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For Optional Federal Incorporation

George W. Dent, Jr.*

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For decades, state chartering of public corporations and Delaware's domination of this activity have been criticized by many business law scholars.[1] They believe, as Bill Cary put it, that Delaware has led a "race for the bottom" that has "watered the rights of shareholders . . . down to a thin gruel."[2] To escape this "race for the bottom," some have urged mandatory federal chartering of public corporations.[3] Even among critics of state chartering, this position has never commanded broad support for fear that mandatory

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1. Delaware is the domicile of 58% of publicly traded companies, 59% of the Fortune 500 companies, and 68% of companies that went public during 1996–2000. Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 389 (2003). Most public companies that are not incorporated in Delaware are incorporated in their home state. *Id.* at 420. Fewer than 10% of public companies are incorporated in a foreign state other than Delaware.

2. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974). However, the race to the bottom was alleged earlier by Justice Brandeis in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 559 (1933) (Brandeis, J., dissenting in part) ("The race was one not of diligence but of laxity."). *See also* Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporation Law*, 105 HARV. L. REV. 1458 (1992) (arguing that state competition for corporations does not lead to maximized shareholder value); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1506–07 (1989) (discussing the debate concerning Delaware corporate law); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 56–57 (2004) (examining additional evidence to support the "race for the bottom" theory).

3. *See infra* note 66.

federal incorporation would only make matters worse.[4] Whatever the flaws of incorporation in Delaware, they cannot be too bad, or investors would flee Delaware corporations for companies chartered in other states. Because mandatory federal incorporation would preempt all competition, it threatens abuse with no means of escape.

This objection disappears, though, if federal incorporation were voluntary.[5] The federal government then would simply offer a 51st option that would be elected only if superior to the other 50. If the choice were entrusted to shareholders, they could escape the status quo in which states compete for franchise fees primarily by appealing to corporate executives. Even if federal incorporation never became dominant, its potential appeal to investors would prod Delaware to pay them more heed.

Part I of this Article describes the current corporate governance problem and defects of state chartering. Part II explains why federal incorporation is likely to be superior. Part III weighs and rejects mandatory federal incorporation of public companies. Part IV argues for optional federal incorporation.

I. WHY FEDERAL INCORPORATION?

A. The Growing Corporate Governance Problem

Complaints about corporate governance have been voiced for as long as there have been public companies. The central problem was long ago identified as the separation of ownership and control—executives (especially the chief executive officer (CEO)) held sway and could run public companies to their own advantage and at the expense of the shareholders.[6] In theory, a corporation is "managed by or under the direction of a board of directors."[7] Also in theory, the directors are chosen by (and thus responsive to) the shareholders. The executives are hired hands who serve at the pleasure of the board. In practice, however, CEOs deeply influence, if not entirely dominate, their boards.

Recent developments show that the corporate governance problem has not abated and may indeed have worsened.[8] Executive compensation at public companies has

4. *See infra* note 79 (providing citations to authorities discussing problems with mandatory federal incorporation).

5. Optional federal incorporation has occasionally been suggested, but has never been adopted. For recent suggestions, see Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 611–12 (2002) (arguing that shareholders should receive a vote regarding corporate reincorporation to another state); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 163 (2001) (proposing the creation of an optional federal incorporation regime); Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313, 352 (2007) (arguing that shareholders should be able to elect incorporation under a federal corporate law). However, the idea is not new—it was proposed by President Taft a century ago. William Howard Taft, President of the United States, Special Message to Congress, *available at* http://www.presidency.ucsb.edu/ws/print.php?pid=68486 (last visited Jan. 31, 2010).

6. *See* ADOLF BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 124 (1932) (discussing the conflict inherent in separating management and control).

7. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (2010).

8. "The most significant problem facing corporate America today is the management-dominated, passive board of directors." Charles M. Elson, *Director Compensation and the Management-Captured Board—The History of a Symptom and a Cure*, 50 SMU L. REV. 127, 127 (1996). *See also* JOHN GILLESPIE & DAVID ZWEIG, MONEY FOR NOTHING: HOW THE FAILURE OF CORPORATE BOARDS IS RUINING AMERICAN BUSINESS AND

ballooned to wild excess.[9] Worse, the compensation plans of many CEOs have little to do with the success of the company.[10] Stock options are intended to motivate CEOs to raise the firm's stock price, but many boards back-date or "spring load" options so that CEOs profit even if the stock does not appreciate.[11]

The current economic downturn has revealed another facet of the problem. The compensation plans of many CEOs offer them lavish rewards if their companies prosper, but leave them unscathed if their companies flounder. In other words, managers and stockholders share in the good times, but in bad times the shareholders alone suffer all the losses.[12] Not surprisingly, CEOs respond to these incentives by committing their

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COSTING US TRILLIONS 5 (2009); D. QUINN MILLS, WHEEL, DEAL AND STEAL: DECEPTIVE ACCOUNTING, DECEITFUL CEOS, AND INEFFECTIVE REFORMS 183 (2003) ("CEOs have found a way to enormously increase their own wealth by a variety of means in a period in which shareholders have been losing their shirts. . . . [T]he core of the problem faced by investors today, as revealed by corporate scandals, is that investors must be better protected from CEOs."); John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 847 (1999) ("Both theoretical and empirical reasons exist to believe that boards of a substantial minority, and perhaps a substantial majority, of U.S. public companies are dominated by managers."); Glyn A. Holton, *Investor Suffrage Movement*, 62 FIN. ANALYSTS J. 15, 19 (2006) (stating that "[r]ecent market crashes and financial scandals are symptomatic of a capitalism in which shareholders have lost control over the corporations they own" and urging steps to make shareholder voting more effective); Laura Lin, *The Effectiveness of Outside Directors as a Corporate Governance Mechanism: Theories and Evidence*, 90 NW. U. L. REV. 898, 898–903, 913–17 (1996) (cataloging the many ways that CEOs dominate outside directors); Roberta Romano, *Less Is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 192 (2001) ("Firms whose boards have a majority of independent directors . . . do not perform significantly better than those whose boards . . . have fewer outside directors."); James Surowiecki, *Board Stiff*, NEW YORKER, June 1, 2009, at 34 ("All these changes [in board composition], though, have had a much smaller impact than expected."). Sophisticated investors realize this. *See* Rachel McTague, *Advisers, High-Net-Worth Investors Think Boards Serve Executives, Survey Says*, 39 SEC. REG. & L. REP. (BNA) 1662, 1662 (2007) ("A survey of more than 200 investment advisers and high-net-worth investors found that the respondents clearly perceive that corporate boards primarily answer to management, rather than shareholders . . . .").

9. George W. Dent, Jr., *Academics in Wonderland: The Team Production and Director Primacy Models of Corporate Governance*, 44 HOUS. L. REV. 1213, 1244–46 (2008); Richard A. Posner, *Are American CEOs Overpaid, and, if So, What if Anything Should Be Done About It?*, 58 DUKE L.J. 1013, 1041 (2009) ("Theory and evidence suggest that there is indeed overcompensation of the CEOs of American publicly held corporations."). Despite the current recession "many boards are handsomely rewarding bosses." Nanette Byrnes & Jena McGregor, *CEO Pay: Is It Still Out of Sync?*, BUS. WK., Sept. 7, 2009, at 22.

10. LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE 7 (2004); Ronald R. Mau & Catherine Shenoy, CEO Compensation: Does Performance Matter? (June 2009) (unpublished manuscript, available at http://ssrn.com/abstract=1431490) (describing the results of an empirical study finding that CEOs can increase their compensation before exceptionally bad performance through the timing of option exercises).

11. *See* Jesse M. Fried, *Option Backdating and Its Implications*, 65 WASH. & LEE L. REV. 853, 886 (2008) ("Secret backdating . . . provides further support for the view that managerial power has played an important role in shaping executive compensation arrangements."). "Spring-loading" "describes the practice where a corporate executive receives stock options shortly before the release of favorable company news that is expected to raise the company's stock price." Matthew E. Orso, *"Spring-Loading" Executive Stock Options: An Abuse in Need of a Federal Remedy*, 53 ST. LOUIS U. L.J. 629, 631 (2009). The practice seems to be common. *See* David Yermack, *Good Timing: CEO Stock Option Awards and Company News Announcements*, 52 J. FIN. 449, 449–50 (1997) (noting that CEOs can "obtain more performance-based pay in advance of anticipated stock price increases); *see also* Lucian Bebchuk et al., *Lucky CEOs and Lucky Directors*, J. FIN (forthcoming 2009), *available at* http://ssrn.com/abstract=1443364 (describing an empirical study "find[ing] that both CEO and independent directors received an abnormally high number of lucky grants" of stock options).

12. *See* RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF 08 AND THE DESCENT INTO

companies to huge risks.[13] This strategy disastrously exacerbated the damage to investors when the economy and the stock market collapsed. Obviously corporate boards were not protecting shareholders when they adopted these plans.

The flight of capital abroad has underscored America's corporate governance problem. Until recently the United States was unrivaled as an investment venue. Now many countries protect investors better than America does.[14] As the Paulson Committee found, the resulting exodus of investors threatens to deprive American industry of the funds needed for robust growth.[15] The costs of our poor corporate governance are large.[16]

For over 75 years, the federal government and stock exchanges have added a second layer of regulation of public companies to the state corporation laws, including SEC registration and disclosure obligations, proxy regulation, increasingly rigorous standards

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DEPRESSION 93 (2009) ("The tendency of corporate management . . . to maximize short-run profits . . . is strengthened if, as on Wall Street during the boom, executive compensation is both very generous and truncated on the downside."); Michael Jensen, *The Takeover Controversy: Analysis and Evidence*, *in* KNIGHTS, RAIDERS, AND TARGET: THE IMPACT OF THE HOSTILE TAKEOVER 314, 320 (John C. Coffee, Jr. et al. eds., 1988) ("Sometimes [myopic behavior] occurs when managers hold little stock in their companies and are compensated in ways that motivate them to take actions to increase accounting earnings rather than the value of the firm."); Jeff Madrick, *How We Were Ruined & What We Can Do*, N.Y. REV. BOOKS, Feb. 12, 2009, at 15, 16, *available at* http://www.nybooks.com/articles/22280 ("The ability to take immediate [personal] profits from fees on risky loans infected the financial industry and eventually the entire economy, and made possible disproportionately large annual bonuses."); David I. Walker, *The Challenge of Improving the Long-Term Focus of Executive Pay* 4 (Boston Univ. School of Law, Working Paper No. 09-22, 2009), *available at* http://ssrn.com/abstract=1396663 ("Perhaps the leading corporate governance concern of legislators and commentators at the present is the reckless pursuit of short-term profits by corporate executives who will have cashed out before the long-term repercussions are felt."); David I. Walker, *Evolving Executive Equity Compensation and the Limits of Optimal Contracting* 3 (Boston Univ. School of Law, Working Paper No. 09-34, 2009), *available at* http://ssrn.com/abstract=1443170 ("Some commentators and policymakers believe that heavy use of options led to excessive risk taking which contributed to the recent financial meltdown as well as earlier fiascos . . . ."); Luigi Zingales, *The Future of Securities Regulation* 23 (Chicago Booth School of Business, Research Paper No. 08-27, 2009), *available at* http://ssrn.com/abstract=1319648 ("The 2007-8 financial crisis is perceived as a manifestation of excessive risk taking by managers who were enriching themselves with short term bonuses, while destroying the long term value of their companies."). *But see* Rüdiger Fahlenbrach & Rene M. Stulz, *Bank CEO Incentives and the Credit Crisis* 25 (Charles A. Dice Center, Working Paper No. 2009-13, 2009), *available at* http://ssrn.com/abstract=1439859 (finding no connection between CEO compensation incentives and the meltdown of banks).

13. *See* Chris Armstrong & Rahul Vashishtha, Executive Stock Options and Risk Substitution 30–31 (Dec. 17, 2009) (unpublished manuscript, available at http://ssrn.com/abstract=1525025) (finding that CEOs with more stock options tend to increase the firm's risk).

14. *See* George W. Dent, Jr., *The Essential Unity of Shareholders and the Myth of Investor Short-Termism*, 35 DEL. J. CORP. L. 97, 148 n.234 (2010) (discussing foreign countries with stronger shareholder rights than the United States).

15. INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 16 (2006), *available at* http://www.capmktsreg.org/pdfs/11.30Committee_Interim_ReportREV2.pdf.

16. *See* Paul Gompers et al., *Corporate Governance and Equity Prices*, 118 Q.J. ECON. 107, 145 (2003) (stating that gains from improved corporate governance "would be enormous"); Gretchen Morgenson, *Too Many 'No' Votes To Be Ignored*, N.Y. TIMES, Sept. 20, 2009, at BU1 (quoting money manager and investor activist Frederick E. Rowe as estimating that "the excess costs associated with management compensation, Wall Street fees and political expenditures by corporations reduce investor returns about 3 percent on average every year"). Note also the subtitle of GILLESPIE & ZWEIG, *supra* note 8: "How the Failure of Corporate Boards is Ruining American Business and Costing us Trillions."

of independence for directors, and the Sarbanes–Oxley Act (SOX). Some of these regulations have been beneficial.[17] Others have been ineffective or counterproductive.[18] The SEC is now considering changes to the proxy rules to allow broader shareholder initiatives.[19] With certain minor exceptions, though, these national standards have not addressed internal corporate affairs, which remain primarily in the jurisdiction of the states. Federal regulations have not significantly improved corporate governance and were not intended to do so.

B. The Failure of State Chartering

Some believe that state chartering has led to a "race to the top," with the states competing to offer the best corporate law.[20] In practice, however, there is not much of a race because of weak incentives for and impediments to the competition.[21] More important, although there is some competition to offer the best corporate law, one must ask, "best for whom?" Unfortunately, the answer is not the best law for shareholders, but the best for corporate managers.

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17. *See* Irwin Friend & Edward S. Herman, *The S.E.C. Through a Glass Darkly*, 37 J. BUS. 382, 389 (1964) ("We doubt that any person reasonably well acquainted with the evolution of the stock-market practices between the pre- and post-S.E.C. periods could lament or underrate the success of the new legislation in eradicating many of [the] weaknesses in our capital markets."); Michael Greenstone et al., *Mandated Disclosure, Stock Returns, and the 1964 Securities Acts Amendments*, 121 Q.J. ECON. 399, 403 (2006) ("Overall, the results suggest that the benefits of the 1964 Amendments substantially outweighed the costs of complying with this law as measured by stock returns.").

18. *See, e.g.*, HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES-OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT 3 (2006) (calling SOX a "costly mistake" that was enacted in a "regulatory panic" and imposed net costs of $1.1 trillion); Anwer S. Ahmed et al., How Costly Is the Sarbanes Oxley Act? Evidence on the Effects of the Act on Corporate Profitability (Sept. 29, 2009) (unpublished manuscript, available at http://ssrn.com/abstract=1480394) (finding that "average cash flows decline by 1.3 percent of total assets after SOX"); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1528 (2005) (calling SOX "ill-conceived"). *But see* Stephen Wagner & Lee Ditmar, *The Unexpected Benefits of Sarbanes-Oxley*, HARV. BUS. REV., Apr. 2006, at 133, 140 (claiming that SOX improved operations of American companies).

19. Facilitating Shareholder Director Nominations, Exchange Act Release No. 34-60,089, 74 Fed. Reg. 29,029 (June 18, 2009).

20. *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 264 (1977) (stating that state corporate law has caused competition among the states for corporations—particularly Delaware); *see also* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 213 (2002); William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 303 (1997); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 541 (2001); Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 549–50 (1984); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 919–20 (1982).

21. *See* Bebchuk & Hamdani, *supra* note 5, at 584; Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 631–33 (2004); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 738 (2002) (arguing that many obstacles stand between states and the "top").

1. The Weakness of State Competition

It might seem that other states have motivation to challenge Delaware for corporate franchise fees and related income, and could do so by simply drafting a corporate law better than Delaware's, even if only slightly so. This is not the case. First, the financial motive is not that great. Delaware does get much of its state revenues from franchise fees.[22] It also realizes related income. For instance, for a small, economically minor state, Delaware has a remarkably large and prosperous corporate bar because of the importance of Delaware corporate law and corporate litigation in Delaware courts.[23] Naturally, the state corporate bar carefully controls corporate law legislation.[24]

But Delaware is a small state. For a large state, even grabbing all Delaware's franchise fees and spinoff income would not be very significant.[25] If another state did threaten to lure companies, Delaware would certainly fight back by revising its corporate law, lowering its incorporation fees, or both. Thus, a potential competitor faces the prospect of incurring considerable expense to enter the race with no assurance of much return.

If another state offered minor improvements over Delaware's law, Delaware would probably not even react because it would not lose many companies. Delaware dominates because of path dependency—it is favored not because of its statute, which does not differ much from other states' laws, but because it has a better developed body of corporate case law that is familiar to lawyers and business people nationwide.[26] Its Chancery Courts are well known for their expertise in handling business litigation, and the Delaware courts are notoriously partial to managers.[27] In the rare case when a court

22. Bebchuk & Hamdani, *supra* note 5, at 581 n.66 (calculating that Delaware derives about 27% of its tax revenues from franchise fees).

23. *See* Kahan & Kamar, *supra* note 21, at 694–99 (describing income to Delaware from corporate litigation in the state); Roberta A. Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 278–79 (1985); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 888–90 (1969) [hereinafter *Law for Sale*].

24. *See* ROBERTA A. ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 28–31 (1993); Ernest Folk, III, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. B.J. 409, 410–12 (1968) (stating that the 1963 committee that reviewed the Delaware law "consisted chiefly of pro-management corporation attorneys . . . the only interest represented [in the committee] was management"); Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1754–57 (2006) (describing the operation of the Council of Corporation Law Section of the Delaware State Bar Association); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 506–09 (1987); *Law for Sale*, *supra* note 23, at 868.

25. *See* Bebchuk & Hamdani, *supra* note 5, at 556, 584 (stating that for large states the potential profits "would not be significant"). For instance, Nevada, striving to be the "Delaware of the West," took in only $26,200 from the 18 companies that went public as Nevada corporations between 1996–2000. Kahan & Kamar, *supra* note 21, at 693.

26. *See* Oren Bar-Gill et al., *The Market for Corporate Law*, 162 J. INSTL. & THEORETICAL ECON. 134, 137 (2006) ("A state that has moved first to invest in legal infrastructure will be able to obtain, and subsequently maintain, a dominant position."); *id.* at 151–52, 155–56 (elaborating on the first-mover advantage); Adam C. Pritchard, *London as Delaware?* 10 (University of Michigan Law School, John M. Olin Center for Law & Economics, Working Paper No. 09-008, 2009), *available at* http://ssrn.com/abstract=1407610 ("The predictability of Delaware law is further bolstered by the large stock of precedents to which its courts can look in deciding cases.").

27. *See* Pritchard, *supra* note 26, at 10 (stating that Delaware guarantees that when litigation is brought, the directors will not be held personally liable). *See generally* Jill E. Fisch, *The Peculiar Role of the Delaware*

ruling upsets managers, the legislature quickly amends the law to restore calm.[28]

Delaware's deference to managers is subject to an instructive exception. In periods of dissatisfaction with its corporate law and agitation for federal legislation, the Delaware courts issue opinions seeming to ramp up the protection of investors. As soon as the heat is off, the kowtowing to CEOs resumes.[29]

Although the Delaware Chancery could be copied by other states, the effort would impose another big startup cost. A new court could not quickly match the reputation of the Delaware Chancery for expertise and for catering to management.[30] An aspiring competitor would have to commit to a long-term, expensive effort with no guarantee of much success.

The well developed case law and level of familiarity with Delaware law also could not be equaled by another state for many years, even if it did capture much of Delaware's franchise business. In sum, the barriers to competing with Delaware discourage any serious race among the states to the top, the bottom, or anywhere else. The potential for competition from other states or for preemption by the federal government does restrain Delaware somewhat, but it hardly assures an optimal system.

Although other states have made little effort to snatch Delaware's franchise business, there is evidence of defensive competition.[31] In a few cases, Delaware amended its corporate law so as to lure some companies from other states.[32] Many states responded by copying Delaware's changes in an effort to keep corporations they already had.[33] The effect of these efforts (or their absence) was significant—states that reacted slowly to Delaware's initiative lost many more corporations than did states that responded quickly.[34]

2. The Best Corporate Law for Whom?

Although interstate competition is weak, Delaware still has an incentive to offer the most attractive corporation law. But attractive to whom? The obvious answer is those

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Courts in the Competition for Corporate Charters, 68 U. CIN. L. REV. 1061 (2001) (discussing the unique roles of the Chancery courts in corporate lawmaking).

28. *See* Gordon Moodie, *Forty Years of Charter Competition: A Race to Protect Directors from Liability?* 39–41 (John M. Olin Fellows' Discussion Paper Series, Discussion Paper No. 1, 2004), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Moodie_1.pdf (describing the quick adoption of Delaware General Corporation Law section 102(b)(7) in order to legislatively negate *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985)).

29. *See* Jones, *supra* note 21, at 629, 644–62 (describing Delaware's responses to the federal preemptive threat); Moodie, *supra* note 28, at 33 ("As the federal threat abated [in the early 1980s], Delaware's approach gradually changed back in favor of managers."); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 642 (2003) (describing several incidents in which Delaware modified its pro-managerial tilt under federal threat, then restored that tilt once the threat dissipated).

30. *See Law for Sale*, *supra* note 23, at 861–62 ("Delaware is in the business of selling its corporation law" and it therefore "tries to give the [CEO] what he wants. In fact, those who will buy the product are not only consulted about their preferences, but are also allowed to design the product and run the factory."); *see also* Bebchuk & Hamdani, *supra* note 5, at 599–601, 607–08, 615.

31. *See* Moodie, *supra* note 28, at 20–27, 42–52 (surveying other states' actions and Delaware's response).

32. *See id.* at 17–20.

33. *See id.* at 20–27.

34. *Id.* at 25, 51–52.

who have the power to decide where to incorporate. In public companies that is the top managers, especially the CEO.[35] Shareholders alone cannot change the state of incorporation.[36] Neither can managers alone make the change, but a typically compliant board can propose a change to shareholders and expend corporate funds to exhort them to approve it. Board proposals enjoy a big advantage in a proxy vote; they are generally adopted unless the measure would seriously damage share value.[37]

Delaware corporate law might cater to investors rather than executives if investors could influence Delaware's politics. They cannot. Less than one percent of the American population and, accordingly, fewer than one percent of American shareholders of public companies, live and vote in Delaware.[38] Investors who live elsewhere can wield little influence in Delaware politics.

As a result, Delaware law heavily favors managers and directors over shareholders.[39] To the extent that there is competition for incorporations among the states, it is competition to appeal to managers. In two cases where other states reacted defensively by copying changes in Delaware law, the changes expanded the scope of permissible indemnification and insurance of directors and permitted elimination of the directors' duty of care.[40]

When a public company shifts its domicile to Delaware from another state, its stock price typically rises.[41] However, announcements of plans for such a shift are often

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35. *See* Bebchuk & Ferrell, *supra* note 5, at 133 ("Managers have significant control over reincorporation decisions."). The same incentive drives the other states. *See id.* at 140 (referring to the "persistent and uniform tendency of states to provide considerable protection to incumbents"); *see also* Bar-Gill et al., *supra* note 26, at 136 ("[W]ith respect to rules that have a substantial effect on managers' private benefits of control . . . states might adopt rules that make shareholders worse off.").

36. "[R]eincorporation is generally accomplished by merging the corporation into a shell corporation incorporated in the desired state." Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 844 (2005). This requires a resolution of the board of directors before a shareholder vote. *See id.* at 846–47; *see also, e.g.*, DEL. CODE ANN. tit 8, §§ 241, 251 (2002–03); *see also* WILLIAM MEADE FLETCHER, CORPORATION FORMS ANNOTATED § 1883.14 (4th ed. 2009) (describing shifting incorporation from one state to another by creation of a new corporation in the destination state and merging the old corporation into the new).

37. *See* Yair Listokin, *Management Always Wins the Close Ones*, 10 AM. L. & ECON. REV. 159, 161–62, 172–82 (2008) (showing that "management-sponsored proposals . . . are overwhelmingly more likely to win a corporate vote by a very small amount than lose by a very small amount"); Bayless Manning, Book Review, *Livingston, The American Stockholder*, 67 YALE L.J. 1477, 1485–89 (1958) (describing incumbent control of the proxy voting machinery).

38. According to the 2000 census, Delaware has about one-quarter of one percent of the population of the United States. *See* Delaware QuickFacts from the U.S. Census Bureau, http://quickfacts.census.gov/gfd/states/10000.html (last visited Feb. 26, 2010).

39. *See* Folk, *supra* note 24, at 410 (stating that corporate law revisions were "exclusively concerned with only one constituent of the corporate community—management"); Manuel Cohen, *Introduction*, *in* PROXY CONTESTS FOR CORPORATE CONTROL xv (E. Aranow & H. Einhorn eds., 1968) ("The history of state corporation laws over the past decade . . . has been one of reducing protections for shareholders and expanding the discretion of corporate management."). Another reason for Delaware's popularity with executives may be its strong protections of financial secrecy. *See* Nick Mathiason, *Delaware – A Black Hole in the Heart of America*, THE OBSERVER, Nov. 1, 2009, at 8.

40. *See* Moodie, *supra* note 28, at 20–27, 42–52 (discussing other states imitating Delaware's liberalization of its director liability statute).

41. *See* Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 381 (2002) (reviewing in detail how event studies have been used

accompanied by announcements of other beneficial corporate developments (such as the listing of the firm's stock on a major stock exchange), so the typical rise in stock price may be a response to the accompanying good news, and not to the adoption of Delaware corporation law.[42] This inference is supported by the lack of evidence that incorporation in Delaware is generally associated with higher stock prices or other indicia of value.[43] Even if incorporation in Delaware is associated with higher stock prices, that correlation could reflect just "network externalities, which arise when many companies choose to incorporate in one specific state."[44]

It is also argued that investors can price the quality of a company's governance, including its applicable state law, so insiders have an incentive to choose the best state of incorporation when a company goes public.[45] The market for initial public offerings (IPOs) has many inefficiencies, though.[46] At most, then, the frequent choice of Delaware by firms making IPOs shows that no other state's law is greatly superior. The discussion in the preceding Part explains why this is so.[47]

II. THE PROMISE OF FEDERAL INCORPORATION

Why might a federal corporation law be better than existing state laws? First, the economic incentives are different for the federal government than for the states. Again, Delaware gets a substantial part of its revenue from franchise fees, and therefore is motivated to maximize that revenue. That amount of revenue is too small to influence the

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to evaluate the wealth effects of corporate and securities law and corporate governance); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1792–94 (2002).

42. *See* ROMANO, *supra* note 24, at 250; Bhagat & Romano, *supra* note 41, at 385.

43. *See, e.g.*, Subramanian, *supra* note 2, at 33 (finding no evidence of a correlation in the 1990s, except for firms with small market value).

44. Bar-Gill et al., *supra* note 26, at 142. "Such externalities include the benefits that a company may enjoy from having more precedents to rely on and from being subject to rules and practices with which capital market participants are well familiar." *Id.* at 136. *See also* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 733–36 (1997) (discussing the effects of network externalities); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 772–86 (1995) (discussing corporate contract terms and network externalities).

45. *See* Stephen M. Bainbridge, Response, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1737 (2006) (discussing benefits for investors when a corporation goes public); Jeffrey N. Gordon, *Shareholder Initiative: A Social Choice and Game Theoretic Approach to Corporate Law*, 60 U. CIN. L. REV. 347, 358 (1991) (positing that "entrepreneurs selling stock to the public would bear the cost" of suboptimal corporate governance terms); Marcel Kahan & Edward B. Rock, *Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment*, 152 U. PA. L. REV. 473, 502 (2003) ("[W]e continue to believe that the IPO charter terms provide substantial evidence of appropriate governance structures."); Lynn A. Stout, *Do Antitakeover Defenses Decrease Shareholder Wealth? The Ex Post/Ex Ante Valuation Problem*, 55 STAN. L. REV. 845, 853–56 (2002) ("[S]hareholders *act as if* they value corporate governance rules that insulate boards from hostile takeovers.") (emphasis added).

46. *See* Dent, *supra* note 9, at 1256–60 (discussing vulnerabilities in evaluating IPOs); *see also* Jay C. Hartzell, Jarl G. Kallberg & Crocker H. Liv, *The Role of Corporate Governance in Initial Public Offerings: Evidence from Real Estate Investment Trusts*, 51 J.L. & ECON. 539, 539 (2008) (empirical study finding that companies with strong shareholder rights "have higher IPO valuations").

47. *See supra* Part I.B.1 (noting that Delaware's greatest advantage is the level of experience and reputation of the corporate bar).

federal government. Unlike Delaware, the federal government would not be swayed by the lure of related income (e.g., to local lawyers) since all the related activity already occurs and will continue to occur somewhere within the United States. Indeed, Congressional representatives from the other 49 states have an incentive to spread this income around more equally, rather than having it concentrated in tiny Delaware. Congress should also care more than the Delaware legislature does about the hundreds of billions of dollars lost to the national economy by poor corporate governance.[48]

Second, the political vectors differ for the federal government. Fewer than one percent of investors live and vote in Delaware, but all shareholders of American companies other than foreigners can vote in federal elections. Although investors always face collective action problems,[49] there are investor organizations that strive to influence federal law.[50] At the least, the playing field is not so severely tilted against shareholders at the federal level as it is in Delaware.

The resources and structure of the federal government make it less likely to snub investor concerns. Congressional staffs are larger than those of state legislatures. Part of the work of the Treasury, the Federal Reserve, and other government agencies is to analyze the economic effects of government policy. The SEC and other agencies are charged with protecting the interests of investors. With these resources and missions, the federal government can poll and weigh investor concerns, rather than having to rely on well funded and organized corporate executives and their lawyers, as Delaware does.[51]

Finally, only the federal government has the authority to preempt state law.[52] States cannot lure public companies from Delaware by catering to shareholders, because under Delaware law shareholders cannot change the state of incorporation.[53] The federal government, however, could preempt state law and permit shareholders alone to shift the state of incorporation.[54]

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48. *See* Bebchuk & Hamdani, *supra* note 5, at 613–14 ("The federal government . . . has different incentives. . . . [It] would take into account not only the likely effects . . . on its incorporation-related revenues, but also the overall effect on the economy.").

49. *See* Coates, *supra* note 8, at 849 (stating that the two traditional collective action problems facing shareholders are "costs of communication, negotiation, and coordination" and "free-riding"); Shann Turnbull, Invigorating Capitalism 4 (Sixth International Conference on Corporate Governance & Board Leadership Paper, 2003, available at http://ssrn.com/abstract=437981) (stating that cost-benefit analysis, free riders, and uncertain outcomes prompt "institutional shareholders to be 'reluctant,' apathetic or negligent in exercising their ownership rights").

50. One such group is the Council for Institutional Investors. About the Council, http://www.cii.org/about (last visited Jan. 25, 2010). Another is Investors for Director Accountability. *See* Investors for Direct Accountability, http://www.investorsfordirectoraccountability.org/about.html (last visited Jan. 25, 2010). Another is ShareOwners.Org, a new web-based organization intended to give investors a bigger voice in regulatory reform. *See* Shareholders.org, http://www.shareowners.org (last visited Feb. 26, 2010); *see also* Jones, *supra* note 21, at 636–37 (describing the participation of investor groups in some federal corporate and securities law matters).

51. *See supra* note 24 and accompanying text (describing potential conflicts of interest).

52. U.S. CONST. art. VI, § 1 cl. 2 ("This Constitution, and the Laws of the United States . . . shall be the supreme Law of the Land . . . .").

53. *See supra* note 36 (discussing the methods for changing a company's state of incorporation from Delaware to another state).

54. *See infra* Part IV.A (discussing the potential implications of shareholder selection procedures).

It has been urged that the federal government (both Congress and the SEC) not actually intervene in corporate governance, but only *threaten* to intervene.[55] One argument for this approach is that the federal government is likely to botch actual intervention, citing the example of SOX.[56] However, federal intervention has often been beneficial.[57] Further, the argument begs the question of how benign state (i.e., Delaware) corporate law now is. Delaware's corporate law now is so bad[58] that even a badly flawed federal statute might well be better. Most important, though, the intervention proposed here is merely optional; if an optional federal corporate law is not materially superior to the state law under which a company is already incorporated, shareholders will simply not opt into the federal law.

It is also hard to see how a strategy of federal threats to intervene could be effectively implemented. In order to work, the strategy must be backed up sometimes by actual intervention. If it is not, the states will soon realize that it is a bluff and ignore it. However, Congress is ill-suited to make threats and then "wait a sufficiently long period of time"[59] to give Delaware a chance to mend its ways before Congress intervenes. For Congress, corporate law is a minor issue that it addresses only during brief periods of public outrage,[60] and then it tends not to wait but to act hastily and clumsily.[61]

The threaten-and-wait strategy also invites a sham response by Delaware. Knowing Congress's short attention span in matters of corporate law, Delaware can pretend to take the steps that Congress wants. When the heat is off, Delaware can revert to its usual anti-investor policies. Evidently, that is exactly what Delaware does.[62]

Because of the problems of Congressional intervention, it is suggested that the strategy of threats would be better implemented by the SEC.[63] However, the SEC's jurisdiction is limited to matters like disclosure and proxy solicitations; it does not extend to corporate governance in general.[64] If it tries to correct problems of state corporate law, its effort must be indirect, and probably inefficient. There is no movement now among

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55. *See* Note, *The Case for Federal Threats in Corporate Governance*, 118 HARV. L. REV. 2726, 2741–47 (2005) [hereinafter *Federal Threats*] (arguing that federal threats could be effective, even without acting on these threats); *see also* Jones, *supra* note 21, at 629 ("I urge a sustained vigilance from Congress and a willingness to take limited preemptive measures when state corporate law rules fall short in providing adequate protection for investors.").

56. *See Federal Threats*, *supra* note 55, at 2740–41 (arguing that Congress hastily considered and approved SOX, leading to an inefficient response).

57. *See supra* note 17 (marshalling sources citing effective federal regulations).

58. *See supra* Part I.

59. *Federal Threats*, *supra* note 55, at 2742.

60. *See infra* note 98 and accompanying text (arguing that Congress only addresses corporate law when it becomes a hot-button issue).

61. *See supra* note 18 and accompanying text (citing prior ineffective or counterproductive regulations).

62. *See supra* note 29 and accompanying text (arguing that Delaware corporation law caters to management at the expense of investors).

63. *See Federal Threats*, *supra* note 55, at 2742 (noting that the "SEC can make threats by considering proposed rules").

64. *See* Cort v. Ash, 422 U.S. 66, 84 (1975) ("[E]xcept where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation.") (emphasis added); *see also* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 479 (1977) (rejecting an interpretation of SEC Rule 10b-5 under which "the federal securities law would overlap and quite possibly interfere with state corporate law").

investors or anyone else to expand the SEC's jurisdiction to corporate governance, and such a move could lead to serious public choice problems.[65]

III. WHY OPTIONAL?

If federal incorporation holds such promise, why not make it mandatory for public companies? Mandatory federal incorporation has often been proposed.[66] There are some arguments for it, but they are not compelling. Moreover, mandatory federal incorporation would pose some dangers that would be avoided by an optional system.

Mandatory federal incorporation would provide uniformity. The rules would be the same for all public companies, and the courts would develop a uniform body of case law. Uniformity would reduce the costs to lawyers, investors, and business people of having to deal with 50 different state laws. A national body of case law could also reduce the uncertainty of the current system, in which the division of case law into 50 separate bodies leaves many issues unsettled in many states.[67]

Lack of uniformity and uncertainty about the law are not major problems now, though. Since most public companies are incorporated in Delaware, its statute to some extent functions as a national law, and its case law is well developed. Other states tend to follow Delaware,[68] which further enhances uniformity and predictability.

Mandatory federal incorporation would also eliminate the transaction costs and inefficiencies of having to opt in to federal incorporation. No proxy votes or other action would be needed, and there would be no possibility of wrong choices. However, proxy statements already typically present many proposals, including several shareholder proposals mandated by public law.[69] The cost of adding a one-time item to the proxy statement of each public company would be small.

The chances of shareholders making a bad choice are small. Shareholders are sophisticated, get good advice, and tend to vote wisely.[70] A vote on whether to elect federal incorporation would get close attention, especially since it would initially arise simultaneously for all public companies. If a federal law is indeed shareholder friendly, corporate executives will certainly give full voice to the arguments against it. In the unlikely event that shareholders later concluded that they had made wrong choices in

65. *See infra* notes 100–02 and accompanying text (arguing that corporate special interests will prevail over less-powerful investors).

66. *See, e.g.*, Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89, 95–96 (1972) (giving the history of efforts for mandatory federal incorporation); Kent Greenfield, *It's Time to Federalize Corporate Charters: Delaware and Other States Aren't Tough Enough*, TOMPAINE.COM, July 26, 2002, http://www.corporation2020.org/corporation2020/documents/Resources/Greenfield_Charters.htm (noting that most states will not reform corporate law because they fear losing substantial revenue).

67. Indeed, one widely recognized advantage of Delaware is that its case law is better developed and more predictable than that of other states. *See* Pritchard, *supra* note 26, at 10 (stating that the "predictability of Delaware law is further bolstered by the large stock of precedents to which its courts can look in deciding cases").

68. *See* Moodie, *supra* note 28, at 20 (stating that "Delaware's success led to widespread imitation"); *id.* at 20–27, 42–52 (documenting that claim); *see also* Romano, *supra* note 23, at 233–37 (stating that other states "follow the leader" because they would otherwise "lose incorporations at the margin").

69. *See* 17 C.F.R. § 240.14a-8 (2009) (requiring inclusion of certain shareholder proposals in proxy statements of public companies).

70. *See infra* note 85 and accompanying text.

some or all cases, federal law can (and should) allow them to change again.[71]

Third, mandatory federal incorporation would allow a corporate governance system that would serve the interests of stakeholders other than shareholders and managers. It has been argued that the employees, customers, suppliers, and communities in which a company operates have concerns about the company that should be represented in corporate governance.[72] The general public also has concerns about corporate conduct with respect, for example, to activities affecting the environment. These stakeholders have no direct voice in corporate governance under current state law.[73] If federal incorporation is optional, inclusion of stakeholder interests under federal corporate law may repel shareholders from electing that option.

However, direct stakeholder participation in corporate governance is a bad idea.[74] Employees, customers, and suppliers can protect their interests through contracts with the corporation that specify the consideration on both sides. The general public can protect its interests in matters like the environment by legislation addressed to those issues. By contrast, the shareholders' relationship with the corporation is not a true contract at all, and it gives shareholders almost no specific rights.[75] Investors have some protections under state and federal law, but these are inadequate.[76] Moreover, only shareholders have an incentive to maximize profit, which corresponds with society's interest in maximizing efficiency.[77] Thus, the possibility that mandatory federal incorporation would give stakeholders a substantial role in corporate governance is a liability of that approach, not an asset.

Mandatory federal incorporation would invite other problems.[78] Although the federal political arena would give shareholders a more level playing field than do the states, Congress would, as always, be tempted to use mandatory federal incorporation to indulge rent-seeking by other special interests.[79] The power of investors to reject federal

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71. *See infra* Part IV.A.

72. *See, e.g.*, Kent Greenfield, *Defending Stakeholder Governance*, 58 CASE W. RES. L. REV. 1043 (2009) (arguing that, to succeed, businesses must include a wide array of people and entities in financial investments).

73. *See id.* at 1044.

74. *See* George W. Dent, Jr., *Stakeholder Governance: A Bad Idea Getting Worse*, 58 CASE W. RES. L. REV. 1107, 1107 (2008) (arguing that shareholder primacy is the preferred system).

75. *See* Stephen M. Bainbridge, *Shareholder Activism in the Obama Era* 3–4 (UCLA School of Law, Law-Econ Research Paper No. 09-14, 2009), *available at* http://ssrn.com/abstract=1437791 (cataloging direct and indirect limits on shareholder powers); Bebchuk, *supra* note 36, at 843–47 (same).

76. *See supra* text following note 20; *supra* Part I.B.2.

77. Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1267–68 (1999) ("[S]hareholders, as residual claimants, have the greatest incentive to maximize the value of the firm."). *See also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 68 (1991) ("As the residual claimants, shareholders have the appropriate incentives . . . to make discretionary decisions."); E. Han Kim, *Corporate Governance and Labor Relations*, 21 J. APPLIED CORP. FIN. 57, 57 (2009) ("[S]hareholders . . . are in the best position to make the value-maximizing tradeoffs that all companies confront."); *id.* at 58 ("Taking their perspective ends up increasing the odds that social resources are put to their highest valued uses."); Anant K. Sundaram & Andrew C. Inkpen, *The Corporate Objective Revisited*, 15 ORG. SCI. 350, 353 (2004) ("Only residual cash flow claimants have the incentive to maximize the total value of the firm.").

78. *See* ROMANO, *supra* note 24, chs. 4–5; Bebchuk & Ferrell, *supra* note 5, at 141.

79. The initial enthusiasm for investor control might assure that a mandatory federal incorporation law would favor shareholders. Over time, however, the collective action problem inherent in such a large, scattered

incorporation if it does not serve their interests would limit the ability of federal incorporation to saddle public companies with inefficiencies.

Mandatory federal incorporation would also forfeit the benefits of jurisdictional competition. Even if Congress tries to serve the public rather than special interests, there is disagreement about the optimal features of corporate law.[80] Under optional federal incorporation, the states could compete for franchise fees by trying to offer a law more appealing to shareholders.[81] Mandatory federal incorporation would preclude such competition.

Some have argued for federal minimum standards for state incorporation instead of mandatory federal incorporation.[82] Although this approach might improve on the status quo, it is less promising than optional federal incorporation, because it would establish mandatory national standards. It would pose most of the dangers of mandatory federal incorporation. Congress would still be tempted to cater to special interests. Even if well-intended, the federal law might be sub-optimal. In either case, injured investors would have no way of opting out of detrimental national rules.

Minimum federal standards would also foster complications, rather than the greater simplicity and certainty of optional federal incorporation. Litigation would be necessary, possibly quite often, to determine whether a state's law met the federal minimum. Such litigation would raise federal questions and therefore would presumably be delegated to the federal courts. If litigation over ordinary interpretation were relegated to state courts, case law would be fragmented and thus less certain than a uniform federal body of law. Difficult issues might be shunted back and forth between state and federal judiciaries.

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group as investors, see *supra* note 50, could weaken their influence and allow manager and stakeholder interests to obtain anti-investor revisions of the federal law, or, at least, block desirable pro-shareholder revisions. *See* Bebchuk & Ferrell, *supra* note 5, at 141–42 (arguing that a mandatory federal incorporation would be less desirable than the current state incorporation system). This seems to have happened as management interests have persuaded Congress to restrict civil claims under the federal securities laws. *See* Steven A. Ramirez, *Arbitration and Reform in Private Securities Litigation: Dealing with the Meritorious as Well as the Frivolous*, 40 WM. & MARY L. REV. 1055, 1087 n.156 (1999) (describing management efforts that led to the restrictions imposed by the Private Securities Litigation Reform Act of 1995); *see also* MILLS, *supra* note 8, at 87 (describing how lobbyists representing auditing firms thwarted SEC head Arthur Levitt's attempts to eliminate some conflicts of interest by barring auditors to also do consulting for those whom they audit).

80. *See, e.g.*, *supra* notes 18 (concerning disagreement over the effects of SOX), 20–21 (discussing whether there is a "race to the top" among the states), 72–77 and accompanying text (concerning disagreement over the desirability of a direct stakeholder voice in corporate governance); *infra* notes 93–96 and accompanying text (concerning disagreement over the desirability of enhancing shareholder power in corporate governance).

81. Bebchuk & Hamdani, *supra* note 5, at 613 ("In Canada, the introduction of a federal option has had a substantial impact on the rules offered by the provinces . . . .") (citing Douglas Cummings & Jeffrey MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141 (2000) (undertaking an empirical examination of both the supply and demand sides of Canadian corporate law to determine whether competitive corporate law production in Canada shares any similarities with United States corporate law)); Ronald Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130 (1991).

82. *See* Cary, *supra* note 2, at 696–705; Joel Seligman, *The Case for Federal Minimum Corporate Law Standards*, 49 MD. L. REV. 947, 949 (1990) (supporting "minimalist federal corporate law" in light of the deterioration of old restraints on corporate managers).

IV. THE CONTENT OF A FEDERAL OPTION

A. Selection Procedures

A potential problem with optional federal incorporation is that under current state law, entrenched executives have the power to prevent a corporation from reincorporating in another jurisdiction.[83] If an optional federal corporation law would weaken their hold on corporate power, they could block shareholders from opting into that law. It is therefore essential that an optional federal incorporation law allow public companies to elect that option by a simple shareholder vote.[84]

It is most unlikely that shareholders would vote against their best interests. They have already shown themselves able to vote in their own interests. Shareholders (especially of mutual funds) tend to support proxy proposals that increase share value.[85] They certainly could be expected to do so on such an important question as whether to choose a new federal corporation law.

Opponents of increased shareholder power (other than stakeholder advocates) charge that shareholders are often myopic and that different shareholders have very different goals and interests. They claim that expanding shareholder power would result in public companies focusing excessively on short-term results[86] and in battles among

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83. *See supra* notes 36–37 and accompanying text (noting that shareholders alone cannot change the state of incorporation).

84. *See* Bar-Gill et al., *supra* note 26, at 154 (stating that the current incentives of states to cater to managers "can be improved by giving shareholders the power to initiate and adopt reincorporation decisions").

85. *See* Angela Morgan et al., Mutual Funds as Monitors: Evidence from Mutual Fund Voting 30 (July 7, 2009) (unpublished manuscript, available at http://ssrn.com/abstract=1431072) (finding, in an empirical study, that mutual "funds tend to support proposals which are likely to positively impact shareholder wealth," which "supports the theory that mutual funds act as effective monitors when exercising their proxy voting rights"). Proxy advisory services would surely make recommendations on these votes, and their recommendations are associated with positive stock price effects. *See* Cindy R. Alexander et al., *The Role of Advisory Services in Proxy Voting* 3, 16, 34–35 (Nat'l Bureau of Econ. Research Working Paper Series No. 15143, 2009), *available at* http://www.nber.org/papers/w15143 (finding, in an empirical study, that the recommendations of Institutional Shareholder Services, the largest proxy advisory service, are associated with positive stock price changes); *see also* Lucian A. Bebchuk, *Reply: Letting Shareholders Set the Rules*, 119 HARV. L. REV. 1784, 1799 (2006) ("Although a wide range of precatory resolutions are put forward [for shareholder vote], the ones that obtain majority support are those . . . that are widely viewed by financial institutions as serving shareholder interests."); Yair Listokin, *Corporate Voting versus Market Price Setting*, 11 AM. L. & ECON. REV. 608, 610, 622–27 (2009) (finding in empirical study that "[w]hen management wins a close [proxy contest] election, market value declines; when a dissident wins, the value rises"); Luc Renneboog & Peter Szilagyi, *Shareholder Activism Through the Proxy Process* 3 (CentER Discussion Paper Series No. 2009-031), *available at* http://ssrn.com/abstract=1460578 (empirical study finding that "shareholder proposals tend to be carefully targeted at firms that both underperform and have generally poor governance structures" and that "proposal announcements . . . are actually met with significantly positive stock price reactions"). The trend for institutional investors to hold larger blocks of stock of individual companies may further improve shareholder voting because large blockholders tend to do better monitoring. *See* Aviv Pichhadze, *The Nature of Corporate Ownership in the USA: The Trend Towards the Market Oriented Blockholder Model*, 5 CAPITAL MKT. L.J. 63, 71–82 (2010) (describing the trend toward holding larger blocks); *id.* at 82–83 (stating that large blockholders engage in "increased monitoring").

86. *See* Patrick Bolton et al., *Pay for Short-Term Performance: Executive Compensation in Speculative Markets*, 30 J. CORP. L. 721, 725 (2005) (alleging a conflict between current shareholders who profit from "earnings manipulation" and future shareholders); William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1284 (2002); Martin Lipton & Steven A. Rosenblum, *Election Contests in the*

various shareholder groups trying to enrich themselves at the expense of other shareholders.[87] These accusations are almost entirely false. With a few exceptions (notably labor unions and employee pension plans), shareholders are remarkably united behind the goal of maximizing share value.[88] There is no credible evidence of substantial shareholder "short-termism;" indeed, the goal of maximizing share value rules out myopia.[89] To the extent that there is a problem of "short-termism" in American public companies, it stems from the skewed incentives of executives, not pressures from shareholders.[90]

A federal law giving shareholders continuing power to change the jurisdiction of incorporation would also prevent Congress from catering to corporate executives or other interest groups by changing the rules to the disadvantage of shareholders after public companies have opted into the federal law. Indeed, this power would precipitate ongoing competition among the states and the federal government to devise the law most attractive to shareholders, since managers would no longer be able to override the shareholders' preferences.

There is little danger, though, that this competition would lead to such frequent changes as to cause confusion. Changing jurisdictions will always entail substantial transaction costs. Any shareholders seeking to change jurisdiction will have to absorb the costs of persuading a majority of their colleagues to approve the change. Inertia will favor the status quo. Only the promise of a substantial improvement is likely to earn that approval.

Carl Icahn has proposed a federal law that would simply give shareholders the power to choose the state of incorporation.[91] This change might trigger a real race to the

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Company's Proxy: An Idea Whose Time Has Not Come, 59 BUS. LAW. 67, 78 (2003) (stating that some shareholders "may seek to push the corporation into steps designed to create a short-term pop in the company's share price"); Lynn A. Stout, *Why Carl Icahn Is Bad for Investors*, WALL ST. J., Aug. 1, 2008, at A11 (stating that "'[a]ctivist' shareholders are usually short-termers").

87. *See* Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 577–93 (2006) (alleging various conflicts of interest among shareholders); Bainbridge, *supra* note 45, at 1751, 1754–57 (positing danger of special interest shareholders); Jill E. Fisch, *Measuring Efficiency in Corporate Law: The Role of Shareholder Primacy*, 31 J. CORP. L. 637, 661 (2006) ("[I]nvestors vary considerably among such dimensions as the time frame over which they invest, the extent to which they trade versus passively holding the corporation's stock, their degree of diversification, the extent to which they hold non-equity interests in the issuer, any option or other hedging positions that they hold, and so forth."); Gordon, *supra* note 45, at 368–70 (noting shareholder differences over time horizons, risk preferences, and expectations for the future); Lipton & Rosenblum, *supra* note 86, at 78 ("[M]any institutional investors and other activist investors have competing interests that may conflict with the best interests of the public corporation and its shareholder body and other constituencies taken as a whole."); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 794 (2002) ("Board power . . . protect[s] shareholders from *each other*."); Lynn A. Stout, *Takeovers in the Ivory Tower: How Academics Are Learning Martin Lipton May Be Right*, 60 BUS. LAW. 1435, 1447–49 (2005) (claiming that highly diversified shareholders may oppose share-price maximization in some firms because of their interests in others).

88. *See* Dent, *supra* note 14, at 100–05.

89. *See id.* at 105–22.

90. *See supra* notes 11–14 and accompanying text; *see also* Dent, *supra* note 14, at 109–10.

91. Carl Icahn, *Corporate Boards That Do Their Job*, WASH. POST, Feb. 16, 2009, at A15 ("What is needed is a superseding federal law that gives shareholders the right to vote by simple majority to move their company's legal incorporation to states that uphold greater shareholder rights."); Carl Icahn, *We're Not the Boss of A.I.G.*, N.Y. TIMES, Mar. 29, 2009, at 9 (arguing that the "best hope" to improve corporate governance is "to

top. Since shareholders want to maximize share value rather than CEO welfare, states would have an incentive to stop striving for the latter and start striving for the former. If there are insuperable political obstacles to creation of a federal chartering option, Icahn's proposal would probably be a good second choice. However, even with shareholders choosing the state of incorporation, the financial incentives to the states would still be small,[92] so the race might be apathetic. Further, so long as federal incorporation is optional with the shareholders, it is hard to see what danger it poses.

B. The Substantive Law

There is considerable debate about the optimal rules of corporate law, but a convincing argument exists for giving shareholders greater power in corporate governance. Although the corporate bar that serves managers and some academics still oppose a stronger voice for shareholders,[93] the explosion of executive compensation, the corporate recklessness that has contributed to the current economic meltdown, and the flight of investors to other nations[94] show that our corporate governance system now is broken. The SOX Act and other measures taken in the last few years to increase transparency and disclosure, to strengthen "gatekeepers" like lawyers and accountants, and to bolster the independence of corporate boards from the CEO have not worked.[95] Further steps of this kind will likely be unsuccessful also.

There are many ideas for increasing shareholder power. I have suggested that the corporate governance problem could be solved simply by having each company's official slate of nominees for election to the board chosen by a committee of the 10–20 largest shareholders, rather than by the incumbent directors.[96] Even without a change in the composition of boards, this innovation would radically alter corporate governance—directors would become responsive to shareholders rather than CEOs because they would know that they would be *chosen* by shareholders rather than the CEO.

Steven Ramirez has recommended the creation of a federal agency that would dictate governance standards for companies that choose federal incorporation in the way that the Federal Reserve Board dictates monetary policy.[97] Although I generally applaud the substantive rules he proposes, it might be wiser to eschew a package of substantive rules in favor of an "enabling" act that allows companies wide discretion to set their own rules so long as ultimate power is vested in the shareholders. First, however wise and disinterested the drafters of specific rules may be, they can err. Rule-making is cumbersome. Specific rules may become outdated through failure to promptly adjust to rapidly changing conditions or to adopt new and better ideas when they emerge. Delay would be an even greater problem if rules were not subject to revision by an

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allow shareholders the power to move the state of incorporation of public companies from one state to another").

92. *See supra* note 24 and accompanying text.

93. *See supra* notes 86–87 (describing the problems which could result from expanding shareholder power).

94. *See supra* Part I.A (analyzing the corporate governance problem).

95. *See supra* notes 18–19 and accompanying text (discussing reactions to SOX and other initiatives).

96. George W. Dent, Jr., *Toward Unifying Corporate Ownership and Control*, 1989 WIS. L. REV. 881, 907.

97. Ramirez, *supra* note 5, at 317, 347–58.

administrative agency, but rather enshrined in a statute that could be amended only by Congress. There, corporate law is usually neglected in favor of matters of greater political significance,[98] and the complexities of law-making allow a small minority to block action supported by the majority.

Further, it would be impossible for a federal agency (much less Congress) to consider the differences among various companies and to design the optimal governance program for each.[99] Better to leave enterprise design to shareholders, who have a financial motive to customize governance rules to maximize profits.

More importantly, as public choice theory shows, in both legislation and regulation special interest groups often prevail over the public interest.[100] Although investors are more effective in law-making at the federal level than in Delaware, many other groups (e.g., labor unions, plaintiffs' lawyers, and local governments) also wield considerable clout there,[101] and they generally pursue different goals from the maximization of share value.[102] A substantial number of the over 100 million Americans who are investors may be sufficiently aware and concerned to voice support once for a federal corporation law giving shareholders ultimate power. They will not be willing or able to exert themselves in frequent agency proceedings precipitated by management interests or other groups seeking exceptions to shareholder control for particular categories of companies.

In summary, however desirable in general a particular set of corporate governance rules might be, it is unlikely that it could overcome interest group politics to be enacted into law; it would probably not be optimal for some companies; over time it would cease to be optimal; and it would be chipped away by interest groups better positioned for

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98. *See* Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2530 (2005) (stating that Congress generally deals with corporate law only when "constituents scream, fire alarms go off, and the media spots a big issue"). A related problem is that when Congress is goaded to address corporate law, it is likely to act hastily and carelessly, as happened with SOX. *See* William B. Chandler III & Leo E. Strine, Jr., *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 U. PA. L. REV. 953, 957 (2003) (claiming that the provisions of SOX "suffer from the rapidity of their enactment and a tendency to deal with many issues somewhat superficially and sporadically"); Michael A. Perino, *Enron's Legislative Aftermath: Some Reflections on the Deterrence Aspects of the Sarbanes-Oxley Act of 2002*, 76 ST. JOHN'S L. REV. 671, 672 (2002) (stating that Congress's haste resulted in "a disorganized law"); *Federal Threats*, *supra* note 55, at 2739 ("Moreover, once Congress adopts an inefficient rule, the rule is unlikely to generate enough public interest for Congress to abandon or correct it.").

99. A common objection to SOX has been that, whatever its effects on large public companies, it has been detrimental for smaller public companies. Thus, enactment of SOX was followed by an increase in going private transactions. *See generally* Stanley B. Block, *The Latest Movement To Going Private: An Empirical Study*, J. APPLIED FIN., Spring/Summer 2004, at 36; Ellen Engel et al., *The Sarbanes-Oxley Act and Firms' Going-Private Decisions*, 44 J. ACCT. & ECON. 116 (2007); Ehud Kamar et al., *Going-Private Decisions and the Sarbanes-Oxley Act of 2002: A Cross-Country Analysis*, 25 J.L. ECON. ORG. 107 (2009). It was also followed by an increase in firms "going dark"—i.e., deregistering without eliminating all public shareholders. *See generally* Christian Leuz et al., *Why Do Firms Go Dark? Causes and Economic Consequences of Voluntary SEC Deregistrations*, 45 J. ACCT. & ECON. 181 (2008) (arguing that SOX created shocks to the costs and benefits of reporting, which are frequently stated by management when explaining why their firms went dark).

100. *See, e.g.*, J. Mark Ramseyer, Lecture at the University of Chicago Law School (Feb. 21, 1996), *in* CHICAGO LECTURES IN LAW AND ECONOMICS 101, 104 (Eric A. Posner ed.) (2000) ("[I]nterest groups often [have] an influence all out of proportion to the number of their members.").

101. *See generally* JEFFREY M. BERRY, THE INTEREST GROUP SOCIETY (3d ed. 1977); JOHN R. WRIGHT, INTEREST GROUPS AND CONGRESS (2003).

102. *See* Dent, *supra* note 14, at 106–09 (discussing the behavior of employee and political shareholders).

lobbying than investors were. Better instead a law that simply gives shareholders ultimate control and lets them decide on specifics at the company level. They are unlikely to vote against their own (and the public's) interest in maximizing share value.[103]

More important than the initial content of an optional federal corporation law, though, is that its enactment will create a whole new ballgame. Experience with the initial law will be monitored by all affected groups, and some will undoubtedly call for revisions. With shareholders empowered to choose the jurisdiction of incorporation, the states will also be motivated to change their approach and compete for franchise fees by trying to design a law superior to the competing federal and state corporate laws. In sum, creation of an optional federal corporation law should ignite a process of thought, discussion, and competition by which corporate governance law will constantly evolve and improve.

V. CONCLUSION

The American economy suffers from the domination of corporations by CEOs who exercise control for their own benefit, at considerable cost to shareholders and to efficiency. The costs of this defect are rising as capital flees the United States for a growing number of countries that treat investors better. America's corporate governance problem began and persists because corporations are franchised by the states, and it is in the economic interest of the states (especially Delaware) to cater to CEOs because they control the choice of the state of incorporation.

To break this destructive arrangement, the federal government should offer its own incorporation law as a voluntary alternative to the state franchises, and stipulate that the choice of jurisdiction will be made by shareholders alone. Shareholders are the only constituency whose goal is to maximize share value, and this goal coincides with society's interest in economic efficiency. Shareholders also have the sophistication to decide major corporate questions wisely.

The federal government would have strong incentives to offer a law that facilitates the shareholders' goal of efficiency. The existence of this law and the institution of shareholder choice of jurisdiction of incorporation would motivate states to seek franchise fees by offering statutes that favor shareholders even more. Thus optional federal incorporation would trigger a true "race to the top," a competition to offer the most efficient corporation law. This process would make America more attractive to investors, and the resulting influx of investment capital would stimulate economic prosperity.

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103. *See id.* at 134–41 (showing that shareholders generally vote to maximize share value); *see also supra* note 85 and accompanying text.