DEMOCRACY AND THE DOMINANCE OF DELAWARE

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Delaware has a population less than one-third of one percent of the nation, but it is the state of incorporation of over 50% of U.S. public companies and over 60% of the Fortune 500.[1] Delaware's resulting dominance over the terms of corporate governance in the United States has been the focus of one of the grandest and most persistent debates within corporate law scholarship. And still the question remains whether Delaware's dominance has been the result of, in William Cary's famous phraseology, a "race to the bottom" – toward a legal regime that benefits managers at the expense of the shareholders – or a "race to the top" – toward an efficient, shareholder-centric governance framework.[2] The conventional wisdom is that if a race to the bottom, the dominance of Delaware is illegitimate, and a federal chartering statute is appropriate. If a race to the top, Delaware's dominance represents simply its success in providing the best, most efficient set of governance laws available. Delaware's dominance is, in the words of a leading corporate law scholar, a laudable result of the "genius of corporate law."[3]

From a progressive perspective, this famous and popular debate is beside the point. Here is the progressive claim: *Even if* Delaware's dominance is the result of a "race to the top" resulting in a corporate law framework that efficiently serves the interests of shareholders, it is still illegitimate. This is because Delaware's ability to define the rules of corporate governance depends on the so-called "internal affairs" doctrine, which says that the internal affairs of corporations (i.e., the rules of corporate governance) are provided by the state where the corporation is chartered. This is in contrast with conflict of laws principles that apply in all other areas of law. Typically, the state with the greatest interest in regulating the behavior in question provides the governing law. But under modern incorporation statutes, a corporate charter is extremely easy to obtain, and there is no requirement of any meaningful contact whatsoever with the chartering state. Thus corporations can, in effect, choose the corporate governance laws that will apply to them, regardless of whether they have any other contact with the state whose laws they choose. This ability of corporations to elect their governance law is illegitimate as a democratic matter and inefficient as an economic matter.

The dominance of Delaware is staggering. Over 300,000 companies are incorporated there, and nearly 300 of the Fortune 500. The state with the second-most of the Fortune 500, New York, has only 25. In fact. so many companies incorporate in Delaware that incorporation and franchise fees provide one-quarter of total state revenues.[4]

But Delaware has little contact with these corporations other than being the jurisdiction that provides the corporate charter. Of the thousands of corporations incorporated there, only a few have significant numbers of employees or shareholders there. Only two Fortune 500 companies -- DuPont and MBNA -- are headquartered in Delaware.[5] More importantly, even though Delaware has less than 820,000 citizens (as of 2003),[6] its corporate governance rules govern companies with millions of employees. The 300 largest companies incorporated in Delaware employ over 15 million people, only an infinitesimal fraction of whom actually reside in Delaware. The largest company incorporated in Delaware, Wal-Mart, employs over 50% more people than live in the entire state.[7] What's more, Wal-Mart's total net sales in their 2003 fiscal year, $244.5 billion,[8] was more than *six times* the entire Gross State Product of Delaware.[9]

So under the internal affairs doctrine, unique in law, to allow corporations to choose the corporate governance law that applies to them, Delaware has reached an exceptional position of power. This position is guarded jealously by the Delaware legislature and judiciary, since it brings them disproportionate influence. (Indeed, the state's Chancery and Supreme Courts are arguably the most important judicial bodies for corporations in the entire world.) Importantly, nobody within the tiny state has any reason to challenge the state's dominance.

The Internal Affairs Doctrine

Delaware's dominance would perhaps not be so striking if by "internal affairs" we meant only the narrow relationship between managers and the company. But because companies affect so many stakeholders, and because even the most "internal" rule has implications for those stakeholders, it is impossible to claim that internal affairs are immaterial to anyone other than shareholders and managers. Examples abound. Other stakeholders undoubtedly are affected by a rule that directors should maximize profit to shareholders, or a rule that directors should not disclose information to communities about their business practices absent a legal or financial imperative, or a rule that shareholders need not pay the debts of the corporation.

Indeed, the law of fiduciary obligation itself – arguably the most "internal" of all rules – says that the directors owe duties of care and loyalty to shareholders. In so doing, obligations toward other stakeholders are excluded. Workers are not represented on the boards of directors of the vast majority of companies incorporated in the United States not because of some element of labor law or federal securities law, but because of the state law of corporations. One cannot avoid the difficulties of the internal affairs doctrine by claiming that only shareholders and managers are affected by it.

The key problem is that Delaware law, in the process of establishing the laws governing the internal workings of corporations chartered in the state, reaches beyond its borders to affect all the corporation's stakeholders. This includes those who have no political influence over the terms, requirements, or status of the laws. Delaware law can therefore be crafted without attention to the political influence of any important stakeholder residing outside the state, unless that influence can be transformed into market terms that the corporation itself will care about. The internal affairs doctrine thus allows Delaware to externalize the costs of its rules on other stakeholders and indeed other states.

This practice of deferring to Delaware law to govern most of the nation's largest and most powerful corporations is undemocratic. Indeed, if areas of the law can be evaluated on their susceptibility to democratic or political pressures, then corporate law must be among the least open to political influence. In a democracy, this should be seen as a serious flaw in the framework of corporate law. This result is so awkward that one would expect the internal affairs doctrine to be subject to serious attack, or at least prolonged scholarly attention. But the internal affairs doctrine is a foundational principle "wholeheartedly embraced" by the corporate law academy and bar because of its seeming "irresistible intuitive appeal."[10] Despite its foundational status, or perhaps because of it, the doctrine attracts scholarly attention only sporadically.[11] Fierce defenses are infrequent, but forceful attacks rarer still.[12] But the doctrine deserves more attention, especially at a time when there is a large amount of popular distrust of the methods of corporate governance and increased attention on the issue of corporate accountability.

The doctrine would not seem so awkward if other areas of the law had similar rules. But the internal affairs doctrine is the exceptional case in the area of law governing conflicts between and among the laws of different states. Courts have long struggled with cases in which it was unclear which state's law should apply in a given context. If a car manufactured in Michigan driven by a Florida citizen crashes on a New Jersey highway into a Kentucky-made truck driven by a Texas citizen, which state's tort law will apply? The answer is provided by the doctrine of conflicts of law. The principles in this area of law are complex, but they generally suggest that the state with the greatest interest in regulating the behavior in question should provide the governing law for the behavior.

But the internal affairs doctrine allows a state that is hardly affected by the corporate behavior at issue to dictate the rules governing that behavior.[13] Of all the areas of law that control and limit corporations – from contract law to tort law to environmental law to labor law – it is only corporate law that is left to the corporation itself to choose. And just like those other areas of law, the rules of corporate governance affect more than just the parties to the "deal" embodied in the corporate charter. From the standpoint of democratic legitimacy, it is no more justifiable to allow corporations to choose the state that provides the corporate laws to govern them than it is to allow such corporations to choose which state should provide the tort law or environmental law that governs them.

The typical justification given for the internal affair's exceptional status is that corporations desperately need a clear rule. Businesses need to know which state's corporate law governs them, and the internal affairs rule is the simplest and clearest to apply. This is basis of the "irresistible intuitive appeal" mentioned above. But there are other simple and clear rules available, such as a rule that says company's governing law should be provided by the state where the company is headquartered, or the state where the company has the greatest number of long-term shareholders or employees, or – as in other areas of law – the state that has the greatest interest in regulating the corporation. Admittedly, there may be a small increase in clarity with a "state of incorporation" rule rather than the alternatives, but the real question is whether this gain in clarity is worth much at all, especially in comparison to the costs such a rule imposes. In other areas of law in which conflicts among states are a problem, the need for clarity does not in itself trump other interests. Nor should it in the corporate context.

Making corporate law the exception in this way creates genuinely weird results. A corporation headquartered in New York, with all of its facilities, employees, and shareholders in New York, and with all or most of its business in New York, will have its rules of corporate governance provided not by New York, but by the state where its incorporators secured a charter, usually Delaware. The internal affairs doctrine says that Delaware law will govern such a corporation even if New York *wants* to exert its authority over the internal affairs of the corporation, and even if a claim arises in a New York court. The doctrine allows Delaware to reach into New York courts (or Massachusetts courts, or California courts, or wherever) and claim an interest in applying its law in disputes between residents of other states and that pertain to corporations that have little or no contact with Delaware.

Corporate law should not promote this odd result. Rather, the conflict rules for corporate governance should be consistent with the conflict rules in other areas of the law: The state that has the greatest interest in regulating the internal affairs of a corporation should provide the rules for corporate governance. If this simple, straightforward, and consistent rule were followed, it would bring about fundamental changes in the way corporate law is provided in the United States. Instead of being an area of law uniquely insulated from democratic pressures, corporate law would become subject to the same political pressures that other areas of the law are subject to.

A Hypothetical Statute

Let's imagine that a particular state legislature in, for example, Massachusetts, believes that corporations consistently undervalue the interests of their employees, especially when corporations consider fundamental decisions such as a merger, an acquisition, or a major sale of assets. In such a context, Massachusetts might consider the following statute.

> Regardless of where such a corporation is chartered, the directors of:
> (a) a corporation that employs 51% or more of its employees within Massachusetts; or
> (b) a corporation that employs more employees within Massachusetts than in any other state or political subdivision of the United States or other nation;
> shall consider the interests of the corporation's employees in making decisions that have a material effect on the level of the corporation's present or future employment. Such a duty shall be deemed satisfied if the board of directors includes at least one member who is elected by hourly-wage employees rather than shareholders.

Without a doubt, this statute purports to regulate the internal affairs of certain corporations. The statute also almost certainly conflicts with Delaware law, in that Delaware law by most accounts requires corporate directors to owe an "unyielding" duty to the corporation and its stockholders.[14] This legal duty is interpreted to bar the consideration of employee interests except insofar as is necessary to further shareholder interests.[15] The hypothetical Massachusetts statute also conflicts with the Delaware requirement that directors be elected by shareholders.[16]

Let us now imagine a case arising under this statute. A Massachusetts employee of a corporation sues in Massachusetts court to enjoin a planned merger of that corporation with another. The employee shows that the majority of the corporation's employees reside in Massachusetts and that the corporation's directors have refused to consider the interests of the employees in the merger negotiations. The corporation files a motion to dismiss, saying that it is chartered in Delaware and that Delaware law governs its internal affairs.

Should the suit be dismissed? At first look, the answer seems to be an easy "yes." The statute purports to regulate the internal affairs of corporations incorporated in Delaware, and if the internal affairs doctrine controls, then the statutes would not be valid when applied to such corporations. The corporations will argue that the statutes should not be applied to them and that the cases should be dismissed.

In fact, if one asked corporate lawyers or corporate law scholars what the proper result is, very few would contest the suits' dismissals. The internal affairs doctrine is, as noted above, one of the foundational principles of corporate law. It has been remarkably immune from attack. It is even the subject of a special section of the Restatement (Second) of Conflicts, which is often quoted as saying that: "Issues involving the rights and liabilities of a corporation… are determined by the … local law of the state of incorporation."[17] (But this quote is misleadingly incomplete. The full text of the section includes an important caveat: The law of the state of incorporation will be applied "except in the unusual case, with respect to the particular issue, some other state has a more significant relationship to the occurrence and the parties, in which even the local law of the other state will be applied.")

The internal affairs doctrine is so embedded that this hypothetical statute would likely not be passed by a state legislature in the first place. Few would think of such regulation as a real possibility. Nevertheless, there is an economic argument for this kind of statute and a democratic argument for this kind of statute, and these arguments are remarkably similar.

The Economic Argument for the Hypothetical Statute

The economic argument is straightforward. It focuses on externalities, which are routinely cited as a cause of inefficient decisions and thus a rationale for government regulation. Indeed, the internal affairs doctrine is easily characterized, to paraphrase Lawrence Mitchell, as an "externality machine."[18] Because of the internal affairs doctrine, states can compete for corporate charters on the basis of which state can provide a set of laws most beneficial to the decision makers – directors, senior manager, and major shareholders. Even if this competition is correctly viewed as a "race to the top" in that it maximizes the interests of shareholders, the economic interests of other stakeholders need not be taken into account by the jurisdiction providing the rules, since the other stakeholders have no say in the decision as to where to incorporate. The jurisdictions competing for corporate charters have no incentives to take into account the economic interests of other stakeholders of the firm, even though those other stakeholders undoubtedly are affected by the terms of the corporate charter.[19]

When certain stakeholders (for example, employees and communities) lack political clout in the jurisdiction making the rules, that jurisdiction can construct laws that benefit the corporate decision makers at the expense of those other stakeholders. And the jurisdiction in question can do so at no cost to itself. This is a classic example of externalities. The state can internalize the benefits of its manager- and shareholder-centric corporate governance rules and externalize most of the cost onto stakeholders it need not concern itself with. These externalities essentially guarantee that the state law that is created diverges from those that would maximize social welfare, even from a simple economic standpoint. As Luician Bebchuck once noted in this context, "When externalities are present... rules that maximize shareholder value may well diverge from the socially desirable ones."[20]

Law and economics scholars would suggest that states maximize social welfare by imagining what the various parties would agree to absent transaction costs. If that is the model, then the internal affairs doctrine almost certainly results in a different, less socially optimal legal framework since the jurisdiction need not consider any parties other than those who have a hand in choosing where to incorporate. The hypothetical, socially optimal negotiation has all stakeholders at the table. The real negotiation has only a few.

Indeed, it is difficult to imagine how, given the internal affairs doctrine, a state could craft a socially optimal corporate governance framework. Suppose, for example, a state sought to create a corporate governance rule (such as the hypothetical statute above) that would take into account the interests of non-shareholder stakeholders. In response, shareholders and managers would likely move their corporations to other states with more manager- and shareholder-centric governance regimes. The internal affairs doctrine makes this possible because the decision makers would face no serious consequences from moving to another jurisdiction and choosing a different set of corporate laws. In the end, because of the internal affairs doctrine, "the state [trying to protect non-shareholder constituencies] may both lose its incorporations and fail to achieve any protection of third party interests."[21]

This argument against the internal affairs doctrine assumes that the socially optimal level of public regulation is not zero. States, localities, and the federal government are charged with regulating the public and private spheres in order to maximize social welfare (broadly defined). Governments care, and should, about crafting the proper mix of regulation to reach certain social goals in the most efficient way. Even if one cares only about economic wellbeing, governments must routinely step in to the market to adjust for market defects such as monopolies, insufficient information, obstacles to negotiation, and (yes) externalities. Over time and if guided conscientiously and honestly, governments find out which policy tools are more efficient than others in reaching public policy objectives. One way that governments learn is through feedback from the citizenry. To quote Louis Brandeis, states are the "laboratories of novel social and economic experiments."[22] When a state tries a new regulatory initiative and it is successful in maximizing social welfare, then the state and its officials receive certain benefits as a consequence of the policy (for example, an increase in population for the state, or reelection for the officials).

When a state makes a mistake, the feedback is negative (a decrease in population, or failure to be reelected).

Now note that the unique trait of the internal affairs doctrine is that this opportunity to provide feedback on corporate law is available only to the corporation itself. If the corporation benefits from a state's regulation of corporate governance, then the corporation reacts positively by incorporating or staying in the state. If the corporation does not benefit, then the corporation reacts negatively and incorporates elsewhere. Because the corporation need not actually be based in the state in question when it incorporates there, it can express feedback on corporate governance to any state. No other stakeholder can influence the corporate governance rules of any state other than the state in which the stakeholder is physically located.

Actually, the situation is worse than just described. Not only are non-shareholder stakeholders prevented from having an influence on the corporate governance rules of other states, the internal affairs doctrine means they have little reason to be concerned about the corporate law of their own states. Imagine that an activist for worker rights in Boston wanted to advocate for real improvements in the lives of Massachusetts blue collar workers. Imagine also that she wanted to use corporate law as one of the policy tools available, as we saw in chapter seven, perhaps by requiring large Massachusetts companies to have an employee representative on its board. The activist would not be able to change Delaware law, so under the internal affairs doctrine any Massachusetts-based company chartered in Delaware would not be affected by a change in Massachusetts corporate law. Any hard-won change in Massachusetts corporate law would thus have only a limited effect. Moreover, because some companies incorporated in Massachusetts are based elsewhere or have a significant number of employees elsewhere, many of the benefits of such a worker-oriented change in Massachusetts law would flow outside the state. So the benefits of the activist's work in corporate governance would be more limited and more diffuse than if the activist worked in some other policy arena. (This is perhaps the very reason very few worker-rights activists and advocates toil in the area of corporate law. Delaware's monopoly in providing corporate governance essentially shuts out other states from using it as a policy tool.)

It is almost needless to say that this result diverges from that which is socially optimal. By any reasonable assumption, a socially optimal law of corporate governance would take into account the interests of parties other than shareholders and managers. The internal affairs doctrine all but makes this impossible and thus guarantees that the corporate law actually provided will fall short of optimality.

Nor is the optimal result reached even if one assumes, as do many corporate scholars, that the concerns of non-shareholder constituencies should be left to bodies of law other than corporate law (such as labor and employment law, environmental law, or consumer protection law). A state seeking to create a socially-optimal system of regulation for corporations doing business within its jurisdiction but not chartered there will have fewer regulatory options at its disposal. As long as the internal affairs doctrine applies, changes in corporate governance will be unavailable. Fewer regulatory options will usually result in less efficient and more costly regulation, and will move the end result away from social optimality.

This argument is further illustrated if one were to analogize the "internal affairs" doctrine to another area of law – for example, environmental law. Imagine that Delaware allowed companies to come to it and, for a fee, receive permits to increase sulfur dioxide emissions, to log in old-growth forests, or to construct shopping malls in open spaces. What's more, these permits would have legal force regardless of where these activities occurred. Such a regime would be disastrous. No one would suggest that Delaware was engaging in a "race to the top" in environmental protection. Nor would anyone suggest that the end result was the most efficient because states could compete on the basis of what permits to offer. Indeed, if Delaware attempted to adopt such a doctrine, other states would object strenuously. For the same reasons, states should object to Delaware's dominance in corporate law.

There is perhaps another possible objection to the economic argument against the internal affairs doctrine made above. One could say that the other stakeholders are not shut out of the negotiation at the state level about corporate governance. Even though they themselves do not have a hand in the decision about where to incorporate (or reincorporate) they can make their interests known to the persons who do. They do so my translating their concerns into some kind of market pressure on the decision makers. For example, if a firm incorporates in a state that prohibits the firm's management from taking into account the interests of workers (unless those interests are consistent with the interests of the shareholders) then the workers will hypothetically demand a higher wage from that firm. The firm will incorporate in that state only if the cost imposed by the workers is less than the benefit received from the shareholders in the form of lower cost of capital. If this story is correct, then the state that wins the bulk of firm incorporations can indeed claim to offer an economically efficient set of corporate regulations. The costs of any regulation to non-shareholder stakeholders will simply be translated into a cost for the firm via the free contracting among the firm's numerous stakeholders. (This argument is simply an application of the Coase Theorem, which posits that we need not worry about externalities when people can contract around them.)

There are many reasons why this story does not work. The story assumes that the negotiation among the various stakeholders is efficient, informed, and inexpensive to perform. (Coase himself recognized that his theory works only in the absence of transaction costs.) But in reality, the barriers to engaging in the kind of real negotiation necessary for an efficient outcome are immense. As discussed in chapter three, the labor market is much less efficient than the securities market. This means that it is much more difficult for workers to translate their concerns into market terms. Moreover, it is much less likely that workers will be able even to discover the implications for them of various corporate governance regimes. In other words, the barriers to information about the implications of corporate law are greater for workers (who do not have many institutions who help them in such matters) than for shareholders (who do).

Finally, the internal affairs doctrine gives the shareholders and managers a huge advantage in any real or hypothetical negotiation. They begin with the "right" to decide where to incorporate, and they give it up only if they are compensated in some way. Because of the internal affairs doctrine, states must pay attention to the interests of shareholders and managers and need pay attention to the interests of others only if they learn that shareholders are better off if they do. In such a situation, the shareholders hold the initial right to have the state pay attention to them; everyone else has to "pay" to have the state pay attention to them. This default position is very "sticky," in that it is difficult to move away from it. Numerous studies show that even inefficient starting points in a negotiation have a great bit of staying power.[23]

All this is to say that there is absolutely no reason to believe that the framework of corporate governance in the United States has reached an efficient outcome for stakeholders other than shareholders and managers. Even if we have experienced a "race to the top" for the corporate elite, other stakeholders are disadvantaged severely because of the internal affairs doctrine. States are bullied into catering to the interests of firms' decision makers. If any state wants to take account of other stakeholders in their corporate law in any serious way – that is, in any way that actually hurts shareholders and managers – the state is dooming itself to an exodus of firm incorporations. This virtually guarantees that the state will decline to use corporate law as a policy tool to the extent it should be so used, leaving the state to less efficient regulatory options.

The Democratic Argument for The Hypothetical Statute

The argument from democracy is strikingly similar to the economic argument. The difference is that in addition to being inconsistent with social welfare, the internal affairs doctrine is inconsistent with democratic legitimacy. The internal affairs doctrine allows Delaware to insulate its laws from democratic pressures by allowing corporations to take advantage of Delaware's laws of corporate governance without subjecting themselves to the other laws of the state. Corporations located outside of Delaware can adopt Delaware's laws for their internal affairs, leaving other non-shareholder stakeholders affected by those laws but with no democratic mechanism to influence those laws.

This is not true with regard to any other area of law. It is possible, of course, for two or more states to have conflicting laws on a specific subject, or to have the laws of one state affect the citizens of another. (For example, the tort law of a given state will affect the citizens of other states whenever they travel within the given state.) But typical conflict of laws notions help resolve these disputes, and these notions -- which balance the interests of states in regulating given behavior -- embody important democratic principles. When state laws are in conflict, one reason why the governing law comes from the state with the greatest interest in regulating the behavior is that such law typically has a better democratic pedigree. A state may have an interest in regulating because it is the site of the behavior at issue, or because most of the people regulated are residents there. But the state that has the greatest interest in a specific dispute will, almost by definition, be subject to democratic pressures with regard to the law at issue.

Indeed, there is a value in recognizing the interest of the particular state in which the political accountability for the law in question is maximized. If the legislature or courts "get it wrong" in making regulatory decisions, it is easier to correct the mistake when the state has within its borders those whose behavior is regulated or who those who bear the costs or gain the benefits of the regulation. More to the point, one would not expect a state whose interest in regulating the behavior at issue derives only from the desire to gain incorporation fees to have the appropriate democratic incentives to correct missteps within the regulatory framework.

There is an even more fundamental point. At some level, politics is about constructing a community. The rules of the community should, according to democratic theory, be put in place either by the community itself or by representatives of the community who are subject to community oversight. Those who live in such a community are deemed to have voluntarily subjected themselves to the laws of such a community. One can have a say in the laws of the community as long as one consents to be governed by those laws. The laws of one community should not be thrust on another without the consent of the other.

Under this very simple construct, the internal affairs doctrine is open to attack. Corporations are quite insulated from the constraints of community because of the impersonal nature of the corporate form, which separates the firm's decision makers from the legal and cultural norms that influence behavior. The internal affairs doctrine makes this problem worse by allowing corporate elites to choose the law that governs not only their interactions among themselves but also many of their interactions with others. If a community (read: state) were to attempt to regulate the internal affairs of a corporation within its borders, the corporation could simply reincorporate in another jurisdiction. In the usual situation, if someone wants to avoid the laws of a community, she has to leave the community, thereby giving up the benefits of living in that community. The internal affairs doctrine, however, allows a corporation to opt-out without leaving, allowing it to have its cake and devour it as well.

Again, note how unique the corporate law is in this respect. In virtually every other context in which law matters, someone affected by a law has consented to that effect and has some way to influence what the law is. For example, if you are subject to the environmental law of a state, by definition you performing some act in the state subject to regulation. You may not be a citizen of that state, but you have voluntarily done something – opened a business, disposed of solid waste, cut down trees – that meant that you would subject to the state's power to regulate environmental law. Similarly, if you are subject to a state's tort law, you have done something to subject yourself to that common law framework either by being a citizen of the state or performing some negligent act in the state. Moreover, in both cases, most people regulated, hurt, or benefited by the law in question have some ability to affect what the law actually is. There may be exceptions at the margins, such as when a tort victim is a short-term visitor in the jurisdiction whose law controls the resulting law suit. But the general point stands. Only in the context of corporate law do states purposely reach beyond their borders to affect those without any genuine recourse. To take the most obvious example, employees in companies incorporated in Delaware have not consented in any meaningful way to be subject to the laws of Delaware and have no way to influence what Delaware law is.

One response to this argument would be to say that the other stakeholders are not at all left without remedies. Just because workers, creditors, or consumers cannot affect the internal affairs of a company is not to say that they have no recourse. Even if they have no political power in Delaware, they have political power in their own states. Moreover, the other stakeholders have significant market power. If, for example, employees desire to be treated better they need not change the internal affairs rules to have directors owe them a fiduciary duty. They need only exert their desires in the marketplace, either by going to other firms or threatening to do so.

But these responses beg the question. The political power of stakeholders in states other than Delaware is beside the point. What matters for corporate law is their power in Delaware. One could imagine, for example, that the best way for workers to protect their interests is to require a representative on the board of directors. But under the internal affairs doctrine, even if all of a company's workers lived in one state, that state could not impose such a requirement on a company that was incorporated elsewhere. Gaining a worker representative on the board of such a company would thus require a successful vote of the shareholders, which is highly doubtful.

Nor is it a response to the democratic legitimacy critique to say that other stakeholders still have market power. Democracy is not the market, nor vice versa. The market is available as a recourse whether the internal affairs doctrine is in place or not. Often, the best way to protect one's interests is not through the market but through the political process. Yet the internal affairs doctrine places the governance of corporations off limits to the political process, except to the political process of Delaware. And because few corporations are actually based in Delaware, no one – certainly not the Delaware citizenry who have to pay lower taxes the more corporations that are enticed to incorporate there – has an interest in looking out for the interests of corporate stakeholder elsewhere in the nation.

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The power of the internal affairs doctrine is so strong that few states challenge it. But more should. The doctrine is not required by federal law or by any aspect of constitutional law.[24] It is not required, or could it be, by the restatement. In fact, as mentioned above, the restatement assumes that the interests of a given state could trump the "rule of thumb" that the state of incorporation provides the laws of internal affairs. A handful of states have indeed begun to exert their prerogative of regulating the internal affairs of companies that have particularly strong connections to the state.[25] Why more states have not attempted to do so is a bit of a mystery, probably explained by the mere fact that not many state legislators think about using corporate law as a regulatory tool, especially for corporations chartered elsewhere.

Perhaps, when all is said and done that the power of Delaware is best answered not by other states but by the federal government stepping in to provide a consistent, national corporate governance regime for large companies. But short of federalizing corporate charters, the nation could experience a genuine increase in the democratization of corporations simply by states asserting their own prerogative to regulate the corporations they have a significant interest in regulating. In other words, states other than Delaware can simply decide that they will no longer allow Delaware to dominate corporate governance. A state that has significant interests in the internal affairs of corporations doing business in that state can pass corporate statutes such as that suggested above, and when claims arise under these statutes the state can assert its interest in court as it could in any other circumstance in which it had a significant interest in regulating the behavior at issue. A state may not always be able to convince a judge that its interests are the most significant and that its law should apply. But if usual conflicts of laws rules were to apply, such a state would win sometimes. That would be more often than such a state wins now, which is never. In relaxing the constraints of the internal affairs doctrine, corporate law would become more accountable to the states in which the corporations themselves are enjoying the benefit of the social and legal fabric. That would be a good thing.

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[1]See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition Over State Charters*, 112 Yale L. J. 553 (2002).
[2] William Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L. J. 663, 666 (1974)(using phrase "race for the bottom"). See also, e.g., Daniel Fischel, *The Race to the Bottom Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW.

U. L. Rev. 913, 919-20 (1982). There is one other possibility, namely that state competition produces a race to the top in some issues and a race to the bottom in others. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435, 1440 (1992).

[3] ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

[4] Jonathan Chiat, Rogue State, The New Republic (August 19, 2002).

[5] Largest U.S. Corporations, Fortune, April 14, 2003, at F1.

[6] U.S. Census Bureau statistics, available at <http:eire.census.gov.>

[7] Id.

[8] Wal-Mart 2003 Annual Report, available at www.walmartstores.com.

[9] Bureau of Economic Analysis, Regional Accounts Data, available at http://www.bea.gov/bea/regional/gsp/action.cfm.

[10] Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 Law & Contemp. Prob. 161-2 (1985).

[11] See, e.g., P. John Kozyris, *Corporate Wars and Choice of Law*, 1985 Duke L. J. 1; Jack L. Goldsmith III, *Interest Analysis Applied to Corporations: The Unprincipled Use of a Choice of Law Method*, 98 Yale L. J. 597, 599 (1988).

[12]For one excellent current example, see Daniel H. Greenwood, *Democracy and Delaware: The Puzzle of Corporate Law* (draft of June 14, 2002).

[13] One might say that Delaware cares a great deal about regulating the behavior at issue, but a state's desire to regulate, without more, does not constitute a genuine interest. Delaware's desire to regulate springs from the fact that without such power, it cannot dominate the market for corporate charters. Such a desire should not be material in the conflicts interest analysis, since it is a desire that many, of not all, other states share. Rather, the analysis should ask whether the act of gaining a corporate charter from Delaware's secretary of state gives Delaware a greater state interest in regulating the internal affairs of a corporation than a state where, for example, the corporation is headquartered, or where most of the corporation's employees or shareholders are located.

[14] Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); see also Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986)(obligation of directors is to "maximize" interests of shareholders).

[15] Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del 1986) (the "board may have regard for various constituencies in discharging its responsibilities, provided there are rationally related benefits accruing to the stockholders"). Note that Delaware law had feinted toward the allowance of such consideration, cf. Unocal Corp. v. Mesa Petroleum, Co., 493 A.2d 946, 955 (Del. 1985) (implying that directors could take into account interests of constituencies other than stockholders in defending against hostile takeovers), before retreating in Revlon. Some scholars believe that Delaware law does not require shareholder interests to be maximized. See, e.g., Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247 (1999). But even if not, there is little doubt that the above statute would be deemed to be in conflict with Delaware law.

[16] Del. G. Corp. L. §§ 211-212.

[17] Restatement (Second) of Conflict of Laws (§ 302).

[18] Lawrence Mitchell, Corporate Irresponsibility (2001).

[19] See Bebchuck, *supra*, at 1485 ("if the rule is designed by the states, then the competition among them will lead state officials to exclude consideration of [third party] interests").

[20] *Id*.

[21] *Id.*, at 1486.

[22] New State Ice Co. v. Liebmann, 285 U.S. 262, 311 (1932) (Brandeis, dissenting).

[23] Cites.

[24] Jed Rubenfeld, *State Takeover Legislation and the Commerce Clause: The "Foreign" Corporations Problem*, 36 Cleveland St. L. Rev. 355, 357 (1988).

[25] Cites.