

FEDERAL CORPORATE LAW: LESSONS FROM HISTORY

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This Essay analyzes the history of federal intervention in corporate law and draws from it lessons for the future. We show that federal intervention has generally not alternated between tightening state law restrictions on corporate insiders and relaxing them. Rather, federal law has systematically replaced state law arrangements with ones imposing tighter constraints on insiders. Without federal intervention, state law would have produced a corporate system that provides substantially weaker investor protection than the United States enjoys today. We also show that federal interventions have systematically taken advantage of additional tools (including public enforcement, criminal sanctions, gatekeeper liability, and agency-based regulations) beyond those that state law has chosen or been able to use. Overall, unless one views existing levels of investor protection as substantially excessive, past patterns suggest that state competition on its own is unlikely to produce an adequate level of investor protection. Furthermore, the recurring need for federal officials to rectify state law failures in order to provide investors with adequate protection indicates that federal lawmaking should be proactive rather than reactive. We thus recommend that, going forward, federal policymakers examine in a systematic and comprehensive fashion which corporate law areas should be federalized either because tighter restrictions on insiders are needed or because the additional tools available to federal law would be useful.

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INTRODUCTION

One of the fundamental questions facing corporate law scholarship concerns regulatory competition. Does the competition for corporate charters induce states to offer arrangements that enhance shareholder value?¹ What role if any should federal law play in the regulation of corporate affairs? With these questions in mind, we examine the history of federal intervention in corporate law over the past seven decades. We draw from this history lessons about the past performance of regulatory competition and the desirable scope of state law in the corporate area. History, we conclude, suggests that, on its own, competition for corporate charters is unlikely to produce sufficient protection for investors. Rather than continue to respond to visible failures of state law by incremental federalization, federal officials should proactively and systematically re-

1. For the view that state competition results in a "race to the top," see, e.g., Roberta Romano, *The Genius of American Corporate Law* 14–24 (1993) [hereinafter Romano, *Corporate Law*]; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251, 255–58 (1977). For the opposite view, see, e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1435, 1494 (1992); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *Yale L.J.* 663, 666 (1974).

view all corporate law areas now governed by state law to determine which ones should be fully or at least partly federalized.

Early literature on the merits of regulatory competition has assumed that Delaware is mostly influenced by competition for incorporations with other states. However, our recent study,² as well as a contemporaneous study by Marcel Kahan and Ehud Kamar,³ provide evidence that the competition among states for out-of-state incorporations is much less vigorous than had been previously assumed. It turns out that Delaware is a virtual monopoly in the market for out-of-state incorporations.⁴ While many public companies incorporate in the state of their headquarters, very few companies incorporate out of state in a state other than Delaware. States' failure to mount a meaningful challenge to Delaware's dominant position implies that the main threat that Delaware faces is federal intervention.

Indeed, federal intervention has not been a mere threat. It has taken place at various points during the past seven decades.⁵ In a recent article, Mark Roe provides a vivid and comprehensive account of the history of federal intervention since the New Deal.⁶ Roe argues that this history precludes any assessment of the merits of regulatory competition over corporate charters.⁷ Actual federal incursions and the omnipresent threat of such interventions, the argument goes, make it impossible to determine whether regulatory competition works well or to derive conclusions from recent empirical evidence.⁸

We share the view that past federal interventions are highly relevant for assessing both the evolution of investor protection in the United States and the performance of state competition. In our view, however, the mere fact that the existing regime of U.S. investor protection is partly a product of federal interventions does not impede the assessment of state competition. To the contrary, a careful examination of the history of federal intervention can illuminate and resolve the debate over state competition. In particular, this examination identifies systematic patterns that have important implications for both (1) assessing the performance of state competition, and (2) choosing the course that federal officials should pursue going forward.

2. Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 *Yale L.J.* 553, 563–85 (2002) [hereinafter *Bebchuk & Hamdani, Corporate Charters*].

3. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 *Stan. L. Rev.* 679, 684–85 (2002).

4. See *Bebchuk & Hamdani, Corporate Charters*, *supra* note 2, at 576–79.

5. See Joel Seligman, *The New Corporate Law*, 59 *Brook. L. Rev.* 1, 1 (1993) (“In the twentieth century state corporate law norms for the large publicly held corporation have been progressively supplanted by federal standards . . .”).

6. Mark J. Roe, *Delaware's Competition*, 117 *Harv. L. Rev.* 588, 602–03 (2003) [hereinafter *Roe, Competition*].

7. See *id.* at 592–93.

8. See *id.* at 592.

As to assessing the performance of state competition, our examination of the history of federal intervention lends support to the view that regulatory competition tends to produce insufficient investor protection. Supporters of state competition believe that (1) state competition does not favor insiders over shareholders;⁹ (2) even if it does, there is no reason to expect insiders to have less influence at the federal level to tilt corporate rules in their favor;¹⁰ and (3) state law—and especially Delaware’s—is capable of providing arrangements that would maximize shareholder value. We argue that, for anyone who does not view current investor protection in the United States as substantially excessive, history provides a good basis for questioning each of these claims.

Consider first whether state law excessively favors corporate insiders. A key pattern that emerges from the past is that federal lawmaking has nearly always imposed greater constraints on insiders. A priori one expects intervention to take both directions. If state law had not systematically favored insiders, then intervention likely would have imposed greater restrictions on insiders in some instances and relaxed existing restrictions in others. But that is not the case. Rather, the federal government has consistently intervened to restrict insiders. Thus, anyone who does not view the current system as providing considerably excessive protection to investors should conclude that state competition tends to produce arrangements that excessively favor insiders. For history makes it clear that, left to its own forces, competition would have produced a regime that is much more lax toward insiders than the current one. This Essay, we should stress, does not seek to contribute to the literature analyzing the mechanisms that might lead state law to favor insiders.¹¹ Rather, it provides evidence that, whatever the underlying mechanism is, state law does display such a tendency.

History also provides a basis for rejecting the claim that insiders are at least as powerful at the federal level as they are at the state level. While there are good theoretical grounds for rejecting this claim,¹² this Essay provides empirical support for doing so. If insiders were as powerful at the federal level as they are at the state level, we again would expect federal intervention to go in both directions, sometimes in favor of insiders and sometimes against them. But the fact that this is not the case is tell-

9. See Daniel R. Fischel, *The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law*, 76 *Nw. U. L. Rev.* 913, 921 (1982).

10. See sources cited *infra* note 163.

11. For a representative example, see Oren Bar-Gill, Michal Barzuzá & Lucian A. Bebchuk, *The Market for Corporate Law*, 162 *J. Institutional & Theoretical Econ.* 134, 135–38 (2006).

12. See, e.g., Lucian Arye Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice*, 87 *Va. L. Rev.* 993, 1002–04 (2001) (explaining why federal government is more likely than states to produce corporate laws that enhance shareholder value); Bebchuk & Hamdani, *Corporate Charters*, *supra* note 2, at 609–10 (stating that federal regulators would not face market incentives that encourage Delaware to favor management).

ing. Whatever clout insiders may have at the federal level, their influence at that level has proven to be weaker than their influence at the state level. Insiders have generally been unable to gain sufficient support for federal interventions that would replace state law restrictions on insiders with laxer federal arrangements, and they have failed to prevent federal pro-investor reforms that were blocked at the state level.

History further leads us to reject the claim that state law, and especially Delaware law, is capable of providing the full range of optimal corporate arrangements. Federal law has repeatedly used instruments beyond those that states have been willing or able to employ.¹³ While state corporate law has largely relied on judge-made standards, federal law has used both judge-made standards and agency-made regulations. While state law has limited itself to imposing direct duties on company directors and officers, federal law has directly regulated not only directors and officers but also outsiders, such as gatekeepers and bidders for corporate control. While state corporate law has relied on enforcement by private parties, federal law has used both private and public enforcement. Finally, while state corporate law has limited itself to civil sanctions, federal law has used both civil and criminal sanctions. Agency-based regulations, regulation of gatekeepers and other outsiders, public enforcement, and criminal sanctions are now commonly viewed as critical elements in an effective system of investor protection. The inability or unwillingness of state law to use them undermines the view that state competition can by itself provide adequate investor protection.

Federal interventions thus have not hopelessly muddled the evidence, making it difficult or even impossible to assess the performance of regulatory competition which never got a chance to operate by itself. To the contrary, the pattern of past interventions provides useful evidence for such assessment. For the past seven decades, regulatory competition has consistently failed to provide adequate investor protection with respect to many issues. The proposition that competition among states can, on its own, produce sufficient investor protection has failed to pass the test of history.

As stated earlier, our analysis also has implications for the course that federal officials should pursue going forward. It indicates that it would be a mistake to turn back the clock and return to state law the corporate law areas that have already been federalized. Furthermore, and importantly, our examination of history suggests that federal intervention should take a different form in the future than in the past. Given that a wide range of corporate issues are still left to state law, should federal officials continue to rely on the combination of the threat of federal intervention and occasional incursions? We argue that they should not. It

13. For an insightful analysis of differences in the tools employed by federal law and Delaware law, see Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 *Vand. L. Rev.* 1573, 1604–07 (2005).

is time for federal officials to abandon the presumption that corporate arrangements are best left to the states unless a crisis or other visible failure requires federal officials to intervene.

To begin, while it might exert some influence on state legislators, the threat of federal intervention is generally insufficient to induce states—and Delaware in particular—to adopt the arrangements that federal officials prefer. Adopting such arrangements might expose Delaware to competition from other states, whereas the failure to do so would not necessarily trigger federal intervention. Delaware's optimal strategy is thus hardly that of trying to imitate what federal officials would have done.¹⁴ Indeed, history clearly illustrates the insufficiency of the mere threat of federal intervention. Despite this threat, the feds repeatedly have had to intervene and federalize substantial parts of corporate law.

We also argue that the past approach of federalizing pieces of corporate law in reaction to a crisis or visible and significant shortcomings of state law is problematic. Reacting to a crisis might produce arrangements that are designed in a hurry and without careful consideration, as some have argued happened when Congress rushed to adopt the Sarbanes-Oxley Act.¹⁵ Furthermore, some pieces of state corporate law may be inadequate, but not to an extent that is sufficiently salient and alarming to overcome the prevailing presumption in favor of state law solutions. Federal policymakers should thus recognize the structural shortcomings of state competition and abandon the presumption that corporate affairs should normally be left to the states. Instead of federalizing a corporate law area when a crisis occurs,¹⁶ the federal government should examine in a systematic and comprehensive fashion which corporate law areas should be federalized.

There are several ways to implement this proactive approach. For example, Congress could appoint a National Corporate Law Commission charged with conducting a comprehensive review of corporate law. The

14. Larry Hamermesh argues in this Symposium that interstate competition and the federal threat exert marginal influence on Delaware's lawmakers. Delaware's policymakers, he argues, are principally influenced by principles of conservatism, avoidance of disruption of commercial relationships, resistance to regulatory prescriptions, and the facilitation of private ordering. Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 *Colum. L. Rev.* 1749, 1771–86 (2006) [hereinafter Hamermesh, *Policy Foundations*]. For purposes of our analysis, what matters is that the threat of federal intervention is insufficient to make actual interventions unnecessary, and it matters less whether this threat has a significant or marginal influence.

15. Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.).

16. Securities regulation reform, for example, tends to follow crashes. See Stuart Banner, *What Causes New Securities Regulation? 300 Years of Evidence*, 75 *Wash. U. L.Q.* 849, 850 (1997) (“[M]ost of the major instances of new securities regulation in the past three hundred years of English and American history have come right after crashes.”); Larry E. Ribstein, *Bubble Laws*, 40 *Hous. L. Rev.* 77, 79–83 (2003) (explaining cycle of new types of fraud developing during boom times, followed by exposed frauds and new regulations after crashes).

Commission would examine whether there are issues currently governed by state law that (1) should be governed by arrangements that are less lax toward insiders, or (2) could be more effectively regulated with the help of the additional tools that federal law uses, such as agency-based regulations, outsider regulation, public enforcement, and criminal sanctions. The Commission would then recommend to Congress which corporate law issues should be federalized fully (by replacing state law arrangements with federal ones) or partly (by establishing federal minimum standards or supplementing state law with federal arrangements or enforcement devices). Because it would conduct a systematic and comprehensive examination of corporate law, the Commission may also be used to draft a proposed corporate law code for a federal incorporation option.

Our analysis is organized as follows. Parts I and II identify and discuss key patterns in federal intervention over the past seven decades. Part I shows that federal intervention has systematically replaced state law arrangements with ones that are more restrictive vis-à-vis insiders. Part II compares the various mechanisms through which corporate arrangements are produced and enforced at the state and federal level. Finally, Part III discusses the implications of our analysis for the debate on state competition.

I. THE PATTERN OF PAST INTERVENTIONS

In this section, we provide an overview of the history of federal regulation of corporate affairs in recent decades. As we shall demonstrate, federal lawmaking in this area has generally followed a consistent pattern of tightening restrictions on corporate insiders. Whether by adopting substantive rules or by strengthening the enforcement of existing ones, the federal government has consistently displayed greater willingness than the states to act against insider interests.

Before proceeding, we would like to address at the outset two potential objections to our analysis. First, it might be argued that this pattern is not a unique feature of federal lawmaking in the corporate area. After all, the argument goes, government intervention can generally be expected to limit the freedom of private actors. When it decides to regulate a certain area, the government is expected to impose various restrictions on all parties involved. This, however, is not the case here. Federal intervention should not be assessed against hypothetical “free market” arrangements. Rather, it should be evaluated against the state law regime it displaces or modifies. Compared to the restrictions set by the state law arrangements that it replaced, therefore, federal regulation could be either more or less restrictive of corporate insiders.

Second, it might be argued that federal arrangements only seem more restrictive. These arrangements, the argument goes, should be compared not to the state law arrangements preceding federal intervention, but to the ones that states would have adopted if federal intervention had not denied them the opportunity to do so. Indeed, once Con-

gress preempted certain corporate issues, states lacked the authority to devise their own arrangements. As this section shows, however, federal intervention generally did not take place before states had the opportunity to act. We discuss below various areas—including insider trading and disclosure obligations—in which states had ample opportunity to adopt their own restrictive arrangements before federal officials had to intervene.

In Part I.A, we discuss how federal lawmaking has limited insiders' ability to preserve control of public corporations. In Part I.B, we examine how federal action has limited the extent to which insiders can use their position to extract private benefits. Part I.C then considers the role of federal law in regulating disclosure and its implications for the governance of public corporations. We will not attempt to provide a comprehensive analysis of the extensive body of federal law regulating public corporations or the historical background underlying each federal intervention. Rather, our goal in this section is to uncover the consistent pattern of federal intervention.

A. *Insider Control and Insulation*

This subsection considers federal action that has impacted the extent to which incumbents are protected from insurgents aspiring to take control of the corporation or from shareholders wishing to have greater say in its affairs. As we shall demonstrate, states and the federal government have adopted different approaches to insider insulation. Whereas states have generally sought to bolster insider ability to protect their controlling position, the federal government has acted to hinder insider entrenchment.

1. *Hostile Takeovers.* — One of the important constraints on managerial behavior is an effective market for corporate control. Indeed, takeover law has been one of the most important areas of U.S. corporate law in the last three decades. During this period, state lawmakers have been more eager than their federal counterparts to impose restrictions on takeovers.

At first sight, one may argue that the federal regulation of takeovers demonstrates that federal officials can sometimes cater to managerial interests. Prior to the enactment of the Williams Act in 1968,¹⁷ cash tender offers were essentially unregulated.¹⁸ In the Williams Act, Congress imposed extensive disclosure obligations and other requirements on bidders contemplating a tender offer.¹⁹ By making hostile bids more difficult to implement than they would have been under then-existing state

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

18. See Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 896–97 (2d ed. 1995).

19. For a review of the Williams Act and the SEC rules promulgated thereunder, see *id.* at 896–1008.

law, this statute undoubtedly assists incumbents seeking to entrench their position. Thus, the argument goes, the Williams Act demonstrates that federal intervention can—and has—operated not only to restrict insiders, but also to assist them.²⁰

But this initial impression is out of historical context. Upon closer inspection, it becomes clear that while the Williams Act did make hostile bids somewhat more burdensome to implement, it did not enable insiders to block indiscriminately any offers that shareholders found attractive. Rather, it allowed shareholders to decide whether to accept a tender offer without being subject to improper pressure. Indeed, it seems that Congress made a deliberate effort to protect shareholders without completely blocking takeovers.²¹ Moreover, with the benefit of hindsight, it is evident that whatever impediments the Williams Act created, they were minor compared to the major effort undertaken by the states to block hostile bids regardless of their potential value for shareholders. The Williams Act merely attempted to create an auction between bidders when a corporation is up for sale. State takeover law, in contrast, has repeatedly attempted to block unwanted bidders.²²

Consider the record of state law in the area of takeover regulation. State law impeding hostile takeovers has developed in several waves, with state legislators going back to the drawing board multiple times to bolster insider protection. The first wave commenced with the first state takeover statute enacted by Virginia in 1968,²³ with thirty-six states adopting similar statutes by 1981.²⁴ These statutes typically imposed disclosure requirements on bidders intending to pursue a tender offer, and often required an administrative approval for a bid to proceed. This first wave ended with the Supreme Court's decision in *Edgar v. MITE Corp.*, which invalidated the Illinois antitakeover statute.²⁵

States, however, did not acknowledge defeat, and a “second generation” of takeover statutes quickly followed. Trying to avoid constitutional challenges, the so-called second generation statutes adopted measures that were limited to the issues traditionally regulated by state corporate

20. See, e.g., Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 *Theoretical Inquiries L.* 387, 537–38 (2001) [hereinafter Romano, *International Securities*] (relying on the Williams Act to argue that federal intervention is unlikely to increase shareholder value).

21. See Lyman Johnson & David Millon, *Misreading the Williams Act*, 87 *Mich. L. Rev.* 1862, 1896 (1989) (noting that in the Williams Act Congress refused “to take sides in the controversial debate over whether takeovers should be discouraged or encouraged”).

22. Indeed, the opponents of state antitakeover legislation relied on the Williams Act in their constitutional objections to the entrenchment measures that states adopted. *Id.* at 1868–89.

23. *Take-Over-Bid Disclosure Act*, 1968 Va. Acts 167 (codified as amended at Va. Code Ann. §§ 13.1-528 to -541 (1985) (repealed 1989)).

24. Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 *J.L. Econ. & Org.* 225, 234 fig.1 (1985).

25. 457 U.S. 624, 634–46 (1982) (holding Illinois takeover statute violates dormant Commerce Clause).

laws. Some states adopted “fair price” statutes, which prohibit a merger between the bidder and the target company unless a supermajority shareholder vote approves the merger or the bidder provides a “fair price” for the remaining shares. Other states enacted “control share acquisition” statutes, which require a shareholder vote approving an acquisition of control by a party. States also enacted “business combination” statutes, which prohibit mergers between bidder and target for a period of time, usually three years from the bidder’s acquisition of a significant ownership position.

State efforts to impede hostile bids intensified in the aftermath of the Supreme Court’s decision in *CTS Corp.*, which essentially granted a constitutional pass to second generation statutes.²⁶ Overall, twenty-three states adopted “fair price” statutes, twenty-five states adopted “control share” statutes, and twenty-three states adopted “business combination” statutes.²⁷

Other examples illustrate the substantial difference in attitude concerning hostile takeovers.²⁸ In 1983, for instance, the SEC Advisory Committee on Takeovers devised recommendations that were much more restrictive of managers’ ability to use defensive tactics than what state law has subsequently permitted.²⁹ The SEC also got on a collision course with state antitakeover law with its promulgation of the “all holders” rule. One of the formidable defenses against takeovers is a discriminatory tender offer—a (typically generous) tender offer by the company to its shareholders that excludes a bidder who manages to secure a toehold position. In the *Unocal* case, the Supreme Court of Delaware approved the deployment of this defense by management.³⁰ The *Unocal* decision played a key role in motivating the SEC to adopt Rule 14d-10, which provides that no bidder shall make a tender offer unless the offer is open to all security holders of the class that is the subject of the tender offer.³¹

26. *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 88–94 (1987) (upholding Indiana’s second generation antitakeover statute against dormant Commerce Clause challenge).

27. William J. Carney, *The Production of Corporate Law*, 71 S. Cal. L. Rev. 715, 735–36 (1998).

28. It is also noteworthy that in 1987, corporate management failed in their attempt to pass restrictive federal takeover legislation. See Stephen M. Bainbridge, *The Politics of Corporate Governance*, 18 Harv. J.L. & Pub. Pol’y 671, 705–07 (1995) [hereinafter *Bainbridge, Politics*].

29. See SEC Advisory Comm. on Tender Offers, *Report of Recommendations*, reprinted in [1983–1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,511 (Mar. 28, 1984).

30. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 949 (Del. 1985).

31. 17 C.F.R. § 240.14d-10 (2006). Rule 14d-10 applies to bidders in general. Rule 13e-4 reiterates that rule in the context of tender offers by the issuer. See 17 C.F.R. § 240.13e-4(f)(8) (regulating outside offers). The SEC acknowledged that the all holders rule was in response to the *Unocal* decision. See Proposed Amendments to SEC Tender Offer Rules, 17 Sec. Reg. & L. Rep. (BNA) 1320, 1321 n.5 (1985).

But what the SEC tried to prohibit through the all holders rule, states in effect allowed by granting management the power to adopt a poison pill.³² Like the discriminatory tender offer, the poison pill grants management the power to defeat hostile acquisitions and penalize bidders regardless of the merits of their offer.³³ Since poison pills do not involve the purchase of securities, the SEC could not regulate them in the absence of congressional authorization.

To summarize, throughout the past thirty years, state law has been far ahead of federal law in rescuing incumbents from unwanted bidders. The Williams Act does increase the cost of acquiring control, but its insulating effect pales in comparison to the various impediments that states eagerly adopted to prevent hostile bids. Furthermore, while the Williams Act was designed to protect shareholders against coercive offers, no parallel justification can be found for the blunt measures adopted or endorsed by states. It is also noteworthy that state efforts have persisted for a long period of time and with unprecedented zeal, responding promptly to any judicial intervention in favor of hostile bids.³⁴

2. *Defensive Recapitalization.* — One of the most effective defenses against hostile acquisitions is granting management voting control of the company.³⁵ In the 1980s, management of many public corporations attempted to gain voting control of their companies by a dual class stock recapitalization in which management (or an existing dominant shareholder group) received a class of stock that conferred voting control while public shareholders received a class of stock with no voting rights (or reduced voting rights).³⁶ State corporate law imposed virtually no limits on the ability of firms to separate ownership from control through the use of dual class structures.³⁷ Although controversial and potentially

32. The Delaware Supreme Court upheld the pill in *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del. 1985).

33. For a description of how the pill works, see John C. Coates IV, *Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence*, 79 Tex. L. Rev. 271, 287 n.62 (2000).

34. When several courts ruled that boards lacked the power to adopt a pill unilaterally, state lawmakers quickly amended the relevant statutes to explicitly provide boards with such power. See Lucian Arye Bebchuk & Assaf Hamdani, *Optimal Defaults for Corporate Law Evolution*, 96 Nw. U. L. Rev. 489, 514 (2002). Moreover, as Roe acknowledges, the threat of protakeover federal intervention has apparently led Delaware to adopt a relatively mild position against hostile takeovers. See Roe, *Competition*, supra note 6, at 630–32.

35. See Jeffrey N. Gordon, *Ties That Bond: Dual Class Common Stock and the Problem of Shareholder Choice*, 76 Cal. L. Rev. 1, 4 (1988) (“[I]f management and its allies hold the voting stock necessary to elect directors, a hostile bid becomes practically impossible.”).

36. For a description of the techniques used by management to achieve voting control, see Gilson & Black, supra note 18, at 749.

37. See, e.g., *Providence & Worcester Co. v. Baker*, 378 A.2d 121, 124 (Del. 1977) (holding that original charter can create differential voting rights).

coercive,³⁸ such recapitalization of *existing* companies was also allowed under state law.³⁹

The federal government, in contrast, did attempt to constrain management power to follow this practice. In 1988, the SEC adopted Rule 19c-4, which prohibited the stock exchanges from listing the securities of an issuer who engaged in midstream dual-class stock recapitalization.⁴⁰ Shortly after Rule 19c-4 was adopted, however, the D.C. Circuit invalidated it as an improper incursion into matters of state corporate law.⁴¹ Despite the defeat of its initial effort in court, the SEC continued in its attempts to prohibit dual-class stock recapitalizations.⁴² Finally, in 1994, the stock exchanges gave in to the pressure from the SEC and adopted anti-dual-class listing standards.⁴³

The SEC's persistent effort to prohibit dual-class stock recapitalizations demonstrates that the federal government is willing to step in and constrain insiders when states decline to take the initiative. The prohibition on defensive recapitalizations denies management the ability to regain, without the expense of purchasing a sufficient amount of outstanding stock, voting control of the corporation after it goes public. This rule therefore makes public companies more susceptible to hostile bids and thus is clearly unfavorable to managers of existing corporations.

3. *Voting.* — Shareholders of publicly traded companies with dispersed ownership are largely passive and have little input concerning corporate affairs. In large part, this is the outcome of a fundamental collective action problem: With stock ownership divided among many owners, shareholders have little incentive to exert effort to monitor management and actively intervene in corporate decisionmaking. Shareholder passivity, however, is also the result of the background legal rules that often make it difficult for shareholders to intervene.⁴⁴

38. See Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 Va. L. Rev. 807, 823-41 (1987); Gordon, *supra* note 35, at 9; Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 Colum. L. Rev. 979, 980 (1989).

39. See, e.g., *Williams v. Geier*, 671 A.2d 1368, 1371 (Del. 1996) (holding that midstream recapitalizations can change voting allocation).

40. *Voting Rights Listing Standards*, Exchange Act Release No. 25,891, 53 Fed. Reg. 26,376 (July 12, 1988) (codified at 17 C.F.R. § 240.19c-4).

41. *Bus. Roundtable v. SEC*, 905 F.2d 406, 408 (D.C. Cir. 1990).

42. See Special Study Group of the Comm. on Fed. Regulation of Sec., *Am. Bar Ass'n, Special Study on Market Structure, Listing Standards and Corporate Governance*, 57 Bus. Law. 1487, 1505-06 (2002) (reviewing SEC's efforts on this issue following D.C. Circuit's invalidation of Rule 19c-4).

43. See, e.g., NYSE, Inc., *Listed Company Manual* § 313.00(A) (2002); see also *Order Granting Approval to Rule Changes Relating to Shareholder Voting Rights*, Exchange Act Release No. 35,121, 59 Fed. Reg. 66,570, 66,570-72 (Dec. 27, 1994).

44. See generally Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 Harv. L. Rev. 833 (2005) (arguing for increasing shareholder power to intervene in certain corporate affairs); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 Mich. L.

Although state law sets the basic allocation of power between management and shareholders, federal law has intervened on many occasions in issues related to shareholder voting. Federal intrusions have generally aimed at facilitating shareholder participation or granting shareholders more voice. In this subsection, we consider some of the key issues with respect to which the federal government has taken action to bolster shareholder voting power.

a. *Access to the Company's Proxy.* — State law generally prevents shareholders from intervening in corporate affairs other than through electing directors and voting on certain fundamental issues. Against this backdrop, the SEC has acted to boost shareholder voice through the proxy rules. Specifically, the SEC promulgated Rule 14a-8, which provides shareholders with the right to include their proposals in the company's proxy materials.⁴⁵

In the first decades after the promulgation of Rule 14a-8, the SEC generally respected the allocation of powers under state law and allowed management to exclude shareholder proposals relating to corporate governance. In the 1990s, however, the SEC shifted its position and required management to give access to shareholders' precatory proposals relating to corporate governance matters.⁴⁶

In 2003, the SEC proposed a rule that would require companies under certain circumstances to include shareholder board nominees in the company's proxy materials.⁴⁷ Although it now appears that the SEC is unlikely to adopt this rule in the near future, it is notable that the SEC has come close to passing this measure, while state law has never seriously considered such a reform.

One may argue that these measures do not significantly alter the balance of power within public corporations. After all, the proposed rule concerning shareholder nominations does not purport to grant shareholders the right to nominate directors when the applicable state law does not recognize such a right,⁴⁸ and the SEC will allow shareholder proposals on corporate governance matters under Rule 14a-8 only if the proposals have no binding effect. This argument, however, fails to appreciate the full impact of these reforms. Although not formally binding, precatory shareholder resolutions on governance matters can exert substantial pressure on management.⁴⁹ Under this rule, shareholders have

Rev. 520, 530–66 (1990) (providing comprehensive overview of various legal obstacles to shareholder action, especially in context of institutional investors).

45. 17 C.F.R. § 240.14a-8 (2006).

46. See *Waste Management, Inc.*, SEC No-Action Letter, 1991 SEC No-Act. LEXIS 450, at *1 (Mar. 8, 1991).

47. See *Security Holder Director Nominations*, Exchange Act Release No. 48,626, Investment Company Act Release No. 26,206, 68 Fed. Reg. 60,784, 60,817–26 (proposed Oct. 23, 2003).

48. *Id.* at 60,808, 60,819.

49. See *Roe, Competition*, *supra* note 6, at 622 (describing precatory shareholder proposals as “means to power”).

been passing, for example, precatory resolutions to dismantle staggered boards.⁵⁰ In addition, by requiring companies to include shareholder nominees in their proxy, the SEC alleviates the difficulty associated with shareholder nomination of directors, making contested elections more likely.⁵¹

b. *Proxy Solicitation by Challengers.* — In 1956, the SEC overhauled its proxy rules and expanded the registration and review requirement to all forms of communication to shareholders “under circumstances reasonably calculated to result in the procurement, withholding, or revocation of a proxy.”⁵² This reform made it more difficult for challengers to disseminate information to shareholders.⁵³

One might thus argue that the 1956 proxy reform shows that the SEC may act to shield incumbents from challenges. We believe, however, that this is not the case. The expansion of the proxy rules did make challenges to management more difficult and was thus widely supported by managers of public corporations.⁵⁴ The reform, however, was also perceived at the time as a proper response to the genuine concern for protecting investors from large corporate raiders, who did not always provide shareholders with all the relevant information necessary to decide how to vote in a proxy fight.⁵⁵ Indeed, the rules were designed to enable shareholders to receive a clear, full presentation of accurate information necessary for casting their vote.

Most importantly, when it became clear that the proxy rules impeded communication among institutional shareholders, the SEC significantly modified the proxy rules.⁵⁶ Prior to this change, institutional investors were limited in their ability to influence corporate management due to the concern that oral or written communication among share-

50. See Georgeson S’holder, *Annual Corporate Governance Review: Shareholder Proposals and Proxy Contests 7* (2002), available at <http://www.georgesonshareholder.com/pdf/02wrapup.pdf> (on file with the *Columbia Law Review*) (showing increase in shareholder support for precatory resolutions in favor of dismantling staggered boards in 2002).

51. It is also important to note that the proposed rule concerning director nominations has been considered by the SEC on several occasions in the past, starting as early as 1942. See *Security Holder Director Nominations*, 68 Fed. Reg. at 60,785.

52. See *Amendments to Proxy Rules*, Exchange Act Release No. 5276, 21 Fed. Reg. 577, 578 (Jan. 17, 1956) (codified as amended at 17 C.F.R. pt. 240).

53. See John Pound, *Proxy Voting and the SEC: Investor Protection Versus Market Efficiency*, 29 J. Fin. Econ. 241, 267 (1991).

54. See, e.g., *Roe, Competition*, supra note 6, at 613 (noting that 1956 proxy reform was perceived at time as responding to “managerial pressure”).

55. See Pound, supra note 53, at 263–64.

56. See *Regulation of Communications Among Shareholders*, Exchange Act Release No. 31,326, *Investment Company Act Release No. 19,031*, 57 Fed. Reg. 48,276, 48,290–96 (Oct. 22, 1992) (codified as amended at 17 C.F.R. pts. 240, 249).

holders would amount to proxy solicitation subject to the proxy rules.⁵⁷ It is thus not surprising that managers of public corporations viewed this modification of the proxy rules as a restriction of their power. The Business Roundtable, for example, argued that the proposed change would “further the disturbing trend toward the determination of the outcome of shareholder voting by secret back-room lobbying of and negotiations with institutional investors.”⁵⁸

But the 1992 proxy reforms did not stop at lifting restrictions that had been originally put in place by the SEC in 1956. Until 1992, the proxy rules followed state law and allowed management to submit to a single shareholder vote a “group of related matters.” As part of the 1992 proxy reform, however, the SEC required that the form of proxy provide for a separate vote for each matter presented to shareholders.⁵⁹ Although it does not prevent management from conditioning the effectiveness of one proposal on the approval of another, this unbundling rule makes it impossible for management to avoid shareholder opposition to certain proposals simply by bundling them with other issues for a single shareholder vote.⁶⁰

4. *Board Composition.* — Although independent directors are widely recognized as a key component of good corporate governance,⁶¹ states generally granted companies freedom in choosing the composition of their boards, and did not require them to appoint independent directors.⁶² Through judicial interpretations of fiduciary duties in certain con-

57. See Black, *supra* note 44, at 536 (“[Proxy rules] impose costs, delays, and legal risks on shareholder efforts to communicate with each other, if the communication is even loosely tied to the prospect of a shareholder vote.”).

58. Thomas W. Briggs, *Shareholder Activism and Insurgency Under the New Proxy Rules*, 50 *Bus. Law.* 99, 100 (1994); see also Roe, *Competition*, *supra* note 6, at 622 (noting that reform was perceived “as counterbalancing state antitakeover laws” (quoting *Regulation of Communications Among Shareholders*, 57 *Fed. Reg.* at 48,278)).

59. See Rule 14a-4, 17 C.F.R. § 240.14a-4(b)(1) (2006).

60. The SEC also promulgated Rule 14a-7, which sets forth the so-called list-or-mail rule. See 17 C.F.R. § 240.14a-7. Under this rule, a company must, upon request by a dissident shareholder, either provide a shareholders’ list or agree to mail the dissident’s proxy statement and solicitation materials. *Id.* This rule was adopted in light of the perceived inadequacy of the arrangement supplied by state law concerning access to the shareholder list. See *Regulation of Securityholder Communications*, Exchange Act Release No. 29,315, Investment Company Act Release No. 18,201, 56 *Fed. Reg.* 28,987, 28,997 (proposed June 25, 1991) (stating that purpose of Rule 14a-7 is “to facilitate dissemination of material information to securityholders by reducing the expense and delay requestors typically encounter in obtaining a securityholder list”).

61. See, e.g., Ira M. Millstein & Paul W. MacAvoy, *The Active Board of Directors and Performance of the Large Actively Traded Corporation*, 98 *Colum. L. Rev.* 1283, 1291–99 (1998) (arguing that independent directors enhance corporate performance). But cf. Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 *J. Corp. L.* 231, 233 (2002) (finding no empirical support for hypothesis that firms with independent directors perform better).

62. See, e.g., *Brehm v. Eisner*, 746 A.2d 244, 256 (Del. 2000) (stating that norms of good corporate governance “are not required by the corporation law and do not define standards of liability”).

texts, state corporate law did provide incentive for corporations to have independent directors.⁶³ However, even in the limited cases in which they did recognize the value of independent directors, states adopted a broad definition of independence.⁶⁴

In 2002, Congress decided to intervene in the area of board composition. The Sarbanes-Oxley Act requires the SEC to issue rules that prohibit the stock exchanges from listing securities of an issuer unless the members of its audit committee are independent.⁶⁵ Congress also intervened in board structure by strongly encouraging public companies to have at least one “financial expert” on their audit committee.⁶⁶

The most far-reaching reforms concerning director independence, however, were introduced through the listing standards of the stock exchanges. Under these new listing requirements, the majority of a listed company’s directors must be independent under an enhanced independence standard, and the independent directors must hold regular sessions without management present.⁶⁷ The New York Stock Exchange listing standards, for example, require that two board committees (in addition to the audit committee)—the compensation and nominating-governance committees—consist only of independent directors. While Nasdaq and the American Stock Exchange do not mandate that companies form independent nomination or compensation committees, the listing standards of both exchanges require that executive compensation and director nomination issues be considered by a majority of indepen-

63. See, e.g., *Aronson v. Lewis*, 473 A.2d 805, 814 (Del. 1984) (noting that committee of independent directors can overcome “demand futility” in context of derivative actions); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 709 n.7 (Del. 1983) (commenting that committee of independent directors negotiating cash out merger could indicate transaction satisfied entire fairness test).

64. See, e.g., *In re Walt Disney Co. Derivative Litig.*, 731 A.2d 342, 354–56 (Del. Ch. 1998) (holding that director will be considered independent concerning derivative action only when director has no financial interest in outcome of such litigation); see also Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 *J. Corp. L.* 625, 653 (2004) [hereinafter Jones, *Corporate Federalism*] (arguing that standards for director independence adopted by Delaware courts are “notoriously low”).

65. See Sarbanes-Oxley Act of 2002 § 301, 15 U.S.C. § 78j-1 (Supp. II 2004); Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47,654, Investment Company Act Release No. 26,001, 68 Fed. Reg. 18,788 (Apr. 16, 2003) (codified in scattered sections of 17 C.F.R.).

66. See Sarbanes-Oxley Act of 2002 § 407, 15 U.S.C. § 7265; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5110 (Jan. 31, 2003).

67. See Order Granting Approval for Proposed Rule Change by the American Stock Exchange, Exchange Act Release No. 48,863, 68 Fed. Reg. 68,432, 68,432–34 (Dec. 8, 2003) (codified in scattered sections of 17 C.F.R.); NASD and NYSE Rulemaking Relating to Corporate Governance, Exchange Act Release No. 48,745, 68 Fed. Reg. 64,154, 64,179 (Nov. 12, 2003).

dent directors or by committees consisting solely of independent directors.⁶⁸

One may question the wisdom of mandatory independence requirements.⁶⁹ For our purpose, however, the important point is that, from management's perspective, mandating director independence is undesirable. In other words, the reforms concerning director independence follow the consistent pattern of federal willingness to restrict insiders when the states refrain from doing so.

B. *Insiders' Benefit of Control*

The previous subsection surveyed federal lawmaking that limits the extent to which insiders are insulated from challenges to their control of public corporations. In this subsection, we show that federal intervention has also reduced the extent to which those in control of public companies can use their position to extract private benefits.

1. *Executive Compensation.* — One of the direct means through which insiders can extract benefits from public corporations is arranging for generous compensation packages.⁷⁰ With the exception of certain minimal process requirements, state corporate law has effectively granted insiders unlimited freedom to shape their compensation schemes.⁷¹ The federal foray into the area of executive compensation was rather subtle at first. Yet, notwithstanding its limited scope, federal intervention has repeatedly demonstrated a willingness to take a position against excessive executive compensation.

Because it viewed this matter as an internal corporate affair subject to state law, Congress initially attempted to discourage excessive compensation indirectly by modifying its treatment for federal income tax purposes. Congress thus imposed an excise tax and limited the deduction on certain golden parachute payments made to senior executives when they unexpectedly leave the firm.⁷² Congress also made executive compensa-

68. As in other areas, however, the full impact of the federal reforms concerning board composition is not limited to federal law. The federal focus on director independence may put pressure on Delaware courts to scrutinize director independence issues more carefully. See Leo E. Strine, Jr., *Derivative Impact? Some Early Reflections on the Corporation Law Implications of the Enron Debacle*, 57 *Bus. Law.* 1371, 1377–85 (2002).

69. See, e.g., Stephen M. Bainbridge, *A Critique of the NYSE's Director Independence Listing Standards*, 30 *Sec. Reg. L.J.* 370, 393 (2002) (“[T]he empirical evidence on the merits of board independence is mixed (at best).”).

70. See generally Lucian Arye Bebchuk, Jesse M. Fried & David I. Walker, *Managerial Power and Rent Extraction in the Design of Executive Compensation*, 69 *U. Chi. L. Rev.* 751, 845–46 (2002) (discussing how executives in public corporations are able to receive excessive pay packages).

71. See, e.g., Melvin A. Eisenberg, *Corporations and Other Business Organizations* 651 (unabridged 8th ed. 2000) (“Courts only seldom overturn the compensation of senior executives in publicly held corporations if the compensation has been approved by disinterested directors.”).

72. I.R.C. §§ 280G, 4999 (2000).

tion above one million dollars nondeductible for the corporation unless the compensation was tied to the company's earnings or stock price.⁷³ Although they do not impose any mandatory restrictions on pay arrangements, these amendments to the tax code demonstrate that the federal government has been more willing than the states to impose substantive limits on executive compensation.

Federal authorities have since adopted a more direct approach against abusive compensation practices. In the Sarbanes-Oxley Act, Congress expressly prohibited loans made by a company to its executives,⁷⁴ and required the CEO and CFO of a public corporation to disgorge certain bonuses, equity-based compensation, and gains on the sale of the company's stock if the company restates its financial statements as a result of material noncompliance with the SEC's financial reporting requirements.⁷⁵ Stock exchanges have also moved to require greater scrutiny of executive compensation arrangements. In 2003, the SEC approved Nasdaq and NYSE listing rules that require shareholder approval of equity compensation plans.⁷⁶

To be sure, the array of new requirements concerning executive compensation—especially the flat prohibition on loans to executives—may be overly broad. For our purposes, however, what is important is that this prohibition again displays a much greater willingness on the part of the federal government to intervene in a manner that limits insiders' discretion.

2. *Insider Trading.* — Prior to the federal regulation of insider trading, only state law governed the extent to which management and other insiders could trade the stock of public corporations on the basis of their inside information. States did not enact statutes to regulate insider trading. Addressing the issue under the common law of deceit and general principles of corporate law,⁷⁷ state courts typically refused to rule against insiders who traded based on information not available to shareholders.⁷⁸ Managers, therefore, were generally free to trade the stock of their corporations on the basis of inside information.⁷⁹

73. *Id.* § 162(m).

74. Sarbanes-Oxley Act of 2002 § 402, 15 U.S.C. § 78m(k) (Supp. II 2004). State corporate law generally allows companies to make loans to their executives. See, e.g., Del. Code Ann. tit. 8, § 143 (2001) (authorizing loans to employees and officers of corporation).

75. Sarbanes-Oxley Act of 2002 § 304, 15 U.S.C. § 7243.

76. See Order Approving NYSE and Nasdaq Proposed Rule Changes Relating to Equity Compensation Plans, Exchange Act Release No. 48,108, 68 Fed. Reg. 39,995 (July 3, 2003).

77. See Robert C. Clark, *Corporate Law* 310–11 (1986).

78. See, e.g., *Goodwin v. Agassiz*, 186 N.E. 659, 661–62 (Mass. 1933) (dismissing suit against company directors with insider stock information). For a general overview of the common law rule and the circumstances under which it prohibited insider trading, see Eisenberg, *supra* note 71, at 772–74.

79. Moreover, corporations rarely attempted to prohibit trading by managers in possession of nonpublic information. See Frank H. Easterbrook & Daniel R. Fischel, *The*

The federal prohibition on insider trading evolved gradually through different branches of the federal government. First, Congress enacted section 16 of the Exchange Act, which requires certain corporate insiders to file public reports of any transactions in the corporation's securities, and to disgorge to the corporation any profits they realize from so-called "short-swing" transactions.⁸⁰ Federal courts later began to apply the general, open-ended, antifraud provisions of section 10(b) of the Exchange Act and Rule 10b-5 to prohibit the trading by insiders on the basis of nonpublic information, culminating in a mandatory ban on insider trading.⁸¹

The rationale underlying the mandatory prohibition on insider trading is a matter for lively scholarly debate.⁸² There is little doubt, however, that the federal rule against insider trading is more restrictive of management than the permissive approach under state law. The reporting requirements under section 16 of the Exchange Act impose an administrative burden on any insider who trades in the corporation's shares, and the disgorgement provisions under this section limit the liquidity of corporate insiders' stock ownership. More importantly, by limiting insiders' ability to benefit from the nonpublic information available to them in their managerial capacity, the rule against insider trading limits the monetary rewards associated with the management of a public corporation.⁸³ Finally, the federal prohibition against insider trading turns this practice into a criminal offense with severe penalties.

3. *Freezeout Mergers.* — The existing federal regulation of "freezeout" transactions is rather limited in scope. But a closer look at the evolution of federal law governing these transactions and its impact on state law provides a powerful demonstration of how various federal authorities displayed greater willingness than Delaware to constrain improper attempts

Economic Structure of Corporate Law 265 (1991) [hereinafter Easterbrook & Fischel, Economic Structure].

80. For an overview of section 16 of the Exchange Act, see William T. Allen & Reinier Kraakman, Commentaries and Cases on the Law of Business Organizations 587–89 (2003).

81. For the seminal decision on this matter, see *Cady, Roberts & Co.*, 40 S.E.C. 907, 911–12 (1961); see also *SEC v. Tex. Gulf Sulphur Co.*, 401 F.2d 833, 848 (2d Cir. 1968) (en banc) (stating that "anyone in possession of material information" must either disclose this information to public or abstain from using it). For an overview of the evolution of the federal prohibition on insider trading, see Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 Colum. L. Rev. 1491, 1499–1506 (1999).

82. See, e.g., Dennis W. Carlton & Daniel R. Fischel, *The Regulation of Insider Trading*, 35 Stan. L. Rev. 857, 869–72 (1983) (arguing that insider trading might be efficient way to compensate corporate managers).

83. To be sure, insiders can demand larger compensation in an amount equal to the forgone rewards from insider trading. Unlike other forms of executive compensation, however, insider trading does not require continual renegotiations and is less susceptible to "outrage" constraints. See Bebhuk, Fried & Walker, *supra* note 70, at 786–91 (analyzing impact of outrage constraint on design of executive compensation arrangements).

by controlling shareholders to extract benefits at the expense of minority shareholders.

In the 1960s and 1970s, there was a wave of public companies undergoing freezeout transactions, whereby the controlling shareholder would cash out the minority shareholders in order to take the corporation private.⁸⁴ There may be a variety of legitimate business reasons for taking a public company private, such as avoiding the burden of SEC reporting. But these transactions also provide controlling shareholders an opportunity to abuse their power in order to deny the minority the option of sharing in the future profits of the company. Thus, the proper treatment of freezeout transactions was a controversial issue during the 1970s.⁸⁵ Initially, Delaware's courts held that minority shareholders' exclusive remedy was their appraisal right,⁸⁶ a remedy that many view as inadequate.⁸⁷

Federal authorities were clearly discontented with Delaware's position. In 1976, the SEC proposed to adopt Rule 13e-3, which would have imposed substantive limitations on the terms under which controllers could take companies private.⁸⁸ And, for a brief period, it seemed that federal courts would expand the antifraud provisions of Rule 10b-5 to include oppressive freezeouts.⁸⁹

Ultimately, however, the federal incursion into this domain of state law turned out to be quite limited in scope. The Supreme Court held that, in the absence of fraud, Rule 10b-5 does not apply to controlling

84. For a review of the mechanics of implementing freezeout transactions, see Gilson & Black, *supra* note 18, at 1252-54.

85. See generally Arthur M. Borden, *Going Private—Old Tort, New Tort or No Tort?*, 49 N.Y.U. L. Rev. 987 (1974) (arguing for legality of going private transactions under certain circumstances); Victor Brudney & Marvin A. Chirelstein, *A Restatement of Corporate Freezeouts*, 87 Yale L.J. 1354 (1978) (criticizing Delaware jurisprudence on corporate freezeouts); Mark K. Kessler, *Elimination of Minority Interests by Cash Merger: Two Recent Cases*, 30 Bus. Law. 699 (1975) (analyzing two federal cases involving freezeouts).

86. See, e.g., *Stauffer v. Standard Brands Inc.*, 187 A.2d 78, 80 (Del. 1962) ("It is sufficient to say . . . there is no remedy except appraisal."); *David J. Greene & Co. v. Schenley Indus.*, 281 A.2d 30, 35 (Del. Ch. 1971) ("[I]f plaintiffs and others are not satisfied with the value placed on their shares . . . their recourse is to an appraisal.").

87. On the problems associated with the appraisal remedy, see, e.g., Lucian Arye Bebchuk & Marcel Kahan, *Adverse Selection and Gains to Controllers in Corporate Freezeouts*, in *Concentrated Corporate Ownership* 247, 247-52 (Randall K. Morck ed., 2000).

88. See Notice of Public Fact-Finding Investigation and Rulemaking Proceeding in the Matter of "Going Private" Transactions by Public Companies and Their Affiliates, [1974-1975 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 80,104, at 85,092 (Feb. 6, 1975) (proposing rule under which, among other things, consideration in freezeout shall be no lower than consideration recommended jointly by two qualified independent persons).

89. The minority shareholders of Santa Fe sued in a federal court alleging that a freezeout merger without a business purpose is fraudulent under Rule 10b-5, and the Second Circuit accepted the plaintiffs' application of Rule 10b-5 to freezeouts. *Green v. Santa Fe Indus., Inc.*, 533 F.2d 1283, 1287 (2d Cir. 1976).

shareholders in freezeout mergers.⁹⁰ And, responding to comments that it lacked the authority to regulate the substance of going private transactions, the SEC limited the final Rule 13e-3, promulgated in 1979, to disclosure issues.⁹¹ Today, this rule subjects controlling shareholders in going private transactions to extensive disclosure requirements, which include the true purpose of the going private transaction and the reasons for both the timing and the structuring of the transaction.

The threat of federal intervention, however, appears to have led to a dramatic change in the attitude of the Delaware courts.⁹² In a landmark decision, the Supreme Court of Delaware held that controlling shareholders must show both a corporate business purpose for the merger and the merger's "entire fairness."⁹³ Delaware, therefore, abandoned its position that the appraisal remedy was the only one available to dissenting minority shareholders in a going private transaction.⁹⁴

Moreover, although Rule 13e-3 appears to be technical in nature, its impact transcends the administrative burden of complying with its disclosure requirements. As Robert Clark explains, its intrusive disclosure requirements put insiders who wish to squeeze out minority shareholders primarily to make profits for themselves into a dilemma.⁹⁵ On the one hand, they can hide their true motives and face liability for violating Rule 13e-3. On the other hand, if they fully disclose their true purpose they may provide minority shareholders with the evidence they need to challenge the transaction in state courts.

C. *Insiders' Disclosure*

Federal regulation of corporate affairs has been most salient in the area of mandatory disclosure by public companies. This subsection considers the corporate governance implications of the disclosure requirements under federal law, as well as those of the key mechanisms that were put in place to better implement these requirements. As we shall explain, federal regulation of corporate disclosure produces significant restrictions on corporate insiders.

1. *Disclosure as a Key Constraint on Insiders.* — Until the enactment of the Securities Act of 1933, the extent to which managers were required to disclose information to shareholders was a matter of state corporate

90. *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 473–74 (1977) (holding that without misrepresentation or nondisclosure, freezeout merger will not amount to violation of Rule 10b-5).

91. See Gilson & Black, *supra* note 18, at 1307.

92. See Clark, *supra* note 77, at 520–21 (linking reversal in position of Delaware to *Santa Fe* decision).

93. *Singer v. Magnavox Co.*, 380 A.2d 969, 980 (Del. 1977).

94. On the developments in Delaware law subsequent to *Singer*, see Clark, *supra* note 77, at 521–22, 525–28.

95. *Id.* at 524.

law.⁹⁶ States generally did not compel managers to disclose information to shareholders,⁹⁷ and little information was indeed disseminated.⁹⁸ In the wake of the 1929 stock market crash and the Great Depression that followed, Congress intervened to fill this perceived gap in investor protection by enacting the Securities Act of 1933⁹⁹ and the Securities Exchange Act of 1934¹⁰⁰—requiring management of public corporations to disclose information to shareholders.¹⁰¹ This federal foray has evolved into the extant body of statutes, regulations, and case law currently governing the disclosure of information to shareholders.

Whether the federal regime of mandatory disclosure is justified is beyond the scope of this Essay.¹⁰² For our purposes, it is important to note that, compared to the then prevailing norms under state law, this major federal intrusion substantially expanded the scope of duties imposed on managers of public corporations.

Mandatory disclosure affects management in several ways. To begin, the duty to disclose information on a regular basis obviously imposes a significant administrative burden on management and increases its exposure to liability. Moreover, the disclosure requirements under the securities laws extend to many issues, including areas especially vulnerable to insider abuse, such as going private transactions, executive compensa-

96. Prior to the enactment of the 1933 Act, there were several attempts by the exchanges to regulate corporate disclosure. See, e.g., Robert B. Thompson, Collaborative Corporate Governance: Listing Standards, State Law, and Federal Regulation, 38 Wake Forest L. Rev. 961, 969–70 (2003) (explaining that in 1923 NYSE required listed companies to disclose their quarterly earnings).

97. See Allen & Kraakman, *supra* note 80, at 210. To this date, Delaware law imposes very limited disclosure obligations on management. See Robert B. Thompson & Hillary A. Sale, Securities Fraud as Corporate Governance: Reflections upon Federalism, 56 Vand. L. Rev. 859, 868 (2003) (noting that Delaware law “does not require disclosure, except in the sporadic circumstances in which shareholders are asked to vote”). For a comprehensive review of disclosure duties under state law, see Lawrence A. Hamermesh, Calling off the Lynch Mob: The Corporate Director’s Fiduciary Disclosure Duty, 49 Vand. L. Rev. 1087, 1123–41 (1996).

98. See David F. Hawkins, The Development of Modern Financial Reporting Practices Among American Manufacturing Corporations, 37 Bus. Hist. Rev. 135, 140 (1963) (describing management of many turn-of-the-century public corporations as “notoriously secretive,” providing little or no financial disclosure to shareholders).

99. Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77aa (2000)).

100. Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a–78nn).

101. On the history of this intervention, see generally Joel Seligman, *The Transformation of Wall Street 1–72* (3d ed. 2003).

102. On the justification for mandatory disclosure, see, e.g., John C. Coffee, Jr., Market Failure and the Economic Case for Mandatory Disclosure, 70 Va. L. Rev. 717, 722–23 (1984) (arguing that mandatory disclosure reduces costs, increases efficiency, aligns incentives, and most effectively provides information necessary for optimizing portfolios); Paul G. Mahoney, Mandatory Disclosure as a Solution to Agency Problems, 62 U. Chi. L. Rev. 1047, 1048 (1995) (citing reduction of agency costs as justification for mandatory disclosure).

tion, and self-dealing transactions.¹⁰³ As most practitioners can testify, this sweeping disclosure regime often has a chilling effect on abuses by management or controlling shareholders because it presents these insiders with a dilemma: They can hide the true nature of the arrangement at stake and face liability, including criminal liability, for violating the securities laws. However, if they fully disclose all the relevant facts, they may provide shareholders with the evidence they need to challenge the transaction in state courts. An extensive regime of mandatory disclosure and continuous reporting thus increases management accountability and impedes its ability to siphon wealth to itself at the expense of shareholders.¹⁰⁴

Finally, as we will discuss in more detail in the next section, federal disclosure obligations have served as a vehicle for introducing powerful enforcement mechanisms, such as public enforcement by the SEC and criminal liability. In addition, by creating express and implied private rights of action,¹⁰⁵ federal securities laws have significantly empowered shareholders and plaintiffs' attorneys to bring suits against management. Indeed, some argue that federal securities laws have become more important than state law in preventing abuses by corporate insiders,¹⁰⁶ and recent empirical evidence shows that most federal securities class actions address corporate governance issues.¹⁰⁷

2. *Mandatory Auditing and Its Regulation.* — The securities laws do not stop at prescribing what information corporations must disseminate. They also impose a detailed set of supplementary rules designed to improve the quality of corporate disclosure. The principal example is the mandatory requirement for auditor certification of financial statements. This requirement restricts managerial freedom of action by subjecting the affairs of the corporation to an (ideally) independent scrutiny by an accounting firm.

Federal action in this area, however, has transcended the basic requirement for auditor certification. For many years, management was responsible for retaining the accounting firm providing the required certification. In recent years, however, federal law has intervened in the

103. See Thompson & Sale, *supra* note 97, at 875 (explaining that SEC has adopted "various mandatory disclosure items that arguably regulate the duty of loyalty").

104. See, e.g., Donald C. Langevoort, Seeking Sunlight in *Santa Fe's* Shadow: The SEC's Pursuit of Managerial Accountability, 79 Wash. U. L.Q. 449, 453-55 (2001) (noting that SEC disclosure requirements are designed to increase managerial accountability and that "prevailing view is highly supportive of this strategy").

105. See Securities Act of 1933 § 11, 15 U.S.C. § 77k (imposing liability to investors on issuers and certain outsiders when registration statement contains material misrepresentation); Securities Exchange Act of 1934 § 18(a), 15 U.S.C. § 78r(a) (creating express right of action for misleading reports filed with SEC).

106. See Thompson & Sale, *supra* note 97, at 861 ("[D]isclosure has become the most important method to regulate corporate managers.").

107. See *id.* at 863 (giving examples of revenue recognition and accounting practice as issues frequently addressed by federal securities class actions).

relationship between public companies and their auditors, leaving management with very little say concerning the company's auditors. Thus, federal law currently requires mandatory rotation of auditing partners and limits the scope of nonauditing services that accounting firms can provide to their auditing clients.¹⁰⁸ Most importantly, the Sarbanes-Oxley Act requires that the audit committee (which must consist of independent directors only) approve all auditing and nonauditing services provided to an issuer by its auditor.¹⁰⁹ The various requirements concerning auditor independence take power away from management and limit management's ability to improperly influence auditor scrutiny of the company.

II. THE FEDS' EXTRA TOOLS

Our discussion thus far has largely focused on the substantive body of federal law governing corporate affairs. In this section, we compare the tools used by state and federal corporate lawmaking and enforcement. Federal corporate law has deployed a significantly broader range of devices than has state law. First, while state law primarily relies on judge-made standards to address corporate issues, federal law uses *both* judge-made law and detailed agency-made regulations. Second, whereas state law imposes duties and restrictions only on company insiders—most notably directors and officers—federal law regulates both insiders and outsiders, such as gatekeepers and bidders for corporate control. Third, while state law relies on enforcement by private parties, federal law uses both public and private enforcement. Finally, while state law limits itself to civil sanctions, federal law uses both civil and criminal sanctions.

State law's use of a narrower set of tools might be the outcome of either states' reluctance to use other tools or their inability to do so. For our purposes, however, identifying the precise reason is not critical. What matters is that, like the consistent pattern of federal intervention to restrict insiders, the additional instruments that federal law consistently employs have implications for the proper role of federal law in the corporate area. Some of these tools could be useful for regulating corporate areas that have not been federalized due to Congress's past inclination to leave corporate issues to state law absent a crisis or acute problems that compel intervention.¹¹⁰

108. See Strengthening the Commission's Requirements Regarding Auditor Independence, Securities Act Release No. 8183, Exchange Act Release No. 47,265, Investment Company Act Release No. 25,915, 68 Fed. Reg. 6006 (Feb. 5, 2003) (codified at 17 C.F.R. pts. 210, 240, 249, 274).

109. Sarbanes-Oxley Act of 2002 §§ 201(b), 202, 15 U.S.C. §§ 7231, 78j-1 (Supp. II 2004).

110. Kahan and Rock view the federal use of additional tools as an advantage of the existing allocation of power between the federal government and Delaware. Kahan & Rock, *supra* note 13, at 1619–22. While we also view these tools as an advantage of past federal interventions, our focus is on the implications that the feds' extra tools have for leaving to state law issues not yet targeted by federal incursions.

A. Agency-Based Regulations and Judge-Made Standards

One of the noteworthy features of Delaware law is its heavy reliance on judge-made standards to regulate corporate affairs. Delaware extensively relies on its judiciary to promulgate the arrangements governing important corporate law issues,¹¹¹ including director liability,¹¹² duties of controlling shareholders,¹¹³ and the regulation of self-dealing transactions.¹¹⁴ Delaware judges, in turn, tend to produce flexible and highly fact-intensive standards rather than bright-line rules.¹¹⁵ Prominent examples for such loose—some say indeterminate—standards include those governing the permissible scope of takeover defenses¹¹⁶ and the corporate opportunity doctrine.¹¹⁷

The federal government, in contrast, often uses elaborate, bright-line rules to regulate public corporations. Prominent examples of such federal practice include the rules governing auditor independence and the disclosure of executive compensation. The sharp contrast between the Delaware approach and the federal one is perhaps best illustrated by the rules governing director independence. In the limited circumstances in which Delaware law attaches significance to director independence, courts have refused to adopt rigid definitions to determine who qualifies as an independent director.¹¹⁸ Instead, Delaware courts decide questions of director independence on a case-by-case basis taking into account the

111. See, e.g., Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. Cin. L. Rev. 1061, 1064 (2000).

112. See, e.g., *Gagliardi v. TriFoods Int'l, Inc.*, 683 A.2d 1049, 1052–53 (Del. Ch. 1996) (applying common law business judgment rule to find no director liability).

113. See, e.g., *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 720 (Del. 1971) (explaining application of intrinsic fairness test to parent-subsidiary dealings).

114. See, e.g., *Marciano v. Nakash*, 535 A.2d 400, 404 (Del. 1987) (establishing legal standard for evaluating transactions when company directors are on both sides).

115. See William T. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894, 900 (1997) (explaining that Delaware cases are fact-specific applications of principles that are difficult to generalize); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. Rev. 1009, 1024 (1997) (explaining that Delaware courts employ “standards, not rules”).

116. See generally Ronald J. Gilson & Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 Bus. Law. 247, 248 (1989) (examining Delaware’s “intermediate standard of review mandating that management’s defensive tactics be ‘reasonable in relation to the threat posed’ by hostile offer” (quoting *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985))).

117. See Clark, *supra* note 77, at 244–46 (proposing clearer test).

118. See, e.g., Lisa M. Fairfax, *Sarbanes-Oxley, Corporate Federalism, and the Declining Significance of Federal Reforms on State Director Independence Standards*, 31 Ohio N.U. L. Rev. 381, 395 (2005) (“Delaware courts have not identified any specific categories of relationships that would presumptively prohibit a director from being independent.”).

specific issue at stake.¹¹⁹ In contrast, federal law—through the exchange listing requirements—relies on detailed rules to provide guidance on the issue of director independence.¹²⁰ For example, the national exchange listing requirements include a lengthy list of relationships that preclude a director from being independent.¹²¹

Note, however, that federal law does not rely exclusively on rules to regulate corporate affairs. Many important issues are regulated at the federal level through judge-made standards. For example, courts applying the general antifraud provisions under Rule 10b-5 are those that have largely defined both the range of conduct prohibited as insider trading and the scope of disclosure duties imposed on companies and their management.¹²²

Competing theories purport to explain Delaware's heavy reliance on judge-made standards. In the past, we have argued that this reliance reduces the likelihood of federal intervention by camouflaging the extent to which Delaware law favors insiders.¹²³ In a recent article, Kahan and Rock posit that this feature of Delaware law provides Delaware with political legitimacy.¹²⁴ In some cases, states may simply find it economically wasteful to invest in the complex process of producing elaborate rule-based regulations. A regime of bright-line rules would normally require states to establish a regulatory agency and provide it with adequate funding. The agency would then have to invest considerable resources in researching the issues, drafting proposed rules, analyzing the public's comments, and finalizing the rules. Consider the recent initiative to modify the disclosure rules concerning executive compensation. The SEC release with the proposed rules is roughly 370 pages long, including a detailed analysis of the proposed rules, their underlying rationale, and re-

119. See E. Norman Veasey, *Should Corporation Law Inform Aspirations for Good Corporate Governance Practices—or Vice Versa?*, 149 U. Pa. L. Rev. 2179, 2182 (2001) (“[T]here is no ‘bright line’ or ‘litmus test’ for independence.”).

120. See sources cited *supra* note 67.

121. See Note, *And Now, the Independent Director! Have Congress, the NYSE, and Nasdaq Finally Figured Out How to Make the Independent Director Actually Work?*, 117 Harv. L. Rev. 2181, 2187–91 (2004) (reviewing definition of “independence”).

122. See Thomas Lee Hazen, *Law of Securities Regulation* § 12.17[1], at 522 (5th ed. 2005) (“[T]here is no statutory definition to precisely identify which types of insider trading are permissible and which are not.”). See generally Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 Vand. L. Rev. 1639, 1684 (2004) (examining history of duty to disclose under Rule 10b-5 and arguing that insider trading “came to dominate thinking so much that it appeared to be paradigmatic rather than unique”).

123. See Bebchuk & Hamdani, *Corporate Charters*, *supra* note 2, at 603.

124. Kahan & Rock, *supra* note 13, at 1609; see also Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 Colum. L. Rev. 1908, 1929–32 (1998) (describing how Delaware's reliance on open-ended standards excludes rival states from Delaware's network benefits); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 Tex. L. Rev. 469, 472 (1987) (arguing that reliance on judge-made standards increases litigation and thus fees paid to Delaware's attorneys).

quests for comments.¹²⁵ Needless to say, states might find this regulatory process to be prohibitively costly.

For our present purposes, however, the motivation for this feature of Delaware law is unimportant. As the next section explains, regardless of the real reason underlying it, the heavy reliance on judge-made standards significantly constrains the manner in which states can produce their corporate law arrangements.

B. *Regulation of Outsiders and Insiders*

Rules of personal jurisdiction and conflict of laws impose considerable limits on the range of matters and actors that state corporate law can effectively regulate. Under the prevailing legal regime, the law of the state of incorporation governs the internal affairs of the corporation.¹²⁶ State corporate law is thus significantly limited in the scope of actors that it can govern, as states normally lack jurisdiction over important participants in the corporate sphere, such as creditors, bidders for control, and sometimes even controlling shareholders.¹²⁷ For example, since controlling a Delaware corporation is not a sufficient nexus for personal jurisdiction, Delaware has only indirect ways to regulate controlling shareholders. Likewise, Delaware does not impose any duties on bidders for corporate control. Federal law, in contrast, does impose certain requirements on bidders with respect to structuring their tender offers.¹²⁸

Most notably, federal law extensively regulates corporate gatekeepers. Business corporations and their management interact with a wide range of advisors, including lawyers, accountants, and investment banks. State corporate law has generally refrained from intervening in the relationship between public companies and their advisors. Federal law, in contrast, has directly and indirectly regulated the relationship of companies with their so-called gatekeepers.¹²⁹ Although this interference does not directly modify state corporate laws, it does have substantial implications for the governance of public corporations. Providing a full account of the extensive regulation of gatekeepers by the federal government is beyond the scope of this Essay. For illustration purposes only, we will consider two specific forms of federal intervention—subjecting gatekeep-

125. See Executive Compensation and Related Party Disclosure, Securities Act Release No. 8655, Exchange Act Release No. 53,185, Investment Company Act Release No. 27,218, 71 Fed. Reg. 6542 (proposed Feb. 8, 2006) (to be codified in scattered sections of 17 C.F.R.).

126. See Note, The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy, 115 Harv. L. Rev. 1480, 1482 (2002).

127. See Kahan & Rock, *supra* note 13, at 1620.

128. See Securities Exchange Act of 1934 §§ 13(d), 14(d), 15 U.S.C. §§ 78m(d), 78n(d) (2000).

129. The term “gatekeepers” refers to “private parties who are able to disrupt misconduct by withholding their cooperation from wrongdoers.” Reinier Kraakman, Gatekeepers: The Anatomy of a Third Party Enforcement Strategy, 2 J.L. Econ. & Org. 53, 53 (1986).

ers to liability, and the professional conduct rules for attorneys of public corporations promulgated by the SEC.

Federal securities laws subject a variety of gatekeepers to liability for failure to prevent issuer fraud.¹³⁰ Under section 11 of the Securities Act of 1933, multiple parties may be subject to liability for the company's fraud at the capital-raising stage.¹³¹ Gatekeeper liability also applies to fraud committed by public companies not in connection with an offering of securities to the public. After the Supreme Court's decision in *Central Bank* abolished aiding and abetting liability to private parties under Rule 10b-5,¹³² Congress explicitly authorized the SEC in the Private Securities Litigation Reform Act of 1995 to impose civil liability for aiding and abetting securities fraud.¹³³ Moreover, some courts, including the *Enron* court,¹³⁴ have interpreted the *Central Bank* decision very narrowly.¹³⁵

Under certain circumstances, attorneys representing issuers have been subject to liability even prior to the Sarbanes-Oxley Act.¹³⁶ But the alleged involvement of attorneys in many of the recent corporate debacles induced the federal government to intervene in the relationship between issuers and their counsel.¹³⁷ Section 307 of the Sarbanes-Oxley Act thus directs the SEC to issue rules requiring attorneys representing issuers to report evidence of certain material misconduct, including "breach of fiduciary duties," to the company's chief legal officer or CEO. If the latter does not respond appropriately, the attorney is required to bring

130. See Assaf Hamdani, Gatekeeper Liability, 77 S. Cal. L. Rev. 53, 56–58 (2003) (analyzing strategy of imposing gatekeeper liability); Kraakman, *supra* note 129, at 53 (same).

131. 15 U.S.C. § 77k(a).

132. *Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 177 (1994) (holding that civil liability under Section 10(b) does not extend to aiding and abetting).

133. 15 U.S.C. §§ 78b, 78d, 78t(f).

134. *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 581–94 (S.D. Tex. 2002). For an account of the *Enron* court's interpretation of *Central Bank*, see Kurt Eichenwald, Ruling Leaves Most Players Exposed to Suits on Enron, N.Y. Times, Dec. 21, 2002, at C3.

135. Some courts hold gatekeepers liable by finding them to be "primary wrongdoers." On the elusive distinction between primary and secondary liability for securities fraud, see generally Jill E. Fisch, The Scope of Private Securities Litigation: In Search of Liability Standards for Secondary Defendants, 99 Colum. L. Rev. 1293, 1296 (1999) (analyzing effects of *Central Bank* on liability for secondary defendants and arguing that "recent decisions have been unduly restrictive in their reading of section 10(b) liability").

136. See, e.g., Lewis D. Lowenfels & Alan R. Bromberg, Liabilities of Lawyers and Accountants Under Rule 10b-5, 53 Bus. Law. 1157, 1167–79 (1998) (finding that after *Central Bank* lawyers, though having no independent duty to disclose information about clients, are not excused from liability for a "material lie").

137. See, e.g., Roger C. Cramton, Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues, 58 Bus. Law. 143, 162–73 (2002) (reviewing multiple ways in which lawyers were legally implicated in Enron affair).

the matter to the attention of either the audit committee, another committee consisting of independent directors, or to the entire board.¹³⁸

C. *Public Enforcement and Private Enforcement*

Federal authorities enforce corporate law norms through an elaborate system—using private, public, and criminal enforcement mechanisms. Under state law, in contrast, the sole mechanism for enforcing the rules of corporate law is private litigation in state courts. States' narrower range of devices leads to two salient differences between them and the federal government: First, states normally lack the apparatus for scrutinizing compliance with corporate law on a routine basis. Second, states do not rely on public enforcement *ex post*.

The federal government engages in a wide variety of proactive measures designed to enhance investor protection even in the absence of any indication of wrongdoing. These measures include not only the promulgation of a variety of prophylactic rules, but also the ongoing inspection of public companies. The Division of Corporation Finance at the SEC, for example, scrutinizes prospectuses and other disclosure documents, provides administrative interpretation of securities legislation, and issues no-action letters to companies seeking assurances.¹³⁹ Similarly, the Public Company Accounting Oversight Board regularly inspects audit firms to determine their compliance with auditing standards.¹⁴⁰ No state has a comparable function of inspecting public companies' compliance with applicable corporate laws. In fact, it is likely that no state would find it economically worthwhile to make such considerable investment in the regulatory infrastructure necessary for fulfilling this function.¹⁴¹

Federal law also implements a wide array of public enforcement devices to facilitate the enforcement of corporate norms, especially those

138. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8185, Exchange Act Release No. 47,276, Investment Company Act Release No. 25,919, 68 Fed. Reg. 6296 (Feb. 6, 2003) (codified at 17 C.F.R. pt. 205). The SEC originally proposed a rule that included a "noisy withdrawal" obligation. Implementation of Standards of Professional Conduct for Attorneys, Securities Act Release No. 8150, Exchange Act Release No. 46,868, Investment Company Act Release No. 25,829, 67 Fed. Reg. 71,670, 71,673 (proposed Dec. 2, 2002). Given widespread opposition, the SEC has extended the comment period concerning this portion of the rule. Implementation of Standards of Professional Conduct for Attorneys, Securities Exchange Act Release No. 8186, Exchange Act Release No. 47,282, Investment Company Act Release No. 25,920, 68 Fed. Reg. 6324 (proposed Feb. 6, 2003).

139. See U.S. Sec. & Exch. Comm'n, 2005 Performance and Accountability Report 43–50 (2005), available at <http://www.sec.gov/about/secpar/secpar2005.pdf> (on file with the *Columbia Law Review*) [hereinafter SEC 2005 Report].

140. See Pub. Co. Accounting Oversight Bd., 2004 Annual Report 10–12 (2005), available at http://www.pcaobus.org/About_the_PCAOB/Annual_Reports/2004.pdf (on file with the *Columbia Law Review*).

141. In fiscal year 2005, for example, the Corporation Finance Division at the SEC reviewed the financial statements of over 6,000 reporting companies. See SEC 2005 Report, *supra* note 139, at 11.

stemming from securities laws. The SEC carries out a variety of enforcement functions, including investigating cases of financial fraud, bringing civil actions in federal courts, and imposing administrative and disciplinary penalties.¹⁴² In severe cases (such as Enron and Adelphia), the Department of Justice brings criminal indictments. States, in contrast, rely almost exclusively on private enforcement of corporate norms. No state has established an agency to investigate corporate matters or to bring actions against insiders who have breached their fiduciary duties.¹⁴³ The enforcement system available to federal authorities thus goes far beyond that of the states in controlling insiders.

D. *Criminal and Civil Sanctions*

Criminal liability occupies a key role in the federal government's enforcement arsenal. Federal authorities have used criminal law to enforce disclosure duties and the prohibition on insider trading under the federal securities laws. In certain cases, moreover, federal criminal law has been extended to cover breach of fiduciary duties by corporate officers.¹⁴⁴ Indeed, most recent scandals have ended with criminal charges brought against the allegedly responsible corporate insiders in federal courts.¹⁴⁵ Finally, responding to perceived deterrence failure underlying the recent corporate debacles, Congress introduced even harsher penalties on corporate insiders in the Sarbanes-Oxley Act.¹⁴⁶

In contrast, states normally do not rely on criminal law to enforce corporate law norms. The motivation underlying states' reluctance to rely on criminal law is unclear. One might argue that this reluctance has changed in recent years, with New York Attorney General Eliot Spitzer bringing criminal charges against investment banks and mutual funds, and other states' authorities indicting corporate officers for their involvement in corporate scandals. Yet, states that bring criminal charges are often not the states of incorporation and the charges are not based on

142. See James D. Cox & Randall S. Thomas with Dana Kiku, *SEC Enforcement Heuristics: An Empirical Inquiry*, 53 *Duke L.J.* 737, 746–53 (2004).

143. See, e.g., Carlton & Fischel, *supra* note 82, at 891 (noting that states have not enacted public enforcement schemes directed against insider trading).

144. See John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 *B.U. L. Rev.* 193, 204 (1991) (describing how, in mid-1980s, defendants were "convicted of a federal felony on facts that would have been unlikely to support civil liability in a derivative suit"). For an overview of the federal offenses that may apply to insider fraud, see Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 *Fla. L. Rev.* 937, 946–48 (2003).

145. See Kathleen F. Brickey, *In Enron's Wake: Corporate Executives on Trial*, 96 *J. Crim. L. & Criminology* 397, 401 (2006).

146. See 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, 684–89 (2002).

the states' corporation statutes.¹⁴⁷ Spitzer, for example, used New York's blue sky statute—also known as the Martin Act—to bring charges against corporate wrongdoers.¹⁴⁸ Finally, while other states have occasionally prosecuted corporate insiders, we are not aware of any criminal action by Delaware.¹⁴⁹

III. LESSONS FOR THE FUTURE

In this section, we consider the implications of our analysis for future policymaking. Part III.A evaluates the performance of state competition. Persistent federal interventions, we argue, do not hinder the assessment of state competition. To the contrary, the pattern of federal intervention supports the view that state competition cannot by itself produce adequate investor protection.

Part III.B considers whether federal intervention should take the same form in the future as in the past. We argue that the mere threat of federal intervention is insufficient to induce states to adopt desirable arrangements. We also highlight the shortcomings of occasional federalization of corporate law issues in reaction to scandals or manifest problems.

Part III.C argues that the federal government should take a more proactive approach to regulating corporate affairs. Federal officials should abandon the presumption that corporate issues should normally be left to state law. Rather, federal policymakers should undertake a systematic and comprehensive examination to determine which corporate law issues should be subject to full or partial federalization.

A. *The Race to the Top/Bottom Debate*

1. *Do Past Interventions Make the Effect of State Competition Indeterminate?*—In a recent article, Mark Roe argues that the state competition debate is inherently inconclusive given extensive federal intervention and the omnipresent threat of such intervention.¹⁵⁰ In his view, because Delaware's corporate lawmaking has been influenced by both state competition and the federal threat, it is impossible to isolate the effect of state competition on corporate law rules.¹⁵¹ In other words, because the pre-

147. See Kahan & Rock, *supra* note 13, at 1606 ("Some states publicly prosecute corporate misconduct, albeit under the guise of their criminal, rather than their corporate, law.").

148. See Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 *Conn. Ins. L.J.* 107, 115–21 (2004) (detailing Spitzer's Wall Street investigations and use of Martin Act); Johnathan Mathiesen, *Survey, Dr. Spitzlove or: How I Learned to Stop Worrying and Love "Balkanization,"* 2006 *Colum. Bus. L. Rev.* 311, 316–25 (same).

149. See also Kahan & Rock, *supra* note 13, at 1607 ("[W]e are not aware of any instances in which Delaware prosecutors have investigated or charged corporate officials.").

150. Roe, *Competition*, *supra* note 6, at 634–43.

151. *Id.* at 635 ("The state race analysis must be inconclusive because we live in a federal system.").

mise of a “pure” race among states is a counterfactual one, corporate law scholars face a fundamental problem of observability when trying to assess whether competition pushes states in a positive or a negative direction.

We believe such agnosticism is unwarranted. Analytically, the fact that an outcome is the product of two distinct forces does not necessarily make it impossible to identify the separate effect of each force. To be sure, this cannot be done merely by evaluating the outcome produced by the two forces. In our case, however, it is possible to isolate the effect of state competition and obtain evidence about its direction.

For simplicity, assume that we can rank the quality of corporate law rules on a scale of one to ten, and suppose that Delaware is at five. Delaware is influenced by both the threat of federal intervention and the desire to compete with other states over incorporations. According to Roe, we cannot determine in which direction state competition pulls Delaware. State competition might have pulled Delaware to lower the quality of its corporate arrangements, but the federal threat made it settle at five. But it also might be that state competition pulled Delaware up toward the top, but the federal threat pulled it down to settle at five.

There is, however, a way to identify the direction in which competition pulls states. State competition can influence a state to the extent that the state is interested in attracting incorporations. Thus, as long as states vary in the quality of their corporate law rules, one can examine whether states with superior rules attract more incorporations. For example, if states with a low quality score do worse in attracting companies than states with a high score, then the motive to attract incorporations pulls to the top; improving the quality of Delaware’s corporate rules would also increase Delaware’s number of incorporations. Conversely, if states with a low quality score do better in attracting incorporations than states with a high score, then Delaware’s interest in attracting incorporations pulls it down the quality ladder.

We can thus evaluate the effect of state competition, notwithstanding the presence of federal lawmakers, by examining cases of cross-state variations to find whether states do better in terms of incorporations when they provide value-enhancing rules. This test is not only analytically feasible, but also has been partly pursued.

There is substantial agreement among academics that state takeover law provides excessive protection against takeovers.¹⁵² Even some prominent supporters of state competition view state antitakeover statutes as

152. Some believe that takeover defenses are desirable. See, e.g., Stephen M. Bainbridge, *Director Primacy in Corporate Takeovers: Preliminary Reflections*, 55 *Stan. L. Rev.* 791, 808 (2002) (arguing that eliminating antitakeover defenses will reduce premium amount shareholders will receive upon acquisition). But see Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 *Yale L.J.* 621, 635–40 (2003) (finding no evidence that strong antitakeover defenses increase premium shareholders receive in negotiated acquisitions).

undesirable.¹⁵³ And the empirical evidence supports this view. The overwhelming majority of event studies found either no price or negative price reactions to the adoption of state antitakeover statutes.¹⁵⁴ Researchers have also found evidence that state antitakeover statutes increase agency costs.¹⁵⁵

While consistent with the view that state competition produces adverse incentives concerning issues with a substantial effect on managers' private benefits,¹⁵⁶ the proliferation of antitakeover statutes presents a challenge for advocates of state competition. Supporters of regulatory competition thus seek to reconcile their view with the belief that state antitakeover statutes reduce shareholder value by arguing that state competition does not encourage, and is thus not responsible for, the adoption of antitakeover statutes.¹⁵⁷ Most of these statutes were adopted, the argument goes, by states that could not resist the lobbying or political pressure of some managers concerned about the threat of a takeover. Under this view, state competition has operated not to encourage the adoption of antitakeover statutes but to discourage and moderate it.

Under this view, therefore, amassing strong antitakeover statutes is likely to decrease rather than increase the number of incorporations. However, recent research conducted by Alma Cohen and one of us shows otherwise.¹⁵⁸ The study finds that states adopting more antitakeover stat-

153. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161, 1174–82 (1981) (arguing against use of defensive tactics by targets' boards); Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 *Fordham L. Rev.* 843, 860 (1993) (acknowledging “dismal track records of most states in takeover regulation”); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 *Yale J. on Reg.* 119, 177 (1992) (noting that almost all state antitakeover law is unwarranted and harmful); Winter, *supra* note 1, at 287 (stating that antitakeover statutes increase transaction costs of takeovers and thus do not benefit shareholders).

154. See, e.g., Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 *J. Fin. Econ.* 291, 293 (1989) (finding that announcement of state takeover law is associated with small decrease in stock prices of firms). For surveys of these many studies, see Romano, *Corporate Law*, *supra* note 1, at 62 tbl.4-1.

155. See, e.g., Marianne Bertrand & Sendhil Mullainathan, *Is There Discretion in Wage Setting? A Test Using Takeover Legislation*, 30 *RAND J. Econ.* 535, 536 (1999) (noting that adoption of antitakeover statutes reduced managers' incentives to minimize labor costs); Marianne Bertrand & Sendhil Mullainathan, *Executive Compensation and Incentives: The Impact of Takeover Legislation 4–5* (Nat'l Bureau of Econ. Research, Working Paper No. 6830, 1998), available at <http://www.nber.org/papers/w6830> (on file with the *Columbia Law Review*) (stating that adoption of state antitakeover statutes resulted in increased extraction of rents through executive compensation).

156. See Bar-Gill et al., *supra* note 11, at 3; Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 *Colum. L. Rev.* 1168, 1175–76 (1999).

157. See Easterbrook & Fischel, *Economic Structure*, *supra* note 79, at 222–23; cf. Romano, *International Securities*, *supra* note 20, at 533–34.

158. See Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 *J.L. & Econ.* 383, 387 (2003).

utes are more successful in attracting incorporations of firms located in the state and preventing the migration of such firms to Delaware.¹⁵⁹ Indeed, adopting all the standard antitakeover statutes enabled the state to more than double the percentage of local firms incorporating in the state.¹⁶⁰ Moreover, the study found no evidence that the incorporation market has penalized the three states that adopted the most far-reaching antitakeover statutes.

Thus, the recurring federal interventions do not preclude an assessment of whether state competition has a beneficial effect on state law-making in the corporate area. Indeed, recent empirical work provides evidence—the validity of which is in no way undermined by federal interventions—that state competition provides incentives to protect insiders.

2. *Does State Competition Induce States to Favor Insiders?* — We have thus far rejected the claim that federal interventions undermine any attempt to assess the performance of state competition. We will now explain that past federal interventions, in fact, provide useful evidence for making such an assessment.

A key question underlying the state competition debate is whether competition pushes states in a positive direction. Supporters of state competition argue that it generally leads states to adopt corporate law rules that enhance shareholder value. Examining past interventions, however, casts doubt on this claim. The systematic pattern of federal interventions suggests that competition pushes states to produce arrangements that excessively favor insiders. Without federal interventions, we have shown, state law would have produced investor protection levels that are substantially below the existing ones. Thus, unless one is prepared to view the existing regime as providing investors with substantially excessive protection, history indicates that state competition tends to produce substantially suboptimal levels of investor protection.

To be sure, there are those—including perhaps some supporters of state competition—who believe that the U.S. rules concerning investor protection are too strict and should be relaxed. But it seems fair to say that the majority of corporate law scholars and policymakers—while not necessarily endorsing all the existing federal rules concerning corporate issues—would oppose rolling back the times to a more *laissez faire* system. And there is a significant body of empirical evidence suggesting that the current level of investor protection has contributed to the success of the U.S. stock market.¹⁶¹

159. *Id.* at 411–15; see also Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. Pa. L. Rev. 1795, 1801 (2002) (reporting evidence that antitakeover statutes attract incorporations).

160. See Bebchuk & Cohen, *supra* note 158, at 414.

161. See, e.g., Rafael La Porta et al., *Law and Finance*, 106 J. Pol. Econ. 1113, 1152 (1998) (describing recent research on correlation between country’s legal system and economic development).

The pattern of federal intervention that we have identified is relevant for examining whether state competition produces arrangements that are too lax on corporate insiders. Federal intervention has not varied between favoring and disfavoring insiders. Rather, federal lawmakers have consistently had to adopt restrictions on insiders that state law failed to provide. Moreover, states did not fail to act because federal law acted faster to produce corporate law arrangements. If that were the case, then our inference would not be valid. Rather, federal officials have typically acted only after state law failed to provide adequate arrangements for some time.

In other words, but for federal intervention, the regime of investor protection might have been even worse than what you would get by simply excluding existing federal arrangements. Without the omnipresent threat of intervention, state law arrangements might have been more lax toward insiders than the current ones. After all, as Mark Roe vividly describes, current state law rules have often been adopted against an omnipresent threat of federal intervention.¹⁶²

Federal lawmakers presumably do not view the existing investor protection regime—much of it the product of federal interventions—as excessive. Otherwise, the right thing for them to do would be to dismantle the protections that federal law has adopted. Our analysis suggests that this view should lead to the conclusion that state competition tends to be too lax with respect to insiders.

3. *Do Insiders Have as Much Influence on Federal Law as on State Law?*—The pattern of federal lawmaking suggests that state competition produces arrangements that favor insiders. This, however, does not necessarily imply that a federal regime that displaced state competition would be superior. After all, it might be argued, federal law could do even worse. In this subsection, we suggest that the history of federal intervention undermines this argument as well.

State competition supporters, including Bainbridge, Macey, Romano, and Sitkoff, contend that federal law is unlikely to provide corporate law arrangements that would maximize shareholder value.¹⁶³ The

162. See Roe, Competition, *supra* note 6, at 601–07. However, Hamermesh argues that the influence of the threat of federal intervention on Delaware lawmaking has been marginal. See Hamermesh, Policy Foundations, *supra* note 14, at 1787.

163. See Bainbridge, Politics, *supra* note 28, at 706–07 (“Congress is institutionally incapable of serious corporate governance reforms.”); Jonathan R. Macey, Displacing Delaware: Can the Feds Do a Better Job Than the States in Regulating Takeovers?, 57 Bus. Law. 1025, 1027–28 (2002) (arguing that federal takeover law might be more management friendly than state law because of ability of management to lobby Congress without counterweight of states’ reputational concerns); Roberta Romano, The Future of Hostile Takeovers: Legislation and Public Opinion, 57 U. Cin. L. Rev. 457, 468–85 (1988) (arguing that collective action problems and history of congressional involvement suggests federal takeover law would have same or greater bias toward management than state law); Romano, International Securities, *supra* note 20, at 537 (stating that it is highly unlikely Congress would adopt takeover legislation superior to Delaware’s); Robert H. Sitkoff,

federal government, they argue, has its own political dynamic and is influenced by various interest groups. Insiders, sometimes aligned with labor interests, have substantial political clout and thus have influence on lawmaking at the national level. Choi and Guzman, for example, argue that managerial lobbying will be especially intense at the federal level since federal rules would be relevant to every firm in the nation.¹⁶⁴ Thus, state competition supporters believe that political economy considerations caution against a federal role in the corporate area.

Would federal lawmaking be as (or even more) favorable to insiders? Before discussing the evidence, let us explain why, on theoretical grounds, federal lawmaking is less likely than state lawmaking to favor insiders. At both the state and federal level, lobbying and pressure by interest groups are likely. But regulatory competition creates an important additional force—not existing at the federal level—that pushes states to cater to insider interests.

In an earlier work, we showed how the desire to influence reincorporation decisions induces states to provide corporate law arrangements that are favorable to insiders.¹⁶⁵ Even if insiders invested no resources in lobbying, state lawmakers would likely be attuned to their interests. Put differently, beyond whatever lobbying by interest groups occurs, charter competition pushes states to favor managerial interests. This pressure would not apply to federal lawmakers.

To be sure, lobbying by insider interests might be strong at the federal level, but such lobbying can occur at both the state and the federal levels. At the national level, however, lobbying by financial interests and institutional investors would likely provide some counterweight to insider lobbying.¹⁶⁶ Moreover, with the rise of the shareholder class, the political dynamics at the federal level might induce federal authorities to modify corporate law arrangements so as to further restrict corporate insiders even without organized lobbying.¹⁶⁷

The pattern of federal interventions lends further support to this analysis. If pro-insider lobbying had been as effective at the federal level as at the state level, then a considerable share of federal interventions

Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters, 69 U. Chi. L. Rev. 1103, 1160–61 (2002) (stating that federal statute regulating takeovers will likely be worse than current regime under state law).

164. See Stephen J. Choi & Andrew T. Guzman, Choice and Federal Intervention in Corporate Law, 87 Va. L. Rev. 961, 975–76 (2001).

165. See Bebchuk & Hamdani, Corporate Charters, *supra* note 2, at 599–601.

166. Cf. Mark J. Roe, Delaware's Politics, 118 Harv. L. Rev. 2491, 2537–38 (2005) [hereinafter Roe, Politics] (arguing that shareholders and managers are likely most influential at state level).

167. See William W. Bratton & Joseph A. McCahery, The Equilibrium Content of Corporate Federalism 44–51 (European Corporate Governance Inst., Working Paper No. 23/2004, 2004), available at <http://ssrn.com/abstract=606481> (on file with the *Columbia Law Review*) (suggesting that political demand for certain congressional interventions stemmed from general public rather than organized interest groups).

would have favored insiders. But that has not been the case. Whatever forces operate at the federal level, past patterns indicate that they tend not to be as pro-insider as those operating at the state level.

One might argue that the history of federal lawmaking provides a misleading snapshot of the balance of powers under a system of federal corporate law. Since it has thus far taken place against the backdrop of the prevailing norm under which states regulate companies' internal affairs, federal intervention typically has been limited to periods of financial crisis. Given the strong populist sentiment underscoring federal action during these crisis periods, it might be argued, it is not surprising that the arrangements produced by federal officials disfavor insiders. Things would be different, however, were the federal government to engage in corporate lawmaking on a regular basis. Under such a regime, managers would have greater opportunity to influence lawmakers, especially when the general public is not focused on corporate law topics.

This potential objection paints an overly simplistic picture of the circumstances underlying past federal interventions. As Part II indicates, not all federal arrangements have been introduced during periods of crisis. To be sure, some of the most extensive federal incursions were sparked by the collapse of the stock market or some other national crisis. This description applies to most of the extensive reforms undertaken by Congress to federalize what had previously been matters regulated exclusively under state law. However, many rules adopted by the SEC or federal courts were not adopted during such periods of crisis. For example, while it contrasted sharply with the approach of state lawmakers at the time, the SEC's persistent attempt to prohibit dual-class stock recapitalizations cannot be attributed to any particular crisis or a populist demand. The same applies to the federal courts' decisions extending the application of Rule 10b-5 to insider trading.

4. *Does State Law Have All the Necessary Tools?* — Our analysis highlights another reason why state law alone cannot be relied upon to produce an adequate regime of investor protection. Beyond whatever problems exist as a matter of substantive law, states also use a much narrower arsenal of instruments to govern corporate affairs. In this subsection, we consider the implications of the limited toolkit that state law uses. As we explain, there are, most likely, cases in which some of the tools used only by federal law would be useful. The limited tools that states deploy significantly call into question the ability of a state competition regime to provide desirable arrangements.

a. *Judge-Made Standards.* — Delaware corporate law relies heavily on standards to regulate corporate affairs. As the academic literature shows, however, rules sometimes may well be superior to standards.¹⁶⁸ Consider, for example, public companies' duty to disclose information concerning

168. See, e.g., Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L.J.* 557, 577 (1992).

executive compensation. Given the complexity of compensation arrangements and the need for a uniform disclosure format across issuers, detailed, bright-line rules are presumably superior to open-ended standards. Indeed, the SEC has adopted an extensive scheme of detailed disclosure rules concerning executive compensation.¹⁶⁹

Furthermore, the central role that courts occupy in state corporate law (and the related reliance on private enforcement) substantially limits the nature of corporate lawmaking. The reliance on courts undermines the ability of Delaware corporate law to respond quickly to exigent circumstances.¹⁷⁰ Unlike legislators or agencies with rulemaking power, courts need to wait for the proper dispute to reach them in order to modify existing rules. Furthermore, even when the proper occasion arrives, courts typically cannot simply overrule prior precedents. A legal system that heavily relies on judge-made law is normally bound to make only gradual changes to existing rules.¹⁷¹

The gradual and slow evolution of state corporate law stands in sharp contrast to the federal response in the aftermath of Enron and other debacles. This response included quick action by Congress, followed by extensive rulemaking by the SEC. Delaware, on the other hand, did not respond so quickly.¹⁷² Again, we do not argue that the federal response to the recent crisis was optimal. In fact, some argue that the federal response was too hasty, and that some of the reforms lack merit.¹⁷³ Rather, our point is that state law based on judge-made standards cannot respond in a prompt and comprehensive manner to a substantial change in circumstances.

169. See Executive Compensation and Related Party Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54,302A, Investment Company Act Release No. 27,444A, 71 Fed. Reg. 53,157 (Sept. 8, 2006) (to be codified in scattered sections of 17 C.F.R.).

170. See Kahan & Rock, *supra* note 13, at 1617–19.

171. In a recent article, Justice Steele and Professor Griffith argue that its reliance on standards provides Delaware with the ability to alternate between lax and stringent regulation. See generally Sean J. Griffith & Myron T. Steele, *On Corporate Law Federalism: Threatening the Thaumatrope*, 61 *Bus. Law. J.* (2005). This analysis, however, overlooks two important points. First, as we explained above, federal law also relies on judge-made standards. Second, judge-made law may be a poor device for regulating areas in which detail-intensive rules are optimal.

172. We do not argue that Delaware's legislature is slow to respond to rapidly changing business conditions. Indeed, some believe that Delaware's lawmakers promptly amend corporate laws when the need arises. See, e.g., Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough? A Response to Kahan & Kamar's Price Discrimination in the Market for Corporate Law*, 86 *Cornell L. Rev.* 1257, 1268 (2001) [hereinafter Strine, *Response*]. When case law governs an important issue, however, legislators are limited in their ability to respond, unless they are willing to adopt legislation that would displace the case law on the issue.

173. See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 *Yale L.J.* 1521, 1528 (2005) [hereinafter Romano, *Quack Corporate Governance*] (suggesting that Sarbanes-Oxley Act will not achieve its goals).

b. *Private Enforcement.* — The virtually exclusive reliance by states on private litigation may be sensible from the economic perspective of each individual state. The failure to provide for public enforcement, however, may lead to underenforcement of corporate norms.¹⁷⁴ There are some issues for which public enforcement may outperform private litigation. The same applies with respect to routine inspections of companies' compliance with corporate law norms.

c. *Criminal Law.* — A similar analysis applies to states' exclusive reliance on civil remedies. As is well established in the literature on enforcement, monetary penalties may sometimes produce under-deterrence. When the probability of detecting wrongdoing is smaller than one (that is, when there is some probability that the wrongdoer will not be caught), the optimal penalty should equal the social harm divided by the probability of detection.¹⁷⁵ Monetary sanctions may be insufficient when the wrongdoer possesses limited wealth and cannot always pay damages. Under these circumstances, the use of criminal law allows the state to overcome the judgment-proof problem.¹⁷⁶

B. *The Feds' Desirable Role*

The analysis thus far leaves open the question whether federal intervention should take the same form as in the past. In this subsection, we argue that federal officials should take a more proactive approach to regulating public corporations.

1. *Is the Federal Threat Sufficient?* — We have shown that, if left alone without the threat of federal action, state competition would likely not produce adequate investor protection. We have also explained why federal intervention is likely to be less biased in favor of insiders. This still leaves open the possibility that the existing regime of state competition, coupled with the mere threat of federal intervention, may be sufficient. Under this view, which is supported by some commentators,¹⁷⁷ if states went too far in the direction of favoring insiders, federal officials would be expected to intervene; the threat of such hypothetical intervention, the argument goes, will discourage states from adopting undesirable arrangements in the first place. For the reasons explained below, however, we believe that the mere threat of federal intervention is insufficient. Put differently, the constraint produced by the threat of federal intervention is hardly a tight one.

174. Cf. Steven Shavell, *The Optimal Structure of Law Enforcement*, 36 *J.L. & Econ.* 255, 268–70 (1993) (arguing that incentives for private enforcement may be “misaligned” with public needs and may lead to over or underenforcement).

175. See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 *J. Pol. Econ.* 169, 180–85 (1968) (analyzing variables involved in deterrence).

176. See Shavell, *supra* note 174, at 266.

177. See, e.g., Jones, *Corporate Federalism*, *supra* note 64, at 636–37 (arguing that “vertical” competition between federal government and Delaware produces sufficient disciplining effect).

To begin, for states other than Delaware, the federal threat has little deterrent effect. Since the corporate law of any such state affects only a small fraction of U.S. public companies, each such state does not expect its actions to have a significant impact on the likelihood of federal intervention. These states can thus adopt laws favoring insiders without meaningfully increasing the likelihood of intervention.

Unlike other states, Delaware cannot consider the effect of its choices on the likelihood of intervention to be negligible. Because Delaware's adoption of insider-favoring arrangements would increase the risk of federal intervention, the threat of such intervention does provide Delaware with an incentive not to adopt such arrangements. Still, this incentive may well be insufficient.

First, Delaware's dominance is a two-edged sword in this context. On the one hand, its dominant position induces Delaware to pay greater attention to the risk of federal intervention. Thus, Delaware cannot be expected to lead other states in terms of insider protection.¹⁷⁸ On the other hand, Delaware's desire to preserve its dominant position also discourages Delaware from falling too far behind other states in protecting insiders and thus bearing the risk of losing favor in insiders' eyes.

Second, Delaware's adoption of some insider-favoring arrangements is not expected to trigger federal intervention. Failure by Delaware to serve shareholder interests would be expected to trigger federal intervention only if it were sufficiently substantial and salient so as to induce federal officials to take action. Congress is unlikely to act unless there is sufficient political payoff associated with doing so. The SEC, on the other hand, is legally constrained from regulating the internal affairs of public corporations in the absence of explicit statutory authorization.¹⁷⁹ In addition, Delaware can use various measures—such as relying on courts to regulate corporate affairs—to secure legitimacy and reduce the risk of intervention.

Finally, whereas the threat of entirely displacing the existing system of regulatory competition with a mandatory regime of federal law has a clear deterrent power, it is far from clear that the threat of federalizing specific issues will serve as a deterrent. After all, notwithstanding the federalization of many issues, Delaware continues to derive a substantial fraction of its tax revenues from franchise taxes.¹⁸⁰ As long as it expects limited federal intervention, Delaware can adopt insider-favoring arrangements with only a limited risk. In other words, while placing some limits, the threat of federal intervention clearly provides Delaware

178. For example, Delaware has adopted fewer and milder antitakeover statutes than many other states. See, e.g., Romano, *International Securities*, *supra* note 20, at 533–34.

179. See also Joel Seligman, *A Modest Revolution in Corporate Governance*, 80 *Notre Dame L. Rev.* 1159, 1169 (2005) [hereinafter Seligman, *Modest Revolution*] (arguing federalism norm is example of impediment explaining relatively sporadic involvement of SEC in corporate governance issues).

180. See Bebhuk & Hamdani, *Corporate Charters*, *supra* note 2, at 556.

with substantial slack to stray away from shareholder wealth maximization without triggering federal action. The optimal strategy for Delaware might thus be to take a calculated risk of intervention and hope for the best.

Indeed, the patterns of the past convincingly demonstrate that the sheer threat of federal action is hardly sufficient to induce states to provide adequate investor protection. If the mere threat were sufficient, there would never—or rarely—be actual interventions, as states would do whatever was required to avoid federal action. The evidence, however, is inconsistent with this view. Intervention has not occurred once—it has been repeated in various forms throughout the last seven decades. History thus supports our view that the sheer threat of federal intervention does not impose a tight constraint on state law’s adoption of insider-favoring rules.

2. *Is Reactive Federal Lawmaking Sufficient?* — Having concluded that the disciplining impact of the federal intervention threat is insufficient, we now turn to *actual* federal interventions. We believe that the existing practice of occasional interventions suffers from several drawbacks.

First, federal officials have followed a reactive approach under which the “inadequacy threshold” needs to be quite high in order to trigger federal action. Federal lawmakers have generally federalized issues only when their regulation by state law seemed to be patently and grossly inadequate. State law arrangements that are merely inadequate but are not crying for repair are unlikely to trigger the federal government to act. To be sure, the paucity of federal incursions is not always the outcome of legal restrictions. Congress undoubtedly has the power to make laws in whatever areas of corporate law it wishes.¹⁸¹ Yet, the presumption in favor of state law produces a substantial political impediment to federal intervention.¹⁸² Moreover, federal courts and the SEC lack the power to federalize additional corporate law areas. And when they try to use the powers they have to regulate, they are subject to political pressures to focus on their “core responsibilities.”¹⁸³

The upshot is that some federal interventions—most importantly, those that require Congress to act—often take place in response to a financial or other crisis providing lawmakers with compelling reasons to respond to the public outcry and restore confidence.¹⁸⁴ The circumstances in which such federal intervention takes place affect its nature. First, given the perceived need to restore public confidence, legislators

181. See Kahan & Rock, *supra* note 13, at 1578 (stating Congress has power under Commerce Clause to enact national corporate laws that would displace state law).

182. See *id.* at 1586 (noting that, although not necessarily binding legally, underlying themes of “corporate federalism” and “states’ rights have significant political . . . salience”).

183. Seligman, *Modest Revolution*, *supra* note 179, at 1169.

184. See, e.g., Roe, *Politics*, *supra* note 166, at 2530 (stating that Congress intervenes in corporate law primarily when “constituents scream, fire alarms go off, and the media spots a big issue”).

typically act quickly, and the legislative process often lacks deliberation and thorough consideration of the issues at stake.

Roberta Romano has recently criticized the legislative process leading to the enactment of the Sarbanes-Oxley Act as being rushed.¹⁸⁵ This critique might be warranted, but its lesson is not to shun federal intervention. Rather, federal lawmakers should start thinking about the issues in a proactive way without waiting for a crisis atmosphere.¹⁸⁶ In other words, the rushed process leading to the adoption of Sarbanes-Oxley was not due to some inherent shortcomings of the federal system. Rather, it resulted from the federalism norm which normally leads Congress to stay away from regulating corporate affairs.

Second, limited interventions that focus on concrete problems crying for repair are inherently problematic. The corporate field is complex, with many interrelations and interconnections between the rules regulating different corporate issues. Unlike occasional interventions, a proactive approach would allow federal officials to develop a comprehensive assessment of corporate reforms and carefully study interrelations between various corporate law issues and the federal rules regulating them.

Finally, because the threshold for congressional intervention is high, the SEC and federal courts sometimes seek to address state law failures, but their ability to do so is significantly constrained by the congressional demarcation of the corporate law areas that are federalized. As a result, the SEC and federal courts might adopt strategies that are not necessarily optimal. The SEC, for example, has often addressed perceived state law failures through enhanced disclosure requirements. Perhaps disclosure requirements were indeed the right instrument, but one cannot escape the concern that the SEC adopted this strategy only because it was the one clearly within its authority. The SEC might have acted differently if it could have chosen from a broader menu of options.

C. *Going Forward*

Federal policymakers should adopt a proactive approach to corporate law. They should go back to the drawing board and review, without the pressure caused by a scandal or other pressing problem, all the issues now governed by state law. For each issue, federal policymakers should examine whether: (1) the existing state law arrangement is optimal, and (2) any of the tools that are now unavailable at the state level—rules, agency involvement, public enforcement, criminalization, duties on agents not subject to the jurisdiction of the state of incorporation—would be superior. Most importantly, this review should not proceed under the

185. See Romano, *Quack Corporate Governance*, *supra* note 173, at 1549.

186. Constant evaluation of the need to revise corporate law rules is considered to be one of the advantages of Delaware over the federal government. Strine, *Response*, *supra* note 172, at 1262.

prevailing strong presumption that corporate affairs should normally be left to state law absent compelling reasons to intervene.

Such a systematic review would not suffer from the drawbacks of the existing approach of reactive, occasional interventions. To begin, whereas Congress in the past expanded federal law only when it perceived the state law treatment of a certain subject to be sufficiently inferior to present a compelling reason for intervention, a systematic review could result in the expansion of federal law to many issues whose treatment by state law is “merely suboptimal.”

Second, while the reactive approach has led to congressional interventions done quickly and without sufficient deliberation, a systematic review process would not suffer from such a problem. Because the review process would not be conducted against the background of a crisis and a perceived need to act quickly, decisions could be made with appropriate deliberation and investigation. Thus, those who criticized the passage of the Sarbanes-Oxley Act for being too hurried¹⁸⁷ would not be able to attribute similar flaws to the outcome of the proposed review. Federal law has thus far taken an “emergency-room” attitude of addressing only acute problems calling for immediate treatment. The review we have in mind would also address problems that do not demand immediate treatment but whose solution could well provide significant benefits over time.

Thirdly, the comprehensive review that we advocate would enable federal officials to examine in an integrated and unconstrained fashion the optimal design of all corporate law arrangements specified by federal law. As we explained, some of the existing elements of federal law were adopted by the SEC or the federal courts, which sought to address perceived state law failures by using disclosure requirements. Because the proposed review would allow for congressional legislation, it could utilize a wide range of instruments beyond disclosure requirements. It would thus reconsider the strategies pursued by the SEC and the courts. For example, the proposed review would examine whether federal law would do better to address self-dealing problems through substantive rules rather than disclosure requirements.

One way for conducting such a review would be for Congress to appoint a National Corporate Law Commission to study in a comprehensive manner the arrangements that should govern public companies.¹⁸⁸ This Commission would prepare for congressional consideration a proposed revision of all the congressional legislation concerning public companies—a federal public companies code. This code could include applica-

187. See Romano, Quack Corporate Governance, *supra* note 173, at 1549.

188. The model we have in mind is the National Bankruptcy Review Commission. See National Bankruptcy Reform Act of 1994 §§ 601–610, 11 U.S.C. ch. 1 note (2000); see also M. Caldwell Butler, The National Bankruptcy Review Commission (1997), at <http://library.findlaw.com/1997/Nov/1/130505.html> (on file with the *Columbia Law Review*) (discussing history and role of National Bankruptcy Review Commission).

tion of federal law to areas of corporate law thus far regulated only by state law as well as revision of existing elements of federal law.

Of course, public companies live in a dynamic and ever-changing world and the task of adjusting optimally the body of federal corporate law will never come to an end. Delaware has a process that produces periodic revisions of its Corporate Code. Similarly, congressional legislation could provide a periodic adjustment of the federal public companies code. To this end, the National Corporate Law Commission could be a standing commission which would continue to monitor and review corporate law issues after the completion of its initial comprehensive set of recommendations.

Whether carried out through a National Corporate Law Commission or otherwise, the systematic review we advocate should seek to determine the full range of corporate issues which should be regulated by federal law rather than state law. With respect to some issues, the federal rule might simply provide a minimum requirement to which states could add, or even a default arrangement from which states could opt out to a specified extent. Because some of the rules governing a public company would continue to be supplied by its state of incorporation, we believe that it would be desirable for the proposed systematic review to develop a supplemental code to govern those companies that would choose a federal incorporation option.

We have already made a detailed case for a federal incorporation option in our earlier work.¹⁸⁹ Even the strongest supporters of regulatory competition cannot and should not oppose a federal incorporation option. A federal incorporation option does not impose any rules on public companies that do not choose to use this option, but merely expands the menu of choices available to such companies. Furthermore, because the incentives and tools of federal lawmakers are different from those of state lawmakers, the federal incorporation option could well provide a meaningful expansion in this menu of choices given that states offer codes that are rather similar.

To the extent that a National Corporate Law Commission would be appointed to conduct a comprehensive and continuous review of the optimal design of a federal public companies code, the Commission would be naturally positioned to develop and adjust over time the supplemental code for the federal incorporation option. Alternatively, the task of drafting this supplemental code could be given to a separate standing commission whose job would then largely parallel the work done by the state committees developing recommendations for changes in state law corporate codes.

As we argued earlier, one advantage of federal regulation is the ability to make significant use of rulemaking and enforcement by regulatory agencies. To the extent that the comprehensive review we recommend

189. Bebchuk & Hamdani, *Corporate Charters*, *supra* note 2, at 612–14.

would conclude that expansion of federal law is desirable, the role and responsibility of the SEC could expand as well. Furthermore, developers of the supplemental federal incorporation code might also conclude that agency involvement might be desirable for enforcing some of the supplemental code's provisions or for developing rules that provide detailed specification to implement some of the supplemental code's general provisions.

Given the discussion above regarding the federal bodies that should play a role in the future development of federal corporate law, we wish to note that the systematic review process we recommend should consider the establishment of a federal corporate law court. Critics of federal corporate law have stressed the benefits of having a judge-made law developed by Delaware's Court of Chancery which has a great deal of expertise in corporate matters. However, the absence of a specialized corporate court is not an *inherent* disadvantage of federal corporate law.¹⁹⁰ A federal court specializing in corporate law—or a number of such courts—could be established and staffed with judges with great expertise in the corporate area. Such a court could be charged with jurisdiction over disputes arising from the elements of the mandatory federal public companies code, from the elements of the supplementary code that might be adopted for companies choosing a federal incorporation option, or both.

In any event, while corporate law scholars might reasonably differ in the recommendations they will make to federal officials engaged in a comprehensive review of the law governing public corporations, we hope that many will come to recognize the value of such a review. Indeed, in this Essay we seek to help bring about such recognition.

CONCLUSION

The persistent federal interventions throughout the past seven decades do not make it more difficult to assess the performance of state competition. To the contrary, the patterns of federal intervention that we have identified provide important evidence that can help resolve the state competition debate. This evidence cuts against the claims of state competition supporters. Unless one is prepared to view current levels of investor protection as excessive, history indicates that state competition produces arrangements that are excessively lax toward insiders. History also suggests that insiders' influence on federal corporate law is not as strong as it is on state corporate law. Furthermore, for anyone who accepts that adequate investor protection requires the modern tools that state law has been unwilling or unable to use—agency-made regulations, regulation of outsiders, public enforcement, and criminal sanctions—history provides another argument against state competition.

190. See Lucian Arye Bebchuk & Allen Ferrell, A New Approach to Takeover Law and Regulatory Competition, 87 Va. L. Rev. 111, 146–47 (2001) (advocating specialized federal body to adjudicate proposed body of optional federal takeover law).

The history of federal interventions helps us not only to identify the shortcomings of state competition, but also to address them better in the future. History indicates that the mere threat of federal intervention is not sufficient to induce states to provide adequate investor protection. It further suggests that federal policymakers should abandon their presumption against intervening unless and until state law failures provide a compelling reason to do so. While occasional interventions are better than absolute deference to state law, a more systematic and proactive approach is desirable.

A systematic and comprehensive examination by federal policymakers can lead to the design of arrangements without the rush that characterized the Sarbanes-Oxley legislation. It can also produce improved arrangements not only with respect to issues whose regulation by state law is alarmingly worrisome, but also with respect to ones whose regulation by state law is merely inadequate. Additionally, such an examination can ensure that different federal corporate law arrangements are designed in a coordinated way that takes into account the interrelationships and interactions among various arrangements.

One way to implement the approach we advocate is for Congress to appoint a National Corporate Law Commission to examine all the issues now governed by state law and determine which, if any, should be fully or partially federalized. The optimal path for federal intervention in the future should be different from the one that it has taken during the past seven decades. History teaches us that state competition cannot be relied on to produce adequate investor protection on its own. A systematic and comprehensive examination of the desirable scope of federal intervention in corporate law is long overdue.