

**THE “RACE TO THE TOP”
IN STATE CORPORATE LAW:
THE DELAWARE MODEL**

by

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INTRODUCTION

Proposals for increased federalization of state corporate law routinely overlook the absence of a system of institutions at the federal level which are ready and experienced in promulgating, interpreting and applying corporate law, as well as the myriads of difficulties in creating such a system of institutions. Along with the substantial body of empirical evidence suggesting that the current system of competition among the states is efficient and maximizes shareholder wealth, these practical considerations vividly show that increased federalization of state corporate law is an ill-conceived and false panacea for improving corporate governance and likely to have far reaching negative effects.

Thanks to the financial scandals of the last several years, we are again faced with the growing threat of federal preemption of state corporate law.

These scandals have given new life to once the moribund theory that there is a “race to the bottom” among the fifty states to see which state can provide the most permissive corporate oversight of business managers, thus allowing those managers to enrich themselves at the expense of their shareholders. The purported cure for this supposed pandemic of silent self-dealing is greater oversight of corporate governance by the federal government through a uniform, nationwide regime of federal regulation of corporate internal affairs.

What the proponents of federalization seem to overlook is the difficulty of creating a set of institutions within the federal system that would reflect the institutional mechanics of how state corporate law is promulgated, interpreted and applied. With that in mind, this WORKING PAPER will examine how these institutional mechanics have evolved and function in Delaware, home to a majority of U.S. public corporations, and what stumbling blocks lie in the way for those seeking to replicate these institutions in a national federalized system. It demonstrates that federal preemption of state corporate law would unleash a blizzard of unintended consequences, and is likely to erode corporate governance rather than improve it.

I. FEDERAL PREEMPTION OF STATE CORPORATE LAW — A BRIEF HISTORY

The federal preemption theory was first given life in 1974 when, in language more provocative than descriptive, professor William L. Cary declared that Delaware was a “pygmy among the 50 states” and leading a “race to the bottom” among the states to see which could offer corporate laws most favorable to management at the expense of shareholders.¹ In the late seventies and eighties, practitioners and academics discredited Cary’s thesis and its underpinnings.² Congress and the United States Supreme Court also remained unpersuaded and consistently refused to federalize state corporate law.³ In fact, over time, a body of empirical evidence developed that not only was there no “race to the bottom,” but rather competition between states caused a “race to the top.”⁴ Like bell bottoms,

¹William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663, 701 (1974).

²S. Samuel Arsht, *Reply to Professor Cary*, 31 BUS. LAW 1113 (1976); Ralph K. Winter, Jr., *Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STD. 251 (1977).

³See, e.g., *CTS Corporation v. Dynamics Corp.*, 481 U.S. 69 (1987), *Santa Fe Indus. v. Green*, 430 U.S. 462, 472-73 (1977).

⁴Ralph K. Winter, Jr. *The “Race for the Top” Revisited: A Comment on Eisenberg*, 89 Colum. L. Rev. 1526 (1989); Frank H. Easterbrook & Daniel R. Fischel, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Roberta Romano, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

the mood ring, and disco, the race to the bottom theory appeared to have been one of those things that could only gain currency in the Seventies.⁵

As it turns out, the theory was dormant and not dead. The spate of securities law violations and criminal behavior by corporate officers and directors for companies such as Enron, WorldCom, Adelphia, and Tyco has given federal preemption new political life, if not data that would suggest that federalization is desirable.⁶ The Sarbanes–Oxley Act of 2002 made incursions into traditional areas of state corporate law such as the composition of audit committees.⁷ More recently, the SEC’s proposals to give shareholders the power to nominate directors, a power typically reserved to a board’s nominating committee, represents a potentially substantial federal incursion into corporate governance. At the recent ABA Annual Meeting in August, Chief Justice Myron T. Steele of the Delaware Supreme Court noted: “I worry about the chilling effect that federal

⁵Daniel Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. L. 1437, 1454 (1985) (“Cary’s position has been discredited; indeed, in recent years it has been discussed only as an illustration of how it is possible to reach the wrong conclusions if one lacks a basic understanding of the economic structure of the corporation and of corporate law.”) (Citing authorities).

⁶David A. Kotler and Rick Swedloff, *Sarbanes-Oxley’s Impact on State Corporate Governance*, LEGAL OPINION LETTER (Wash. Lgl. Fndt.), July 25, 2003; Stephen M. Bainbridge, *The Creeping Federalization of Corporate Law*, Research Paper No. 03-7 (2003) (downloaded from <http://ssrn.com/abstract=389403>).

⁷Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (the various provisions of the act are codified in various sections of 15 U.S.C.).

encroachment will have on our flexible market approach....The bottom line in my view is that competitive federalism is under attack.”⁸

As with Professor Cary, the new generation of enthusiasts for federalization relies heavily on the premises both that the current regime of competition among the states does a poor job and that the federal government would get things right. But both of these premises are dubious at best.

First, although they contest the conclusiveness of the extensive empirical data suggesting that state competition in corporate law leads to wealth maximizing and shareholder-friendly laws,⁹ even academics who question the race to top do not argue that there is an active race to the bottom.¹⁰

⁸*BNA's Corporate Counsel Weekly*, Vol. 19, No. 32, at 250 (Aug. 18, 2004). In the same vein and also during the ABA Annual Meeting, E. Norman Veasey, immediate past Chief Justice of the Delaware Supreme Court, also commented on the undesirability of federal encroachment. E. Norman Veasey, “Musing from the Center of the Corporate Universe,” Section of Business Law Luncheon, America Bar Association Annual Meeting, Aug. 9, 2004 (downloaded from www.abanet.org/bus/law/newsletter/0027/materials/speech.pdf).

⁹R. Daines, *Does Delaware Law Improve Firm Value?*, New York University Center for Law and Business Working Paper #CLB-99-011 Columbia Law School Center for Studies in Law and Economics Working Paper No. 159 (downloaded from the Social Science Research Network Electronic Paper Collection at: http://papers.ssrn.com/paper.taf?abstract_id=195109); R. Romano, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* (AEI Press, 2002).

¹⁰Lucien Bebchuk and Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 *JOURNAL OF LAW AND ECONOMICS*, 383, 384 (2003). Guhan Subramanian, *The Disappearing Delaware Effect*, 20 *JOURNAL OF LAW, ECONOMICS AND ORGANIZATION* 32 (2004).

Second, federalization's adherents have not shown that a federalized system would work better than what is currently in place. Indeed, they make little effort to account for the existing institutional infrastructure that allows state corporate law to be responsive to the challenges of our dynamic economy, and how that infrastructure would work in a federalized corporate law regime.¹¹ A comparison of the real world mechanics of how corporate law is promulgated, interpreted, and applied under the Delaware System with how these mechanics might operate in a federalized system provides additional support for why federalization of corporate law is unwise.

II. THE DELAWARE SYSTEM

The term "Delaware System" is used because Delaware's preeminence in corporate law reflects more than its Legislature's ability to enact sensible laws. It is built on an institutional framework for the interpretation, application, and modification of corporate law over time and has three main components: first, Delaware's corporate laws themselves, as periodically modified by its Legislature; second, Delaware's Court of Chancery, a

¹¹Although supporters of federalization acknowledge these institutional issues, they have only discussed them in passing and have not dealt with them in a comprehensive way. See e.g., Lucien Bebchuk and Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VIRGINIA LAW REVIEW, 101, 136-138 (2001). From a practitioner's point of view, they are unduly optimistic about how these difficulties might be addressed. Some academic literature has explored the federalism issue in light of Delaware's institutional framework. See e.g., Jill E. Fisch, *The Peculiar Role of Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2002) (suggesting an analysis of the federalism debate through an institutional or process analysis of Delaware courts).

specialized court which hears corporate disputes; and third, the corporate legal bar in Delaware which has developed and grown along with Delaware's Legislature and courts, and provides invaluable support to them. Together, these three institutions allow Delaware's corporate laws to be amended, interpreted and applied with consistency and predictability, yet with enough flexibility to meet the emerging challenges that the ceaseless creativity of the business world throws at it. These three institutions' achievements together, account for Delaware's popularity as a state of incorporation and as a place to resolve corporate disputes.

The Delaware System was not created overnight or by an act of fiat. It has evolved over decades. As described below, Congress and the federal courts would have great difficulty devising and implementing a system to replicate, much less improve upon, the Delaware System.

A. The Delaware General Corporation Law

Of the three parts of the Delaware System, the black letter of the Delaware General Corporation Law would be the easiest for the federal government to replicate as is, or in a modified form.¹² But even if the federal government were to enact Delaware's corporate law word for word, the

¹²Indeed, Nevada has adopted both Delaware statutory corporate law and a commitment to follow Delaware's case made corporate law. *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342, 1346-47 (D. Nev. 1997). Nonetheless, Nevada's impact on the development of corporate law has not been significant. See Frisch, *supra* note 11, 68 U. CIN. L. REV., at 1068 (citing Jonathan Macey and Geoffrey Miller, *Toward and Interest Group Theory of Delaware Corporate Law*, 65 TEXAS L. REV. 469, 488 (1987)).

Model Business Corporation Act, or a new code of its own invention, Congress would have comparative difficulty keeping a federal corporate code up to date.

One of Delaware's advantages over the federal government is that it is agile and adaptable.¹³ It enjoys comparative political ease in which its corporate law can be modified to meet developments in business. The federal securities laws and most states' corporate laws are revised infrequently. In Delaware, corporate laws are revised nearly annually. These amendments have little trouble getting on the Delaware Legislature's agenda. Because of Delaware's size, corporate law amendments are not competing with the more burdened agendas of the U.S. Congress or the legislatures of larger states such as New York and California, all of which have a broader range of issues and a larger number of competing interest groups. Moreover, the Delaware Legislature is assisted by the Court of Chancery, the Delaware Supreme Court, and the practitioners in Delaware's specialized corporate bar in identifying needed amendments and then crafting these changes.¹⁴ As a result, Delaware's corporate laws are more

¹³Frisch, *supra* at note 11, 68 U. CIN. L. REV. at 1068, n.2.

¹⁴Macey and Miller, *supra* at note 12, 65 TEXAS L. REV., at 488-89 ("For example, the Delaware legislature's drafting committees historically have been staffed with attorneys experienced in corporate law. This expertise means that Delaware is likely to adopt desirable rules to handle complex and technical problems as they arise. Delaware judges, attorneys and legislators have both the expertise to guide the development of corporate law in a way that is consistent with its overall philosophy — thus ensuring

adaptable than those of its sister states, or more than a federal corporate code is likely to be.

In addition, Delaware is a politically neutral corner in which to promulgate corporate law. Because of Delaware's compact geography, corporations choosing to incorporate in Delaware by and large do not have substantial business operations in Delaware.¹⁵ The major shareholders, officers and directors and employees of the corporation rarely reside in Delaware. Changes to Delaware's corporate laws are not as politically charged as they would be in the federal system where different constituents are present and politically active. This allows Delaware to examine these issues with relative political dispassion. By contrast, in the early eighties, many larger states enacted "anti-takeover" statutes to thwart hostile takeovers of local businesses. These statutes were usually enacted at the behest of the management or employees of large local employers. Many of these anti-takeover statutes were found to be unconstitutional under the Commerce Clause of the United States Constitution.¹⁶ Putting aside the constitutionality or desirability of anti-takeover statutes, they illustrate the

stability — and the knowledge of the structure of the law to make needed changes in response to unforeseen circumstances.”).

¹⁵Jonathan R. Macey, *State and Federal Regulation of Corporate Takeovers: A View from Demand Side*, 69 WASH. U. L. Q. 383, 399 (1991) (“Incumbent management teams represent a powerful in-state lobby, while shareholders are widely dispersed throughout the country.”).

¹⁶*Edgar v. MITE, Corp.*, 457 U.S. 624 (1982).

pressures that constituent groups can put on a legislature. The Delaware Legislature is not immune to these pressures, but it generally does not have them in its backyard.¹⁷

It is beyond the scope of this paper to discuss in depth the comparative ability of Congress to get corporate law right. However, recent experience in amending the securities laws — both the Private Securities Litigation Reform Act of 1995 and the Sarbanes-Oxley Act — are suggestive. Congressional efforts to address these issues were politically charged and have been prone to unexpected consequences that often prove difficult to fix after the political urgency for legislation in these areas dissipated. What is politically feasible at the federal level is often compromise, which is not an optimal approach from a corporate governance or economic perspective.¹⁸

B. The Court of Chancery

In inexperienced hands, even a Stradivarius violin will sound sour notes. Without the Delaware Court of Chancery's expertise and ability to review contested corporate action with speed, Delaware's corporate laws would be a

¹⁷Frisch, *supra* at note 11, 68 U. CIN. L. REV. at 1091.

¹⁸By way of example, for all its incursions into corporate law, Sarbanes-Oxley leaves the perverse accounting incentives that now exist for executive compensation. W. Chandler and L. Strine, *The New Federalism of the American Corporate Governance System: Preliminary Reflections of Two Residents of One Small State*, 152 UNIVERSITY OF PENNSYLVANIA LAW REVIEW, 953, 955 (2003) Messrs. Chandler and Strine are respectively, the Chancellor and a Vice Chancellor of the Delaware Court of Chancery.

mute instrument. Unlike most states, Delaware never merged its courts of equity and law and as a result, it has a separate Court of Chancery that retains jurisdiction to hear equitable claims. Although its jurisdiction encompasses other traditional areas of equitable jurisdiction such as wills, trusts, and real estate, it is known primarily for its contributions to corporate law.¹⁹ It is comprised of five judges, a chancellor and four vice chancellors.

One only need review the Court of Chancery's opinions to gauge the Court's remarkable scholarship, attention to factual detail and unparalleled expertise in corporate disputes. In addition, most of the chancellors are prolific authors and teachers on the subjects of corporate law, governance and valuation. It would not be an overstatement to say that they treat their positions as a calling and are deeply committed to the sound development of Delaware's corporate laws.

The Court of Chancery's ability to match the business world's speed of operation in hearing and deciding cases is both legendary and well earned. By way of example, in the recent battle for control of Hollinger International Inc., the case went from complaint (January 26, 2004) to a three day trial (February 18, 19, 20) in twenty-two days, followed by a weekend of post trial

¹⁹Michal Barzuza, *Price Considerations in the Market for Corporate Law*, Discussion Paper No. 486, 08/2004, Harvard Law School, John M. Olin Center for Law, Economics and Business at 61-62 (forthcoming in 25 CARDOZO LAW REVIEW (2004)).

briefing (February 21 and 22) with Vice Chancellor Strine ruling and issuing a comprehensive 130 page opinion four days later (February 26, 2004).²⁰ Five months later the Court decided a fact intensive challenge to the sale of \$1.2 billion of Hollinger International's assets on a similar schedule.²¹ In resolving corporate disputes, expedition is undoubtedly a plus, if not a prerequisite, for meaningful relief.²² The Court of Chancery stands out in an American legal landscape better known for slow and grinding deliberation.

In pointing out the Court of Chancery's advantages in resolving corporate disputes, one does so without disparaging the courts of other states or the federal bench. They are asked to do a different job and the vast majority of them do it very well. The general jurisdiction courts of other states and the federal courts have far more subject matters to cover and simply do not have the time or opportunity to develop the deep expertise and knowledge of the financial and business relationships that corporate law presents.

For many state trial courts, it is difficult to fit a major corporate dispute in with the other important matters they handle, such as protection from abuse orders, criminal arraignments, pleas, trial and sentencing

²⁰*Hollinger International Inc. v. Black*, 844 A.2d 1022 (Del. Ch. 2004).

²¹*Hollinger Inc. v. Hollinger International Inc.*, 2004 Del. Ch. LEXIS 100 (July 29, 2004), *appeal denied*, 2004 Del. LEXIS 329 (Del. Supr. July 29, 2004).

²²*See also*, Baruza, *supra* at note 19, at 62, n. 303 (describing the speed of the Hewlett Packard proxy manipulation case).

matters, major tort cases, land use, and the other state law matters which arrive at a trial court of general jurisdiction in a steady and unending flow. Outside of Delaware, a corporate law dispute is typically the first such dispute the trial judge has had the opportunity to address. Adding to the trial court's learning curve, the decisional law on corporate subjects outside of Delaware is limited. Although trial courts have the benefit of the American Law Institute's PRINCIPLES OF CORPORATE GOVERNANCE — a highly useful restatement of corporate decisions throughout the country — as well as other treatises, borrowing from a restatement or a treatise is not the same as building on a body of organic decisional law you as a judge, or judicial colleagues whom you know well, have created.

There is every reason to believe the federal bench would have an even tougher time interpreting and applying a federal corporate code.

First, the recent history of the federal bench is one of a judiciary groaning under an ever increasing work load. As the load of criminal and civil rights cases has burgeoned, the federal judiciary has been able to devote less time to its civil caseload, particularly time-consuming commercial matters. Some federal courts have had to suspend their civil docket, and commentaries about the “vanishing civil trial” abound.²³ This bodes poorly

²³John Austin, *Jury Trials Maybe Headed to the Vanishing Point*, 29 LITIGATION NEWS, No. 4, at 1 (May 2004).

for the federal bench's capacity to take on the traditional state law domain of corporate disputes.

Second, the coherence of Delaware corporate law reflects in part that there are only five chancellors involved in creating it with a single Delaware Supreme Court of five justices (many of whom are former chancellors) reviewing those decisions. Interpretation of a federal corporate code by 877 district court judges and 169 appellate court judges has the potential to create a corporate law Tower of Babel. The history of judicial development of the federal securities laws' anti-fraud provisions is illustrative of this problem. It was not until twelve years after Section 10(b) of the Securities Exchange Act was enacted that the courts identified that it created an implied private right of action.²⁴ It took another 45 years before the United States Supreme Court determined the applicable statute of limitations²⁵ and 48 years to determine that it did not create aiding and abetting liability.²⁶ The breadth of the federal system means inevitable splits among the circuit courts and it is often decades before the United States Supreme Court has an opportunity to resolve those splits. These splits between the circuits would dramatically decrease predictability in corporate law.

²⁴*Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946).

²⁵*Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991).

²⁶*Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994).

Third, the inevitable splits between the circuits and districts would have another undesirable side effect — they would add a new layer of procedural gamesmanship to corporate cases. Where one decided to file suit would be a significant decision depending on how corporate law had developed in each particular circuit. Although some forum shopping goes on in current practice, the applicable Delaware law does not change based on where a plaintiff brings suit. In a federalized system, venue choices could affect the applicable law.

One can also imagine that a hostile takeover might receive different treatment in the federal district where the target is a major employer than in the district where the acquiring company resides. Again, Delaware provides a politically neutral battleground for these disputes, as it is rarely either side's home town.

Fourth, Delaware is a relatively centrist and politically balanced state and the judiciary is selected in a consensual and unpartisan way.²⁷ Under the Delaware Constitution, the Supreme Court and Court of Chancery must be politically balanced.²⁸ This stands in stark contrast to the ever-increasing

²⁷Frisch, *supra* at note 11, 68 U. CIN. L. REV. at 1094; Macey and Miller, *supra* at note 10, 65 TEXAS L. REV. at 500.

²⁸DEL. CONST. art. I.V., § 3.

partisanship that plagues the current federal judicial selection and confirmation process.

C. The Delaware Corporate Bar

The Delaware Court of Chancery is aided by a highly skilled cadre of lawyers that practice before it on a regular basis.²⁹ The bar's small size and high degree of specialization yield advantages that would be difficult to duplicate on a national basis.

The Delaware Court of Chancery would have difficulty maintaining its prodigious, high quality and expedited output if it could not count on a dedicated, specialized, and highly skilled bar to assist it. The modest size of the Delaware Bar helps create this environment as follows. First, the flow of corporate cases in Delaware is brisk enough that lawyers can devote themselves to the corporate practice. If corporate cases were spread throughout the federal district courts, it is questionable that any group of lawyers would have sufficient incentive or opportunity to specialize to this degree.³⁰ Without a highly sophisticated bar briefing, presenting and arguing corporate cases, the trial courts' work would become even more

²⁹Michal Barzuza, *supra* note 19, at 42 n. 197.

³⁰Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG., 225, 275 (1985) ("for lawyers, the cost of doing business is substantially reduced and the value of their human capital less rapidly depreciates, when their expertise can be centered in one jurisdiction.").

onerous. Second, lawyers who have repeated contact with each other tend to work together better, even as adversaries, than those whose contact is sporadic. Within the Delaware Bar, the constant exhortations of the Delaware courts are reinforced, and civility and trustworthiness among its members is taken almost as a civic religion and fiercely observed. Reputations are made quickly and sometimes prove indelible. The Delaware corporate bar's collegiality enables the Court of Chancery to work through cases more quickly and efficiently than it would otherwise.

It is doubtful that a federal corporate law scheme would create a similar environment and indeed one could predict the opposite. If 877 district courts decided corporate disputes, counsel would not be able to specialize and there would be much less regular interaction between adversaries. The dispute would be about today's case and the incentives would run against taking a long term view. This would not help foster a nationally coherent and consistent corporate law.

CONCLUSION

U.S. Supreme Court Justice Brandeis famously posited that the federal government should allow the state courts to be individual laboratories of law and that the nation would benefit from the robust competition that would result between the states. The empirical evidence of

a race to the top in corporate law tends to confirm Justice Brandeis's theory and indicates that federalization is an undesirable policy. As discussed above, when one considers the practical mechanics of replacing more than two hundred years of competitive state law with a federalized law regime, the case for further federalization of state corporate law seems untenable.

Another learned philosopher, Friedrich Hayek, observed that most successful institutions and laws are the products of a cumulative and evolutionary process rather than the product "of intelligent men coming together for deliberation about how to make the world anew." In support, Hayek quotes Cato as saying that the Roman constitution was superior to that of other states because it "was based upon the genius, not of one man, but of many: it was founded, not in one generation, but in a long period of several centuries and many ages of men."³¹ Would-be federalizers of corporate law are running against this wisdom. They seek not only to dispense with the product that the system of state competition has created through years of evolutionary and incremental change, but also they would abandon the machinery of promulgation, application and interpretation in favor of an unknown brave, new, federal world.

Federal preemption of state corporate law will have a negative effect on corporate governance, shareholders and the economy. Any proposals

³¹F.A. Hayek, *THE CONSTITUTION OF LIBERTY* at 57 (1960).

seeking to further federalize the corporate law system should be assessed with great caution and a thorough exploration of their consequences.