Brooklyn Law Review

Volume 74 | Issue 1 Article 3

2008

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Mark J. Roe

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Mark J. Roe[†]

An enduring inquiry for American corporate law scholars is why Delaware dominates corporate chartering in the United States. Several theories explain the result. I add another partial explanation: its large size alone makes Delaware attractive to reincorporating firms by making the state's corporate law more important to the American economy—and corporate interest groups—than that of other states. Any single state with a small number of incorporations could disrupt their firms' corporate structures without inducing any repercussions in Washington. But Delaware—or really its corporate law—is "too big to fail." Damaged players in other states would be unable to enlist Washington to reverse the result. Nor would the low volume players be wary of Washington's attention and the possibility of it over-reacting if a major corporate issue reached its agenda. Delaware, though, as home to about half of the American corporate economy, could not seriously disrupt American business without repercussion.

INTRODUCTION

The question of why Delaware has been the premiere corporate state is a continuing issue of academic inquiry, with explanations ranging from Delaware catering to corporate managers, to it having efficient judicial and responsive legislative decision-making, and to it providing network externalities. I analyze here how Delaware stays big, in part, by simply being big. Delaware, solely due to its large size in the corporate chartering market, provides an advantage to corporations that other states cannot provide. It is not just the network externalities of a (nearly) national but made-in-Delaware corporate law, as has been appropriately analyzed before. It is the additional characteristic that Washington would have little reason to react if another of the fifty states seriously disrupted their corporate legal structures, or sought to extract excessive value from its corporations. But if Delaware did so, its actions would threaten interests and, possibly, public well-being in a way that would induce Washington to act. Delaware might fail locally in making American corporate law, but its corporate law failure would not persist.

[†] Professor of Law, Harvard Law School. The Article is based on part of the October 2007 Pomerantz lecture at Brooklyn Law School. Thanks go to Michal Barzuza, Henry Butler, Martin Gelter, Jeffrey Gordon, Howell Jackson, Marcel Kahan, Donald Langevoort, Geoffrey Miller, Edward Rock, and Guhan Subramanian for comments and discussion, and to Gregory Dickinson for research assistance.

There are two dimensions to the size effect. Managers, shareholders, and their lawyers have reason to think that overall they do better if most corporate decisions are made in Delaware; hence, they have reason to scramble to make it unlikely that Washington would act and put Delaware's corporate lawmaking on the national agenda. But, if they fail in Delaware, they could as a last resort turn to Washington. And if Delaware's corporate law was seen as creating national economic issues, or if the state was unresponsive in a crisis, Washington's eyebrows might be raised and it might act. If Delaware did not adjust in either dimension—of responding to corporate interests or in being seen as damaging the national economy—its corporate law would not be allowed to persist without change or supplement. Washington would step in. Delaware is too big to fail. Other states are not.

In Part I of this Article, I review several existing explanations for Delaware's dominance, including the thinking that jurisdictional competition is not strong and that the federal presence cannot be ignored in corporate lawmaking. In Part II, I show how states with only a few large firms could make errors without attracting national attention because the national stakes would be too small; Delaware's disruptions, however, would not go unnoticed, because its corporate law governs so much of the American economy. In Part III, I extend this contrast, showing that Washington's presence thus bolsters Delaware's stability, but not that of other states. Finally, in Part IV, I further this contrast, showing that Washington's presence limits the contestability of state charter competition because once one corporate center emerges, new ones, lacking the strength of this interaction with Washington, will be relatively riskier.

I. THE STATUS OF ANALYSIS OF DELAWARE'S POSITION IN MAKING AMERICAN CORPORATE LAW

The classic view has been that Delaware dominates the chartering market because it won, and continues to win, a competitive race with other states. The "race view" divides into two sub-categories: first, that the race provides an efficient corporate law, and second, that the race provides insider decision-makers with law that favors them. Recent thinking has advanced two propositions to modify the long-held race perspective: that the race is weak and that Washington is effectively the major alternative corporate lawmaker to Delaware.

A. *The Race*

For decades, the central academic view of Delaware and its role in making American corporate law was that states competed for corporate chartering revenues, with Delaware the leader in that race. In the 1970s, the dominant view was first that of a race to the bottom, particularly after Bill Cary's famous article appeared, in which he advanced the idea that states were bending over backwards to appeal to managers over shareholders.[1] Thinking then shifted in key corporate academic circles to viewing the race as more one to the top by providing efficient corporate law, because some shareholder-oriented, managerial-controlling rules would be too costly overall and because firms, competing in capital markets, could not survive if hobbled by an inefficient state corporate law.[2] More analyses developed with conclusions and explanations as to why the race must be more to the top than the bottom.[3]

B. The New Thinking

The idea of a strong race dominated the academic literature for some time, although disagreement persisted as to whether the race was to the top or to the bottom. But the idea of the race being a strong one has worn thin in recent academic work.

The numbers show that Delaware has had the lion's share of incorporations for some time. Marcel Kahan and Ehud Kamar took our understanding of this indicator a big step forward by showing that no other state actively seeks the incorporation business, that no other state has a corporate franchise tax structure such that it could profit by doing so, and that Delaware is alone in the rechartering market. The few states that tried to compete on one level or another have stopped doing so; internal state politics stymied the effort. Local lawyers often saw themselves as losing out to others if strong commercial, business, and corporate courts emerged, so they lobbied against the effort and

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[1] William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 666 (1974).

[2] Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 251 (1977); *see also* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 21 (1993); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 920 (1982). For those embarking on a reading of the race debate, among the works that would need to be consulted, in addition to those cited elsewhere in this Article, are the following: Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401 (1994); William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303 (1997); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987). Recent contributions and advances come from: Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749 (2006); Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879 (2006); Robert Ahdieh, *The (Misunderstood) Genius of American Corporate Law*, (Emory Law Sch. Pub. Law Research Paper No. 08-35, 2008), *available at* http://ssrn.com/abstract =1105904.

[3] *See* ROMANO, *supra* note 2, at 14-17, 60-75; Robert M. Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 533 (2001) (advancing evidence that Delaware law enhances shareholder value by as much as 5%); Fischel, *supra* note 2, at 921-23; Winter, *supra* note 2, at 254-58, 289.

succeeded.[4] Lucian Bebchuk and Assaf Hamdani provided an economic explanation for the lack of competition: a state that incurred the costs of innovating around Delaware would often find that Delaware could copy the innovation, deflating the new entrant's competitive advantage. The potential competitor, aware of Delaware's potential to easily strike back, would then have had little motivation to innovate in the first place.[5]

In a complementary analysis, I argued that the United States has two primary corporate lawmakers: not just Delaware, but also the American Congress (and Congress's direct "agents," such as the Securities and Exchange Commission and the federal courts, and its indirect ones, such as the stock exchanges, which often make listing rules in the shadow of, or under the direction of, federal authorities). Hence, Delaware is not alone in making American corporate law. Not only is it not alone, but frequently the major corporate issue of the decade actually goes federal or is discussed and debated in the federal arena.[6]

A weak race does not mean that Delaware feels no competitive pressure. To better understand the pressure on Delaware, we must interact the states' somnolence with America's business dynamism. Even if no state actively competes with Delaware, business dynamism is so substantial in the United States that a large fraction of Delaware's tax base would disappear in a decade if Delaware did not get new firms into its tax base. Delaware truncates its tax rate, in that mid-sized companies pay as much as the very largest companies. Therefore, mergers, acquisitions, and disappearances erode Delaware's tax base even more quickly than American business turns over. Delaware must keep convincing firms to reincorporate from their home state into Delaware, even though it faces no important immediate competitor in the interstate chartering market. While this is not the severe competition of the economics textbook market of many producers fighting for the next sale, it is more than no competition at all.[7]

Whatever the nature of the analysis, Delaware has some advantage. Either it is racing and has an advantage, or it won a race and has some persisting advantage, which it has not yet frittered away. Several common explanations include rapid-response lawmaking, warranties of stability tied to Delaware's dependence on the franchise tax, high-quality judging, and network externalities.[8] Although some

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[4] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684, 687-93, 724-35 (2002).

[5] Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 593-95 (2002).

[6] Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 600-34 (2003).

[7] *See generally* Mark J. Roe, *Does Delaware Compete?* (working paper, 2008) (on file with author).

[8] *See* Wells M. Engledow, *Handicapping the Corporate Law Race*, 28 J. CORP. L. 143, 160-61 (2002) (Delaware's streamlined corporate law amendment process); Kahan & Kamar, *supra* note 4, at 725-26 (state courts' judicial expertise); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 847 (1995) (network externalities); Roberta

have contested the centrality of these advantages, I do not contest them. Instead, I seek to add to the list of Delaware's advantages by proposing the possibility that Delaware—or, more properly, its corporate law—is too big to fail. Delaware possesses a structural advantage over other states because it has a corporate law that, if it went awry, could damage the American economy. This power is also a constraint because Delaware lawmakers—alone among state lawmakers—would face federal consequences if its state-made corporate law was seen as having gone awry. As a constraint and as an advantage, therefore, Delaware cannot be allowed to make big mistakes or offend powerful corporate interests. If it does not take care of a corporate problem, some other body in the American economy or polity will.

I'll expand.

II. DELAWARE'S STABILITY

Delaware has provided a stable and efficacious but responsive corporate law for decades. It reacts to business changes, it innovates when needed, and, if it errs, it corrects the errors quickly. Other states have fewer incentives and a lower capacity to be both stable and accommodating. These considerations are often taken to be indicators of a race to the top,[9] although ones that in the modern analysis are not seen as motivated by tight competition for franchise fees.[10] Here, I further unpack our understanding of Delaware's stability, first by examining how local actors' motivations in Delaware differ from those in other states. Delaware cannot stay out of the national spotlight, while other states can.

A. *State Politicians' Motivations versus Business Stability*

State politicians in, say, California and Illinois have reason to provide corporate law stability, but they also have reasons not to do so. The main reason not to do so is that politicians' election-oriented time horizons are shorter than those of business. Corporate law is a long-run endeavor and politicians typically do not have the same long-run horizons. Kahan and Kamar showed that this mismatch in horizons is a reason why few states have tried to provide high-quality corporate law on a continuing basis.[11]

Moreover, and most importantly, mistakes happen. Most state politicians, other than Delaware's, have limited reason to correct them,

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Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 226-27 (1985) (stability).

9 ROMANO, *supra* note 2, at 38, who analyzes how Delaware bonds itself to provide an attractive, stable corporate law through its dependence on the franchise tax.

10 Kahan & Kamar, *supra* note 4, at 687-93.

11 *Id.* at 729.

because they have little at stake. And they have weak public-spirited motivations to correct mistakes that affect the viability of out-of-state businesses. Moreover, state politicians might find it tempting to take something from those out-of-state businesses, to close a budget gap or to relieve property taxes just before an election. Analysis to date has focused on why Delaware is motivated to, and capable of, reacting quickly in making corporate law that responds to current conditions. These analyses, in my view, are correct, but more can be said.

B. *If a Small State Goes Awry*

Consider how the affected interests, firms, and Washington would react if a state with only a few large firms went awry in making corporate law by promulgating rules that seriously diminished its firms' capacity to compete effectively. The damaged interests would seek redress inside the state. They might succeed.

Or, consider a redistributive policy (unlikely, of course, but not impossible) that would give in-state players a reason to resist correction. If many of the corporations physically operated out-of-state, local citizens would pay a small price for the costs of the state lawmakers' corporate error. They might even benefit from the policy (and indeed their benefit might have motivated the action in the first place), if the error is, for example, a very high tax. The damaged firm could try to reincorporate elsewhere. Standard theory suggests that this could be a good remedy, although not a costless one. Moreover, the standard American corporate format for reincorporation is for the board to propose it and shareholders to then approve it. If the state's error is to excessively favor one group over the other (for example, managers over shareholders), one could imagine boards or shareholders trapped in a state that is making corporate mistakes and has become unwilling to correct them. One could also imagine the state lawmakers *deliberately* raising the costs of reincorporating, and increasing the procedures needed to do so, once they adopted an extractive policy.

The damaged firms might be unable to change the mistaken state's law. They could then also turn to Congress for help. Congress, after all, could preempt state corporate law with federal rules.

C. *If Delaware Goes Awry*

Consider the consequences if Delaware did the same. A simple example is where the legislature leaves a judicial mistake uncorrected. Out-of-state firms are those principally hurt in such scenarios. One could also imagine something intentional (albeit unlikely): with many out-of-state firms, errant politicians under pressure to close a budget gap seek to extract value from those firms and simultaneously make it harder for them to leave Delaware. After all, politicians' interests do not always coincide with those of the states' firms, especially those firms whose businesses and employees are physically located out-of-state. One could imagine easy self-justifications: "We built up American business with our corporate law and we have rarely asked for much in return. The state and its citizens are now facing hard times, so it is time that Delaware corporations pay 1% of their multi-trillion assets to the state treasury for each of the next three years, during which time there will be a moratorium on out-of-state reincorporation."[12] Such an extraction possibility is extreme and unlikely, of course, but smaller errors and even modest expropriations could still seriously damage American business.

The Chamber of Commerce, the Business Roundtable, and shareholder groups could all petition Delaware. They certainly would have influence and should be quite credible when they say that this error (or deliberate expropriation) will be a one-time deal, as the firms will one way or another leave the jurisdiction. Local lawyers, representing not just their clients' interests but their own, would want to correct the mistake or reverse the heavy tax; they too would be influential. But one could imagine state politicians remaining recalcitrant, either out of ignorance or due to their own short-term goals. Such a scenario is unlikely but not impossible, and it is useful to analyze the players that would enter if extreme actions did transpire, as doing so can shed light on smaller matters. The state might find a one-time expropriation valuable if it were large enough. Approximately $9 trillion in market capitalization is incorporated in Delaware, a state with an annual budget less than 1/2500 that size.[13] One wonders whether state budget officials have never mused about corporate-based ways to close a budget gap.

The damaged firms, if faced with the unlikely possibility of an errant but adamant Delaware, could turn to Congress for help.

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[12] Whether a straight moratorium would survive a Commerce Clause challenge could be an issue. Presumably, the actual mechanism—were this hypothetical ever to become real—would not be a straight moratorium, but a tightening of the internal corporate requirements for merger with an out-of-state firm. For example, such a merger would be made to need, say, the approval of a super-majority of the board of directors and of shareholders in two consecutive annual meetings. Crafting such a rule so as not to apply broadly to all mergers would pose a drafting challenge.

[13] This number pre-dates the current financial market disruptions. The market capitalization of American public corporations was, recently, about $14 trillion. Wilshire.com, The Dow Jones Wilshire 5000 Composite Index, http://www.wilshire.com/Indexes/Broad/Wilshire5000/Characteristics.html (last visited Oct. 20, 2008). About 55% of NYSE and NASDAQ companies are incorporated in Delaware. Maureen Milford, *Delaware's Corporate Dominance Threatened*, THE NEWS J., Mar. 2, 2008, *available at* http://www.delawareonline.com/apps/pbcs.dll/article?AID=/20080302/NEWS/803020319/1/imagine. If the size distribution of Delaware firms is about that of all firms, the market capitalization of Delaware-incorporated firms approximates $9 trillion, a sum that is about 2,500 times the size of the state's $3.4 billion 2009 budget. Delaware State Financial Overview, http://budget.delaware.gov/fy2009/operating/09opfinoverview.pdf. Recent stock market declines would change the magnitude of the numbers substantially, but not change the fraction by much.

III. HOW WASHINGTON BACKSTOPS DELAWARE, NOT OTHER STATES

The scenario to imagine is that two states have gone awry in making corporate law; one state charters only a few large firms and the other, Delaware, charters many. Cumulatively, Delaware's chartered firms are critical to the American economy, while the other state's firms are not. Consider how Washington would react to each.

Washington has reason to stabilize a shaky Delaware corporate law, but it has much less reason to stabilize another state's corporate law. Delaware's corporate law can affect the American economy in ways that other states' corporate laws cannot. There are many business and regulatory players inside and outside Delaware who would not want an error to persist. Not so for other states' corporate law, which is not important enough to assuredly induce Washington to backstop it.

A. *Does Washington (Implicitly) Guarantee Sound Delaware Corporate Law?*

The greater federal interest reinforces Delaware's dominance. Consider the prospect that a state other than Delaware errs grievously in making corporate law, such that the state systematically hurts firms. Every firm incorporated in the state, say, loses 10% of its value due to the state egregiously erring in making corporate law.

But Congress is unlikely to try to save a few firms in a state with only a few large firm charters. Congress is far more likely to act if that state's corporate business is big enough for a powerful interest group to move it up the national agenda or big enough to affect the national economy. No state's corporate chartering business other than Delaware's assuredly fits that description. Congress thus would have good reason to try to stabilize Delaware, but it would not stabilize a small state with few corporate charters.

This contrast, one can conjecture, could well affect the capacity of states to enter the chartering market to compete strongly with Delaware. A new state entrant would have trouble competing well because it would lack the gravitas of being crucial to the American economy.

One of Delaware's primary advantages, then, might simply be that the density of Delaware's chartering gives the state a critical mass. That critical mass is something that Washington's interests and policymakers have reason not to allow to spin out of control. As a consequence, it may well stay big because it already is big. Moreover, it wants to avoid erosion of its corporate base, not only for its own sake, but also so that it does not lose that critical mass. This is a complex interaction between the states, Delaware, and Washington, one deserving more attention than it has thus far received.

The intuition here is that there is safety in numbers because Delaware—or, more precisely, its corporate law—is too big to fail. Delaware has many reasons to correct its own errors and many interests that will press it to do so. These have been analyzed before. And it is the only state that, if it erred in critical corporate matters, would be quite likely to induce the federal cavalry into action to save corporate America.

B. *Public Policy and the National Interests that Count*

Consider the different economic stakes involved if a lesser corporate state, say, Illinois, damages its corporations, as compared to the damage that Delaware could do to the American economy. If Illinois damaged its corporations by shackling them with a seriously substandard corporate law, Illinois's lawmakers would not have created a national economic problem but an Illinois problem. Members of Congress who understood the problem could sympathize with the owners and employees of Illinois's corporations, but they would not see it as a national economic problem demanding resolution.

Not so if Delaware made the same mistake. By so erring, Delaware would threaten the national economy. Congress would have a strong reason to react. Conceivably, Washington's Sarbanes-Oxley mandates of corporate governance structures could be seen as a pale version of such a process, although I suspect Delaware players and corporate critics of the act would see it neither as a fix,[14] nor, even if a fix, as one fixing a Delaware problem. But Sarbanes-Oxley, even if it fits the abstraction here only awkwardly, helps one to imagine what could happen if Delaware did go awry. Congress has reasons to shield corporate America from a major Delaware mistake but not an Illinois one.

The analysis here is close to, but not identical to, the standard notions of an institution being too big to fail, an issue that after this article was first drafted became prominent in the news. Usually we think of a financial institution as being too big to fail because the externalities from its failure would damage too much else in the economy. So, the government is willing to prop up the institution, sometimes by taking it over, sometimes by arranging a merger, often by investing resources in the failing institution. Here it is really Delaware's corporate law and not Delaware itself that is too big to fail. If Delaware errs, or just does not act when something important to the economy or important to a powerful corporate interest occurs, federal authorities will not necessarily prop up Delaware. Instead, federal authorities will simply make the rules directly,

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[14] Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1529 (2005).

backstopping it. Delaware could indeed fail, but not America's corporate law.[15]

The negative view of Sarbanes-Oxley presents a second channel through which size alone makes Delaware too big to fail. The Delaware players and the groups that represent them, such as the Business Roundtable, often want to avoid federal action in corporate law, because they think federal authorities will be likely to over-correct the local problem. That potential for congressional over-reaction and error motivates them to fix Delaware problems before they reach the national agenda.[16] Other states and their corporate interests do not have the same motivation.

Wronged Illinois businesses, managers, stockholders, and employees could not command congressional attention outside of the Illinois delegation. Wronged Delaware businesses, managers, stockholders, and employees—a large fraction of the American economy—would.

C. *Staying Big by Being Big?*

This interaction need not be explicit, and I do not think it is (yet). Firms and their managers could simply know that "everyone" is in Delaware and that they are all in the same boat. So, something will happen to correct the situation if Delaware's corporate law goes awry by challenging a central corporate interest or by diminishing firms' legal capacity to function well. Similarly, Delaware players need not explicitly consider whether firms will incorporate elsewhere if there is a major error, or whether federal authorities will intervene and embarrass them. They only need to know that errors need to be corrected, for otherwise the state will be penalized, financially or otherwise.

This analysis does not deny that Delaware has interests that want to self-correct. Its judges and legislators are professionals. And Delaware's lawyers are not interested, as a matter of pride and of self-interest, in maintaining a substandard Delaware law that repels corporate chartering in Delaware. They want to fix the problem locally because they expect Washington will over-correct or mis-correct. But if Delaware does not self-correct, another player has reasons to enter the fray.

This Delaware-Washington interaction creates another analytic consideration. To be big, Delaware has to stay big. To the extent that this implicit federal "guarantee" (or, to the extent local players fear

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15 The recent financial crisis made me consider changing the title to *Delaware's Backstop*, as a title that would not evoke the crisis. But "too big to fail" does come close enough to the Article's thesis and it means something to enough corporate academics that the original title stayed.

16 After the Enron and WorldCom scandals broke but before Congress passed Sarbanes-Oxley, Delaware's Chief Justice Normand Veasey said that "[i]f we don't fix it, Congress will, but I hope they've gone as far as they're going to have to go." *What's Wrong with Executive Compensation?*, HARV. BUS. REV., Jan. 2003, at 68, 77 (comment of Norman E. Veasey).

Washington, this implicit federal "threat") is important, Delaware must stay big in order to keep the guarantee. If Delaware lost enough corporate charters so that Congress considered it less important to protect Delaware's corporations, then Delaware could lose even more charters. At the limit, once Delaware slipped below some threshold and lost the guarantee, it could be very hard for it to recover. It would then be seen as too risky, not just for the standard reasons (lower chance of internal, gyroscopic self-correction) but also because it would no longer have the implicit federal guarantee (or the federal inducement to locals to fix the problem to head-off Washington) once the number of Delaware-incorporated firms no longer represented a key part of the American economy.

And, if Delaware lost ground but did not collapse, instead merely falling behind another state in what it thought would be a temporary lapse, the other state might pick up steam because it would be seen as more stable and, with more of the American economy attached to it, could later find that its bigness became self-sustaining.[17]

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To summarize the primary arguments thus far: Delaware's stability has been noted before. Previous analyses have focused on the gyroscopic internal institutions that induce Delaware to be stable—such as the influence of its corporate bar, the quality of its judiciary, and the importance to the legislature of franchise tax revenues for the Delaware state budget. Here I add an external stabilizing factor: Washington would have strong reasons to steady American corporate law if something went awry in Delaware. But if another state—like Illinois, Nevada, or even California—stumbled badly, Congress would have weaker reasons to act and would face weaker interest group-oriented pressures to do so. Moreover, business and local interests, fearful of national over-reaction, have reason to fix Delaware problems before they get onto the national agenda.

This federal-state interaction that stabilizes Delaware is not yet clearly distinguishable from the state-oriented features that have been remarked upon before (the state's dependence on franchise fees, the lawyers' interests, and network externalities).[18] In each instance we are observing *outcomes* and deducing explanations for the outcomes. One explanation may be in play without the other; one may be quite strong

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[17] This bigness feature helps to motivate Delaware to keep the franchise tax for larger firms low. Since the large firms are more important to the American economy, they build up Delaware's guarantee more than smaller firms that pay the same amount in franchise fees to the state.

[18] *See generally* Cary, *supra* note 1 (franchise fees); Romano, *supra* note 8 (franchise fees); Macey & Miller, *supra* note 2 (lawyers' interests); Klausner, *supra* note 8 (network externalities).

and the other quite weak. Or each may be important. Evaluation of impact remains for future analysis. But both the incentives of a federal-state interplay and a purely internal (or state competitive) one are present.

IV. HOW WASHINGTON LIMITS THE CONTESTABILITY OF THE STATE INCORPORATION MARKET

Thus, Washington bolsters Delaware indirectly through two related channels. First, Washington is more likely to react to a grievous Delaware error than to a similar one in another state. Second, Washington's hovering presence incentivizes local Delaware players, who have reason to fear Washington action and over-correction, to re-double their efforts to resolve the matter internally.

In this Part, I examine a related channel through which Washington bolsters Delaware by dampening other states' capacity to start competing with Delaware. To examine this channel, we first need to see how industrial organization's contestable market theory applies to state chartering competition. Then we see how Washington's presence dampens other states' potential to contest Delaware. Some modes of competitive entry would induce Washington to squelch competitive entry.

A. *What Is a Contestable Market?*

William Baumol analyzed the industrial organization concept of a contestable market,[19] and Scherer and Ross summarized it as follows:

> When potential entrants have access to the same technology as incumbents, when there are no sunk costs, and when a firm can enter and exit the market before incumbents can respond, the market is said by Baumol et al. to be *perfectly contestable*. The only sustainable price available to incumbents under these conditions is one that just covers average cost.[20]

Delaware is not the incumbent in a *perfectly* contestable market. Although all states have access to the same technology of making corporate law, none waits actively in the wings, and Delaware could respond to a new entrant quickly.[21] By responding, Delaware would devalue a competing state's investment. With the potential competitor

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[19] WILLIAM J. BAUMOL, THE FREE-MARKET INNOVATION MACHINE 163-65 (2002); WILLIAM J. BAUMOL, JOHN C. PANZAR & ROBERT D. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE 5 (rev. ed. 1988); ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 82-83 (2002).

[20] F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 375-76 (3d ed. 1990).

[21] Delaware's response capability corresponds to the stalking horse impediment to state competition that Bebchuk and Hamdani emphasize. Bebchuk & Hamdani, *supra* note 5, at 593-95.

knowing that Delaware could react, the potential competitor has reason not to do so.[22]

This general point—that Delaware's lock on the chartering market is contestable—is one that has been remarked upon elsewhere.[23] In particular, I have noted that there is vertical contestability in addition to horizontal contestability: just as the risks of a state entering are low but real, the chance of Washington acting further in corporate governance in a contestable-markets-manner is real (but low). After all, it does do so about every decade.[24] Moreover, the federal presence establishes important limits on market contestability *between states*. We see those limits after we first understand the mechanism that could make Delaware's dominance contestable.

Washington simultaneously adds contestability (because it is itself a player that can contest and displace Delaware's lawmaking) and diminishes it (because Washington squelches some of the contestability other states might try to introduce).

B. *Sleeping Competitors*

The no-competition perspective relies on Rhode Island, South Dakota, and Nevada being ineffective today as ongoing competitors of Delaware for reincorporation chartering revenue. Although Delaware might fumble, no state is close behind, ready to pick up the ball and run with it. Delaware, when it stumbles, has time to react, pick itself up, and fix the problem.

Yet, even if no other state's corporate law apparatus is structured so that it could quickly capitalize on a Delaware offense to corporate managers, maybe Delaware is still competing to keep its installed base, albeit in another, weakened form. If it stumbled badly, it could induce contestable-market-type competition for Delaware's existing installed base.

1. Are States Waiting in the Wings?

Imagine that Delaware fumbled, but did not recover. Both managers and shareholders are, let us posit, outraged at Delaware's *Van Gorkom* decision, or another line of decisions, or some statutory toughness. And they are annoyed and disappointed that Indiana, Rhode Island, South Dakota, and Nevada have done nothing to improve the situation. No state is waiting in the wings, as Kahan and Kamar have

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22 *See id.* at 595.

23 ROMANO, *supra* note 19, at 82-83; Roe, *Does Delaware Compete?*, *supra* note 7, at 20.

24 *See* Roe, *Delaware's Competition*, *supra* note 6, at 600-34.

shown; no state is watching whether Delaware fumbles so that it can rush to pick up the ball.[25]

But that does not mean competition is nonexistent. State competition might then start up as a sleeping competitor sees an opportunity and acts before Delaware recovers. Delaware might thereafter recover and imitate the new competitor, and that possibility, indeed likelihood, of a Delaware reaction is one reason, as Bebchuk and Hamdani have said,[26] why other states do not have much of an interest in being a stalking horse that would just induce Delaware to change its law over the long run, rather than yield the new competitor much in the way of corporate chartering revenue.

2. *Van Gorkom* and §102(b)(7)

The interplay between the *Van Gorkom* decision in 1985 and Delaware's subsequent amendment to its corporate code via § 102(b)(7) illustrates how Delaware reacts as if competing. In *Van Gorkom*, the Delaware Supreme Court held a board liable for failing to sell a company for as high a price as they otherwise might have.[27] Corporate America howled, and even institutional investors—who preferred a higher sales price to a lower price—seemed not to want boards and managers to react by becoming overly rigid. With the court-induced possibility of director liability heightened, firms found it harder to buy directors' and officers' insurance policies ["D&O"].[28]

The decision presented a nice competitive opportunity for another state to fight with Delaware. But no state succeeded. The Delaware legislature then eviscerated *Van Gorkom* via § 102(b)(7)[29] (which allowed firms' shareholders to vote to limit directors' liability) when the D&O insurance disruptions deepened and internal pressures to

[25] Or, imagine something more threatening to Delaware's corporation business: business changes in some way that half of the firms prefer rule X, and the other half not X, and there is no good way to compromise. Delaware, no matter what it does in the competency arena, could find itself facing unrest from half of its installed base.

[26] Bebchuk & Hamdani, *supra* note 5, at 594-95.

[27] Smith v. Van Gorkom, 488 A.2d 858, 874 (Del. 1985).

[28] Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1155 (1990). Companies typically buy directors' and officers' insurance, which reimburses the company's directors and officers for a range of their liability.

[29] Whether Delaware reacted primarily to internal pressures, to the disruption in D&O insurance, or to Indiana's reforms has been discussed. *Compare* Henry N. Butler, Smith v. Van Gorkom, *Jurisdictional Competition, and the Role of Random Mutations in the Evolution of Corporate Law*, 45 WASHBURN L.J. 267, 267-68 (2006), *with* Kristin A. Linsley, Comment, *Statutory Limitations on Directors' Liability in Delaware: A New Look at Conflicts of Interest and the Business Judgment Rule*, 24 HARV. J. ON LEGIS. 527, 529 (1987), *and* Elizabeth A. Nowicki, *Not in Good Faith*, 60 SMU L. REV. 441, 478 n.140 (2007).

change increased. Meanwhile, Indiana provided a safe haven from *Van Gorkom*.[30]

Delaware fumbled. But then, with corporate directors' and officers' insurance rates rising and another state in the process of changing its law on the issue, Delaware reacted. Delaware recovered and turned the situation into a competitive advantage, as states that were slow to emulate § 102(b)(7) lost more reincorporations to Delaware than did other states.[31]

3. Must It Be a State That Instigates the Competition?

Imagine a stumbling and persistently recalcitrant Delaware that does not recover after offending key corporate players. The offended corporate players in Delaware could go to Rhode Island or South Dakota or Nevada and make them an offer. Give us, they say, good chancery-court-style judges (and we can provide a few from our law firms to you), give us Delaware law (but without the offending provisions), and then we will give you Delaware's tax revenues, $500 million per year.

Faced with the target state's reluctance to spend resources to compete with Delaware (either for stalking horse reasons or local political ones), *the corporate players* could write up a new corporations code for Rhode Island, *the corporate players* could prepare to staff its judiciary (especially its new commercial law courts), and *the corporate players* could show local lawyers the corporate ropes. That is how the contestable market would work: not via one states' bureaucracies and legislatures competing directly with another's, but by the corporate interests lobbying and instigating other states to act. It is no accident that when North Dakota recently offered an alternative to Delaware's corporate law, a law firm for interested parties presented the state with a draft of a corporate law for the state legislature to consider.[32]

The fact that states are not actively competing for chartering revenue does not mean that they could not compete, or that if Delaware fumbled and did not recover quickly another state would not pick up the ball, or that the offended players in Delaware would not and could not act themselves to create a competitive state. Nor does the current absence

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[30] Butler, *supra* note 29, at 273-74; *see also* Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 221-22 (2006) (describing a more rapid Delaware self-correction).

[31] Gordon Moodie, Forty Years of Charter Competition: A Race to Protect Directors from Liability? (Sept. 2004) (discussion paper, The Harvard John M. Olin Fellow's Discussion Paper Series), *available at* http://www.law.harvard.edu/programs/olin_center/fellows_papers/pdf/Moodie_1.pdf; *cf.* Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1857-64 (2002) (noting that home state takeover law is a factor in whether Delaware can attract a firm to reincorporate).

[32] Martha Graybow, *Delaware Beware: North Dakota Wants Your Business*, REUTERS.COM, Apr. 25, 2007, http://www.reuters.com/article/domesticNews/idUSN25436180 20070425.

of an active competing state mean that Delaware is unaware that if it stumbled, a viable competitor could emerge. Moreover, the offended *interest groups* have reasons to devote resources to starting up a competitor—*even* a stalking horse competitor that Delaware would co-opt. The interest groups that benefit from changing corporate law would win in either scenario: either Delaware changes, or a new more favorable competitor arises. They have reason—if they can overcome their own collective action problem—to instigate a state to compete, even if that state has little reason to invest its own resources. Chambers of Commerce, the American Bar Association, and Business Roundtable committees, some financed by the relevant corporations, could provide much of the start-up costs.

When one adds in the interest groups that could pressure another state to act, the stalking horse problem, albeit real and important, becomes less severe than it first seems to be. True, if the state bore most of the corporate start-up costs, it might be reluctant to stalk and enter, knowing that Delaware might in the end match it. But if the interest groups bore those costs, they would mitigate the stalking horse problem enough to get another state started. The Business Roundtable of the Chamber of Commerce could commission a law firm or a City Bar Association to study the problem and draft a model code as a response. Even if a state has reason to be wary of incurring up-front costs in starting up its chartering capacity, the corporate players could sensibly incur a good part of the costs themselves and start up state competition.

4. New Jersey at the Beginning of the 20th Century

This contestable market strand roughly corresponds to how interstate competition once happened, when New Jersey, with the lion's share of the reincorporation business at the beginning of the 20th century, changed the nature of its corporate regulation. New Jersey had provided a corporate law favorable to the organization of nationwide industry (by easing cross-state mergers and holding companies). Delaware imitated New Jersey's structure, but few firms moved. Then, in the context of 1912 presidential politics, Woodrow Wilson induced the New Jersey legislature to be tougher, for antitrust reasons, on nationwide firms. This induced corporate America to flee from New Jersey to Delaware. The move was swift. The corporate chartering market was contested and one near-monopolist replaced another.[33]

Two states vied for the corporate charter business. And nearly all at once, one state won. The chartering market was then a contestable market in theory and in fact. There was a contest, and one state displaced another.

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[33] I recount the New Jersey to Delaware history in Roe, *Delaware's Competition*, *supra* note 6, at 609-10.

5. Marty Lipton's Threat

Fast forward to nearly a century later for another illustration. The hostile takeover in the 1980s was the overarching corporate transaction. It seemed at the time to be an issue big enough to influence corporations in their state chartering decisions. Many states responded to their local corporations' and managers' goals by passing tough antitakeover laws. Yet, Delaware did little to match other states' antitakeover laws in the mid-1980s. It did little because it was undecided (takeover policy was controversial), because its primary interest groups did not agree, and perhaps because it wanted to head off the threat of federal action, which it might have set off if it acted sharply.[34]

When its Chancery Court wrote a strong pro-takeover opinion[35] and its legislature ignored calls to pass antitakeover laws, Delaware faced the threat of exit, as evidenced by Martin Lipton's famous public proposal for firms to reincorporate out of Delaware. The demands of the race were made clear to Delaware. In Lipton's words, in a memo sent to his clients:

> The *Interco* case and the failure of Delaware to enact an effective takeover statute[] raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.[36]

How much of this was threat and how much bluff is hard to assess, as both managers and shareholders would have had to approve firms going through the reincorporation exit. Whether Lipton and, say, the Business Roundtable would have geared up to show a small state like Rhode Island—or New Jersey again—how to make corporate law is hard to say. Keep in mind that law firms frequently undertake such public service ventures, some of which coincide with their clients' interests. Bar association committees, model law drafting, and American Law Institute activities can fit this model.

These players had the resources to do so. And for some time, they had the motivation. Then Delaware passed an antitakeover law and

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[34] Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE 321, 340-47 (Margaret Blair ed., 1993); Roe, *Delaware's Competition*, *supra* note 6, at 632.

[35] City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 797 (Del. Ch. 1988).

[36] Letter from M. Lipton, Wachtell, Lipton, Rosen & Katz, to clients (Nov. 3, 1988) (on file with author); *see also* Stephen Labaton, *The "Poison Pill" Takes a Beating*, N.Y. TIMES, Nov. 14, 1988, at D2; Roger Parloff, *The Outlook of Poison Pills: After* Interco *and* Pillsbury, *What Next?*, MANHATTAN LAW., Jan. 24-30, 1989, at 31; Tim Smart, *For Managers, Delaware Isn't the Haven It Used To Be*, BUS. WK., Dec. 19, 1988, at 33 ("[L]egal advisers to worried managers already are suggesting that companies should consider playing elsewhere . . . ."); Charles Storch, *As Company, Time Focusing on 1 Newsmaker*, CHI. TRIB., July 9, 1989, at 8 (reporting that Delaware's blocking Interco management from using the pill "so enraged Martin Lipton, the lawyer . . . credited with inventing the . . . pill . . . , that he urged his . . . clients to consider reincorporating elsewhere").

its Supreme Court wrote antitakeover decisions, most prominently that in *Time-Warner*,[37] which explicitly rejected *Interco.* Hostile takeovers declined in frequency, perhaps because of economic reasons, and talk of firms exiting Delaware stopped.

C. *Visibility*

That is how a contestable market would work in the United States: the corporate interests that want a new competitor would provide the resources to a state to compete. Competition would not necessarily come from a state acting *sua sponte*. There are analogues beyond assessing motives and opportunities here: when Citibank needed a state to modernize its usury laws for credit cards, it approached South Dakota, which went along. When investor groups thought they might want a more pro-shareholder corporate law, they approached North Dakota and did not wait for a state to act on its own.

This potential for maneuvering does mean Delaware could face a contestable-market-type bid, one that limits Delaware's discretion. But this kind of maneuvering would attract federal attention, as federal scrutiny would provide Delaware with further too-big-to-fail protection.

Why, federal players would ask, are firms running from Delaware? The contest, if it broke out, especially if it broke out via transparent interest group pushes, would be salient, media-worthy, and, if the movement seemed, for example, motivated mainly by surreptitious managerial protection, could instigate federal actors. While managers often win at the federal level, the mix of interests in Washington differs from that at the state level,[38] so the interstate maneuvering would have to be accomplished in a way that federal actors found tolerable. They might not find the raw state action tolerable, and, hence, they might stymie the contestability of the market. They might in fact find that the maneuvering is a reason to takeover making that part of American corporate law.

Hence, there are limits to contestability beyond the obvious ones. The process most likely to work—interest groups providing the foundation for another state's corporate entry—is likely to be the most visible, the most likely to attract media attention, and hence the most likely to attract Congress's attention. When Congress's attention is captured, the odds that Congress would make the relevant contested rule a national one increases. If Washington makes the rule a national one, it closes that field for state contestability.

As political scientists have said in a related context, much congressional action can be seen as divided between responses to police

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[37] Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1142 (Del. 1989).

[38] Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2499 (2005).

patrols and fire alarms.[39] Police patrols are expensive and 535 members of Congress cannot be well-informed on every issue of significance to the country. But sometimes fire alarms go off and Congress reacts. A massive, interest-group driven effort to create an alternative to Delaware for reincorporation would be the fire alarm that would attract Congress's attention. While the interest groups making state corporate law also have clout in Congress, they are not the only players with congressional clout. If a reincorporation move was convincingly portrayed in the media as, for example, mostly motivated by managers' desire to protect their excessive compensation, it is easy to imagine that the media fire alarms would go off, that Congress would hear them, and that this possibility would weaken this dimension for contestable market competition in the first place. For the market to be made contestable, the stakes have to be raised. And when the players raise the stakes, they increase the chances that Congress will notice. If Congress notices and acts, the contested issue would disappear as a bone of competitive contention between two (or more) states, because Washington would then own the issue.

Federal contestability interacts with state contestability, dampening the latter, especially by limiting vividly scurrilous state competition.

CONCLUSION: ISN'T DELAWARE'S CORPORATE LAW TOO BIG TO FAIL?

In this Article I have analyzed the stability of state actions when there is a federal player who can trump them. The interplay is that the federal authorities act as an implicit guarantor of Delaware's basic soundness but not of other states' soundness. Other states might make corporate law that is bad for their firms, either due to state error or, worse, intentional extraction. But even if such states do so, their actions would not rise to be a federal issue. Delaware, though, as home to half of the corporate economy, could not make a serious error or threaten an influential corporate interest without there being consequences. If the issue was perceived as affecting economic well-being, Washington would likely react to steady the economy. Moreover, Delaware interests have reason to work harder to avoid federal action, either because they (the local interests) would be adversely affected by Washington's action, or because they fear that once Washington acted, it would over-react and make more egregious mistakes. Hence, one structural source of Delaware's stability is not simply the internal mechanism of the state corporate lawmaking structure, but also the existence of a federal backstop. Delaware's corporate law might fail, but its corporate law is too big for Washington to allow Delaware to severely hurt the American economy.

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[39] *See* Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165, 165-66 (1984).