University of Pennsylvania Carey Law School

Penn Law: Legal Scholarship Repository

Faculty Scholarship at Penn Law

2000

The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters

Jill E. Fisch

University of Pennsylvania Carey Law School

Follow this and additional works at: https://scholarship.law.upenn.edu/faculty_scholarship

Part of the [Business Law, Public Responsibility, and Ethics Commons](#), [Business Organizations Law Commons](#), [Courts Commons](#), [Economic Theory Commons](#), [Law and Economics Commons](#), and the [Other Economics Commons](#)

Repository Citation

Fisch, Jill E., "The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters" (2000). *Faculty Scholarship at Penn Law*. 1312.

https://scholarship.law.upenn.edu/faculty_scholarship/1312

This Article is brought to you for free and open access by Penn Law: Legal Scholarship Repository. It has been accepted for inclusion in Faculty Scholarship at Penn Law by an authorized administrator of Penn Law: Legal Scholarship Repository. For more information, please contact PennlawIR@law.upenn.edu.

THE PECULIAR ROLE OF THE DELAWARE COURTS IN THE COMPETITION FOR CORPORATE CHARTERS

Jill E. Fisch*

More large publicly-traded corporations are incorporated in Delaware than in any other state.¹ Since the early 1900s, Delaware has been the dominant choice as state of incorporation for the largest U.S. companies.² Almost half the companies listed on the New York Stock Exchange and nearly 60% of Fortune 500 companies have chosen to incorporate in Delaware.³ This success in attracting corporate charters has been profitable; incorporations bring Delaware approximately \$440 million per year in franchise taxes and related fees.⁴

Scholars continually attempt to explain Delaware's success.⁵ Reasoning that the choice of a state of incorporation involves the selection of a body of corporate law, they posit that the incorporation statistics reflect a preference for Delaware law. Although there is disagreement in the academic community as to whether this process leads to the selection of a value-maximizing body of corporate law or one that permits management self-dealing at the expense of shareholders or other corporate constituencies, scholars agree that the process is appropriately characterized as regulatory competition.⁶ States compete for corporate charters by offering variations in corporate law. Whether

* Professor, Fordham Law School. © 2000 Jill E. Fisch. Prepared for the University of Cincinnati School of Law 2000 Corporate Law Symposium on Contemporary Issues in the Law of Business Organizations. I am grateful to Susan Block-Lieb, Ehud Kamar, Neil Komesar, and Steve Thel for helpful comments on an earlier draft. I have also benefited greatly from discussions with Justice Randy Holland.

1. See, e.g., Demetrios G. Kaouris, *Is Delaware Still a Haven for Incorporation?*, 20 DEL. J. CORP. L. 965, 1010 (1995) (stating that "Delaware remains the preeminent state for incorporation" for publicly traded companies).

2. See *id.* at 969-71 (explaining Delaware's rise to prominence in 1913 when New Jersey passed legislation effectively outlawing trusts and holding companies).

3. See, e.g., Sara-Ellen Amster, *Bureaucrats Move Money Around Globe—all from Delaware*, WILMINGTON NEWS-J., March 24, 1998; *Delaware Division of Corporations* (last modified Feb. 1, 2000) <<http://www.state.de.us/corp/index.htm>> (Web page of the Secretary of State stating that more than 310,000 companies are incorporated in Delaware including 60% of Fortune 500 and 50% of New York Stock Exchange companies).

4. See Sara-Ellen Amster, *Others Try to Imitate Delaware*, WILMINGTON NEWS-J., July 7, 1998.

5. See, e.g., Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEN. L. REV. 469 (1987); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998); William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998); Robert Daines, *Does Delaware Law Enhance Firm Value?* (Working Paper 1999).

6. See, e.g., Kamar, *supra* note 5, at 1909 (describing consensus that corporate law has bred a system of regulatory competition and disagreement about whether the competition results in a race to the top or to the bottom).

the competition is described as a race to the bottom or a race to the top, Delaware emerges as the undisputed winner.

Several factors, however, weaken the explanatory power of the regulatory competition model. First, variations in state corporation laws are minimal.⁷ If there are few substantive differences between Delaware law and that of other states, it is difficult to understand the incorporation decision as reflecting a preference for Delaware law. Second, empirical analysis fails to demonstrate the superiority or inferiority of Delaware's substantive law. For example, studies indicate that state antitakeover statutes reduce shareholder value.⁸ A race to the top theory would therefore predict that Delaware would not adopt an antitakeover statute; a race to the bottom theory would predict the adoption of a strong antitakeover statute. In fact, Delaware has opted for a middle ground and adopted a moderate antitakeover statute that is not adequately explained by either theory. Third, Delaware's advantage in attracting charters seems immune from competition. Despite efforts to enter the race, other states appear to be unable to compete.⁹ Indeed closer examination reveals regulatory competition to be essentially a two horse race. Corporations choose between incorporating in their home state and incorporating in Delaware.¹⁰ Virtually no corporation chooses any other alternative.

Importantly, choosing to incorporate in Delaware is not costless. Delaware's franchise fees for large corporations are significantly higher than those imposed by any other state. The largest corporations pay \$150,000 a year for the privilege of incorporating in Delaware.¹¹ Although these fees may not be financially material for a Fortune 500 company, Delaware's continued ability to impose fees substantially in excess of those charged by other states suggests that Delaware incorporation offers nontrivial value.¹² In other words, it suggests that the corporate preference for Delaware is real.

As a result, scholars have continued their efforts to explain this preference by looking beyond substantive differences in Delaware

7. See, e.g., Carney, *supra* note 5, at 729-34 (concluding that corporate law is relatively uniform).

8. See, e.g., William W. Bratton & Joseph A. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-Regulation*, 73 N.C. L. REV. 1861, 1881 n.65 (1995) (describing "[a] large body of empirical work [that] confirms that the antitakeover statutes had a harmful effect on shareholder value").

9. See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 665 (1974).

10. See Daines, *supra* note 3.

11. See *Delaware Division of Corporations Schedule of Franchise Tax*, (last modified Feb. 26, 1999) <<http://www.state.de.us/corp/sch-tax.htm>> (describing the maximum annual franchise tax as \$150,000).

12. See Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law* (Working Paper, Sept. 22, 1999 draft).

corporate law. For example, commentators have developed transaction cost models of Delaware law,¹³ arguing that Delaware reduces regulatory costs because of network externalities,¹⁴ its commitment to regulatory responsiveness,¹⁵ and the superiority of specialized chancery courts.¹⁶ These alternatives provide explanations for Delaware's success that do not depend on proof that Delaware law is substantively superior. Many of the nonsubstantive explanations look to Delaware's body of case law as an important advantage.¹⁷ The large volume of business litigation in Delaware, coupled with Delaware's specialized court system, results in a well developed collection of corporate law precedents. Commentators have argued that this collection may account both for Delaware's competitive success and the inability of other states to duplicate that success.¹⁸ It is accepted legal lore that well developed precedent is particularly valuable to business decisionmaking. Legal rules that are easy to ascertain, with predictable consequences, reduce the cost of business transactions.¹⁹

A closer look at Delaware precedent reveals, however, that, although well developed, it is far from clear and predictable.²⁰ Recent work demonstrates a degree of indeterminacy in Delaware law that casts substantial doubt on the transaction cost model.²¹ Because of this indeterminacy, it has been suggested that Delaware case law may impose excessive costs on Delaware corporations.²² This finding

13. But see Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 585-89 (1990) (questioning Romano's transaction cost explanation for Delaware's success).

14. See, e.g., Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713, 763-64 (1997); Michael Klausner, *Corporations, Corporate Law, and Networks of Contract*, 81 VA. L. REV. 757 (1995).

15. See, e.g., ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993).

16. See, e.g., Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 918 (1990) (arguing that specialized judiciary makes Delaware incorporation more attractive); Black, *supra* note 13 at 589-90 (arguing that Delaware's prominence is due to the expertise of its judiciary).

17. See, e.g., Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law*, 17 DEL. J. CORP. L. 683, 702 n.79 (1992) (describing scholars' reliance on Delaware case law as an explanation for its competitive success).

18. See, e.g., Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 772 (1987).

19. See, e.g., Henry G. Manne, *The Judiciary and Free Markets*, 21 HARV. J.L. & PUB. POL'Y 11, 18 (1997) (describing how system in which law is settled through well-developed precedent reduces transaction costs for business and increases social capital).

20. See, e.g., Kamar, *supra* note 5; Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85, (1990).

21. See *id.*

22. See Kamar, *supra* note 5, at 1919-22 (suggesting that the amount of indeterminacy in Delaware law may be suboptimal and impose excessive costs on business decisionmakers).

presents a puzzle to those who seek to explain the dominance of Delaware incorporation.

This article offers a solution to the puzzle and an alternative explanation for Delaware's success in attracting corporate charters—the unique lawmaking function of the Delaware courts. The article focuses on the peculiar role of the Delaware judiciary in corporate lawmaking, a role that has received little attention from corporate law scholars. The article demonstrates that Delaware uses an unusual process to make corporate law. Delaware relies heavily on judge-made law, but the structure and operation of the Delaware courts causes Delaware's judicial lawmaking to differ from that in other states. Indeed, the process by which Delaware courts make corporate law resembles legislation in some ways.²³

The article then evaluates this lawmaking structure from a standpoint of comparative institutional advantage. In particular, the article compares Delaware's process to the political process. The article concludes that Delaware lawmaking offers Delaware corporations a variety of benefits, including flexibility, responsiveness, insulation from undue political influence, and transparency. These benefits increase Delaware's ability to adjust its corporate law to changes in the business world. By identifying the role of the Delaware courts as central to Delaware's dominance of the market for corporate charters, this article has important implications for the application of Delaware's success to continuing questions of regulatory design.

I. REGULATORY COMPETITION AND THE CARY-WINTER DEBATE

Analysis of regulatory competition in corporate law begins with the classic Cary-Winter debate. In 1974, William Cary published a seminal article identifying Delaware's leadership status as a corporate domicile.²⁴ Cary analyzed Delaware's success and concluded that, because of its substantial reliance on corporate franchise taxes, Delaware deliberately sought to attract corporate charters. Moreover, because the choice of state of incorporation is made by management, Cary posited that Delaware structured its corporation law to appeal to corporate management. According to Cary, the result was lax legal standards that favored management interests over those of shareholders. Cary termed

23. See, e.g., Jill E. Fisch, *Retroactivity and Legal Change: An Equilibrium Approach*, 110 HARV. L. REV. 1055, 1107-8 (1997) (developing description of traditional process of judicial lawmaking and contrasting that process with adjudication that closely resembles legislative lawmaking).

24. See Cary, *supra* note 9.

the competition a "race to the bottom" and recommended federal minimum standards to stop the race.²⁵

Cary's conclusions were challenged, most famously by Judge Ralph Winter.²⁶ While agreeing with Cary's observation of regulatory competition in corporate law, Winter argued that the competition was more accurately described as a "race to the top." Significantly, Winter argued that market constraints preclude managers from sacrificing shareholder interests by choosing a domicile with inferior rules of corporate law. Indeed, the markets within which firms operate create incentives for managers to choose the corporate law that maximizes firm value.

Corporate law scholars have aligned themselves with Cary or Winter and expanded on the analysis of regulatory competition. Lucian Bebchuk, for example, agrees with Cary that at least some aspects of regulatory competition are value-decreasing.²⁷ Bebchuk warns that state competition is unlikely to produce efficient rules governing "issues that are 'significantly redistributive';" issues that directly affect the strength of the market, particularly takeover regulation; and issues that implicate the interests of third parties.²⁸ Accordingly Bebchuk argues that Cary correctly concludes that state competition will, in some cases, cause states to provide legal rules that favor manager interests over those of shareholders. In his most recent work, Bebchuk, together with Allen Ferrell, argues that states have produced bad takeover law and suggests that takeover regulation is not an isolated example of the failure of regulatory competition but rather a reason to give greater credence to Cary's analysis.²⁹ William Bratton and Joseph McCahery offer a similar perspective, describing charter competition as an example of regulatory capture by corporate management and explaining that, as a result of this capture, state competition is unlikely to produce optimal corporate law.³⁰

Most corporate law scholars, however, align themselves with Winter. Frank Easterbrook and Daniel Fischel, for example, concur in Winter's assessment that market factors are likely to result in corporate law

25. *Id.* at 666, 696-705.

26. See Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

27. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

28. See Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1172-73 (1999) (describing Bebchuk's earlier analysis).

29. See *id.*

30. See Bratton & McCahery, *supra* note 8, at 1862.

maximizing firm value.³¹ Roberta Romano argues that an extensive body of empirical work demonstrates the success of regulatory competition in producing a body of corporate law that increases firm value. Indeed Romano goes so far as to defend the federalist structure that results in regulatory competition as "The Genius of American Corporate Law."³² Recent empirical work by Robert Daines lends further support to Winter's assessment by demonstrating that Delaware law increases firm value.³³

The regulatory competition model has important implications for corporate law. Cary sought to predicate a defense of federal incorporation or, at least, federal minimum standards, on his description of regulatory competition as producing a race to the bottom.³⁴ Romano, in contrast, uses her defense of state competition to argue against federal regulation of takeovers.³⁵ In fact, Romano asserts that the demonstrated success of regulatory competition in corporate law supports adoption of a similar approach to securities regulation in place of the existing system of mandatory national rules.³⁶

It is difficult, however, to explain Delaware's dominance in the market for corporate charters on the basis of the substantive superiority of Delaware corporate law, whether substantive superiority is defined as better for shareholders as in Winter's view, or better for managers, as Cary claimed. For one thing, state corporation statutes contain relatively little substantive variation. Careful empirical research reveals that corporate codes tend toward uniformity.³⁷ Even though innovations may initially cause statutory differences, the statutes rapidly converge.³⁸ Although convergence is a predictable result of regulatory

31. See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-40 (1991).

32. Romano, *supra* note 15.

33. See Daines, *supra* note 5 (concluding that firms which incorporate in Delaware have statistically higher Tobins Qs).

34. See Cary, *supra* note 9, at 701.

35. See Romano, *supra* note 15, at 75-84.

36. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998); see also Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998) (arguing that issuers should be able to choose which jurisdiction's disclosure requirements apply to it).

37. See, e.g., John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence of Corporate Governance and Its Implications*, 93 NW. U.L. REV. 641, 702 (1999) ("the best documented finding in the empirical literature on the U.S. corporate chartering competition is that a high degree of uniformity has emerged in American corporate laws"); Carney, *supra* note 5, at 717 (empirical study concluding that American corporate law is "relatively uniform across most states"); Romano, *supra* note 18, at 709 (finding "substantial uniformity across the states").

38. See Carney, *supra* note 5, at 729-34.

competition, Delaware's ability to dominate the market in light of this convergence is less explicable.³⁹

In addition, evidence suggests that, although Delaware is successful in attracting charters, its law is not optimal. Cary and Bebchuk have noted a variety of ways in which Delaware law appears to favor management interests at the expense of shareholder interests.⁴⁰ Bebchuk's more recent analysis of takeover regulation indicates that Delaware's substantive law of takeovers is particularly problematic, an analysis that is not contradicted by Romano's efforts to defend Delaware law.⁴¹ Romano and other scholars in the Winter camp agree that state antitakeover regulation inefficiently interferes with the market for corporate control, yet these scholars are unable to reconcile this inefficiency with their defense of regulatory competition.⁴² If states compete for charters by offering superior products, it is difficult to understand why competition has not addressed the observed problems in Delaware law.

Indeed, if there is a competitive market for corporate charters, why has no state been able to supplant Delaware by offering a superior statute? To the contrary, no state has been able to duplicate Delaware's success at attracting charters. Although other states have attempted to compete by modeling their law after that of Delaware, they are unable to attract incorporations.⁴³ Cary and other commentators point to the relatively recent effort by Nevada to become a "Delaware of the West."⁴⁴ In addition to adopting the Delaware statute, the Nevada legislature adopted Delaware case law.⁴⁵ Moreover, courts construing Nevada law appear to follow Delaware precedent.⁴⁶ Nonetheless,

39. Bernard Black maintains that substantive corporate law is not merely uniform, it is trivial. See Black, *supra* note 13.

40. See Bebchuk, *supra* note 27; Cary, *supra* note 9.

41. See Bebchuk & Ferrell, *supra* note 28, at 1184-91.

42. See *id.* at 1197. Bebchuk and Ferrell note that Romano's defense of Delaware's antitakeover regulation consists of arguing 1) "that Delaware has been slow to adopt antitakeover legislation"; 2) that Delaware's statute is "not as draconian" as those of some other states; and 3) that "federal takeover regulation is likely to be worse." *Id.*

43. See Carney, *supra* note 5, at 718 (describing unsuccessful attempts by Nevada and Maine to compete with Delaware).

44. See Cary, *supra* note 9, at 665; Macey & Miller, *supra* note 5, at 488; see generally Keith Paul Bishop, *The Delaware of the West: Does Nevada Offer Better Treatment for Directors?*, 7 No. 3 INSIGHTS 20 (1993) (describing Nevada's efforts to compete with Delaware in attracting corporate charters).

45. See Macey & Miller, *supra* note 5, at 488 (explaining that Nevada adopted both Delaware statutory and common law applying to corporations); *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342, 1346-47 (D. Nev. 1997) (rejecting ITT's argument to the contrary and explicitly finding that Nevada follows Delaware case law). See also Kamar, *supra* note 5, at 1911 (describing Nevada's adoption of Delaware law as "wholesale").

46. See, e.g., *Hilton Hotels*, 978 F. Supp. at 1347 (following Delaware law on the power relationship

Nevada has not persuaded corporations to consider Nevada incorporation as a viable alternative to the traditional choice between their home state and Delaware.⁴⁷

These observations have led to a refinement of the academic models of regulatory competition. Commentators have replaced the initial attempts to defend Delaware's dominance on the basis of substantive superiority by a broader range of explanations. Roberta Romano, for example, has done extensive work explaining why Delaware, from a transaction cost perspective, has an incentive to compete for corporate charters and is able to maintain its existing advantage in the race.⁴⁸ Romano explains that, because Delaware is a small state and is heavily dependent on the revenues it obtains from corporate franchise taxes, it is able to commit to its regulatory structure in a way that is impossible for states that lack similar financial incentives.⁴⁹ This viewpoint is shared by Jonathan Macey and Geoffrey Miller, who further explain the selection of Delaware as driven by interest group dynamics.⁵⁰ Under the Macey & Miller model, Delaware competes by making its law attractive to the lawyers who benefit from litigation conducted in Delaware.⁵¹ This competition need not increase firm value; indeed it may lead to a litigation intensive regulatory structure that sacrifices the interests of the firm and its shareholders in favor of the interests of counsel.

Scholars have expanded on the transaction cost approach and identified a variety of nonsubstantive explanations for Delaware's success. Although a complete analysis of these explanations is beyond the scope of this article, they include the responsiveness of the Delaware legislature and its commitment to updating the Delaware statute,⁵² Delaware's specialized and expert judiciary which provides both rapid and high quality litigation decisions,⁵³ network externalities provided by Delaware law,⁵⁴ and herd behavior.⁵⁵

between corporate board and shareholders); *Shoen v. AMERCO*, 885 F. Supp. 1332, 1341 (D. Nev. 1994) (following Delaware precedent with respect to judicial review of directors' interference with shareholder voting power).

47. See Kamar, *supra* note 5, at 1911.

48. See Romano, *supra* note 5; Romano, *supra* note 15.

49. See Romano, *supra* note 15, at 37-42.

50. See Macey & Miller, *supra* note 5.

51. See *id.* at 470 (explaining that "the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state").

52. See, e.g., Kaouris, *supra* note 1, at 973 (describing responsiveness of Delaware legislature to corporate needs).

53. See *infra* notes 112-121.

54. See *supra* note 14.

55. See, e.g., Coffee, *supra* note 37, at 703 (explaining that "[c]orporations may prefer to locate in a popular jurisdiction of incorporation for reasons that are simply based on its popularity, not the inherent

Whatever the source of Delaware's advantage, firms pay for the privilege of Delaware incorporation. The largest firms pay \$150,000 a year for the privilege of incorporating in Delaware.⁵⁶ Although this amount may seem small relative to the operations of a large public corporation, it is five hundred to one thousand times the amount those firms would pay to incorporate elsewhere.⁵⁷ Troubled by the evidence that Delaware can persistently charge what appears to be a noncompetitive price for the privilege of incorporation, scholars persist in an effort to explain how Delaware incorporation adds value. In terms of transaction costs, the choice of Delaware can be explained if Delaware incorporation reduces the costs of business operations. The benefits of Delaware incorporation may include such nonsubstantive advantages as better courts or more readily available case law. So long as the benefits outweigh the slightly higher cost of Delaware incorporation, firms will continue to choose Delaware.

The problem with many of the nonsubstantive explanations for Delaware's success is the inability of scholars to tie Delaware's supposed advantages to predictable cost savings for Delaware firms. For example, although a competent and expert judiciary might reduce the cost of litigation,⁵⁸ Delaware law seems to create an increased risk of litigation for Delaware firms.⁵⁹ The combination of reduced litigation costs but increased incidence of litigation is likely to have an indeterminate effect on firm value.⁶⁰ Scholars also attribute Delaware's success to network externalities, which reduce information and compliance costs.⁶¹ Yet there is no empirical evidence demonstrating that Delaware firms incur

superiority of its law"); Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 WASH. U. L.Q. 347, 353 (1996) (considering the role of herd behavior by corporate lawyers).

56. See *supra* note 11.

57. See Kahan & Kamar, *supra* note 12 (describing franchise tax structures in other states); see also Cyril Moscow, *Michigan or Delaware Incorporation*, 42 WAYNE L. REV. 1897, 1902 n.18 (1996) (quoting proxy statement of Devon Energy Corp. which claimed that the major factor behind decision to reincorporate in Oklahoma was elimination of the annual \$150,000 franchise tax associated with Delaware incorporation).

58. An expert judiciary might, of course, produce better litigation outcomes as well. To the extent that better outcomes are the result of less judicial error, they can be included in the cost of litigation. To the extent they result from superior judge-made law, the better outcomes are another aspect of the structure of Delaware lawmaking analyzed in Part II, *infra*.

59. See, e.g., Kahan & Kamar, *supra* note 12, at 50 (arguing that Delaware law increases the level of litigation for Delaware firms); David A. Skeel, Jr., *Bankruptcy Judges and Bankruptcy Venue: Some Thoughts on Delaware*, 1 DEL. L. REV. 1, 23 (1998) (describing Delaware corporate law as litigation intensive).

60. But see Carney, *supra* note 5, at 727 (arguing that Delaware law makes litigation more costly for businesses than litigation elsewhere, to the benefit of Delaware lawyers).

61. See *supra* note 14.

lower legal costs.⁶² Indeed, the limited scholarship on this issue suggests that interest groups such as Delaware corporate lawyers have market power of their own and are able to extract additional fees from firms that incorporate in the state.⁶³ In addition, the increased legal costs associated with out-of-state incorporation have been cited as a downside to Delaware incorporation.⁶⁴ Moreover, a reduction in attorneys' fees, like the more general reduction in legal costs, would have to be weighed against the greater risk of litigation associated with Delaware incorporation.

Delaware's body of decisional law provides a more general transaction cost explanation for Delaware's success. Commentators argue that, because of the substantial volume of business litigation in the state, Delaware has built up a store of precedent that serves as an independent and valuable resource for firms subject to Delaware law.⁶⁵ Thus Romano explains that Delaware's "well-developed case law with a pool of handy precedent" makes Delaware decisions "more predictable than those of other states."⁶⁶ Mel Eisenberg describes Delaware's rich case law as increasing predictability.⁶⁷

Extensive and predictable case law reduces the cost of business operations in two ways. A well developed body of precedent makes it cheaper and easier to ascertain the legal consequences associated with business decisions, thereby reducing the information cost of structuring transactions. In addition, clear legal rules reduce the risk of subsequent litigation. Notably, these benefits are independent of the substantive merits of the applicable legal rules. Commentators have observed that, with respect to business transactions, it is often more important that the applicable legal rules be settled than that they be settled correctly.⁶⁸ As

62. See, e.g., Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 577 (1998) (questioning extent to which network externalities can be expected to reduce the cost of legal services).

63. See, e.g., Macey & Miller, *supra* note 5, at 472; Kamar & Kahan, *supra* note 12, at 54.

64. See, e.g., Charles W. Murdock, *Why Illinois? A Comparison of Illinois and Delaware Corporate Jurisprudence*, 19 S. ILL. U. L.J. 1, 4-6 (1994) (describing the extra costs for an Illinois business to incorporate in Delaware).

65. See, e.g., Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 894 (1969) (offering as the reason for Delaware's dominance: "the large body of precedent that has been built up since 1899—lawyers know what they are getting into").

66. Romano, *supra* note 5, at 277.

67. See Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1508 (1989).

68. See, e.g., Evan H. Caminker, *Why Must Inferior Courts Obey Superior Court Precedents?*, 46 STAN. L. REV. 817, 872 (1994); Frederick Schauer, *Precedent*, 39 STAN. L. REV. 571, 598 (1987) (citing predictability as more important than optimality in contract and real estate transactions); Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215, 218 (1990) (common approach to the rules of offer and acceptance in contract law is that "it is more important

a consequence, the predictability and stability provided by Delaware's extensive body of precedent are described as one of the affirmative advantages of Delaware incorporation.⁶⁹

Upon closer examination, however, Delaware law is revealed not as predictable, but rather as surprisingly indeterminate. A number of factors contribute to this indeterminacy. Delaware's corporate law rules are standards based, Delaware precedents are narrow and fact-specific, and Delaware courts employ weak principles of stare decisis leading to extensive doctrinal flux. It is difficult to reconcile this reality of Delaware law with the received economic wisdom that stable and predictable legal rules are optimal.⁷⁰ As a result, Ehud Kamar and Marcel Kahan raise questions about the efficiency of Delaware law, suggesting that the indeterminacy of Delaware law may be value-reducing.⁷¹ Moreover, Kamar argues that Delaware effectively employs indeterminacy to impede the ability of other states to compete with Delaware for corporate charters.⁷² Thus indeterminacy increases Delaware's market power. These conclusions create a puzzle for Kamar and Kahan. If Delaware law is suboptimal, is Delaware's market power merely the result of anticompetitive behavior? Is Delaware a successful monopolist that has taken advantage of imperfections in the market for corporate law?

This article suggests another answer. In the following section, the article explores in greater detail the manner in which Delaware produces corporate law. The article demonstrates that Delaware employs an atypical lawmaking process. A substantial portion of Delaware's corporate law is made by the courts, but the Delaware courts make law in a manner traditionally associated with legislative rather than judicial lawmaking. The following section of the article explores the normative implications of this process.

for the law to be settled than to be settled correctly"); see also *Burnet v. Coronado Oil & Gas Co.*, 285 U.S. 393, 406 (1932) (adhering to precedent "is usually the wise policy, because in most matters it is more important that the applicable rule of law be settled than that it be settled right").

69. See, e.g., Kaouris, *supra* note 1, at 1011; Massey, *supra* note 17, at 702-3 (stating that "there is widespread agreement that one important reason [that more large corporations incorporate in Delaware than any other state] is that Delaware offers a more certain and predictable body of law").

70. See, e.g., John C. Coates, IV, "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 147 U. PA. L. REV. 1251, 1256 (1999) ("Ideal rules of corporate law should be consistent.").

71. See Kahan & Kamar, *supra* note 12, at 67 (concluding that "it is likely that Delaware law is more litigation-intensive than is optimal").

72. See Kamar, *supra* note 5. Kamar does not argue that Delaware's use of indeterminacy is purposeful.

II. THE DELAWARE COURTS AS LAWMAKERS

A. *The Traditional Lawmaking Role of the Courts*

In other projects, I have analyzed the lawmaking role of the courts and some of the structural differences between judicial and legislative lawmaking.⁷³ I have developed what might be described as a model of traditional judicial lawmaking. I argue that traditional judicial lawmaking is generally evolutionary in nature.⁷⁴ More specifically, judicial lawmaking is characterized by incremental legal change within the framework of a fixed set of objectives.⁷⁵ Unlike legislatures, courts rarely change legal rules as a result of a shift in political power or a rejection of the policies that motivated the adoption of the original rule, preferring to leave those decisions for the legislative process.

Courts are also limited in the scope of the legal change that they can effect due to limitations on control of their agendas.⁷⁶ Courts, unlike legislatures, generally cannot initiate legal change but must wait for litigants to commence an action.⁷⁷ Courts may also, in some circumstances, be constrained by requirements such as justiciability as to the issues that they can reach.⁷⁸ As a consequence of these limitations, adjudicative legal change is more predictable, coherent and, frequently, smaller in magnitude than legislative change.

These characteristics are enhanced by the doctrine of stare decisis which operates to limit the circumstances under which a court may deviate from a previously adopted legal rule. In another pending project, I explain how stare decisis enhances the stability of judicial lawmaking.⁷⁹ While a legislature requires no justification to overturn a previously adopted statute or reject a policy objective embraced by its predecessor, a court's disagreement with the wisdom of a previously adopted legal rule is rarely sufficient to justify overruling. Instead, a court that wishes to overturn a precedent must generally demonstrate that the prior legal rule suffers from some sort of substantive or

73. See Fisch, *supra* note 23; Jill E. Fisch, *A Theory of Stare Decisis* (working paper, 2000) (on file with author).

74. See Fisch, *supra* note 23, at 1107-8.

75. See *id.*

76. See generally Christopher J. Peters, *Foolish Consistency: On Equality, Integrity, and Justice in Stare Decisis*, 105 YALE L.J. 2031, 2081-83 (1996) (describing differences in relative power of courts and legislatures as lawmakers).

77. See NEIL K. KOMESAR, *IMPERFECT ALTERNATIVES* 125 (1994).

78. See, e.g., RICHARD H. FALLON, ET AL., *HART AND WECHSLER'S THE FEDERAL COURTS AND THE FEDERAL SYSTEM*, 123-293 (4th ed. 1996) (exploring various justiciability doctrines such as standing, ripeness, and so forth, that limit the lawmaking power of the federal courts).

79. See Fisch, *supra* note 73.

procedural defect.⁸⁰ Although a court may seek to escape the consequences of a contrary precedent by distinguishing it, that very act narrows the scope of the court's decision. This distinction between the legislative and judicial processes permits the government to choose greater legal stability by committing particular subject matter to the courts. Thus the doctrine of *stare decisis* fosters stable legal rules and privileges courts over legislators as creators of those rules.⁸¹

Finally, the temporal scope of judicial lawmaking reinforces the traditional judicial role. Judge-made rule changes typically apply retroactively.⁸² This operation can be justified on both fairness and efficiency grounds because of the nature of judicial lawmaking.⁸³ A variety of doctrinal constraints limit the ability of courts to apply new legal rules in a purely prospective manner. In the federal courts, for example, prospective adjudication may run afoul of the Equal Protection Clause or the constitutional ban on advisory opinions.⁸⁴ Forward-looking aspects of judicial opinions may also be characterized as *dicta*, a characterization that allows subsequent courts to disregard such statements as authoritative rulemaking.⁸⁵ These constraints effectively limit the extent to which judicial rulemaking can focus on the regulation of future transactions.

These characteristics of traditional judicial lawmaking increase the stability and predictability of judge-made law relative to legislation. I argue elsewhere that these features may explain the dominance of common law rules in areas such as property and contract law, where stability and predictability are said to reduce transaction costs and facilitate transactions. Indeed, the Supreme Court has identified the primacy of stability and predictability in these areas as a basis for applying principles that restrain judicial lawmaking to this traditional mode, such as requiring courts to adhere closely to precedent.⁸⁶

80. *See id.*

81. *See id.*

82. *See, e.g., Rivers v. Roadway Express, Inc.*, 511 U.S. 298, 311-12 (1994) ("The principle that statutes operate only prospectively, while judicial decisions operate retrospectively, is familiar to every law student.") (quoting *United States v. Sec. Indus. Bank*, 459 U.S. 70, 79 (1982)).

83. *See Fisch, supra* note 23, at 1110.

84. *See, e.g., id.* at 1061 (discussing Supreme Court decisions on adjudicative prospectivity); *James B. Beam Distilling Co. v. Georgia*, 501 U.S. 529 (1991) (rejecting selective adjudicative prospectivity on the grounds that it was impermissible to apply different legal rules to similarly situated litigants).

85. *See, e.g., Michael C. Dorf, Dicta and Article III*, 142 U. PA. L. REV. 1997, 2001 (1994) (distinguishing between holdings and *dicta* and tracing concern over the legitimacy of federal court *dicta* to the case or controversy requirement of Article III).

86. *See, e.g., Payne v. Tennessee*, 501 U.S. 808, 828 (1991) ("Considerations in favor of *stare decisis* are at their acme in cases involving property and contract rights, where reliance interests are involved . . .").

B. Characteristics of Delaware law

Although Delaware's role in the competition for corporate charters is frequently analyzed in terms of Delaware's corporation statute, judge-made law is at least as, if not more, significant. Despite their statutory source, the majority of Delaware's important legal rules are the result of judicial decisions. The scope of the business judgment rule, the analysis of transactions that implicate the duty of loyalty, the legal standards governing management's response to a hostile tender offer, all are based on legal principles articulated by the Delaware courts. Lawyers tend to think of corporate law as statutory, but there is a substantial common law component to Delaware corporate law.

From a transactional perspective, the importance of decisional law increases. Although the Delaware statute provides general guidelines about corporate formalities such as the scheduling of annual meetings⁸⁷ and the required components of a corporate charter,⁸⁸ the statute does not deal with the fiduciary principles that provide the foundation of corporate law and allow, under appropriate circumstances, judicial scrutiny of corporate decisionmaking. As a practical matter, the interpretation and application of these fiduciary principles is the heart of corporate law, yet the Delaware statute provides almost no guidance on the subject. Apart from the provision that relates to interested director transactions,⁸⁹ the Delaware statute does not even address the subject of fiduciary duties.

Moreover, Delaware corporate law relies on judicial lawmaking to a greater extent than other states. Other state statutes, for example, define the standard of care applicable to corporate directors;⁹⁰ the Delaware statute does not.⁹¹ Although Delaware decisions authorize directors to

87. See DEL. CODE ANN. tit. 8, § 211 (1991) (requirements regarding annual shareholder meeting). Indeed, even with respect to these types of issues, literal compliance with the statutory requirements may not save a transaction from judicial scrutiny. See, e.g., *Schnell v. Chris-Craft Indus., Inc.*, 285 A.2d 437, 439 (Del. 1971) (the court rejected advancement of the date of an annual meeting, in compliance with the relevant statute, holding that "inequitable action does not become permissible simply because it is legally possible.").

88. See DEL. CODE ANN. tit. 8, § 102 (1991) (specifying required contents of certificate of incorporation).

89. See DEL. CODE ANN. tit. 8, § 144 (1991).

90. See E. Norman Veasey & Julie M.S. Seitz, *The Business Judgment Rule in the Revised Model Act, the Trans Union Case, and the ALI Project—A Strange Porridge*, 63 TEX. L. REV. 1483, 1493 (1985) (stating that a number of states have codified the duty of care); see, e.g., VA. CODE ANN. § 13.1-690A. (Michie 1985) (defining director's duty of care in terms of "his good faith business judgment of the best interest of the corporation"); REV. MODEL BUS. CORP. ACT § 8.30 (1984) (addressing standards of conduct for Directors); N.Y. BUS. CORP. LAW § 717 (McKinney Supp. 1999) (adopting statutory standard of care).

91. See, e.g., Bishop, *supra* note 44, at 21 (explaining that Nevada has codified the standard of care applicable to directors, but Delaware has not).

consider the interests of nonshareholder constituencies,⁹² Delaware has no "other constituency" statute.⁹³ Other states have codified the business judgment rule;⁹⁴ Delaware has left development of the rule to common law.⁹⁵ Georgia has a statutory provision addressed to the corporate opportunity doctrine;⁹⁶ Delaware relies on precedent.⁹⁷ Even the circumstances under which a demand is excused in a shareholder derivative suit are addressed in Delaware by judge-made chancery court rules rather than by statute.⁹⁸

The lawmaking by Delaware courts is also distinctive. As noted above, Delaware decisional law is relatively indeterminate.⁹⁹ Delaware's judicial lawmaking also has a number of atypical characteristics that cause it to resemble the legislative process. Despite the similarities, Delaware courts do not face the political pressures associated with legislative lawmaking; indeed, for state courts, the Delaware courts enjoy a high degree of political independence.

Recent scholarship has highlighted the indeterminacy of Delaware law.¹⁰⁰ As Ehud Kamar shows, Delaware cases have adopted a largely

92. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).

93. See Lawrence E. Mitchell, *A Theoretical and Practical Framework for Enforcing Corporate Constituency Statutes*, 70 TEX. L. REV. 579 (1992) (describing other constituency statutes and states that have adopted such statutes); John A. MacKerron, *Variety of Choice in the Corporate Law "Menus" of the Great Lakes States*, 71 U. DET. MERCY L. REV. 469, 486-87 (1994) (describing other constituency statutes in laws of Great Lakes states and observing that Delaware has no such provision).

94. See, e.g., REV. MODEL BUS. CORP. ACT § 8.31 (1984) (adopting standards of liability for directors); Julie Gwyn Hudson, *The Exclusivity of the Appraisal Remedy Under the New North Carolina Business Corporation Act: Deciding the Standard of Review for Cash-Out Mergers*, 69 N.C. L. REV. 501, 537 n.248 (1991) (explaining that N.C. GEN. STAT. § 55-8-30 (1990) codifies the business judgment rule).

95. See Veasey & Seitz, *supra* note 90, at 1505 (stating that Delaware does not have a statute on the business judgment rule).

96. See GA. CODE ANN. § 14-2-871(a)(1)(C) (1994) (authorizing an action against corporate officers or directors for the appropriation of any business opportunity of the corporation).

97. See *Guth v. Loft*, 5 A.2d 503 (Del. 1939) (developing Delaware common law corporate opportunity doctrine).

98. See DEL. CH. CT. R. 23.1 (addressing demand requirement); DEL. CODE ANN. tit. 10, § 361 (1999) (authorizing chancellor to adopt rules of chancery court). Compare N.Y. BUS. CORP. LAW § 626(c) (McKinney 1999) (statutorily specifying when demand is required); *Marx v. Akers*, 88 N.Y.2d 189, 198 (N.Y. 1996) (concluding that changing the scope of demand requirement was properly a subject for the legislature not the court).

99. Some commentators go further and characterize substantive areas of Delaware law as incoherent. See, e.g., Coates, *supra* note 70, at 1287 (describing "current Delaware rules on minority discounts [as] incoherent, unpredictable, and inconsistent with the appraisal statute").

100. The discussion here focuses on the indeterminacy of Delaware's liability rules. The nature of corporate law creates highly indeterminate remedial law as well. For example, difficulties in valuation make it difficult to predict the result of a judicial determination to award fair price or fair value. See generally Ruthford B. Campbell, Jr., *Fair Value and Fair Price in Corporate Acquisitions*, 78 N. CAR. L. REV. 101, 105 (1999) (describing absence of underlying principles in valuation determinations and resulting lack of consistency and predictability in case outcomes). This ambiguity is both inherent in business law and not unique to Delaware.

standard-based approach.¹⁰¹ Kamar focuses on cases dealing with fiduciary duties and demonstrates that fact-intensive legal standards dominate the case law. Legal tests that turn on the proportionality of management's response to a perceived threat, that assess the legitimacy of a self-dealing transaction based on whether it meets a test of "entire fairness," and that use reasonableness as a benchmark for evaluating business decisionmaking are standard based. Standards apply general principles that judges must use to evaluate transactions from an ex post perspective. Louis Kaplow explains that standards, in comparison to rules, increase judicial discretion.¹⁰² This discretion, in turn, reduces the ability of decisionmakers to predict the legal consequences of their actions ex ante.

Delaware courts also apply the relevant legal standards in a fact and case specific manner. As a result, one court's determination that a particular course of dealing was reasonable under the relevant legal test provides little guidance to corporate actors about subsequent decisions applying the same legal test. One of the best known illustrations of this problem is the takeover cases. Some commentators¹⁰³ have struggled to formulate a theory of Delaware takeover doctrine that permits them to reconcile cases such as *Paramount Communications, Inc. v. Time, Inc.*¹⁰⁴ and *Paramount Communications, Inc. v. QVC Network, Inc.*¹⁰⁵ Such a reconciliation is extremely difficult, however, and leaves the courts open to the charge that their decisions are random or arbitrary.¹⁰⁶ Although the outcomes in these decisions can be explained instead on the basis of factual differences, this analysis can only be performed on an ex post basis.¹⁰⁷ As a result, the decisions offer little insight to those who seek predictive power from doctrinal analysis.

Kamar's observations about Delaware law admittedly are true, to some extent, about corporate law in other states. Indeed, many states choose to follow Delaware decisional law.¹⁰⁸ Nonetheless, to the extent

101. See Kamar, *supra* note 5.

102. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

103. See, e.g., Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583 (1994) (arguing that Delaware's takeover jurisprudence is based on the scope of authority allocated to directors).

104. 571 A.2d 1140 (Del. 1990).

105. 637 A.2d 34 (Del. 1994).

106. See, e.g., David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 166 (1997) ("From a doctrinal perspective, *Time-Warner* [571 A.2d at 1140] and *QVC* are extremely difficult to reconcile.").

107. See, e.g., Kamar, *supra* note 5, at 1918 (explaining that the "key" to reconciling *Time* and *QVC* is "a close reading of factual nuances").

108. See, e.g., Alva, *supra* note 16, at 903 n.92 (describing frequency with which prominent Delaware decisions have been cited by other courts).

that legal standards diverge, the principles adopted by Delaware courts retain the greatest degree of ambiguity. For example, under Delaware law, a court faced with a motion by a special litigation committee to dismiss a derivative suit may, in addition to considering the degree to which the committee was informed and independent, also evaluate whether, in the court's independent business judgment, dismissal is appropriate.¹⁰⁹ The New York courts have rejected the second component of this test, significantly reducing the degree of judicial discretion.¹¹⁰ Similarly, Delaware's controversial intermediate standard of review in the takeover context is not universally accepted as the appropriate test for evaluating the directors' conduct.¹¹¹

Delaware decisional law is also characterized by a high degree of flexibility and responsiveness. Not only are Delaware courts active lawmakers, they are willing to revise previously announced legal doctrines on the theory that a different approach reflects sounder policy. In part, the flexibility of Delaware case law results from the structure of the Delaware courts. The Delaware chancery courts, which are the trial level courts on corporate issues, are courts of equity.¹¹² Delaware adheres closely to traditional English principles of equity¹¹³ and is one of only three states to retain the equity/law distinction.¹¹⁴ The nature of equity jurisprudence contributes to the flexibility in Delaware corporate law¹¹⁵ and, because chancery courts sit without a jury, they are able to resolve corporate issues rapidly.¹¹⁶ Delaware courts are also known for their ability to respond to business litigation quickly through, for example, granting expedited hearings and providing a rapid turnaround time on decisions.¹¹⁷

The Delaware chancery courts are also specialized courts.¹¹⁸ Approximately three quarters of the cases pending before the chancery

109. See *Zapata Corp. v. Maldonado*, 430 A.2d 779 (Del. 1981).

110. See *Auerbach v. Bennett*, 393 N.E.2d 994 (N.Y. 1979).

111. See, e.g., OHIO REV. CODE ANN. § 1701.59(C) (Banks-Baldwin 1993) (rejection of *Unocal* and codification of existing common law).

112. See *Alva*, *supra* note 16, at 903.

113. See William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery - 1792-1992*, 18 DEL. J. CORP. L. 819, 840 (1993) (explaining that "the Court of Chancery of the State of Delaware, has adhered more closely to the English Court of Chancery and to English precedents, than those of any of her sister States") (footnote omitted).

114. See *Alva*, *supra* note 16, at 903.

115. See, e.g., *Kamar*, *supra* note 5, at 1943 (describing how Delaware courts remain faithful to tradition as courts of equity); *Massey*, *supra* note 17, at 703 (describing how equity jurisdiction contributes to flexibility and responsiveness of Delaware decisional law).

116. See DEL. CONST. art. IV, § 10 (providing that the Chancery court sits without a jury); *Massey*, *supra* note 17, at 704 (explaining that absence of a jury enables the court to act more quickly).

117. See *Massey*, *supra* note 17, at 704.

118. See *id.* at 705.

court are corporate.¹¹⁹ Delaware chancery judges are known for their expertise in business matters, and the court has developed a reputation for its sophistication in corporate law.¹²⁰ As a result, chancery court opinions are widely quoted, and the legal standards announced by the chancery courts are widely taken to reflect the current state of Delaware law.¹²¹

The fact that a specialized trial court is, in Delaware, the primary judicial lawmaker, increases the degree of flexibility in Delaware corporate law. The decision of one chancery court does not bind another, and chancery court decisions are readily overturned by the Delaware Supreme Court even when they appear to have developed workable or predictable legal standards. Thus, as a practical matter, Delaware case law is based on a large number of decisions that have little stare decisis effect.

Although decisions by the Delaware Supreme Court are, of course, binding on the chancery court, the supreme court also appears ready to distinguish or overrule a precedent without regard to considerations of stare decisis. The absence of attention to stare decisis is partially a consequence of the fact-intensive nature of the court's decisions; the court can easily deny that it is overruling a precedent by using case specific facts to distinguish its prior holding.¹²² Similarly the court can narrow the precedential effect of its decisions by framing its holdings narrowly and tying those holdings to specific facts. Yet even when the court overrules itself, it does so seemingly unconstrained by the considerations of stare decisis that commonly limit overruling. For example, when the court explicitly overturned several of its own precedents in *Weinberger v. UOP, Inc.*,¹²³ the opinion made no reference to the doctrine of stare decisis. Instead, the court operates on the basis that it, like a legislature, can rewrite its prior doctrine based solely on a reassessment of the relevant policy considerations.

The unanimity norm of the Delaware Supreme Court further distinguishes the Delaware judiciary from that of other state courts. David Skeel explains that the norm also contributes to the instability of Delaware legal doctrine. As Skeel has observed, the Delaware Supreme

119. See Alva, *supra* note 16, at 903.

120. Delaware courts also enjoy a greater degree of political independence than that of many state courts. See *infra* notes 211-214 and accompanying text.

121. See, e.g., William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 Bus. Law. 351 (1992).

122. See, e.g., Larry Alexander, *Constrained by Precedent*, 63 S. CAL. L. REV. 1, 19-22 (1989) (describing the argument that a court which distinguishes a precedent by narrowing the previously announced rule to the facts of the prior case is, in effect, unconstrained by the precedent).

123. 457 A.2d 701 (Del. 1983).

Court has an unusual tendency to issue unanimous decisions.¹²⁴ Skeel explains that the unanimity norm destabilizes Delaware law by masking the degree to which varying judicial preferences may lead to cycling from one doctrinal approach to another. Skeel demonstrates how the varying preferences of individual justices as to the appropriate legal approach in takeover cases may explain the doctrinal shift from *Time-Warner* to *QVC*.¹²⁵ In addition to departing from the decisionmaking process used by other states, the Delaware Supreme Court's decisionmaking process, in which a single result masks conflicting or cycling lawmaking principles that are likely to animate future results, more closely resembles legislative decisionmaking.

Delaware judges also control their lawmaking agenda to an unusual degree.¹²⁶ Chris Peters explains that, as a general principle, judges cannot generally choose the legal issues that they wish to decide, but rather must wait for the appropriate case to present itself.¹²⁷ Legal rules announced by a court that are unnecessary to the result in a given case are disparagingly characterized as dicta.¹²⁸ Similarly, courts are constrained as to the temporal scope of their lawmaking. Recent Supreme Court precedent finds constitutional support for the principle that judicial lawmaking should be retroactive, and that it is improper for a court to announce a legal rule in a case and then fail to apply that legal rule to the parties before it.¹²⁹

Delaware courts seem unconstrained by these principles. They have repeatedly announced legal principles solely to guide future business decisionmaking.¹³⁰ Ron Gilson explains Chancellor Allen's practice of providing doctrinal guidance for future transactions through dicta.¹³¹ Despite upholding the structure of a transaction or the decision of the board, Allen went out of his way on a number of occasions to point out

124. See Skeel, *supra* note 106. Skeel points to a number of factors that contribute to the unanimity norm, including an unusual Supreme Court rule that provides for an automatic en banc hearing in any case in which a justice dissents from a panel decision.

125. See *id.* at 166.

126. Indeed, Delaware recently amended its Constitution to permit the Delaware Supreme Court to answer questions certified to it by other State Supreme Courts. See DEL. CONST. art. IV, § 11(8) (granting Supreme Court jurisdiction to determine questions of law certified to it by the highest appellate court of any other state). Most states only accept certified questions from federal courts. See Geri J. Yonover, *A Kinder, Gentler Erie: Reining In the Use of Certification*, 47 Ark. L. Rev. 305, 314 (1994) (describing state certification rules as of 1988).

127. See Peters, *supra* note 76, at 2048.

128. See generally Dorf, *supra* note 85 (describing legal significance of characterizing reasoning as dicta).

129. See Fisch, *supra* note 23, at 1060-63 (analyzing decisions requiring retroactive adjudication).

130. Doug Branson terms these announcements "roadmaps." See Branson, *supra* note 20, at 104-05.

131. See Ronald J. Gilson, *The Fine Art of Judging: William T. Allen*, 22 DEL. J. CORP. L. 914, 917-18 (1997).

weaknesses or deficiencies that should be remedied.¹³² A notable example is the *Caremark* decision¹³³ in which Chancellor Allen provided a comprehensive description of the duties of corporate directors¹³⁴ in the context of approving a settlement and despite concluding, at the outset of the opinion, that "there is a very low probability . . . that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise."¹³⁵ The fact that the description was dicta did not seem to affect its importance as an addition to Delaware law. The principles announced in *Caremark* have been among the most frequently cited by subsequent courts and commentators.¹³⁶

Delaware courts have also reached out to apply newly announced doctrines to cases seemingly outside the courts' reach. For example, concerned that stockholders would not anticipate its new rules governing appraisal rights and take the necessary steps to preserve their rights, the court in *Weinberger* announced that it would permit stockholders in a variety of ongoing transactions and lawsuits to retroactively claim the benefits of the new rule.¹³⁷ This decision was in clear contravention of the statutory limitations on the assertion of appraisal rights. The supreme court's action in *Weinberger* was a departure from the lawmaking norm that judges lack the freedom to adjust the timing with which their newly announced legal rules take effect in order to reflect policy considerations.¹³⁸

In conclusion, Delaware courts are not structured like typical state courts and do not restrict themselves to traditional judicial lawmaking. Instead, Delaware courts aggressively adopt and modify corporate law doctrine, exhibiting a degree of activism that more closely resembles the legislative process. This resemblance is enhanced by the nature of

132. Gilson cites this practice with approval.

Such self-conscious attention to influencing the conduct of future transactions, independent of the case before the court, gives special meaning to the phrase "mere dicta." In the fast moving environment into which events thrust the Court of Chancery, traditional common law accretion of precedent was too slow to help. The Chancellor's instrumental use of dicta, directed explicitly at transaction planners, was a creative and elegant response to the problem of keeping the law moving at a pace at least close to that of the market.

Id. at 917-18.

133. See *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

134. See *id.* at 966-70.

135. *Id.* at 961.

136. See, e.g., Melvin A. Eisenberg, *Corporate Governance: The Board of Directors and Internal Control*, 19 CARDOZO L. REV. 237, 261 (1997) (describing Chancellor Allen's statements in *Caremark* as the "most comprehensive and authoritative statement on the current status of [the board's monitoring obligation]").

137. See *Weinberger v. UPO, Inc.*, 457 A.2d 701, 714-15 (applying its remedy to pending and proposed mergers in which prospective plaintiffs might have already lost the right to pursue an appraisal).

138. See Fisch, *supra* note 23, at 1119 (discussing *Weinberger* approach as a way of providing courts with greater temporal flexibility).

Delaware decisional law, which, although largely indeterminate and standard based, appears to be driven by policy considerations, including an effort to respond on an ongoing basis to developments in the business world. In short, Delaware judicial lawmaking may seem more closely tied to legislation. Nonetheless, as the next section will explain, the Delaware courts should not be seen as part of the political process. Indeed, Delaware judges enjoy a number of comparative advantages over state legislators as corporate lawmakers.

III. THE NORMATIVE IMPLICATIONS OF DELAWARE'S LAWMAKING PROCESS

Thus far, this article has characterized Delaware judicial lawmaking as unusual. Does this unusual lawmaking matter? In particular, of what relevance is Delaware's lawmaking process to the debate over regulatory competition? In this section, this article evaluates the normative consequences of Delaware's lawmaking. The article considers whether Delaware's approach to corporate lawmaking is likely to increase firm value, thereby offering an efficiency-based explanation for Delaware's ability to attract corporations. Alternatively, Delaware's lawmaking structure may, as suggested by Kamar, simply be a mechanism by which Delaware can maintain its position and increase its market power.

This article concludes that Delaware's unusual lawmaking structure enhances firm value and perhaps explains the widespread preference for Delaware incorporation. Delaware's lawmaking process is valuable in three ways. First, Delaware's indeterminate corporate law may have benefits as well as costs. Indeterminacy induces negotiation and removes some incentives for strategic behavior. Indeterminate law also gives the courts greater flexibility. Second, Delaware's lawmaking is uniquely structured to maximize responsiveness to changing business developments. Finally by vesting a high degree of legislative lawmaking power in a decisionmaker that is largely insulated from political pressure, Delaware reduces the potential for rent-seeking in connection with the lawmaking process.

A. The Value of Indeterminacy

Traditional analysis favors clear legal rules both because clear rules reduce information and litigation costs and because clear rules are viewed as more likely to induce primary behavior in compliance with

those rules.¹³⁹ A legal system that relies on standards and muddy rules¹⁴⁰ increases uncertainty which, in turn, increases transaction costs. Accordingly, traditional analysis suggests that business is more efficiently conducted under a clear rule based system.

Obviously this argument is overstated. A standard based approach can provide more realistic treatment of particularized facts. In cases in which factual distinctions are important, a rule based approach is likely to be unworkable.¹⁴¹ A broadly written rule will prove overinclusive and discourage valuable transactions; a narrowly written rule will be underinclusive and easy to avoid through careful planning. For example, if one takes the view that management resistance to a hostile tender offer is sometimes desirable, it would be legislatively difficult to specify the circumstances under which such resistance is permissible. A muddy "reasonableness" standard reduces the difficulty of specification while preventing opportunism.

Standards thus increase lawmaking efficiency in two ways. Standards permit the lawmaker to tailor the result in a case and to thereby avoid the hardship or unfairness associated with application of a crystalline rule without destroying the applicable doctrinal structure.¹⁴² Standards also create an affirmative role for the courts as gapfillers.¹⁴³ In the business context, the absence of a explicit prohibition may imply that a transaction is unrestricted although, as a practical matter, it may be impossible to predict and specify the full range of limitations on business decisionmaking. Private business contracts are similarly likely to contain gaps due to changing or unanticipated circumstances or the practical impossibility of complete specification. Standards allow the courts to fill

139. See, e.g., Kamar, *supra* note 5, at 1919 (describing importance of legal determinacy to business decisionmaking); see generally Jason Scott Johnston, *Uncertainty, Chaos, and the Torts Process: An Economic Analysis of Legal Form*, 76 CORNELL L. REV. 341 (1991) (discussing indeterminacy and the relative impact of rules versus standards on primary behavior).

140. The characterization of indeterminate legal rules as "muddy" originated with Carol Rose. See Carol M. Rose, *Crystals and Mud in Property Law*, 40 STAN. L. REV. 577 (1988). Rose describes muddy rules as "fuzzy, ambiguous rules of decision." *Id.* at 578. Muddy rules and standards are closely related concepts, although, as Dan Burk explains, commentators generally choose their terminology based on the focus of their analysis. See Dan L. Burk, *Muddy Rules for Cyberspace*, 21 CARDOZO L. REV. 121, 129 (1999). Rules are described as muddy by commentators who are focusing on the indeterminacy of the rules. Commentators emphasize a standards based approach when they are focusing on the flexibility that standards provide to decisionmakers. See *id.* For purposes of this article, the choice of terminology is unimportant, Delaware decisional law can accurately be described as both standard based and muddy.

141. Indeed, even perfect rules are both under and overinclusive. See Johnston, *supra* note 139, at 363.

142. See Rose, *supra* note 140, at 603-04.

143. See Ian Ayres, *Making a Difference: The Contractual Contributions of Easterbrook and Fischel*, 59 U. CHI. L. REV. 1391, 1404 (1992) (explaining how ex post gapfilling by courts can be more efficient than ex ante specification of rules).

these gaps through ex post determinations. As Ian Ayres has observed, courts and the common law process are particularly well suited to this role.¹⁴⁴

Muddy rules may have particular utility in the business context because of their effect on the bargaining process. Ian Ayres and Eric Talley characterize muddy rules as an example of divided entitlements, in which each party has a probabilistic claim.¹⁴⁵ They then use game theory to demonstrate that muddy rules may facilitate bargaining. First, in the absence of the ability to predict a winner if the dispute results in litigation, the parties may be more willing to negotiate. Second, muddy rules can reduce the incentives to engage in strategic behavior by forcing parties to reveal information during negotiations.¹⁴⁶

Rules that encourage negotiation instead of litigation are especially valuable in corporate transactions, in which litigation costs can be large and create a deadweight loss for shareholders and society. Although Delaware law is often described as encouraging litigation,¹⁴⁷ a careful examination reveals that many Delaware cases settle early in the litigation process and that Delaware law both encourages and facilitates settlement.¹⁴⁸ Indeed, it is possible to explain some of the muddiness of Delaware case law as resulting from the procedural posture of the relevant judicial proceedings. Cases in which a court is considering a request for preliminary relief are apt to appear more indeterminate than cases in which the litigants have developed a complete factual and legal record.¹⁴⁹ Similarly, Delaware's pro-settlement orientation may cause courts to announce legal rules in the context of approving a settlement. The *Caremark*¹⁵⁰ decision is an example of this practice. Another example is *Kahn v. Sullivan*,¹⁵¹ in which the Delaware Supreme Court announced the legal principles that determine when corporate

144. See *id.* at 1394 ("Common law courts are the only institution that could possibly fill gaps better than the firms themselves.").

145. See Ian Ayres & Eric Talley, *Solomonic Bargaining: Dividing a Legal Entitlement to Facilitate Coasean Trade*, 104 YALE L.J. 1027 (1995).

146. See also Jason Scott Johnston, *Bargaining Under Rules Versus Standards*, 11 J.L. ECON. & ORG. 256 (1995) (demonstrating that contingent ex post entitlements may induce efficient bargaining better than clear ex ante entitlements).

147. See *supra* notes 50-51 and accompanying text.

148. See, e.g., Carolyn Berger & Darla Pomeroy, *Settlement Fever*, BUS. LAW TODAY, Sept.-Oct. 1992, at 7 (describing 2½ year study of settlement practices in Delaware Chancery court and finding that court approved 96 of 98 proffered settlements and awarded an average of 92% of the attorneys fees requested).

149. See Gilson, *supra* note 131, at 915 (describing how fast-paced takeover market caused much takeover litigation to be resolved after a chancery court decision on a motion for a preliminary injunction and prior to appellate review or trial on the merits).

150. See *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

151. 594 A.2d 48 (Del. 1991).

philanthropy amounts to waste.¹⁵² Although in reviewing a settlement, the court must consider the strength of the plaintiff's claims, the *Kahn* court warned that its role was extremely limited.¹⁵³ This limited role may result in rules that differ from those that would be announced in a different procedural context.

Muddy rules also enable courts to engage in ex post tailoring of the legal structure to the particular factual context presented. The nature of the litigation process provides courts with information that gives them a comparative advantage over legislatures with respect to this type of tailoring. Although legislatures may be better suited than courts at gathering information ex ante, they are less likely to see the ex post consequences of their chosen rules. Corporate law, in particular, because of the essentially unlimited range of structural possibilities, may make ex ante specification difficult. Corporate lawmakers may be unable to determine the appropriate legal standards until they see a range of factual scenarios.¹⁵⁴ Muddy rules provide courts with the flexibility to respond to these scenarios.

The foregoing analysis does not mean that indeterminate corporate law is an unqualified good, merely that indeterminacy has benefits as well as the costs that have been identified by Kamar and others.¹⁵⁵ Whether these benefits exceed the costs of indeterminacy to Delaware firms is an empirical question.

The costs of indeterminacy may, however, be overstated.¹⁵⁶ Although indeterminacy increases the risk of liability, the penalties for corporate decisionmakers who guess wrong are particularly limited. To the extent that legal rules are indeterminate, corporate officers and directors are able to engage in a broader range of conduct without acting in bad faith. So long as they act in good faith, corporate decisionmakers are unlikely to face personal liability for their decisions. Indeed, good faith is typically the key to insuring their protection under statutory and charter limitations on personal liability¹⁵⁷ and corporate indemnification

152. See Jill E. Fisch, Teaching Corporate Governance Through Shareholder Litigation, 34 Ga. L. Rev. 743 (2000) (discussing *Kahn*'s holding and its significance).

153. See 594 A.2d at 59.

154. See Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLAL. REV. 1009, 1102 (1997) (explaining that "the Delaware legislature and courts cannot promulgate ex ante the standards to govern new situations until they see a variety of cases and figure out how well or badly people behaved").

155. See, e.g., Kamar, *supra* note 5.

156. Ehud Kamar, for example, argues that indeterminacy subjects corporate decisionmakers to the risk of costly sanctions such as liability for money damages. See Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887, 892-96 (1999).

157. See, e.g., Carl S. Bjerré, Note, *Evaluating the New Director Exculpation Statutes*, 73 CORNELL L. REV. 786 (1988) (describing protection of corporate decisionmakers under exculpation statutes).

provisions.¹⁵⁸ As a result, decisionmakers may not face a substantial risk of personal monetary liability under indeterminate legal rules.¹⁵⁹ To the extent that a court's *ex post* application of a muddy rule results in injunctive relief, the injunction may simply have the effect of instructing the corporation as to the legal limits on its conduct. Thus, for example, if directors adopt a poison pill of questionable validity, the court's decision to strike it down is more informational than punitive, and the directors are unlikely to be worse off as a result of the decision than if they had decided not to adopt the pill in the first place.

B. The Value of Responsiveness

At the recent Business Associations session of the Annual Meeting of The Association of American Law Schools, Ron Gilson observed that corporate law matters when the real world changes.¹⁶⁰ The evolution of Delaware case law reflects the truth of this observation. Delaware's law of fiduciary duties in the takeover context was the product of the frenzied takeover market of the late 1970s and early 1980s, including the extensive use of junk bond financing, public concern about the effect of corporate mergers on labor and community members, and the development by corporate management of a range of antitakeover devices. As the independent board of directors grew in importance, and shareholders began to rely on the independent board to monitor management decisionmaking, the Delaware courts responded by developing the scope of the duty of care and the circumstances under which the business judgment rule would protect board decisions. Recent controversies between large shareholders and management over the potential conflict between shareholder voting power and management authority over corporate decisionmaking present questions such as the legality of the dead hand poison pill and the permissibility of shareholder rights bylaw amendments.¹⁶¹

Delaware's lawmaking process is ideally suited to respond to developments in the business world. First, Delaware is able to respond quickly. Although courts can, by nature, respond more rapidly than legislatures to a new development—the filing of a lawsuit is all that is

158. See, e.g., DEL. CODE ANN. tit. 8, § 145 (1999) (permitting indemnification so long as officer or director acted in good faith); cf. *Waltuch v. Conticommodity Servs., Inc.*, 88 F.3d 87 (2d Cir. 1996) (interpreting Delaware indemnification statute to require good faith).

159. Cf. Kamar, *supra* note 156, at 895-96 (arguing that risk of liability constrains behavior of corporate fiduciaries).

160. See Comments at the AALS Section on Business Associations, Washington, D.C. (Jan. 6, 2000).

161. See Lawrence A. Hamermesh, *Corporate Democracy and Stockholder-Adopted By-Laws: Taking Back the Street?*, 73 TUL. L. REV. 409 (1998) (evaluating shareholder rights bylaws under Delaware law).

required to trigger the lawmaking process—the traditional common law process is slow.¹⁶² The unique features of Delaware judicial lawmaking, including the activism of the courts and the limited role of stare decisis, allow Delaware to overcome this problem. Rather than considering themselves constrained by an evolutionary lawmaking process,¹⁶³ Delaware courts respond with the type of broad and aggressive lawmaking more commonly seen in legislatures and administrative agencies.¹⁶⁴ Procedural features of the Delaware courts enhance their responsiveness, including the courts' historic receptiveness to requests for expedited proceedings¹⁶⁵ and their willingness to issue rulings quickly in the context of a fast-paced business transaction.¹⁶⁶ The specialized caseload and the overall small size of Delaware's dockets further add to the judiciary's ability to respond quickly.¹⁶⁷

Second, Delaware is able to respond in a preliminary fashion to initial developments, which enables it both to signal the potential legal response to the business community and to await the development of further information in response to that signal. The procedural context of many chancery court decisions, in which the court is ruling on a request for expedited relief, allows the court to provide tentative guidance about a fast-paced business development while awaiting a full factual record before committing itself. Similarly, the courts can use their standards based fiduciary principles to defer the development of bright line rules.

Delaware's analysis of dead hand poison pills illustrates this process. The first legal guidance on the subject was issued by the chancery court in *Carmody v. Toll Brothers, Inc.*¹⁶⁸ The court narrowly held, in the context of a motion to dismiss, that dead hand pills were subject to challenge

162. See, e.g., Isaac Ehrlich & Richard Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257, 279 (1974) (describing common law process as too slow to keep up with the need for legal change resulting from growth in economic activity).

163. See Fisch, *supra* note 23, at 1118 (explaining that "adjudicative lawmaking is typically evolutionary").

164. See Erlich & Posner, *supra* note 162 at 279-80 (describing legislatures and administrative agencies as able to change the law more quickly, in part because they are not bound by principles of stare decisis).

165. See Kurt M. Heyman, *Expedited Proceedings in the Delaware Court of Chancery: Things of the Past?*, 23 DEL. J. CORP. L. 145 (1998) (explaining how the Delaware courts have developed a reputation for being willing and able to hear litigants on an expedited basis and to render decisions quickly). But see *id.* at 156 (suggesting that this receptiveness may be decreasing).

166. See, e.g., Black, *supra* note 13, at 590 (describing "quick judicial decisions" in Delaware).

167. Neil Komisar observes that lawmaking institutions are able to operate more effectively when they are not burdened by excessive demands for their services. See NEIL K. KOMESAR, *LAW'S LIMITS* (forthcoming 2000). The subject matter limitations on the Chancery court's jurisdiction as well as Delaware's small size keep the size of the Chancery court dockets small relative to those of trial court judges in states such as New York or California.

168. 723 A.2d 1180 (Del. Ch. 1998).

both under the Delaware statute and under fiduciary principles. Additionally, the court explicitly observed that it had no occasion to consider whether a pill of limited duration would present similar problems to the pill in the case at bar.¹⁶⁹ A subsequent Chancery Court decision, *Mentor Graphics Corp. v. Quickturn Design Systems, Inc.*,¹⁷⁰ struck down a variation, a "no-hands" poison pill of limited duration, on narrow fiduciary duty grounds.¹⁷¹ Finally, on the appeal of the *Mentor Graphics* decision,¹⁷² the Delaware Supreme Court, working with the benefit of a full trial and an opportunity for appellate review, addressed the broader legal principle underlying both these decisions. The supreme court concluded that the pill's restrictions on subsequently-elected directors' ability to redeem the pill and sell the company conflicted with the board's statutory power under Delaware section 141(a).¹⁷³

With respect to many legal issues, the Delaware Supreme Court never provides such definitive resolution. Although appellate courts are generally viewed as playing a greater lawmaking role than trial courts, the exigencies of the business world, in many cases, force the chancery court to be the primary lawmaker. Thus, as Ron Gilson has explained, during the 1980s, the rapid transactional demands in the takeover market resulted in the resolution of many cases before they could be reviewed by the supreme court.¹⁷⁴ This caused the Chancery Court to be "the court of first and last resort for many takeover contests."¹⁷⁵

Third, Delaware courts anticipate the effect of business developments and try to develop responsive legal principles. Procedurally, as noted above, the Delaware courts structure the temporal reach of their decisions in a manner that extends beyond the case at bar. The courts seem to be deliberately designing rules for future business transactions. Indeed, as Doug Branson has observed, the Delaware courts self-consciously instruct the business community as to future legal standards through lecturing tools such as roadmaps and dicta.¹⁷⁶

169. See *id.* at 1195 n.52.

170. 728 A.2d 25 (Del. Ch. 1998).

171. See *id.* at 38 n.53 (explaining that, because the pill was invalidated on fiduciary duty grounds, it was unnecessary for the court to address alternative arguments that it was invalid).

172. See *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998).

173. See *id.* at 1290-91 (concluding that delayed redemption provision violates "fundamental Delaware law").

174. See Gilson, *supra* note 131, at 915.

175. *Id.* at 916.

176. See Branson, *supra* note 20, at 104-105 (describing "roadmap case"); Charles M. Elson, *The Duty of Care, Compensation and Stock Ownership*, 63 U. CIN. L. REV. 649, 677 (1995) (explaining that Delaware Supreme Court's decision in *Smith v. Van Gorkam*, 488 A.2d 858 (Del. 1985), "served to create a number of new and important guideposts to 'informed' [Board] decisionmaking").

It is possible to understand the Delaware Supreme Court's decision in *Smith v. Van Gorkam*¹⁷⁷ in this way. *Van Gorkam* generated a tremendous amount of controversy, even criticism, about the court's decision to subject the independent directors to personal liability for violating the duty of care.¹⁷⁸ Yet the court's decision can be seen as an early signal of concern about the degree of oversight exercised by independent directors.¹⁷⁹ Moreover this signal anticipated, by several years, recognition by the investment community of the risks posed by independent directors who do not devote sufficient attention to corporate decisions.¹⁸⁰

Finally, Delaware can fine-tune and even replace its preliminary attempts at regulation if further developments demonstrate that the initial rules are problematic. Both the standards based approach, which permits easy adjustment to new situations, and the other elements of Delaware's flexible use of precedent, allow it easily to adjust legal doctrine. As noted above, this flexibility is a function of the atypical nature of Delaware corporate decisional law and causes the chancery courts, in particular, to act something like administrative agencies.¹⁸¹ The courts' developed corporate law expertise allows them to assess the impact of their decisions. The facility with which Delaware courts can change doctrine allows them to respond to their assessment that a prior approach was unworkable or reflected a poor policy judgment.

C. Political Advantages of Judicial Lawmaking

As the preceding sections have demonstrated, Delaware relies heavily on its courts to develop principles of corporate law, and Delaware courts make law in an unusual way. Why is this structure advantageous to

177. 488 A.2d 858 (Del. 1985).

178. See Elson, *supra* note 176, at 676 n.52 (describing criticisms of court's decision).

179. This signal was not silenced by the Delaware legislature's adoption of DEL. CODE ANN. tit. 8, § 102(b)(7). Although corporations are now statutorily authorized to eliminate some types of director liability, the default rule still imposes liability, and not every corporation opts out of the default rule. See Ayres, *supra* note 143, at 1412. Moreover, the statute does not permit liability to be eliminated for breaches of the duty of loyalty, acts in bad faith, or acts for which the director derives an improper personal benefit. See R. Franklin Balotti & Mark J. Gentile, *Elimination or Limitation of Director Liability for Delaware Corporations*, 12 DEL. J. CORP. L. 5, 11 (1987) (providing technical analysis of § 102(b)(7)).

180. See, e.g., Judith H. Dobrzynski, *When Directors Play Musical Chairs*, N.Y. TIMES, Nov. 17, 1996, § 3, 1 (describing "trophy directors," well-connected, high-profile individuals who sit on multiple boards but provide questionable value); Jill E. Fisch, *Taking Boards Seriously*, 19 CARDOZO L. REV. 265, 270 (1997) (describing efforts by commentators and institutional investors to increase director participation through limiting board positions and compensation incentives).

181. The analogy to administrative agencies is based both on the specialization of the chancery courts, see *supra* notes 118-121 and accompanying text, and on their structure, see *infra* notes 211-214 and accompanying text.

Delaware corporations? This article has argued that Delaware is able to use its courts to fine-tune its legal rules in response to business developments in a manner that is more difficult through the legislative process. It has also argued that the Delaware courts are highly responsive.

Other commentators have, however, emphasized the responsiveness of the Delaware legislature as one of the particular advantages of Delaware incorporation.¹⁸² Moreover, if Delaware's judicial lawmaking resembles legislation, why not rely on the legislative process? This section argues that Delaware's lawmaking structure offers advantages over the legislative process by providing superior access, reducing political influence, and increasing transparency. These attributes give Delaware's lawmaking structure comparative advantages with respect to the development of corporate law principles.

Neil Komesar has done some of the most extensive analysis of institutional competence and comparative institutional advantage.¹⁸³ Komesar suggests that legislative and judicial lawmaking may each have strengths and weaknesses, but that careful analysis should consider the relative competence of each institution. In particular, legislatures may suffer from undue political influence, distortions due to rent-seeking, and the ability of well-organized interest groups to control the flow of information and, to some extent, the legislative agenda.¹⁸⁴ Courts in general, and the Delaware courts in particular, may be less susceptible to these weaknesses. Moreover, the particular dynamics of corporate litigation give courts specific advantages as lawmakers.

One obvious advantage of judicial lawmaking in the business area is that it is litigant driven. In essence, the business community has control over the lawmaking agenda to a degree that cannot be obtained through efforts at legislative influence. Legislators can simply refuse to respond to a lawmaking request, deciding that the transaction is too difficult to understand, that it is improper to cater to business interests by making more corporate law rules, or that the interests of other constituencies have a more urgent claim on the lawmaking resources. Although the Delaware legislature has traditionally been very responsive to corporate requests for rulemaking, many other state legislatures have been less responsive, resulting in out-of-date and unworkable corporate statutes.¹⁸⁵

182. See, e.g., Kaouris, *supra* note 1, at 973 (describing responsiveness of Delaware legislature to corporate needs); Romano, *supra* note 5, at 233-42 (conducting empirical analysis of responsiveness of Delaware legislature).

183. See Komesar, *supra* note 77.

184. See *id.* at 53-97.

185. See, e.g., Simeon Gold & Donna Killmon, *Amendments to New York's Business Corporation Law*, N.Y.

In contrast, business litigants can essentially force the court to evaluate the legality of a new type of transaction by bringing the issue to court.

Komesar argues that the costs of participation represent an important consideration in comparing alternative lawmaking institutions.¹⁸⁶ He warns that courts are at a comparative disadvantage relative to the political process because of the variety of barriers to participation in the legal system, particularly in cases in which stakes are small and widely dispersed.¹⁸⁷ Komesar suggests that it is generally easier and less expensive for consumers and voters to register their preferences through the political process.¹⁸⁸

Particular attributes of corporate law suggest, however, that litigation may offer advantages over the political process in terms of participant access to lawmaking. Many participants in corporate litigation are large corporations, the type of sophisticated, large stakes, participants for which the access barriers associated with adjudication are unlikely to pose a substantial burden.¹⁸⁹

Shareholders are the other major participants in corporate litigation. Komesar's analysis would seem more applicable to shareholders, but corporate litigation relies on a variety of substantive and procedural rules that affirmatively empower shareholders, increasing their access to the lawmaking process in a way that is not replicated in the political process. Mechanisms such as the shareholder derivative suit and the class action enable dissatisfied shareholders to challenge corporate decisionmaking.¹⁹⁰ Most importantly, the rules for shareholder litigation free individual shareholders from responsibility for funding the costs of litigation. A range of fee shifting structures enable courts to award attorneys' fees to successful plaintiffs, allocate responsibility for fees to the corporation, or assess fees against the trial judgment or settlement proceeds.¹⁹¹ By allowing entrepreneurial plaintiff's lawyers to fund

L.J., Aug. 14, 1997, at 1 (describing the New York corporate statute prior to newly adopted amendments as "arcane" and "a deficient and inflexible tool").

186. See Komesar, *supra* note 77, at 127.

187. See *id.* at 125-28.

188. See *id.*

189. See *id.* at 126-28 (describing costs of participation in the adjudicative process).

190. In corporate law, these mechanisms effectively address Komesar's concern about the effect of skewed distribution of stakes on use of the adjudicative process. See *id.* at 130-33. This is due, in part, to the large attorneys' fee awards that are available in corporate litigation.

191. See, e.g., John C. Coffee, Jr., *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 COLUM. L. REV. 669, 670 n.2 (1986) (describing legal rules that lead to these results).

shareholder litigation,¹⁹² these rules permit shareholders with limited funds to challenge corporations with substantial assets.

Moreover, the political process is poorly suited for participation by investors and competing business interests such as potential acquirers. 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,¹⁹³ 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.¹⁹⁴ Given individual investors' relatively small stakes as well as the dispersion of corporate domiciles, investors are even less likely to attempt to buy political influence by making political contributions to out of state legislators. Out of state businesses may have larger stakes, but are similarly likely to lack political influence in a state in which they are not a resident. Moreover, even if political activism were viable, a potential acquirer is unlikely to be able to anticipate where a future target will be incorporated.¹⁹⁵ Accordingly, although the litigation playing field between corporate defendants and shareholder challengers may not be level, given that shareholder participation in the political process is likely to be nonexistent, shareholders clearly achieve greater voice through litigation.

In addition, various aspects of Delaware law facilitate shareholder access to the litigation process. Delaware imposes less onerous procedural burdens than many other states on shareholders seeking to initiate derivative suits. For example, Delaware does not require

192. See, e.g., John C. Coffee, Jr., *The Regulation of Entrepreneurial Litigation: Balancing Fairness and Efficiency in the Large Class Action*, 54 U. CHI. L. REV. 877 (1987) (describing economic structure of entrepreneurial shareholder litigation); Jill E. Fisch, *Class Action Reform, Qui Tam and the Role of the Plaintiff*, 60 L. & CONTEMP. PROBS. 167, 170-74 (1997) (explaining how shareholder litigation has evolved away from traditional litigation model).

193. See, e.g., Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 (1988) (describing influence of local corporations in persuading state legislatures to adopt antitakeover statutes).

194. Voting is the traditional manner by which large dispersed groups exercise political power. See Kosmeser, *supra* note 77, at 74. Nonresident shareholders cannot vote in the state of incorporation. Indeed few investors can vote in Delaware.

195. See, e.g., Bebchuk & Ferrell, *supra* note 28, at 1176 (explaining that potential bidder is less likely than potential target to care about influencing Delaware law, because the law will only affect the bidder if it decides to bid for a Delaware target).

plaintiffs to post security for expenses,¹⁹⁶ and makes it easy for plaintiff shareholders to serve nonresident directors.¹⁹⁷ Delaware law makes it more difficult for a corporate board to dismiss shareholder-initiated litigation.¹⁹⁸ Delaware courts have been generous in granting plaintiff requests for attorneys' fees in connection with shareholder suits.¹⁹⁹ Some commentators even argue that Delaware decisional law reflects a pro-shareholder bias.²⁰⁰

A second advantage of judicial lawmaking is its independence from political influence. Large public corporations have substantial funds available to influence political decisionmaking, and they do not hesitate to use these funds.²⁰¹ Many commentators have expressed concern that corporations can exert a distorting influence on the political marketplace by drowning out competing arguments through extensive political spending.²⁰² Indeed, the United States Supreme Court has upheld the regulation of corporate political expenditures based, in part, on the particular threat of political domination.²⁰³ Despite existing regulation, corporations have a variety of avenues of political influence available. Corporations can and do influence political campaigns through political action committees (PACs) and soft money contributions to the national

196. See, e.g., Macey & Miller, *supra* note 5, at 511 (contrasting Delaware with New York, Pennsylvania, Florida and California, all of which require the posting of a bond).

197. See *id.* at 511-12 (explaining how Delaware legislature rapidly responded to continue this approach after Delaware sequestration statute was ruled unconstitutional).

198. See, e.g., William T. Quillen, *The Federal-State Corporate Law Relationship—A Response to Professor Seligman's Call for Federal Preemption of State Corporate Fiduciary Law*, 59 BROOK. L. REV. 107, 121 (1993) (describing Delaware hurdles to dismissal as "prodigious" and more onerous than those imposed by several courts outside of Delaware).

199. See, e.g., Andrew G.T. Moore, II, *Shareholder Rights Still Alive and Well in Delaware: The Derivative Suit: A Death Greatly Exaggerated*, 38 ST. LOUIS L.J. 947, 958-59 (1994) (describing generosity of Delaware's approach to awarding attorneys' fees in derivative suits and explaining that attorney is entitled to a fee if he or she can show any benefit to the corporation, monetary or nonmonetary); Skeel, *supra* note 59, at 23 (explaining that Delaware is "notably generous in granting attorneys' fees in shareholder suits").

200. See Branson, *supra* note 20, at 105 (finding evidence supports hypothesis that Delaware law has both substantive and procedural pro-shareholder biases).

201. See, e.g., Matt Keller, *Ending Greenback Politics*, IN THESE TIMES, Feb. 21, 2000, at 12 (revealing that soft money donations in the 1996 elections totaled \$262 million); Ann Reilly Dowd, *Look Who's Cashing in on Congress*, MONEY, Dec. 1997, at 128 (describing the amount and influence of corporate soft money contributions to political action committees).

202. See, e.g., Andrew Stark, *Strange Bedfellows: Two Paradoxes in Constitutional Discourse Over corporate and Individual Political Activity*, 14 CARDOZO L. REV. 1343, 1370-72 (1993) (describing the arguments that corporate political spending corrupts the political marketplace); David R. Lagasse, Note, *Undue Influence: Corporate Political Speech, Power and the Initiative Process*, 61 BROOK. L. REV. 1347, 1349 (1995) (arguing that corporations can control outcome of initiative votes because of their ability to outspend other groups).

203. See *Austin v. Michigan St. Chamber of Com.*, 494 U.S. 652, 658-59 (1990) (finding that corporate spending can unfairly influence elections); see also *United States v. UAW*, 352 U.S. 567, 577-78 (1957) (explaining the fear that corporations will use their raw economic power to buy influence with elected officials to advance their interests over those of the public).

political parties.²⁰⁴ State campaign finance laws, are, in many cases more permissive than federal law in allowing direct corporate expenditures in connection with state elections. Finally, corporations exert extensive political pressure through lobbying, which is not subject to the legal restrictions that apply to election contributions and expenditures.²⁰⁵

Commentators have observed how interest groups may influence the legislative process.²⁰⁶ 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.²⁰⁷ Indeed, although legislative lawmaking is sometimes defended as the product of more complete information than that which is available to courts,²⁰⁸ 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.²⁰⁹

Judges obviously are not subject to the same types of direct political influence as legislators.²¹⁰ Ethical rules and prohibitions on ex parte communications prohibit litigants from lobbying judges. Delaware

204. See, e.g., Keller, *supra* note 201, at 12 (explaining how the "soft money loophole" allows corporations to circumvent legal limits on political contributions); Adam Winkler, *Election Law As Its Own Field of Study: The Corporation of Election Law*, 32 LOY. L.A. L. REV. 1243, 1265 (1999) ("Corporation are allowed to use shareholder funds to create and administer corporate PACs, and make unregulated and unlimited soft money contributions to the national political parties from their general treasuries.") (citations omitted).

205. See Adam Winkler, *Beyond Bellotti*, 32 LOY. L.A. L. REV. 133, 168-69 (1998) (explaining that campaign finance laws do not restrict corporate lobbying, on which often spend much more than on initiatives or candidate campaigns); Jill E. Fisch, *Frankenstein's Monster Hits the Campaign Trail: An Approach to Regulation of Corporate Political Expenditures*, 32 WM. & MARY L. REV. 587, 597n. 63 (1991) (describing corporate lobbying). Indeed, until 1993, section 162(e) of the internal revenue code allowed a tax deduction for corporate lobbying expenses. See Shannon King, Note, *The Lobbying Deduction Disallowance: Policy Considerations, Comparisons and Structuring Activities Under Amended Section 162(e)*, 15 VA. TAX REV. 551, 552 (1996) (describing elimination of the tax deduction for corporate direct lobbying expenses).

206. See, e.g., Carney, *supra* note 5 at 716 (citing concerns expressed over interest group influence over corporate law); Komesar, *supra* note 77, at 54-75 (explaining interest group theory of politics and detailing ways in which interest groups can exert influence over political process).

207. See, e.g., Carney, *supra* note 5 at 717 (describing rent-seeking in connection with the production of corporate law and describing rent-seeking problem as greatest with respect to management sponsored changes in corporate rules).

208. Cf. Saul M. Pilchen, *Politics v. the Cloister: Deciding When the Supreme Court Should Defer to Congressional Factfinding Under the Post-Civil War Amendments*, 59 NOTRE DAME L. REV. 337, 375-76 (1984) (critiquing the argument that the legislative investigative apparatus is superior and that, as a result, legislatures are better factfinders than courts).

209. See Komesar, *supra* note 77, at 62-63 (explaining how concentrated groups with large stakes can present distorted pictures of the public interest to political officials).

210. See *id.* at 124 (describing structure of judicial independence).

judges also enjoy an unusual degree of political independence relative to other state judges. Delaware is one of only twelve states to use appointed rather than elected judges.²¹¹ Both chancery and supreme court judges are appointed, based on a system of merit selection, for renewable twelve year terms,²¹² thereby insulating the courts, to a large degree, from the political pressures that judges in other states may face.²¹³ Finally, the Delaware Constitution mandates balance between the two major political parties in appointment of Delaware judges.²¹⁴ These factors contribute to insulating Delaware judges relative to legislators from political influence.

A comparison of Delaware's legislative and judicial lawmaking in the takeover area provides some support for the hypothesis that Delaware's judiciary is subject to less political influence than its legislature. The political process leading to state adoption of antitakeover statutes has been widely analyzed.²¹⁵ Commentators have observed that state antitakeover legislation was widely adopted in response to local corporations seeking protection from hostile bidders.²¹⁶ As Romano explains, antitakeover statutes "are frequently pushed through the legislature at the behest of a major local corporation that is the target of a hostile bid or apprehension that it will become a target."²¹⁷ Delaware was not exempt from this process; indeed the Delaware statute was the

211. See Martin Scott Driggers, Jr., *South Carolina's Experiment: Legislative Control of Judicial Merit Selection*, 49 S.C. L. REV. 1217, 1222 n.39 (1998) (citing Delaware as one of nine states in which judges are appointed by the governor; in three others, the legislature appoints judges). Because many states use a combination of methods in selecting their judiciary, some sources classify states differently. See *id.* at 1222, n.38. See also Edwin Chemerinsky, *Preserving an Independent Judiciary: The Need for Contribution and Expenditures Limits in Judicial Elections*, 74 CHI.-KENT L. REV. 133 (1998) (explaining that state judges are elected in 23 states and face periodic retention elections in fifteen other states).

212. Delaware Const. of 1897, Art. 4, § 3. See Quillen & Hanrahan, *supra* note 26, at 835 (describing development of Constitutional provisions for appointment of Delaware judges); Moscow, *supra* note 57, at 1917 (explaining the structure of the Delaware Supreme Court).

213. See, e.g., Paul D. Carrington, *Judicial Independence and Democratic Accountability in Highest State Courts*, 61 LAW & CONTEMP. PROBS. 79 (1998) (discussing degree to which election of state judges may subject judicial decisionmaking to political influence).

214. DEL. CONST. art. I.V., § 3. See, e.g., E. Norman Veasey, *An Economic Rationale For Judicial Decisionmaking in Corporate Law*, 53 BUS. LAW. 681 (1998) (describing selection process for Delaware judges).

215. See, e.g., Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987) (exploring politics behind enactment of Connecticut antitakeover statute); Romano, *supra* note 192, at 461 (describing political process leading to adoption of state antitakeover statutes); Carney, *supra* note 5, at 750-51 (describing process of enacting state antitakeover statutes).

216. See, e.g., Carney *supra* note 5, at 750-51 (listing corporate sponsors of state antitakeover statutes); Romano, *supra* note 192, at 461 n. 11 (citing examples of statutes passed in response to pressure imposed by local corporations on state legislatures).

217. Romano, *supra* note 193, at 461; see also Romano, *supra* note 215, at 120 (describing the political process by which Aetna enlisted the support of the Connecticut Business and Industry Association to lobby effectively for the adoption of an antitakeover statute in Connecticut).

product of corporate influence and lobbying efforts.²¹⁸ The result of this political influence is legislation that uniformly favors the interests of corporate management.²¹⁹ 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.

In contrast, courts have responded to takeover litigation with an attempt to balance deference to management decisionmaking with concern over shareholder treatment.²²⁰ The result, in Delaware, is a series of decisions²²¹ that increase the degree of judicial scrutiny and heighten management obligations beyond the traditional business judgment rule analysis.²²² In other words, corporate management has been able to obtain more favorable takeover regulation in the legislature than in the courts. This outcome is likely the result of the greater opportunity for potential target corporations to influence lawmaking through the political process than through litigation.

Finally, judicial decisionmaking has the advantage of greater transparency than legislative lawmaking. The specific effects of corporate influence in politics are difficult to identify. Disclosure of corporate political spending is spotty and incomplete. More importantly, the substantive arguments that corporations make to legislators through lobbying and political spending are made in private, with no forum for response or public debate. The political process thus creates a real possibility that legislators will not receive a balanced perspective or even hear both sides of an issue.²²³ When legislators

218. See Romano, *supra* note 193, at 462-64 (describing adoption of Delaware statute and lobbying by corporate executives over the legislation).

219. Lucian Bebchuk and Allen Ferrell explain that the political process is poorly suited to reflect the views of those who oppose antitakeover legislation. In addition to shareholders, who face collective action problems, prospective bidders are likely to oppose restrictions on takeovers. Yet, because antitakeover statutes protect targets, not bidders, a prospective acquirer is unlikely to find it useful to oppose antitakeover legislation even in its home state, since it cannot predict which state's law will apply to a future acquisition. See Bebchuk & Ferrell, *supra* note 28, at 1176-77.

220. See, e.g., Skeel, *supra* note 106, at 152 n. 75 (describing *Revlon* and *Unocal* decisions as acknowledging the importance of shareholder prerogative and management discretion).

221. See, e.g., *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986); *Paramount Comm., Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990); and *Paramount Comm., Inc. v. QVC Network Inc.*, 637 A.2d 34 (Del. 1994).

222. See Paul L. Regan, *Great Expectations? A Contract Law Analysis for Preclusive Corporate Lock-ups*, 21 CARDOZO L. REV. 1, 97 (1999) (describing Delaware takeover law as providing that board decisions approving change of control will be subjected to substantive judicial review without any threshold showing by stockholder that board breached its fiduciary duty); cf. *Hanson Trust PLC v. ML SCM Acquisitions, Inc.*, 781 F.2d 264 (2d Cir. 1986) (applying New York law) (placing the initial burden on the plaintiff to prove a director's breach of fiduciary duty in a takeover situation).

223. See Komesar, *supra* note 77, at 63 (explaining how concentrated groups can distort information about the public interest and mislead even a public-interested public official).

decide to act, the legislative process provides a poor record of the basis for the legal rules that are enacted. Legislative history is incomplete and readily manipulated.²²⁴ Without an indication of why legislators made their decisions, it is more difficult for critics to challenge the resulting laws.

Judicial lawmaking is far more transparent than legislative lawmaking. The adversary process provides a mechanism for presenting both sides of an issue to the decisionmaker. The litigation process itself is open to the public, and the pendency of legal questions is a matter of public record. Even nonlitigants have the opportunity to ensure that the court has the benefit of full information on an issue by submitting amicus briefs. Finally, by making law through the process of issuing written opinions, judges provide the business community and the public with an explanation of the reasons for their decisions.²²⁵ Because the Chancery courts are courts of equity they sit without juries and maintain a tradition of issuing written opinions. These practices distinguish them from trial courts in other states.

IV. THE ANALYSIS APPLIED—INSTITUTIONAL ACTIVISM

Institutional activism provides a case study with which to apply the foregoing analysis and consider Delaware's ability to respond to changes in the business world. The activism of institutional investors represents a major and relatively recent business development. Institutions are becoming increasingly involved in corporate governance.²²⁶ Institutions have experimented with negotiation, litigation, and shareholder voting as tools for influencing corporate decisionmaking on topics ranging from

224. See, e.g., Frank H. Easterbrook, *Text, History, and Structure in Statutory Interpretation*, 17 HARV. J.L. & PUB. POL'Y 61 (1994) (stating that legislative history is "slanted, drafted by the staff and perhaps by private interest groups"); Kenneth W. Starr, *Observations About the Use of Legislative History*, 1987 DUKE L.J. 371, 376 (1987) (claiming that the greatest concern about legislative history is "its potential for manipulation"); Daniel A. Farber & Philip P. Frickey, *Legislative Intent and Public Choice*, 74 VA. L. REV. 423, 423 (1988) (explaining how legislators and legislative staff members can insert false rationales for legislation into legislative reports).

225. See, e.g., Frederick Schauer, *Opinions as Rules*, 62 U. CHI. L. REV. 1455, 1465-66 (1995) (explaining how judicial opinions provide litigants and the public with explanations of the results reached); see generally Frederick Schauer, *Giving Reasons*, 47 STAN. L. REV. 633 (1995) (examining extent to which legal decisionmakers give reasons for their decisions).

226. See, e.g., Mark R. Wingerson & Christopher H. Dorn, *Institutional Investors in the U.S. and the Repeal of Poison Pills: A Practitioner's Perspective*, 1992 COLUM. BUS. L. REV. 223, 226-235 (1992) (describing recent increase in institutional investor activism and detailing strategies employed by institutional investors to affect corporate governance).

executive compensation to board composition to corporate employment policies.²²⁷

The academy is sharply divided on the implications of institutional activism for firm value.²²⁸ On the one hand, activism offers the possibility of reducing agency costs through the involvement of sophisticated monitors with substantial stakes.²²⁹ On the other hand, institutional interests may differ from those of other investors, causing activism to reduce overall firm value.²³⁰ In addition, institutions' access to managers creates the possibility for collusion.²³¹

States can approach the issue of institutional activism in several ways. One possibility is for state lawmakers to determine the appropriate level of institutional participation in corporate governance and to adopt legal rules tailored toward achieving that level. A second possibility is for states to maintain the existing legal allocation of decisionmaking responsibility, which largely reserves such decisionmaking for corporate management and limits opportunities for shareholder voice. A third alternative would expand the opportunities for shareholder voice and monitoring, with the expectation that institutional activism would improve corporate decisionmaking.²³²

These regulatory approaches have several problems. Each requires states to make a normative judgment about the appropriate level of institutional activism. In light of the inability of even academics to agree on the potential value of institutional participation in corporate governance, it is unclear that state lawmakers are capable of making this assessment. Structural flaws in the legislative process are likely further to detract from legislators' ability to evaluate institutional activism. Like state antitakeover statutes, regulation addressing institutional activism

227. *See id.*

228. *See* Jill E. Fisch, *Relationship Investing: Will it Happen? Will it Work?*, 35 OHIO ST. L.J. 1009, 1009-11 (1994) (describing academic commentary debating the likelihood and effectiveness of institutional activism).

229. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 29 UCLA L. REV. 811 (1992) (describing how institutional activism can improve corporate governance); Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991) (advocating greater institutional activism).

230. *See, e.g.*, Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 797-98 (1993) (expressing concern that political pressure will cause public pension funds to pursue goals other than maximization of share value).

231. *See, e.g.*, Fisch, *supra* note 228, at 1038-45 (explaining potential for institutional investor to pursue private gains through activism); Edward B. Rock, *Controlling the Dark Side of Relational Investing*, 15 CARDOZO L. REV. 987, 989-93 (1994) (describing pursuit of private gains as "corrupt" relational investing).

232. This is not unlike the SEC's 1992 amendments liberalizing the federal proxy rules to facilitate increased shareholder activism through the proxy process. *See* Fisch, *supra* note 228, at 1018-19 (describing amendments as a "direct response to complaints by institutional investors that the proxy rules prevented them from . . . participating effectively in corporate governance").

is likely to be strongly influenced by interest group dynamics. In particular, corporate management has an obvious stake in limiting the degree to which corporate law facilitates institutional activism. Moreover, institutions are unlikely to be effective counterweights to management's political influence. Institutions are poorly organized political actors, with little ability to lobby effectively.²³³ Their political weakness is evidenced by their relative impotence in connection with state adoption of antitakeover legislation.

Additionally, responding to institutional activism is responding to a moving target. As institutions and issuers work through corporate governance issues, the nature of institutional activism has evolved, and this evolution is likely to continue.²³⁴ Even a careful legislative assessment of the appropriate regulatory approach may rapidly become out of date as institutions become more sophisticated, more corrupt or more innovative in their activism.

Finally, clear rules that specify the appropriate degree of institutional involvement create incentive problems. Rules favoring management discretion can potentially frustrate institutional attempts to monitor and can eliminate any incentive on the part of corporate management to negotiate with institutions. Rules favoring institutions create the potential for excessive litigation and give institutions a tool that they can use strategically. Indeed, rules that broadly empower institutions can lead to rent-seeking and the extraction of private gains.

Delaware law takes a different approach. First, Delaware's muddy rules encourage institutions and management to bargain over governance changes rather than litigating or stonewalling. Second, judicial review of management responses to institutional activism conducted through the framework of fiduciary principles allows courts to oversee and respond to changes in the nature of institutional activism. Judicial review also allows courts to rebalance the legal structure in response to perceived overreaching on the part of either institutions or management. The flexibility provided by Delaware law enhances judicial power to prevent opportunism. This backdrop of judicial oversight may give the parties increased confidence to negotiate voluntarily. Finally, judicial lawmaking provides institutions with

233. See, e.g., John C. Coffee, Jr., *The Folklore of Investor Capitalism*, 95 MICH. L. REV. 1970, 1981 (1997) ("Fragmented among tens of thousands of pension and mutual funds, and lacking the lobbying resources of corporate managements, institutional investors are anything but an efficiently organized political or economic force. Coordination among them remains largely ad hoc and crisis-driven.").

234. See, e.g., Wingerson & Dorn, *supra* note 226, at 234 (describing how nature of institutional activism has changed).

greater access to the lawmaking structure than they are likely to achieve in the legislature.

V. CONCLUSION

In analyzing regulatory competition in corporate law, commentators have focused on substantive law. A comparative institutional perspective suggests, however, that a regulator can also provide advantages through its lawmaking process. Because of the inherent difficulty in evaluating substantive provisions of corporate law and in tracing incorporation decisions to differences between states,²³⁵ a process oriented approach offers the potential for new insights about the value of state competition.

Although it has received little attention, Delaware's corporate lawmaking process addresses systematic challenges in structuring corporate regulation. These challenges include the difficulty of assessing the impact of corporate rules on various corporate constituencies and the problems associated with designing rules that must function in a rapidly changing business environment. Delaware's equity courts are able to formulate flexible yet responsive legal principles that permit transactional evolution without increasing strategic behavior.

The manner in which Delaware courts maintain an aggressive lawmaking agenda, focus on articulation of principles to govern future standards, and freely adjust previously announced principles based on policy considerations, resembles the legislative process. At the same time, the standards based muddiness of Delaware law retains a degree of ex post review for which courts are well suited. In addition, Delaware's extensive reliance on judicial lawmaking offers several advantages over the legislative process, including greater and more balanced access to the lawmaking process, increased political independence, and enhanced decisionmaking transparency. This article has argued that this lawmaking structure is particularly appropriate in corporate law.

In conclusion, the peculiar role of the Delaware courts may provide greater explanatory power for Delaware's success in attracting corporate charters than previously identified theories. Delaware has developed a unique corporate lawmaking structure and process. If, as this article

235. See, e.g., Jill E. Fisch, *Picking a Winner*, 20 J. CORP. L. 451 (1995) (questioning validity of relying on event studies to evaluate regulatory change).

suggests, Delaware lawmaking addresses the needs of corporations, it may explain why Delaware is consistently winning the race.