The Architecture of American Corporate Law: Facilitation and Regulation

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The Architecture of American Corporate Law: Facilitation and Regulation

Melvin Aron Eisenberg†

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INTRODUCTION

In his paper Criteria for Good Laws of Business Association,¹ Bill Klein masterfully enumerates and discusses all the criteria that in theory should be taken into account in determining what makes good law in the area of business associations. In practice, however, what makes good law in any given sector of law normally requires singling out a few salient variables. One goal of this paper is to do just that. In Part I, I develop two central features of good law for publicly held corporations. In Part II, I describe the architecture of American corporate law, and show that this architecture is driven by these two central features, together with considerations of political economy.

I. TWO CENTRAL FEATURES OF GOOD LAW FOR PUBLICLY HELD CORPORATIONS

Corporate law serves various functions. It enables corporations to be formed. It provides corporations with certain endowments—most prominently, entity status, limited liability, perpetual existence, the right to own property and make contracts, and the power to sue and be sued. It sets the level of care required of directors and officers. It provides a special remedial structure to resolve claims by shareholders. It addresses various transactions and conduct in which corporations may choose to engage. It addresses various kinds of conflict of interest.²

This paper concerns only the two central functions of corporate law: addressing transactions and conduct that do not involve conflicts of interest between top managers (essentially, CEOs) and shareholders; and addressing transactions and conduct that do.³ I focus on these two functions both because

². For ease of exposition, in this paper I will use the term corporations to mean publicly held corporations (by which I mean corporations whose shareholder populations are sufficiently large that they are likely to involve a separation of ownership and control); the term corporate law to mean American law concerning such corporations; and the terms conflicts of interest and conflicts to mean conflicts of interest between top managers and shareholders.
³. Partly because of constraints on the length of this paper, I do not consider conflicts of interest either between controlling and noncontrolling shareholders, or between shareholders and creditors. Given the structure of American shareholdings and credit markets, those conflicts are not quite as important for corporate law as conflicts between shareholders and top managers. Furthermore, much of
of their centrality and because they explain almost all of the architecture of corporate law. In addition, most issues concerning the remaining functions of corporate law are either settled in practice and largely in theory, or can be understood by a modest extension of the analysis of these two central functions.

The thesis of Part I is that good corporate law requires that non-conflict transactions and conduct should be facilitated, but that conflicts of interest between top managers and shareholders should be regulated.

The reason that good corporate law should facilitate non-conflict transactions and conduct is simple. In the absence of a conflict of interest, the corporation should be able to make the same lawful choices that an individual can make.

By comparison, the reasons that good corporate law should regulate conflicts of interest between top managers and shareholders are complex. In considering this issue, it is useful to begin by drawing two distinctions between conflicts of interest involving ordinary agents, on the one hand, and top managers, on the other.

First, ordinary agents have an interest in not acting with proper diligence. This problem is known as shirking. In the case of top managers, however, shirking is rarely a problem. CEOs may be inefficient, but normally they will be diligent, because both their career and self-esteem are usually tied to an inclination for hard work and accomplishment. (Shirking may be a problem in the case of directors who have different incentives than CEOs. I do not address that issue in this paper.)

Second, all agents, including top managers, have a potential interest in using their positions to divert the principal’s assets to themselves through unfair transactions or conduct. This is the problem of traditional conflicts of interest. Top managers, however, have a type of conflict that ordinary agents do not have. Ordinary agents cannot maintain and enhance their positions without their principals’ consent. In contrast, top managers, nestled within the board, have the ability, within broad limits, to take actions that maintain and enhance their positions without shareholder consent, and indeed even when they know that their actions are opposed by a majority of the shareholders. For example, top managers may make it difficult for shareholders, or anyone else, to effectively monitor their performance, through their control over information. They may impose extra-high barriers, such as poison pills, to their removal for poor performance. They may increase corporate size to maximize their power, prestige, and compensation, even if an increase in corporate size does not increase shareholder wealth. They may diversify the corporation’s business to reduce the risk to their human-capital investment, even if

the analysis concerning conflicts between shareholders and top managers also applies, pari passu, to conflicts between controlling and noncontrolling shareholders.
diversification is not wealth-maximizing for shareholders, who can diversify their investment risks through portfolio management. They may hoard the cash at their command, even when distributions to shareholders would be wealth-maximizing. I will call the interest of top managers in maintaining and enhancing their positions positional conflicts of interest.

Traditional conflicts of interest between top managers and shareholders are a major concern because if not properly addressed, they may unfairly and improperly redistribute income from beneficiaries to fiduciaries, and reduce efficiency by sapping the vigor of the capital markets through the degradation of investor confidence. Positional conflicts are of even greater concern. Like traditional conflicts of interest, positional conflicts may result in the unfair redistribution of income and inefficiently sap the vigor of the capital markets. In addition, positional conflicts can introduce inefficiency into the economic system over and above their effect on the capital markets because they can lead to the retention in office of top managers who make poor operating and allocative decisions.

Moreover, while internalized morality and reputational considerations may serve to restrain traditional conflicts of interest, those factors will usually be inadequate to restrain positional conflicts. Traditional conflict transactions and conduct often resemble theft. As a result, such transactions and conduct usually cannot be morally rationalized, and expose actors to shaming. In contrast, moral restraints are normally weak as to actions and conduct that involve positional conflicts, because such actions and conduct do not resemble theft, and can often be morally rationalized by managers on the ground that they benefit the shareholders. Indeed, top managers may fail even to recognize that a positional conflict exists. Inefficient top managers are unlikely to believe themselves to be inefficient. Top managers who enhance their positions through inefficient corporate growth, diversification, or the like, usually believe—sometimes, but not always, correctly—that their actions are in the interest of the shareholders. Finally, top managers may have more difficulty in taming a taste for maintaining and enhancing their positions than in taming a taste for unfair self-dealing.

In short, traditional and positional conflicts of interest raise substantial concerns that need to be addressed. But why address these concerns by regulation? Why not leave them to markets and compensation devices? The answer is that markets and compensation devices only have a limited impact on conflicts involving top managers. Consideration of four salient markets, and of compensation devices, illustrates this point.

1. Product markets. It is occasionally argued that top managers are inhibited from engaging in inefficient conflict behavior because any firm that does not minimize costs will be rendered insolvent by the product markets. This argument drastically overstates the power of those markets. Although a
perfectly competitive product market may have this effect, in imperfectly competitive product markets, inefficient conflict behavior will rarely by itself lead to insolvency. This is because publicly held corporations operating in such markets usually have the capacity to absorb huge losses and still stay afloat. For example, General Motors recently had losses of more than $1 billion in only one fiscal quarter, and has lost considerably more money since then, but at least so far has nevertheless avoided bankruptcy.  

2. The market for managers. It is sometimes argued that the market for top managers adequately addresses traditional and positional conflicts. As a practical matter, this “market” largely turns on the risk of dismissal. But as Jensen and Murphy concluded, “[the] data suggest that CEOs bear little risk of being dismissed by their boards of directors.” For example, a recent report issued by Booz Allen Hamilton, based on a 2004 survey of the world’s 2,500 largest corporations, found that the annual rate of CEO ousters for underperformance in North American corporations was 3%. In contrast, the rate of ouster in European corporations was around 6%. Boards in North America were also the slowest, globally, to remove underperforming CEOs: [By global standards, CEO turnover in North America is too low. Boards in North America are the slowest to remove underperforming CEOs: The 5.2 years the average underperforming American chief gets is significantly longer that the span in any other region of the world. . . . We estimate that the . . . North American CEOs departing between 2000 and 2004 whose companies underperformed the stock market should have been removed much more quickly by their boards; the Michael Eisner soap opera is by no means an isolated case. Our estimate reflects CEOs who underperformed the stock market not only during their full tenure, but also during the second half of their tenure, and whose total tenure exceeded the global average. Shareholders would have been better off if these CEOs had been removed at the midpoint of their tenure.]

3. The capital market. The capital market also has little or no significant effect on traditional and positional conflicts of interest, because the impact of traditional and positional conflicts on the cost of new equity will normally fall on the shareholders, not the managers. For example, suppose that C Corporation wants to raise $500,000 in equity in the capital market. If not for the adverse impact of its CEO’s traditional and positional conflicts, C could raise $500,000 by issuing 10,000 shares at $50 per share. Given the adverse

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4. See N.Y. TIMES, Apr. 20, 2005, at C1, col. 2.
8. Id. at 6 exhibit. 2.
9. Id. at 9. In absolute terms, the rate of ouster of CEOs of large publicly held corporations in North America was about three per month. The rate of ouster in Europe was about six per month. Dash & Timmons, supra note 6.
impact of such conflicts, to raise $500,000 C must sell 11,111 shares at $45 per share. This dilutes the value of C’s stock, and that dilution is a cost. However, that cost will be borne by C’s shareholders rather than by its CEO. If a CEO owns stock or options, he will suffer some loss in the value of the stock or options. However, that loss will normally be miniscule compared to the gain the CEO enjoys from engaging in the conflicted activity, because he reaps 100% of that gain but suffers only a tiny percentage of the shareholders’ loss.

4. The market for corporate control. The market for corporate control—or more accurately, the hostile-takeover market—also has only limited impact on traditional conflicts of interest. A hostile takeover bid cannot succeed unless it includes a premium that is significantly above the market price of the target’s stock, partly because most existing shareholders of the target will value their stock at a price higher than the market price (or they would already have sold), and partly because the target’s management can create formidable obstacles to a takeover, which normally can be overcome, if at all, only by a substantial premium over market price. As a result, the average successful tender offer entails a premium of about 40% above the market price of the target’s stock.\textsuperscript{10}

In addition, a hostile bidder must pay very large fees to investment bankers, lawyers, and other professionals. Because of the need to expend these huge premiums and fees, a takeover bid will almost never be economically justified if the bidder’s only strategy is to end unfair self-dealing by incumbent managers.

The takeover market probably does have some effect on positional conflicts. Undoubtedly, some takeovers are motivated by the inefficiency of the target’s management. Therefore, at least some completed takeovers overcome the barriers that top managers install to maintain themselves in office and result in a substitution of more efficient managers for less efficient management. However, a takeover driven purely by the inefficiency of incumbent management will succeed only if the inefficiency is so malignant that it has driven down the corporation’s stock-market capitalization to about two-thirds of the stock-market capitalization the corporation would have if it was well managed.

The threat of takeover may also increase the efficiency of incumbent managers in at least one respect. A distinction may be drawn between operating and allocative efficiency. By \textit{operating} efficiency, I mean efficiency in managing the resources that a corporation holds. By \textit{allocative} efficiency, I mean efficiency in determining what resources a corporation should hold. The threat of a takeover usually will not increase operating efficiency, because takeover threat or not, a CEO normally will do the best he can in that area. However, the threat of a takeover may lead to an increase in allocative

\textsuperscript{10} LUCIAN BEBCHUK \& JESSE FRIED, PAY WITHOUT PERFORMANCE 55 (2004).
efficiency, principally by leading the CEO to sell off resources the corporation should not hold, so as to make the corporation a less tempting target for a takeover.

On the other hand, in reality an inefficient CEO has little to fear from the threat of a takeover. A recent study found that during the second half of the 1990s, hostile bids were made for only about 1% of publicly traded corporations, and even in these cases, the bid was often unsuccessful. On the other hand, in reality an inefficient CEO has little to fear from the threat of a takeover. A recent study found that during the second half of the 1990s, hostile bids were made for only about 1% of publicly traded corporations, and even in these cases, the bid was often unsuccessful. Furthermore, takeovers are motivated by a variety of economic factors. Inefficient management is only one of these factors, and not necessarily the most important one. As Jensen points out, "[m]ore than a dozen separate forces drive takeover activity, including such factors as deregulation, synergies, economies of scale and scope, taxes, the level of managerial competence, and increasing globalization of U.S. markets." Accordingly, a significant portion of the resources devoted to takeovers seems to be directed not at taking over poorly managed corporations, but at taking over well-managed corporations. Furthermore, the threat of takeover sharpens rather than diminishes positional conflicts, by leading managers to cause their corporations to adopt devices, such as poison pills, that make their ouster even more difficult.

In a well-known article, Easterbrook and Fischel argued that managers should be prohibited from engaging in defensive actions against takeovers, on the ground that the need to pay high premiums to overcome these actions interferes with the operation of the takeover market as an efficiency-monitoring device. Neither courts nor legislatures have accepted this argument. Nevertheless, the argument is instructive. The premise of the argument is that high premiums need to be eliminated so that the takeover market will adequately address the problem of managerial inefficiency, and thereby render unnecessary mandatory legal rules to control that problem. The negative implication is that if legal and business conditions result in a regime of high premiums, which they do, the problem of managerial inefficiency will not be adequately dealt with by the market for corporate control.

The bottom line is that the market for corporate control, in its current form, has virtually no effect on traditional conflicts of interest and has only a limited effect on positional conflicts. Indeed, the market for corporate control has severely enhanced positional conflicts, by providing an enormous incentive for managers to further shore up their positions through the imposition of new barriers to their removal.

5. Compensation devices. There is a widespread conception, often

expressed in the aphorism "pay for performance," that compensation devices can be designed to increase managerial efficiency. This conception is expressed in two basic ways. The first is that managerial compensation should be incentive-driven—if a manager produces better results, he earns more. The second is that managerial compensation should take an interest-alignment form, that is, a form that will align the interests of managers with those of the shareholders. Characteristically, this form is the award of stock options.

As a practical matter, incumbent CEOs often set their own compensation behind a screen of compliant consultants, compliant compensation committees, and compliant boards, all largely engaged in blowing smoke. Probably for this reason, in the real world the compensation of CEOs is not significantly linked to their performance, as Lucian Bebchuk and Jesse Fried have shown.14 Even in an ideal world, however, incentive-driven and interest-alignment compensation would have only limited impact on managerial conflicts of interest.

There is no significant benefit to be gained by utilizing interest-alignment techniques to address traditional conflicts of interest, because unless the CEO holds 100% of the corporation's stock, he will almost always gain more financially by unfair self-interested behavior than he will lose as a shareholder or an option holder. As Bebchuck and Fried point out:

Consider an "average" CEO who is contemplating whether to seek an extra $10 million in compensation, which, because of the poor incentives generated by the arrangement, will reduce firm value by $100 million. This arrangement would provide an extra $10 million in compensation while reducing the value of the CEO's existing shares and options by $1 million, leaving a net gain of $9 million. As this example illustrates, managers' holdings of shares and options [are] unlikely to dissuade CEOs from seeking higher—and potentially inefficient—compensation arrangements.15

Properly designed compensation devices might have some beneficial effect on positional conflicts. In particular, compensation that is keyed to corporate profitability may give a top manager an incentive to work marginally harder. Properly designed stock options may give a top manager that incentive, as well as an incentive to focus on long-term rather than short-term profitability, and an incentive to take seriously the market's evaluation of the corporation's performance.

Normally, however, two factors will significantly limit the effect of compensation devices on positional conflicts. First, except where a top manager is appointed from outside the corporation's ranks, compensation is itself a conflict-of-interest transaction. Therefore, as experience shows, the likelihood that compensation devices will in fact be properly designed is relatively low. Second, the most important problem presented by positional conflicts is that

15. Id. at 55.
grade B and grade C managers will take effective steps to protect their incumbency. Compensation devices do not address this problem. Such devices cannot transform C managers into B managers or B managers into A managers, and cannot reduce the incentives of C and B managers to take effective steps to maintain themselves in office despite their shortcomings.

To summarize the analysis in Part I, conflicts of interest between shareholders and top managers are a serious concern. Because markets and compensation devices will not adequately address this concern, regulation is required. In the case of traditional conflicts of interest, regulation is required to ensure that self-interested transactions are fair and are accompanied by full disclosure, that managers do not unfairly take corporate opportunities, and that managers do not improperly make use of their positions or of corporate assets or information. In the case of positional conflicts, regulation is required to ensure that there is an accurate flow of information concerning management's performance, that internal structures are in place to remove CEOs whose performance is inefficient, that a corporation has adequate internal controls, and that the takeover of inefficiently managed corporations is facilitated. Lawmakers might rationally choose very different menus of rules to regulate traditional and positional conflicts of interest, depending in significant part on the shape of relevant social institutions and social norms, but regulation of some sort is required.

II. THE ARCHITECTURE OF AMERICAN CORPORATE LAW

Against this background, I now turn to the architecture of American corporate law. Corporate law is often conceived of as state law, but this conception is much too narrow. Any body of rules that addresses any of the functions that corporate law serves is a part of corporate law. Therefore, any body of rules that directly or indirectly addresses the facilitation of corporate transactions or conduct, or the regulation of traditional or positional conflicts of interest, is a part of corporate law. From this perspective, corporate law essentially consists of four modules, each of which serves a separate but complementary function: state statutory law, state judge-made law, federal law, and private ordering through soft law. The four modules are like the instruments of a string quartet: each module plays an essential role, none can be privileged over the others, and corporate law makes sense only when the four modules are taken as part of a whole.

A. State Statutory Law

The primary role played by state statutory corporate law is to facilitate corporate transactions and conduct. State legislation plays this role very well. In general, however, state legislation is highly impoverished when it comes to
conflicts of interest between shareholders and top managers. I take as my paradigm Delaware—not because Delaware deserves to be demonized (it does not), but simply because it is the most important state for corporate law. Delaware statutory corporate law is terrific at facilitating corporate transactions and conduct, but completely fails to regulate either traditional or positional conflicts of interest.

There are a variety of techniques to regulate traditional conflicts of interest. All that the Delaware statute does about such conflicts, however, is to deregulate them, by allowing a top manager to escape any judicial review of the fairness of his self-interested transactions if he can get the transaction approved by his "disinterested" colleagues on the board.

The Delaware statute also fails to regulate or even to address positional conflicts. To deal with such conflicts, the law should ensure that: (1) There is an adequate flow of financial and nonfinancial information to the shareholders, and the financial information is prepared according to appropriate accounting principles and attested to by an independent outside auditor. (2) The structure of the board and its committees is such that the board is capable of independently monitoring top management's performance. (3) The corporation has an adequate system of internal controls. (4) Takeovers of inefficiently managed corporations are facilitated. The Delaware statute does none of these things. It makes no provision to ensure the flow of financial or nonfinancial information. 16 It makes no provision for an independent board or for independent committees. It makes no provision for internal controls. And rather than facilitating the market for corporate control, the statute inhibits that market by piling on an additional defense against takeovers.

Three related elements explain why the statutes of Delaware and almost all other states are so impoverished in dealing with conflicts of interest: agency-cost theory, public-choice theory, and asymmetric expertise.

Agency-cost theory. Agency-cost theory tells us that where a principal is represented by an agent whom the principal cannot closely monitor, a third party who wishes to sell a commodity to the principal will have an incentive to give the agent a side payment to induce him to buy the commodity on the principal's behalf. In the market for corporation law—the "charter market"—states are in the position of sellers, because if they can attract incorporation they will derive revenues through franchise taxes. The shareholders are in the position of principals. Top managers are in the position of agents, because

16. Delaware statutory law on the provision of information is summarized as follows by the Delaware Supreme Court in Malone v. Brincat, 722 A.2d 5, 8 (Del. 1999):

In the absence of a request for stockholder action, the Delaware General Corporation Law does not require directors to provide shareholders with information concerning the finances or affairs of the corporation. Even when shareholder action is sought, the provisions in the General Corporation Law requiring notice to the shareholders of the proposed action do not require the directors to convey substantive information beyond a statutory minimum.
normally a decision to reincorporate a publicly held corporation is effectively made by the corporation's CEO. A legislature, as a seller, therefore has an incentive to give a CEO, as an agent, a side payment to induce the CEO to cause his corporation to reincorporate in the legislature's state. For a variety of reasons, the side payment cannot be in the form of money. Instead, the side payment takes the form of a suboptimal, hands-off approach to regulating traditional and positional conflicts of interest.

This is nicely illustrated by anti-takeover provisions. Virtually all scholars agree that these provisions are undesirable, yet many state statutes include such provisions. The reason for this phenomenon is well-documented. As Jill Fisch has pointed out:

The political process leading to state adoption of antitakeover statutes has been widely analyzed. Commentators have observed that state antitakeover legislation was widely adopted in response to local corporations seeking protection from hostile bidders... The result of this political influence is legislation that uniformly favors the interests of corporate management. Although state antitakeover statutes vary in the extent to which they limit the potential for a hostile takeover, in all cases, the statutes, including Delaware's antitakeover statute, make takeovers more difficult.17

The anti-takeover provisions illustrate that given a choice between (i) statutory provisions that protect managerial positions but decrease shareholder value, and (ii) statutory provisions that make it easy to remove inefficient managers and increase shareholder value, managers will always chose the first alternative, and therefore so will most state legislatures most of the time. Furthermore, the reason that most state legislatures have chosen to adopt anti-takeover provisions is more public than, but no different from, the reason that most state legislatures have made all their other choices concerning conflicts of interest between top managers and shareholders. Most state legislatures either fail to regulate, deregulate, or facilitate conflicted behavior by top managers because it is in the states' financial interest to do so.

Public-choice theory. Public-choice theory also helps explain the suboptimal nature of state statutory law in the area of conflicts of interest. Managers have extremely strong lobbying power, while shareholders traditionally have not been well-organized for involvement in the legislative process. As Jill Fisch has also pointed out:

[T]he political process is poorly suited for participation by investors.... Because of the structure of corporate law, only businesses resident in or incorporated in a state will have sufficient interest or ability to participate in the political process. Resident corporations can and do participate in the legislative process effectively, but this participation is, for the most part, not possible for other affected groups. Shareholders invest in a variety of corporations that are not incorporated in their home state. Even if an investor's stake were sufficient to make

participation in the political process rational, dispersed nonresident shareholders are unlikely to have any influence with the legislature in the state of incorporation.

Commentators have observed how interest groups may influence the legislative process. The ability of politicians to extract funds from corporations creates the potential for legislators to extract rents through regulation. This focus on rent extraction, in addition to imposing substantial costs on political participants, can distort the ultimate choice of legal rules. Indeed, although legislative lawmaking is sometimes defended as the product of more complete information than that which is available to courts, the interest group dynamics in corporate lawmaking present particular risks of distortion because in-state corporations, as the only effective political participants, can manipulate the information available to political decisionmakers. 18

Asymmetric expertise. Finally, there is the problem of a lack of legislative expertise, coupled with the non-neutrality of corporate law. A rule of law may be thought of as neutral if, at the time the rule is adopted, it cannot be predicted whether the rule will systematically work for or against the interests of any given class of persons. For example, most rules of contract law—what constitutes an offer, what events terminate an offeree’s power of acceptance, and so forth—are neutral in this sense. In contrast, some bodies of law consist largely of rules that systematically and predictably work for or against the interests of a given class of persons. In particular, corporate law consists largely of rules that lack neutrality. Virtually every rule of corporate law, no matter how trivial, can be quickly and easily analyzed in terms of whether it works for or against the interests of top managers or shareholders, in cases where those interests may diverge.

Neutral legislative rules can be made from behind the veil, solely on the basis of fairness and sound policy. Non-neutral legislative rules cannot, because any class of persons that will be obviously affected by a non-neutral rule has an interest in lobbying for or against it. In some bodies of legislation consisting of non-neutral rules this may not cause serious problems, because all the major classes of persons who are directly affected by the legislation are well-organized for legislative involvement. In other bodies of legislation consisting of non-neutral rules, even though a directly affected class is not well-organized for legislative involvement, the resulting gap is largely filled by independent or countervailing government experts. In the field of securities law, for example, Congress can draw upon the resources of the Securities and Exchange Commission and House and Senate committee staffs.

None of this is true of corporate law. Although corporate law is technical, complex, and outside the expertise of most individual state legislators, almost no states have executive or legislative staffs with significant corporate-law expertise. The result is that the revision of corporate law at the state legislative level typically is de facto delegated to state bar committees consisting entirely

18. Id. at 1091, 1093.
of management lawyers. Given their composition, these committees do not often recommend that the legislature revise corporate law by making it more regulatory.\textsuperscript{19}

There are some limits to how suboptimal state statutory law can become. Fifteen years ago, I developed the thesis that as a result of Delaware's attainment of a monopoly position through its past adoption of suboptimal rules that unduly favor managers, the Delaware legislature now has a special incentive \textit{not} to lead in the adoption of innovative rules of this kind.\textsuperscript{20} This special incentive is to avoid massive federal intervention in corporate law. For various reasons, the federal government does not intervene to correct every suboptimal rule of state statutory corporate-law rule. However, as state statutory corporate law becomes highly suboptimal, the risk of federal intervention increases. A state that has had little success in the charter market has much to gain and little to lose by offering innovative suboptimal rules to managers. If the rules attract incorporation, the state comes out ahead; if the rules stimulate federal intervention, the state is no worse off. In contrast, if comprehensive federal corporate-law rules were established for publicly held corporations, over time Delaware could lose its leading position, because there would be less incentive to incorporate in any one state. Therefore, precisely because of its historical success in the charter market, Delaware is more threatened by the possibility of comprehensive federal intervention than any other state. Furthermore, because of Delaware's massive market share, innovative suboptimal rules in Delaware are more likely to provoke federal intervention than innovative suboptimal rules in any other state. Accordingly, having achieved a monopoly position in significant part because of its past leadership in offering suboptimal rules, Delaware now has an incentive not to lead in the adoption of innovative suboptimal rules.

Time has validated this thesis. On the issue of addressing conflicts of interest, Delaware statutory corporate law has not become demonstrably worse in the last fifteen years. \textit{But neither has Delaware statutory corporate law become demonstrably better}—even in the face of Enron, WorldCom, and the like.

More important, the Delaware statute is only paradigmatic, not unique. The old problem was whether Delaware was leading a race to the bottom. That is no longer a problem, partly because most state corporate-law statutes look pretty

\textsuperscript{19} There are two significant exceptions. First, the California statute has traditionally included a number of regulatory requirements. Second, the American Bar Association's Committee on Corporate Laws, which is responsible for continuing revision of the Model Business Corporation Act, has in the last fifteen or so years adopted some very important regulatory rules. However, the Model Act, although extremely influential, is not itself law, and not all of these rules have worked their way into statutes in a generalized manner.

much alike, and partly because there are statutes that are worse than Delaware's. The problem now is the performance of state legislatures as a group in the area of corporate law. With few exceptions, that performance is exceptionally poor on the issue of conflicts of interest. Fortunately, however, state statutory corporate law is only one of four modules of corporation law, and the other three modules do regulate such conflicts.

B. State Judge-Made Law

In contrast to state legislation, state judge-made law is relatively strong in regulating traditional conflicts of interest. In particular, the courts, especially the Delaware courts, have developed an extremely rich body of judge-made law concerning the fiduciary duties of directors and officers.

Thus, the Delaware judiciary, unlike the Delaware legislature, has made and continues to make a concerted effort to be responsive to the problem of conflicts of interest; and the result has been the adoption, over time, of a comprehensive body of judge-made regulatory law governing such conflicts. Furthermore, although no other state has a comprehensive body of judge-made corporate law, national judge-made corporate law is also sensitive to the need to regulate traditional conflicts of interest between shareholders and top managers. However, the leverage of courts to require corporations to adopt full-bodied mechanisms to deal with positional conflicts is limited. Accordingly, the development of rules addressing those conflicts has largely been left to the two other modules of corporate law: federal law and private ordering through soft law.

C. Federal Law

The political economy of the federal government in making corporate law is much different than the political economy of state governments. State governments have at best an attenuated interest in the vitality of national capital markets. In contrast, the federal government has a critical interest in the vitality of those markets. Investors have a very limited role in state politics. In contrast, investors can be significant players at the national level. State governments tax corporations for the privilege of incorporating, pretty much without regard to corporate profitability. Therefore, state legislatures can view defects in their corporate-law regimes as an externality whose effects fall almost entirely on the out-of-state population. In contrast, the federal government taxes corporations solely on the basis of profitability, and cannot externalize the defects of its corporation law. Accordingly, the federal government has incentives, while the state governments do not, to adopt corporate law that will further the vitality of national capital markets and maximize corporate profitability. As a result, federal law desirably fills in a large part of the gap left
by state law in regulating positional conflicts. In particular, through the Securities Exchange Act, the Rules thereunder, and Sarbanes-Oxley, federal corporation law addresses the flow of information concerning management's performance, accounting principles, and the independence of the outside auditor.

In this connection, there are two stories that can be told about the disclosure requirements of federal law. One story is that disclosure is intended to protect persons who buy or sell securities. The other story is that disclosure is an important instrument to control positional conflicts. These stories are not mutually exclusive. The federal disclosure requirements fall along a spectrum. At one end of this spectrum are provisions that are aimed almost solely at buyer protection, such as the Securities Act of 1933. At the other end are provisions that are aimed almost solely at corporate governance, such as the requirements of the Securities Exchange Act and Rules concerning periodic disclosure of the existence, composition, policies, activities, and charters of a corporation's audit, compensation, and nominating committees. Between those poles are provisions that can be understood to serve both objectives, such as the requirements, under the Exchange Act and Rules, of annual and quarterly financial disclosure, annual disclosure of executive compensation and other conflict-of-interest transactions, and prompt disclosure of certain major corporate events.

D. Private Ordering Through Soft Law

In most or all areas of life, private ordering both underlies and supplements traditional forms of law. In some areas, including corporations, one important form of private ordering is soft law. Soft law consists of bodies of standards, principles, or rules that are promulgated by private institutions, and that have force of some sort although they are not directly backed by state sanctions. Because soft law is not backed by state sanctions, and therefore is not binding in the same sense as traditional or "hard" law, adherence to soft law is voluntary to varying degrees. Among the sanctions that can give soft law force, despite its theoretically voluntary nature, are private pressures, including moral pressures and shaming; the prospect that courts will take account of soft-law standards in evaluating conduct; and exclusion from the benefits of membership in, or the power to obtain benefits from, an organization that makes soft law.

In corporate law, private ordering through soft law takes a variety of forms, including recommended best corporate practices in such sources as the ALI's Principles of Corporate Governance, the ABA's Corporate Director's Guidebook, and The Business Roundtable's Statement on Corporate Governance; codes of conduct adopted by individual corporations; and the governance rules for listed corporations adopted by the major stock exchanges,
in particular the New York Stock Exchange and NASDAQ. This soft law largely concerns how corporations and corporate actors should behave. In significant part, it concerns institutional mechanisms to control positional conflicts.

For present purposes, the most significant soft law of this type consists of stock-exchange rules that require an independent board that is capable of monitoring the CEO, and independent oversight committees or analogous structures. The political economy of stock-exchange soft law parallels the political economy of federal corporate law. Unlike state legislatures, the stock exchanges have an economic interest in the adoption of rules that maximize the vitality of national capital markets, and cannot easily treat defects in corporate law as externalities. Accordingly, the exchanges have an economic interest in addressing traditional and positional conflicts. Both the New York Stock Exchange and NASDAQ have always had some important corporate-governance rules. In the aftermath of Enron and WorldCom, however, the number and scope of these rules have multiplied exponentially. Although these rules have an effect on information flow, their main focus is on corporate structure. Accordingly, the stock-exchange rules complement federal law, which deals with corporate structure in a much more limited way.

An important feature of the stock-exchange corporate-governance rules is that they are a very hard form of soft law. Few if any large publicly held corporations can forgo listing on the New York Stock Exchange or NASDAQ. Accordingly, for large publicly held corporations the corporate-governance rules of these exchanges are mandatory in all but form.

CONCLUSION

Corporate law consists of four modules: state statutory law, state judge-made law, federal law, and private ordering through soft law. Each of these modules focuses on different aspects of the two most important features of corporate law: facilitating non-conflict transactions and conduct, and regulating conflicts of interest. State statutory law facilitates non-conflict transactions and conduct, but does not regulate conflicts of interest. State common law regulates traditional conflicts of interests, but provides only limited regulation of positional conflicts. Federal law regulates positional conflicts largely by addressing information flows. Private ordering through soft law regulates positional conflicts by addressing corporate structure. The four modules, taken together, provide the architecture of American corporate law.

An understanding of the architecture of corporate law serves several functions. It allows us to break away from the common but shallow rhetoric that corporation law consists of state law. It allows us to determine which module of corporation law has a comparative advantage when we make decisions about where new corporate-law rules are best located.
It also illuminates the significance of Delaware statutory law. Several commentators have attempted to determine the effect of Delaware incorporation on firm value. For example, in an article published in 2001, Rob Daines calculated that based on stock-market valuations, Delaware firms were worth more than non-Delaware firms in twelve out of the sixteen years during the period 1981–1996—5% more on average. In a more recent article, Guhan Subrahmanian recalculated the value of Delaware firms during the period 1991–1996 and extended the analysis to the period 1997–2001. Subrahmanian concluded that Delaware firms were worth approximately 3% more than non-Delaware firms during the period 1991–1993; were worth approximately 2% more than non-Delaware firms during the period 1994–1996; and after 1996 were worth the same as (more accurately, did not differ in a statistically significant way from) non-Delaware firms.

The inconclusive nature of the data is not surprising. There are a number of reasons why it is difficult if not impossible to assess the optimality of Delaware’s statutory law by computing stock-market valuations.

One well-known reason is that Delaware might add value, or fail to subtract value, even if its statute is suboptimal, because its judge-made law is richer than that of other states.

Another reason is that today there is not that much significant difference between the Delaware statute and most other state corporate-law statutes. That too is not surprising. Because all states are competing for the favor of top managers, the state statutes converge. Because the state statutes converge, even though the statutes as a group are suboptimal, the Delaware statute is not more suboptimal than the statutes of most other states.

A third, even more important, reason why data on stock-market valuations is inconclusive concerning the optimality of Delaware statutory law is brought out by the architecture of corporate law. A comparison between the Delaware statute and other state statutes has limited significance, not only because the difference between state statutes tends to be small, but also because of the limited significance of state statutory law. Most of the real action in corporate law is not located in state statutory law, but in the other three modules of corporate law—state judge-made law, federal law, and soft law. The effect of small differences between state statutes tends to be swamped by the overriding significance of the law in those other modules.