especially if they are concerned that the market might not give enough credence to such signals, they could try to end the race altogether: They might become a lobby for externally-imposed, universally-applicable

144. *See supra* note 24.

145. Much acquisition activity appears to be motivated by accounting rules that allow acquirors to show increasing profits even though the combined business sells no more at no lower costs than the separated ones. Something is wrong when 1+1 can equal 2.5, providing that stock price, dilution, and depreciation of goodwill rules allow it.

minimum standards to rein in their less straightforward competitors.

At the moment, the accounting reform that is happening mainly seems to be in the latter form, outside the race to the top: imposed by Congress or the SEC, the stock markets, or other centralized institutions rather than voluntarily adopted by corporations reincorporating in order to prove their virtue to the financial markets. The voluntary approach is too easily subverted by defectors, I suspect.

More troubling for the optimistic race-to-the-top theories, it is hard to imagine that the reforms, whatever they ultimately turn out to be, could possibly be enough to eliminate the underlying problem. Managers in an end-game, as all managers are, always have an incentive to find a new way to subvert the existing rules, to exploit accounting loopholes and corporate law positioning, while corporate law creates no one with a countervailing incentive and ability to call the abuses until after the bubble bursts. Thus, it seems nearly inevitable that the "race" will force managers to support changes to limit the particular games of the late 1990s—but then invite them to create a new defection as yet unimagined.

B. *Share Successes*

All these phenomena seem strong evidence that race to the top is not entirely accurate. Still, this is no race to the bottom. Shares have also done extraordinarily well—share returns have exceeded eleven percent per year for three decades, even including the declines of the turn of the millenium.[146] That hardly looks like overwhelming empirical support for a race to the bottom.

Instead it seems clear that companies are run in the interests of *both* shareholders and top managers to a degree inconceivable a few decades ago. Indeed, the very distinction between the two roles has shrunk, as managers have become the largest individual shareholders. Shares have won, even as they have lost, because shareholding managers acting in their own interest now necessarily pull the other shares along.

C. *The New Synthesis*

Here then is a proposed synthesis of the race to the bottom/top. First, strip

146. IBBOTSON ASSOCS., STOCKS, BONDS, BILLS, AND INFLATION 2005 YEARBOOK 297 tbl. C-1 (2005) (reporting 11.2% annual return to stocks for the period 1973-2004). Of course, total stock market return includes not only money paid by corporations to shareholders—dividends—but also the market's estimate of future dividends, which may be entirely wrong. The number one would actually want here is the proportion of the corporate surplus going to shareholders, but that seems impossible to determine, since it would require determining the actual surplus available for all corporate participants (as opposed to reported profits). The extraordinarily high market returns, however, are most easily explained as reflecting investor belief—whether or not well-founded—that shareholders will obtain a large and increasing share of corporate surplus in the foreseeable future.

away the ideological claptrap of inevitability. If we don't like the results of the race, we can change it. Even if we do like the results, we still need to consider the process question, namely whether the system of reaching them is defensible in a democracy.

Second, the likely destination of the race is neither the top nor the bottom but somewhere more complicated. So long as the states continue to allow corporations to choose their own law, managers will happily choose state law in the interests of both shares and managers. It seems safe to assume that corporate managers generally run their corporations in the interests of undiversified shareholders, if only because they hold a large percentage of their own wealth in the shares of the companies they manage.

Direct conflicts between shares and managers should be relatively infrequent, since most of the time the best way for managers to maximize their own net worth will be by maximizing share value for themselves and everybody else.

On the other hand, when managers and shares unavoidably conflict, as in end-games such as hostile takeovers, managers seem to choose law that protects them from shareholders, whether it be state anti-takeover provisions or poison pills, and shareholders rarely succeed in preventing these disempowering moves. Similarly, managers give themselves increasingly large percentages of company equity and the shares have failed to do much about it (or even consistently to view it as negative). Finally, managers seem to participate gleefully in the process of bad accounting chasing out the good and not only in instances where the bad accounting directly enriches managers.

More important than the remnants of conflict between shares and managers, however, is their united front. Both shares and managers gain when they, collectively (and managers as large shareholders), are able to seize a larger share of the corporate surplus from other corporate participants. Managers should expect no squawks from shareholders when they choose law that is in their collective interest—that is, not only law that frees managers to act in response to changing market conditions, but most importantly law that improves the corporation's bargaining position against its other participants (employees, customers, suppliers, tort and environmental claimants, taxing authorities, neighbors) or frees corporations from social and other obligations. Citizens may protest when corporations routinely maintain separate books for the taxing authorities and investors, but role-bound shares and managers will protest only when the character-destroying effects of routine dissembling begin to over-power the profits of tax evasion and free-loading.

"Race to the bottom/top," in short, is a misnomer. The more critical race is to define the corporation as no more than the pursuit of share-value maximization, limited only to the extent that it contradicts the pursuit of managerial return maximization. This is the race to create what Larry Mitchell

calls the "externalizing machine,"[147] Bakan refers to as the "psychopathic corporation"[148] and I've referred to as an "agent for a principle, not a principal."[149] Under our current system, it is a race that proceeds of its own accord, without regard to any political debate regarding whether this is what our corporations ought to be doing, or, indeed, even whether this is good for the non-managerial human ultimate beneficial owners of the shares.

The Delaware-dominated law created by states accepting the race to the bottom/top furthers the interests of an alliance of shares and managers. I do not mean to belittle the conflicts that remain between those roles, which, as discussed above, remain quite significant. Indeed, for practicing litigators, the conflicts within this coalition are not only significant but of almost exclusive importance: These conflicts generate shareholders' litigation and hostile takeover work. For planners and for lawyer-citizens, however, the less visible "non-adversarial" aspects of corporate planning may well be more important. When managers work in the interests of shares, the results are quieter but more profound.

In earlier work I have attempted to describe the behavior of a corporation that is run in the interests of its shares.[150] Here, I summarize (but do not defend) that analysis in order to suggest that the race to the bottom/top is politically important; that is, the process generates predictable results that are not necessarily attractive. The choice to allow our corporate law to be created by the race is a choice to avoid explicit discussion of a series of difficult and controversial issues. But it is not a neutral choice: The race generates a determinate, and not necessarily attractive, answer.

1. *What a Shareholder Is*[151]

Shareholders are a legal fiction. That is to say, corporations are not run in the interests of the actual human beings who own shares, or more typically, are the beneficiaries of institutions that own the shares.

Those human beings have many and complicated interests and views, and for most of them, shareholdings are a tiny part of their financial, let alone more general, interests. Most of non-managerial shareholders are ordinary middle-class Americans, investing small amounts through pension funds or mutual

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147. JOEL BAKAN, THE CORPORATION: THE PATHOLOGICAL PURSUIT OF PROFIT AND POWER 56 (2004).

148. MITCHELL, *supra* note 52, at 49.

149. Greenwood, *supra* note 108, at 1026-27 ("Because managers manage on behalf of a fictional principle rather than a human principal, corporations are a strange, driven kind of institution—neither managers nor anyone alse has the ultimate authority to stop the institution from acting out its logic to the fullest.").

150. *See generally* Greenwood, *supra* note 34; Daniel J.H. Greenwood, *Essential Speech: Why Corporate Speech Is Not Free*, 83 IOWA L. REV. 995 (1998); Greenwood, *supra* note 108.

151. This Subsection summarizes Greenwood, *supra* note 108.

funds. For nearly all of those investors, roles as consumer and employee are far more important than their shareholder role—even taken in strict economic terms, virtually all shareholders have far more wealth tied up in their jobs than in their stock holdings. Indeed, while stocks are held, directly or indirectly, by a majority of Americans, barely five percent of the population has a net worth—in financial and non-financial assets—larger than their annual income.

But corporate law and the financial markets have no mechanism for passing those multifarious interests and views through to corporate managers. Rather, managers are driven to act as if shareholders were just shares. Sometimes this is legally required; for example, ERISA bars pension managers from considering the actual circumstances of the fund beneficiaries, many of whom would often be, or view themselves as, better off as humans if the pension fund worked to preserve their jobs rather than their pensions. Sometimes it is an artifact of the combination of a highly competitive financial market and limited human cognitive ability: From the investor perspective, even if I care deeply about corporate behavior with respect to a series of political issues, as a practical matter I have little choice but to focus on expected return in picking investments. Perhaps I might decide not to invest in companies that make cigarettes. But how am I going to avoid mutual funds that do so? And what if my political views are more extensive or less widely held than simple reluctance to finance the sale of dangerous addictive drugs?

More importantly, however, from the perspective of managers, so long as some significant part of the market focuses only on expected returns (as fiduciaries ordinarily will be required to do), the views of investors who do anything else will all be washed out: Prices will be set by arbitraging profit maximizers who will drive the price of all shares to their best estimate of the risk-adjusted future returns. Even if, for example, a large part of the investing public boycotted Company X because it engaged in widely unpopular activities, so long as some investors were pure profit maximizers, the boycott would have no effect. Were the boycott to reduce the stock price below the risk-adjusted present value of expected future returns, the profit maximizers would see it as an opportunity to earn above-market returns and would purchase the stock until its price returned to "market" value absent the boycott. Thus, the boycott would have no effect on share price and accordingly would send no message to management. In contrast, were managers to pursue a non-profit-maximizing course, for example abandoning a profitable but unpopular activity, the same financial arbitrageurs would bid the stock price down to reflect not only reduced profitability but this anti-financial market behavior. Here, in contrast to the political boycott, a clear message is sent: Return to share profit maximization (and profit yourself!) or a takeover will force you to do so (and someone else will profit).

Consumer boycotts can send a message to managers: If customers don't

buy a product, for whatever reason, fewer units will be sold and the company will be forced to adjust. Thus, companies may sell more product if they take political positions that consumers find attractive and vice versa. (It is an empirical question, of course, whether customers actually act in this way except at insignificant margins: Cognitive limitations would suggest that few people think hard about General Motors' views on what is good for America or its political interventions to support them when choosing what car to buy.)[152] But in a reasonably competitive financial market with a significant part of the trading done by politically unconcerned profit maximizers, the political views of shareholders are simply irrelevant: They cannot affect the number of shares sold or the price at which they sell.

Thus, for purposes of considering the impact of the shareholder/managerial alliance on American society, we must model shareholders counterfactually—as if the shareholders were no more than shares, profit-maximizing rational market participants with no interests, beliefs, or views other than discovering the best possible risk-adjusted future returns to their shareholdings. This simplifies theorizing, since we have a well-developed body of literature modeling how such rational investors would act.[153]

But it is critical to recall that the shares of corporate finance are not human beings or citizens: There is no reason to think that the citizen-voters who directly or indirectly own the shares would act the way the market and corporate law and managers who seek to pursue shareholder interests will construct them as wishing to act.

Were they in a position to trade off their shareholder interests against their non-shareholder interests, an overwhelming majority of shareholders (perhaps even holding a majority of shares) would find their non-shareholder interests weightier. But they are not able to make such trade-offs: Ordinary principles of fiduciary law and intense market pressures on institutional investors and corporate managers alike assure that managers will view their role solely as promoting "shareholder" interests, where shareholders are imagined to have no other interests at all. Indeed, in most cases, fictional shareholders will not even be imagined to own other stock; managers do not invest on behalf of diversified portfolios.

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152. Of course, I don't mean to suggest that customers never do this. On highly salient issues consumer boycotts occasionally are quite important (non-union grapes, German cars, purported Satanic logos, child labor sweatshops come to mind). *See, e.g.*, Kysar, *supra* note 106 (recommending legal reforms to make consumer choice of products a more viable method of controlling corporate behavior).

153. There is a major disconnect between that literature and the world of corporate law, however. Models of rational profit maximizing investors indifferent to all other values assume that, in the absence of inside information, investors should always diversify. Shareholders, thus, are modeled as portfolios. In contrast, managers must act as if shareholders were undiversified: Delta's managers cannot take into account the fact that many of their shareholders also own Southwest and use that as a reason not to compete.

2. *What Shares Want*

According to standard portfolio theory, shares are valued based on the risk-adjusted present value of the anticipated returns (dividends and redemptions or final payment upon dissolution) associated with them. It follows that, at an appropriate discount rate, shareholders as a group are time-indifferent: The value of the shares at any given time reflects all future returns, short term and long term.

The humans behind the shares, of course, may have definite time preferences. (For example, human shareholders may be saving for retirement or college and need returns at a time determined by their life cycles.) However, the market makes these time preferences irrelevant. First, institutional shareholders act like insurance companies; by aggregating individual needs, they cancel out individual variation. Thus, permanent endowments and pension funds, which hold a large portion of publicly traded stock, are essentially time-indifferent and eternal, even though the humans they serve will attend college and retire at specific times. Moreover, the market makes the preferences of even individual human shareholders irrelevant: Any shareholder in search of an immediate return can sell her stock, at the present discounted value of expected future returns, to another market participant looking for distant returns. Thus, in a variant of Modigliani and Miller's separation theorem, the corporation can treat shareholders as if they were entirely time-indifferent—even immortal. Since it makes shares distinctly inhuman, this time-indifference should have strange consequences in firms run in interests of shares.[154]

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154. One legal consequence is quite startling. On a first approximation, fully rational and time-indifferent shareholders should be largely indifferent to certain kinds of fraud that are viewed as quite serious under the securities laws. If a company artificially inflates its reported earnings (and fools the market), the market should respond by adjusting the stock price to heights that would not be warranted by the actual earnings. At some point, usually in the not too long term, however, the company will be forced to bring its stated earnings back to reality. From the perspective of shareholders, the whole exercise is largely a zero-sum game: For every shareholder who gains by selling at the temporarily inflated price, there is another one who loses the same amount by buying at the inflated price. Indeed, for large diversified portfolio shareholders and especially for index investors, the whole thing is largely a matter of indifference: Over time they are equally likely to be on the winning or losing side of such transactions (except to the extent that insiders use the excessive volatility to increase the value of stock options, or to influence the timing of exercise of those options).

In fact, however, we see companies that appear to manage their earnings by accelerating income and deferring expenses, thus showing artificially high profits. Then, they may correct the books during a cyclical downturn, showing artificially high losses. Were shareholders entirely rational, this would be a useless exercise (except for managers who were engaging in inside trading or triggering option grants), as would be prosecuting its practitioners (except for explicit insider trading).

However, modern cognitive theory suggests an explanation, by lifting the perfect rationality assumption. If, as cognitive psychology suggests, investors are more sensitive to directional changes than to absolute amounts, they may not punish firms' stock prices much more for very bad news than for just ordinary bad news, making lumping bad news an attractive game for managers, who will end up with a higher average share price and lower cost of capital than is warranted by rational analysis of the underlying cash flows. If, as the concept of "framing" suggests, investors accept the categories that they are fed, they may treat repeated "one time losses" differently than they would if they were accounted for

Fictional shareholders are odder still, however. They are utterly uncommitted, indifferent not only to time but to place, culture, relationships, history, and all the other things that make human life worthwhile. For the financial markets, prior commitments are just sunk costs, largely irrelevant to its only important calculation: The risk-adjusted present value of future expected returns. If greater profit looms in a new location, shares (though not necessarily the human beings behind them) have no commitment to the status quo.

The result is that the financial market and corporations that cater to it are more revolutionary than the most radical humans of the left or the right. Change, risk, and mobility always have costs for humans; for diversified portfolios, they are largely irrelevant.

Corporations driven to act in the interests of shares can take account of other values only to the extent that shares do. Thus, they will view compliance with the law as a cost of doing business, not a value in itself. They will treat all participants in the corporation (except top managers) as mere means to the end of shareholder value maximization: If making customers or employees happy is profit-maximizing, wonderful; but if not, that isn't a problem either. Shares do not balance competing values—they just weigh all issues against the single test of profit.

To summarize the key points: Managers, driven by the market in a mechanism not unlike that described by the race to the top, will run the corporation in the interests of the financial markets ("shareholders" only in the fictional sense of a profit-maximizing investor holding no other investment and with no other interests in the firm or its competitors or neighbors), with the limited exception of when their own interests directly conflict with share interests in an end-game like situation. The financial markets, in turn, act like aliens or a colonial power: They are interested in the human beings who make up the American economy only to the extent that they are profit centers. Rather than treating ourselves as political ends, we have created a system that treats us as no more than means to be exploited. Our corporate law system causes our own corporate managers to use our own pension funds to colonize us.

American corporate law has been a tremendous success in many ways. Exploitation can be enlightened: It is often the case that the way to get the most of someone, even if you have no regard for them at all, is to act as if you did. Slavery is not always the most profitable route.[155] And economic growth is an

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as ordinary costs, ignoring one-time news as unimportant sunk costs rather than a predictor of the future. Similarly, reporting stock option grants in a footnote rather than on the income statement might actually change valuations if less-than-fully-rational investors use shortcuts to calculate valuation.

155. Fogel made a good case that American slavery actually was fairly efficient at extracting labor from its victims. 1 ROBERT W. FOGEL, TIME ON THE CROSS: THE ECONOMICS OF AMERICAN NEGRO SLAVERY (1974). The possibility that brutal exploitation might work is why this issue is important.

important value for which we often might be willing to sacrifice others. Share-profit maximization can conflict with other values.

If conflicts are possible, we must face the fundamental issue: The race to the bottom/top means that conflicts between share value maximization and other values will be made by managers who are directed to consider the problem as if all other values were important only to the extent that they promote share value maximization. Not only does corporate law teach managers that this is their duty, the right thing to do, but the race to the top assures that (with the possible exception of direct manager/shareholder conflicts) it is in the managers' economic interest to think about problems in this way. We have thus aligned two of the most important human motivators in the same direction: Role morality and personal financial self-interest teach the same message.

The system that sends this powerful directive to the managers of our most important economic institutions is the race to the bottom/top and the share-manager-centered law it produces. Our government, at both the state and federal levels, has decided by means of the internal affairs doctrine to allow corporate managers to determine the law that will regulate the corporations they run. The market that we've created rewards managers for looking to the interests of inhuman, uncommitted shares, not to the needs or desires of real people. It is time now to consider whether that political decision is compatible with our democratic system, and if it is, whether it is the right decision to make. Should states play along with the race to the bottom/top? Should we, as citizens of a democratic polity, allow Delaware to make our corporate law for us? If corporate law matters at all, it should matter enough that those who are affected should reassert their right to determine it.

Treating people as exploitable resources would be less problematic if the most profitable way to do so always were to act as if you thought of them as ends.