

THE RACE FOR THE BOTTOM IN CORPORATE GOVERNANCE

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I'M delighted to be back at Mr. Jefferson's University 25 years after the 50th Anniversary Conference. I assume that there will be a 100th Anniversary conference in 2034, and I'm looking forward to that one too. (Even if the SEC is abolished, as the Treasury has proposed,¹ there will be an occasion for a retrospective.) My association with the SEC goes way back. In the 1970s, when I was in the Solicitor General's Office, I helped them lose some prominent cases, including *Blue Chip Stamps* and *Chiarella*;² I'm sure that the SEC could have lost them without me, but it was fun to have participated.

Twenty-five years ago, Dan Fischel and I presented a paper about mandatory disclosure.³ We concluded that compulsory disclosure could help solve a free-rider problem that might lead each firm, in the interest of its own investors, to say too little (from society's perspective) because some of the value of any disclosure would accrue to investors in rival firms. Reciprocal disclosure would benefit all investors by allowing them to compare investment opportunities, so that funds would flow to their socially most-productive uses; the only way to achieve reciprocal disclosure, given the coordination problem, was through a rule of law. Whether these benefits exceeded the costs of disclosure was (and remains) an open question; likewise it is questionable whether re-

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¹ Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* 11 (2008).

² *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975); *Chiarella v. United States*, 445 U.S. 222 (1980).

³ Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 Va. L. Rev. 669 (1984).

reciprocity could be achieved when firms could choose to remain private (or go private). But at least there was potential for gain.

Fischel and I assumed, as did others during the 50th Anniversary conference, that all important details about what happened after firms raised capital would be governed by state law. That assumption would have been controversial during the 1960s and 1970s, but by 1983 it was common ground among students of corporate and securities law. Why was it controversial in the 1960s, settled in 1983, and controversial again today? That's my topic.

I chose the subject and title of this talk in homage to Ralph Winter's paper, published about 30 years ago, entitled *State Law, Shareholder Protection, and the Theory of the Corporation*.⁴ It is the most important contribution to the economic analysis of corporate law since Ronald Coase's *The Nature of the Firm* in 1937.⁵ Only the roughly contemporaneous paper by Jensen and Meckling about agency costs and the theory of the firm is a serious rival.⁶ To understand why I'm today worried about a race to the bottom, I take you back to the 1970s, when Ralph Winter was a professor at Yale. (He did not become a federal judge until 1982.)

The dominant academic view was that Delaware had waged and won a "race for the bottom" in corporate law by offering ever-more-favorable terms to managers, who then moved their corporations to that lax jurisdiction. William Cary, who was Chairman of the SEC from 1961 to 1964, wrote the most famous denunciation,⁷ but Stanley Kaplan, from whom I took corporate law at Chicago, held the same view. When the faculty of the University of Chicago teaches that markets are bad, as Kaplan did, and that only federal regulation can save the day, you can be confident that there was an academic consensus.

Naturally managers would want the most discretion, the better to steal from investors, the argument goes. Naturally states compete to offer that discretion, the better to increase their franchise

⁴ 6 J. Legal Stud. 251 (1977).

⁵ R.H. Coase, *The Nature of the Firm*, 4 *Economica* (n.s.) 386 (1937), reprinted in R.H. Coase, *The Firm, the Market, and the Law* 33 (1988).

⁶ Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. Fin. Econ. 305 (1976).

⁷ William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663 (1974).

fees. Berle and Means told us that managers are concentrated and strong, while investors are scattered and weak.⁸ The separation of ownership and control, which allows firms to accumulate vast sums from thousands of people, left the investors powerless. Each is too small to have influence either directly or through elections; indeed none of the scattered investors would study the firm with care, because each knows that his shares have too few votes to influence the outcome. All are rationally ignorant and rationally passive. Thus managers can do what they want—and what they want is to appropriate investors' wealth to the extent the law allows.

So the professors and political reformers clamored for stringent federal regulation. Instead of letting managers decide how firms were run and governed, government should establish minimum standards for investors' protection. If states are unwilling, then the national government must do so. This led to calls for national chartering, or at least national standards of governance built on the national standards of disclosure from the Securities Acts of 1933 and 1934.⁹ If the states were the villains of the piece, the national government was to be the knight in shining armor.

What Judge Winter asked is how everyone other than managers and state legislators could be so stupid. If managers could exploit scattered investors by locating in Delaware, everyone had to know it—and know it long before Cary told them. Why would investors be patsies? Major investors are savvy; over the long run, ignorant investors lose their stakes to smart ones, so at any given time the people who control the largest sums and most affect stock prices will be sophisticated. They know everything professors of law know about corporate management and performance. If managers divert returns from investors, professional money managers and other big investors will put their money elsewhere or demand compensation *ex ante*.

To get investors to pony up, managers must make credible promises. If managers set up governance structures that allow them

⁸ Adolph A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* (1933). See also "Corporations and Private Property," the fiftieth-anniversary conference on that book, in Volume 26 of the *Journal of Law & Economics* (1983).

⁹ For just one of the many examples, see Ralph Nader, Mark Green & Joel Seligman, *Taming the Giant Corporation* (1976).

to skim, then investors will pay less at the outset, until the lower investments raise the expected return to the competitive level. In this way entrepreneurs pay *ex ante* for the right to appropriate *ex post*: investors put up less and are not exploited. If entrepreneurs want to raise more capital, they must make promises that the investors find satisfactory. When we observe that investors funnel their money toward firms incorporated in states that allow discretion—where board members need not serve staggered terms on boards, and firms need not offer preemptive rights or cumulative voting—they are telling us that these devices cost more than the benefits they deliver to investors.

Corporate law came to be enabling rather than directory in the United States because that serves investors' interest, not because it serves managers' interest. States that adopt inefficient regulation propel capital out of their jurisdictions. Entrepreneurs and managers choose where to incorporate, and investors then choose whether and how much to chip in. If managers pick a jurisdiction that allows them to exploit investors, then investors put their funds elsewhere.

What drives this engine is ease of movement within the large United States market plus the internal-affairs doctrine, a choice-of-law principle under which each state respects the governance structures of firms incorporated elsewhere.¹⁰

This vital doctrine restricts states' ability to discriminate against corporations that have their headquarters in other states. Firms could move their charters without moving their operations—quite unlike the “real seat” doctrine in Europe, which was created by France in the 19th Century to block competition from England! And it happened that Delaware was small enough to make a credible commitment to maintain an efficient law. It gathers about 25% of the state budget from corporate charter fees, a bond of good faith toward investors who lack votes in the legislature. Delaware enforces a strong fiduciary duty of loyalty but allows firms to select freely among institutions for governance. (It is a sidelight that the European Union has now rescinded the real-seat doctrine, so we

¹⁰ See Roberta Romano, *The Genius of American Corporate Law* (1993); M. Todd Henderson, *Two Visions of Corporate Law* (Univ. of Chi., John M. Olin Law & Economics Working Paper No. 449, 2009), available at <http://ssrn.com/abstract=1328343>.

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can expect more competition there. Until we know how the European Union will deal with choice-of-law issues, that competition will be hindered).

Competition among jurisdictions is insufficient by itself to drive a strong competitive engine. There are only fifty states, most of which use a single model law drafted by the ABA. For jurisdictional competition to work along Charles Tiebout's lines,¹¹ there must be thousands of competing polities, enough to offer all the different combinations of rules that a complex economy requires. Firms differ in their structure and organization; they need lots of different models. Still, there are other sources of competition.

Financial markets, which I have mentioned, are one. Entrepreneurs must compensate investors *ex ante* for inefficient rules. As long as at least one state offers an enabling model, in which entrepreneurs may choose freely among governance devices, competition to raise capital will drive governance strongly toward efficiency. This process operates not only when firms form, or raise venture capital, or go public, or issue large new blocs of securities. It happens all the time. Investors insist that firms distribute money rather than squirrel it away for liquidating dividends. Bonds must be paid down and retired; dividends on shares are common. The adverse tax consequences of these distributions must have offsetting benefits. But I want you to keep in mind my qualifier: "As long as one state offers an enabling model." I'll come back to that.

Michael Jensen and I observed in separate articles in the 1980s, extending Judge Winter's work, that ongoing financial distributions are valuable precisely because they keep firms in the market for money.¹² Corporations distribute and raise capital simultaneously. And whenever they raise capital, the value of their governance devices is assessed in competition. Firms that have poor governance raise less per dollar of anticipated profit—which is to say, the imputed interest rate on their equity financing is higher.

Firms that pay more for money are at a disadvantage in a second competitive market—the market for their products. To have

¹¹ See Charles M. Tiebout, A Pure Theory of Local Expenditures, 64 J. Pol. Econ. 416 (1956).

¹² Frank H. Easterbrook, Two Agency-Cost Explanations of Dividends, 74 Am. Econ. Rev. 650 (1984); Michael C. Jensen, Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers, 76 Am. Econ. Rev. (Papers & Proc.) 323 (1986).

money to appropriate from investors, managers first must *make* profits. They can't do that if their rivals have a lower cost of capital. So to be in a position to appropriate, the managers must make credible promises *not* to appropriate! Competition works wonders. Adam Smith would say: "It is almost as if there were an invisible hand"

And there are still more markets that protect investors. Think of the market for corporate control. If one firm is poorly managed and investors do not receive the highest return on their money, that will depress the price of shares. Someone else can buy up the shares, improve the management or governance devices, and sell the firm again at a profit. I've sometimes suggested that the University of Chicago do this with Harvard, but the lack of traded stock impedes this device. For business corporations, however, the market in corporate control provides helpful incentives *ex ante* and a corrective *ex post*.

In all of this there are no third-party effects. Competition and contracts promote efficiency to the extent that contracting parties bear the gains and losses themselves. In corporate finance that condition is satisfied. Strangers to the finance and governance bargain, such as debt investors and labor, arrange their affairs by their own contracts. With all costs borne by the participants, free contracting in a competitive system just has to promote everyone's welfare.¹³

Professor Winter, as he then was, wrote at a moment when it was becoming possible to test propositions about the way financial and corporate markets work. Data about stock prices were being compiled at Chicago by the Center for Research in Securities Prices; computers were becoming cheaper; statistical software was coming to market. Soon it was possible to conduct what came to be known as "event studies": look at how events in the life of corporations, or corporate law, affect securities prices. Filter out unrelated events,

¹³ This is a major conclusion of my work with Daniel Fischel, much of which is restated in *The Economic Structure of Corporate Law* (1991). Recent studies of many nations' legal systems support this conclusion by showing that an independent judiciary that enforces contracts and penalizes frauds conduces to growth, while nations that regulate businesses via mandatory rules of organization have lower rates of growth. See Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 *J. Econ. Lit.* 285, 291–300 (2008).

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including general market movements—the Capital Asset Pricing Model provides a way to do this—and isolate the effect of the event you care about. With savvy investors, stock prices reflect real information, and even though markets are not perfectly efficient—they don't reflect the value of *all* information—stock prices are what investors want to maximize. Even when markets are inefficient, investors know that higher prices are better than lower ones.

Study after study tested the Winter Hypothesis that more discretion enables managers to design governance devices that investors welcome. When firms reincorporate in Delaware, stock price rises. When firms get rid of classified boards, price rises (and when they stagger directors' terms, prices fall). When states or firms impede the market in corporate control by issuing poison-pill stock, prices fall. The list goes on and on. There are and always will be debates about just how strong these effects are and what we make of the exceptions, but as Everett Dirksen would have put it, a few percent here and a few percent there in a multi-trillion dollar economy, sooner or later it adds up to real money. There is a race, and investors are winning.¹⁴

Now we come to the heart of my topic today: Are we *still* in a race for the top, or has the direction been reversed? When Judge Winter wrote in 1977, the national government played little role in corporate governance. The Securities Exchange Act of 1934 established voting procedures for corporate elections, but these elections were themselves all but irrelevant given rational ignorance and the Wall Street Rule: if dissatisfied, an investor sells rather than votes. The Williams Act of 1968 set some rules for tender offers and thus diminished the force of the market for corporate control, but as the takeover boom of the 1970s and 1980s demonstrated, there was still plenty of force in that monitoring and correction mechanism. And there were the federal disclosure rules themselves, which are costly and have doubtful net benefits. Paul Mahoney has shown that the benefits of disclosure had been achieved by contract *before* Congress acted in 1933; there was little left for legislation to add, unless Congress were to require disclo-

¹⁴ Romano, *supra* note 10, collects and discusses much of this work. But see Lucian Bebchuk, Alma Cohen & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law?, 90 Cal. L. Rev. 1775, 1778–1781 (2002).

sure even by firms that do not have publicly traded equity.¹⁵ But, given competition, neither did the 1933 Act do any harm.

Since Judge Winter published his article, however, the national government has done considerably more.¹⁶ The SEC has added rules to the Williams Act, and many of these—such as rules forbidding warehousing of stock, the secret formation of acquiring groups, and short tenders—have gone far to hamper the market in corporate control.¹⁷ Tax rules have been used to make many takeover strategies unprofitable and hinder many compensation devices used to align managers' financial interests with those of investors. The Sarbanes-Oxley Act has specified many governance devices that all traded firms must employ. Recently the SEC greatly limited short sales—as if it should be deemed a bad thing for trading markets to fall as well as rise. I had thought that the premise of the 1933 and 1934 Acts was the desirability of accurate markets.

These national rules are *not* defaults, which investors may supersede by contract when they deem another device preferable. They are prescriptions, and prescriptions knock out not only jurisdictional competition but also several of the competitive devices in financial markets. If federal law prevents entrepreneurs and managers from using particular organizational devices, they are not penalized (relative to their rivals) for failure to offer them. If the mandatory rules turn out to be bad ones, investors can lose. The national government, in other words, can win a race to the bottom in a way that states cannot. Winter said that Cary was wrong to think that states are racing for the bottom; my addition today is that Cary had things *backward* in thinking that the national government was superior to the states in corporate regulation. And we are moving toward national regulation of corporate governance.

¹⁵ Paul G. Mahoney & Jianping Mei, Mandatory vs. Contractual Disclosure in Securities Markets: Evidence from the 1930s 28–29 (Univ. of Va. Law Sch. John M. Olin Program in Law & Econ. Working Paper Series, Paper 25, 2006), available at <http://law.bepress.com/uvalwps/olin/art25/>.

¹⁶ See generally Lucian A. Bebchuk & Assaf Hamdani, Federal Corporate Law: Lessons from History, 106 Colum. L. Rev. 1793 (2006).

¹⁷ Cf. Lucian Arye Bebchuk & Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, 99 Colum. L. Rev. 1168 (1999).

The Sarbanes-Oxley Act is lengthy, and a detailed exposition is unnecessary.¹⁸ It does three principal kinds of things. First, it requires “equal and fair” disclosure of corporate information. I do not get into details, but the Sarbanes-Oxley Act in combination with Regulation FD (for “fair disclosure”) forbids preferential disclosures to market analysts. The goal may have been to expedite disclosure, but I suspect that it will retard disclosure and make statements more generic, because facts can’t be revealed in confidence—and secrecy may matter to managers who don’t want to tip off their competitors. Paradoxically, rules that require more-equal access to information may produce less total disclosure, and thus hamper the power of financial markets to protect investors.

The second principal requirement of Sarbanes-Oxley is that traded corporations have independent boards—that is, boards of directors, a majority of whose members are independent of the issuer or anyone affiliated with the issuer. Each firm also must have one committee to choose an auditor and another to set executive compensation, and these committees must be 100% independent of the insiders. The idea is that insiders forced to justify themselves to skeptical independents will be better servants of investors’ interests.

That may or may not be so. Sarbanes-Oxley Act sets up an adversarial model of governance more closely related to adjudication than to cooperative production, and it may divert managers’ time from making business decisions to making PowerPoint presentations. Perhaps CEOs will end up, like cabinet officers, as front men who conduct road shows, answer questions, and certify financial statements, while a deputy really runs the firm. Would that be an improvement, or just a layer of pointless bureaucracy?

Independent directors tend to be ignorant directors. Independence means that they don’t know what’s going on, except what managers tell them. Professors of all people should know this. Universities’ boards of trustees are almost completely “independent” but are also kept in the dark, and hence under the thumb of the president and faculty.

¹⁸ John C. Coates IV, *The Goals and Promise of the Sarbanes-Oxley Act*, 21 *J. Econ. Persp.* 91 (2007), provides an accessible description of the Act.

Roberta Romano has written a wonderful article called “The Sarbanes-Oxley Act and the Making of Quack Corporate Governance.”¹⁹ Her main point is that the Sarbanes-Oxley Act’s governance prescriptions find little support in event studies of the kind I described a while back.²⁰ My concern is that even if event studies *did* show benefits, on average, from independent boards and an adversarial model of governance, there would not be an adequate basis for suppressing competition in the design and implementation of governance devices. If the Act is good for 60% of firms and bad for 40%, there could be net gains—but it would promote growth to limit the Act’s rules to the 60% while allowing investors in the other 40% to choose a model that works best for them.

Consider four models of the corporate board. One is the Sarbanes-Oxley model, in which outsiders choose and monitor the managers. The potential drawbacks are that lower stakes means poor incentives; that outside status means less information; and that skeptical relations between managers and the board may enmesh firms in bureaucratic tussles.

Model #2 is a generational competition model. The board includes the current managers and their underlings, who will be tomorrow’s top dogs. Generation #2 monitors Generation #1 closely, to ensure that the corporation flourishes until they take over. They have good information and incentives; investors are incidental beneficiaries of this process. True, the generations may conspire against investors, but Generation #2 does not want to be left holding the bag.

Model #3 depends on large bloc holders to do monitoring. A surprisingly large number of corporations, even the biggest ones,

¹⁹ 114 Yale L.J. 1521 (2005).

²⁰ *Id.* at 1526–29. Empirical work after Sarbanes-Oxley (“SOX”) vindicates these conclusions. See, e.g., Eitan Goldman & Steve L. Slezak, An equilibrium model of incentive contracts in the presence of information manipulation, 80 J. Fin. Econ. 603 (2006); Kate Litvak, Sarbanes-Oxley and the Cross-Listing Premium, 105 Mich. L. Rev. 1857 (2007); Ivy Xiyang Zhang, Economic consequences of the Sarbanes-Oxley Act of 2002, 44 J. Acct. & Econ. 74 (2007); Kate Litvak, Defensive Management: Does the Sarbanes-Oxley Act Discourage Corporate Risk-Taking? (Univ. of Tex. Sch. of Law, Law & Econ. Research Paper No. 108, 2008), available at <http://ssrn.com/abstract=994584>. There is also one event study suggesting that SOX is beneficial. Haidan Li, Morton Pincus & Sonja Olhott Rego, Market Reaction to Events Surrounding the Sarbanes-Oxley Act of 2002 and Earnings Management, 51 J.L. & Econ. 111 (2008).

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have investors (or small groups of investors) that own 10% or more of the stock. Harold Demsetz and Kenneth Lehn showed that these large blocs are associated with better performance because the owners are good monitors.²¹ Many firms lack such helpful monitors, and for them independent boards may be better; but under Sarbanes-Oxley independent boards and committees are required no matter how large the major blocs, and this may frustrate the ability of the very best monitors to protect other investors.

Model #4 is the market in corporate control. Boards can be under managers' thumb, but outsiders are free to gather up stock and displace the incumbents, making a profit if (and only to the extent that) the firm is more valuable after the transformation than it was before. The takeover mechanism judges governance by *results* rather than process. The high transactions costs of the control market make it imperfect—and the national government has been doing its best to increase those costs, which is regrettable. A meta-analysis of empirical work by Lucian Bebchuk and others shows that what *really* helps investors are changes that promote the market for corporate control:²² rescinding poison pills helps; removing staggered boards helps because outsiders can take control more quickly; removing supermajority requirements for mergers helps investors. But the details of independence on the board help investors not at all.

Which of these four models is best for a given firm is impossible to say a priori. Different styles of governance may suit one firm at different times. Perhaps the independent-monitoring model is best for most firms, most of the time. But that does not justify the exclusion of other options, when intelligent adults are willing to put their own money on the line. Vanilla ice cream is best for most people, most of the time; it is far and away the most popular flavor; but no one thinks that society would be better off if all other flavors were forbidden by federal law! A reduction in the opportunity set makes everyone worse off, all of the time; and since there are no third-party effects in corporate governance, there is no excuse for curtailing the opportunity set.

²¹ Harold Demsetz & Kenneth Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 *J. Pol. Econ.* 1155, 1161 (1985).

²² Lucian Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 *Rev. Fin. Stud.* 783 (2009).

The third requirement of the Sarbanes-Oxley Act is more monitoring by accountants, in addition to monitoring by independent directors. This takes several forms. The audit committee chooses the accountant. The accountant is forbidden to offer business consulting services in addition to accounting services; that combination is said to offer too great an incentive to go along with the managers in order to get the consulting profits. The accountant must turn over its engagement leaders every five years, if not more frequently; long tenure is said to lead to excess familiarity, so the costs of training replacements must be borne. Finally, each firm must establish an elaborate system of financial controls supervised by the accountant.

When Congress asked the SEC to estimate the costs of these controls, ultimately required by Section 404 of the Act, it came up with the number \$91,000 per firm per year. That seemed like a small price to pay for better controls on theft. The actual experience has been that Section 404 costs the economy more than \$35 billion annually—that's about \$7.8 million per reporting company, or about 30 times the SEC's estimate.²³ Even the head of the new audit-control body created by the statute says that this is way too much to pay for so marginal a gain—for one must remember that frauds are not caught by auditors and internal controls. Fraud comes to light when those in the know squeal, or when the results of the firm as a whole go south, or when someone stumbles over them by accident.

People often say that in light of Enron, WorldCom, and other scandals something just had to be done—and that Congress acted because Delaware failed to do so. It is not clear to me that something had to be done; fraud has been with us for a long time, and neither OPM nor National Student Marketing nor any of a hundred other scandals led to such legislation. Sarbanes-Oxley did not cause the market to rise, as it would have done if the statute solved a problem that injured investors. Nor would it have made sense for

²³ Robert Charles Clark, *Corporate Governance Changes in the Wake of the Sarbanes-Oxley Act: A Morality Tale for Policymakers Too*, 22 *Ga. St. U. L. Rev.* 251, 292–93 (2005); see also Michael W. Maher & Dan Weiss, *Costs of Complying with the Sarbanes-Oxley Act* (UC Davis Graduate Sch. of Mgmt., Research Paper No. 10-08, Nov. 25, 2008), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1313214.

Delaware to have “done something,” where the “something” in this blank is a reduction in the scope of competition and private choice.

One of life’s ironies is that Enron was a model corporation by the standards of William Cary and the Sarbanes-Oxley Act. It had a majority-independent board. It had independent audit and compensation committees. Its auditor was Arthur Andersen—not only held out as the gold standard of the industry, but also the first to divest its consulting operation, into the separate firm now known as Accenture. The post-Enron “discovery” that Andersen was a bad, indeed, a criminal, firm is a fairy story. The Supreme Court reversed its criminal conviction,²⁴ and Ted Eisenberg and Jon Macey found after a painstaking empirical study that Andersen had lower error rates than other large accounting firms.²⁵

Nonetheless, the upshot of Sarbanes-Oxley Act is that, today, every firm must be governed just like Enron! One thing that went wrong at Enron is that the firm and its operations were *so* complex that people who spent less than full time there could not understand what was going on—and even some insiders have pleaded ignorance. One of the outsiders was Wendy Gramm, an academic economist who had been Chairman of the Commodities Futures Exchange Commission. Enron’s audit committee included a former dean of the Stanford Business School.²⁶ If they could not grasp what Enron was doing with derivatives and special-purpose entities, then what hope is there for a model of monitoring by independent, and thus ignorant, outsiders? Remember, too, that the Compensation Committee of the New York Stock Exchange—also a bunch of independents—said after the fact that it just couldn’t understand the complex package of compensation for Chairman Grasso and never would have approved had they but known.

You are entitled to ask me, if independence and the other features of Sarbanes-Oxley are problematic, how this legislation came

²⁴ Arthur Andersen LLP v. United States, 544 U.S. 696 (2005). The prosecution elected not to retry the case after the Supreme Court’s decision.

²⁵ Theodore Eisenberg & Jonathan R. Macey, Was Arthur Andersen Different? An Empirical Examination of Major Accounting Firm Audits of Large Clients, 1 J. Empirical Legal Stud. 263, 277 (2004).

²⁶ See Paul M. Healy & Krishna G. Palepu, The Fall of Enron, 17 J. Econ. Persp. 3, 14 (2003).

to be. And to get a handle on an answer we have to think public choice—which is to say, the economics of politics.

States can't harm investors for Ralph Winter's reasons—if they make bad laws, capital migrates elsewhere. Managers can't do much harm either; if they make mistakes (whether in selecting governance rules or in running their firms) capital migrates elsewhere. Managers can steal, of course, but criminal law takes care of that without any need for special rules of corporate law.²⁷ Letting the criminal law take care of theft and fraud, while allowing investors freedom of contract to specify governance structures, is the best formula for long-run wealth. Capital is highly mobile, as are governance structures, even when physical assets and labor are immobile. The internal-affairs doctrine coupled with the Constitution's commerce clause prevents states from discriminating against firms that move their governance elsewhere. But it is much harder to remove capital from the United States as a whole, and this country does *not* recognize an internal-affairs doctrine in its dealings with other nations. If Congress makes a mistake, it is not automatically undercut by market forces.

Instead of saying that firms may incorporate in any country they choose, and that we will respect the corporate and securities laws of those nations,²⁸ the United States insists that all firms that raise capital in the United States follow domestic rules, even if their operations and principal sources of capital are abroad! Now the SEC is discussing having the United States adopt the E.U. model of accounting; it sees this as an either-or choice rather than an occasion for competition in which investors can vote with their dollars (and their euros). Having negated the principal means by which interest groups' rent-seeking is undercut, the United States has set itself up for the exploitation of investors at the national level.

²⁷ See, e.g., *United States v. Black*, 530 F.3d 596 (7th Cir. 2008).

²⁸ This is Stephen J. Choi and Andrew T. Guzman's suggestion in *National Laws, International Money: Regulation in a Global Capital Market*, 65 *Fordham L. Rev.* 1855, 1897–98 (1997). Cf. James D. Cox, *Coping in a Global Marketplace: Survival Strategies for a 75-Year-Old SEC*, 95 *Va. L. Rev.* 941, 984–85 (2009) (“The fact that the regulatory gap has narrowed, whether a lot or just somewhat, between U.S. markets and major foreign markets provides an easier ground for mutual recognition to occur . . .”).

Recall the basic model of Mancur Olson:²⁹ Interest groups that want legislation are beset by free riding. Most group members stand on the sideline; and if everyone does this, the public interest may prevail. But small and concentrated groups may succeed where large ones fail. Solve your free-riding problem, while others can't, and your political agenda flourishes. This is what we see over and over. Small groups from which dropping out is hard—for example, dairy farmers and sugar producers—get favorable legislation, provided that the costs are widely distributed and hard to trace. The price of milk and sugar is up; the cost spreads through the entire food chain in a way that consumers cannot fathom. And if they could trace the effects, they could not do much because none has enough of an interest to act. The power of this understanding is borne out by every issue of the *Journal of Law and Economics*, which gives another example of some statute that bestows benefits on a well-organized and small interest at the expense of consumers.

So who are the interest groups in corporate law? Not the academy, surely. William Cary did not accomplish much even when he was head of the SEC; anyway, Ralph Winter converted the academy on this subject, so professors of corporate and securities law are today as market-oriented as they used to be pro-regulation. But the accounting profession, and the professional outside directors, are something else again. The accounting profession is *highly* concentrated and has learned that it can get benefits at the national level. The Sarbanes-Oxley Act increased the amounts corporations pay for accounting services. Does it surprise you that, after multiple scandals showed that accountants were not very good at detecting or preventing fraud, new legislation required firms to purchase more accounting services? Why buy more of a low-quality good? But if you think in public-choice terms, it should not surprise you that accounting failures become a means by which resources are transferred from investors to accountants.

Now wait!, I hear you thinking. Investors lose when governance options are curtailed. Per Ralph Winter's mechanism, managers serve investors' interests. Thus managers should be first in line to

²⁹ Mancur Olson, Jr., *The Logic of Collective Action: Public Goods and the Theory of Groups* (1965).

defeat statutes such as the Sarbanes-Oxley Act. And since “everyone knows” that big corporations are effective lobbyists, this should protect investors fully.

Unfortunately, what “everyone knows” about the power of corporate lobbying is wrong. Consider question number one: how does this group solve the problem of free riding? People who *could* influence legislators, if they tried, need a good reason to try. If other persons similarly situated will do the job, any particular member of the group can sit on the sidelines, reaping the benefits without incurring the costs. As the group grows in size, free riding becomes first serious and then intractable—unless a solution can be found. Overcoming free riding is easier when the group is small, cohesive (ideally, when dropouts are impossible), able to confer large benefits on each member and to exclude non-members from sharing in these benefits, and able to spread the costs widely so that they do not stir up opposition.³⁰ Your group prevails if its free riding problem is less serious than the problem afflicting your rivals. In many ways the *most* powerful groups are those that the conventional wisdom treats as powerless: for example, minorities that have limited agendas, and from which dropping out is not an option.³¹

Corporations fare poorly in handling free riding. Firms do not vote and are forbidden by law from making political contributions. Thus corporate influence depends on ability to engage the interests of investors and other stakeholders. Yet there are many large firms, with constant entry and exit. Large corporations have widely traded investments. Liquid securities markets make buying and selling these investments easy. Dropout at the investor level is almost costless.

³⁰ See, in addition to Olson, any of the many economic analyses of interest group politics reflecting the influence of his work, along with James M. Buchanan and Gordon Tullock's *The Calculus of Consent: Logical Foundations of Constitutional Democracy* (1962). E.g., Gary S. Becker, A Theory of Competition Among Pressure Groups for Political Influence, 98 Q.J. Econ. 371 (1983); Sam Peltzman, Toward a More General Theory of Regulation, 19 J.L. & Econ. 211 (1976); Richard A. Posner, Theories of Economic Regulation, 5 Bell J. Econ. & Mgmt. Sci. 335 (1974); George J. Stigler, The Economists' Traditional Theory of the Economic Functions of the State, in *The Citizen and the State* 103 (1975).

³¹ See Bruce A. Ackerman, Beyond Carolene Products, 98 Harv. L. Rev. 713, 744–46 (1985), for a rare example of a scholar appreciating that, once able to vote, “discrete and insular minorities” hold disproportionately large political power.

Portfolio theory has taught investors, and their surrogates at financial intermediaries such as pension and mutual funds, that safety lies in diversification. A diversified investor cares about the success of the economy as a whole and is indifferent to the fortunes of any corporation. Rational ignorance prevails.³² Most investments today are held in diversified portfolios, and indirectly (by insurance or pension trusts or university endowments) rather than by natural persons. So real people, who alone have the power to vote for Congress, do not much care what happens to particular firms.

To speak of “corporations” is to speak of the economy as a whole, and therefore to speak of a disorganized and ineffectual group—the target of small, concentrated, and therefore powerful adversaries. Businesses are at each other’s throats (this is what competition in both product and political markets is about) and cannot collaborate to dominate the political process. Corporations that want to emit soot must fight off corporations that manufacture soot-control equipment. One hundred years ago corporate holdings were more concentrated; the House of Morgan and the Rockefellers could mobilize political power. Their successors, the Vanguard Group of Mutual Funds and TIAA-CREF, are politically neuter.

Only small, closely held corporations are likely to be politically effective: investors in these firms are not diversified, and dropout is costly. No surprise, then, that the small business lobby is influential—that corporations with fewer than, say, fifty employees regularly win exemptions from laws imposing costs on larger businesses. No surprise that the Sarbanes-Oxley Act does not cover small corporations.

If you doubt this perspective on corporate influence, ask yourself: why is there a corporate income tax? Not because corporations are wealthy; corporations are just place-holders, collective names for aggregates of investments. The corporate tax is attractive to politicians because it is invisible. No natural person pays the bill. Investors are so scattered and diversified that they cannot resist it, cannot even tell who pays it. As a matter of economic theory

³² See Easterbrook & Fischel, *supra* note 13, at 66–67.

the incidence of corporate taxation is hard to pin down.³³ Everyone believes that someone else pays it, and so everyone supports it, although it is in many dimensions less desirable than a unified tax system.³⁴

So, too, everyone believes that “someone else” pays for reductions in emissions, safer products, and problematic “improvements” in corporate governance. No concentrated interest group opposes the demand for regulation, which appears (to those demanding it) to have few costs. Corporations do not hold political power in America: they are too large, and their investors too many. And so they can be exploited at the national level by statutes sold in the name of investor protection.

Worse, the innovations in Sarbanes-Oxley Act are regressive and thus hamper competition in the product market. For very large firms, the costs of Section 404 compliance are between about eight and twelve basis points on sales. For firms with less than \$100 million in revenue, however, the costs are about 2.5% of sales!³⁵ That is a whopping competitive advantage for the larger firms and will slow entry, which not only hampers competitive pressure on governance devices but also may reduce the allocative efficiency of the product markets themselves, producing the same sort of economic loss as does monopoly.

What, then, is to prevent a race for the bottom at the national level? One answer lies in the special nature of this race: It is not being conducted by, or for the benefit of, corporate managers. The managers themselves remain in a competitive system. If they *choose* any sub-optimal governance system, they will pay a price in financial markets, which will hamper them in product markets. Firms whose managers choose poorly will contract relative to firms whose managers choose well. That’s a comfort.

So, too, it remains a comfort that managers can choose to remove themselves, and their investors, from the Sarbanes-Oxley

³³ See Charles E. McLure, Jr., Incidence Analysis and the Supreme Court: An Examination of Four Cases from the 1980 Term, 1 *Sup. Ct. Econ. Rev.* 69, 82 (1982).

³⁴ See President’s Advisory Panel on Fed. Tax Reform, Simple, Fair, and Pro-Growth: Proposals to Fix America’s Tax System 99–102 (2005); Alvin C. Warren, Jr., *Am. Law Inst., Federal Income Tax Project: Reporter’s Study of Corporate Tax Integration* 40–46 (1993).

³⁵ Clark, *supra* note 23, at 293–94.

system by going private—though this weakens the force of mandatory disclosure, the original goal of federal securities law. Markets have become more adept at finding ways to finance private firms, such as LLCs and other entities that Larry Ribstein calls “uncorporations.”³⁶ These entities can adopt optimal governance strategies, and they will put competitive pressure on others, and raise the costs of interest-group, rent-seeking legislation at the national level. Uncorporations may appear to give up the benefits of public markets for raising capital, but institutions such as mutual funds, hedge funds, insurers, pension funds, and even university endowments are available. Perhaps we will see a transition toward a system in which only those large corporations that are *not* hampered by the Sarbanes-Oxley Act and similar laws will remain “public”; the balance between reporting corporations and uncorporations will tell us which devices are efficient.

One caution, however: Uncorporations could be regulated indirectly by controls on mutual funds (including hedge funds) and other pools of capital. Proposals to change the governance of these pools are outside my topic today but need careful study and wary watching.

Another possibility is international competition.³⁷ The United States may try to prevent it, but the time when the United States ruled the global economy is past. Increasingly the United States looks like one state in the larger, global economy, and international capital movements may render rents from domestic regulation unavailable, and thus reduce the demands on political actors.

We have seen this happen in derivative securities—options, futures contracts, and one-off transactions such as swaps. At one time the United States tried to regulate these in detail. New futures contracts had to be proposed and vetted by the CFTC before they could be traded. The SEC tried hard to prevent trading in what it called “narrow-based indexes,” which might compete with options traded by the SEC’s client exchanges, and for a time Congress for-

³⁶ Larry E. Ribstein, *The Rise of the Uncorporation* (Univ. of Ill. Coll. of Law, Ill. Law & Econ. Research Papers Series, Research Paper No. LE07-026, 2007), available at <http://ssrn.com/abstract=1003790>.

³⁷ The Committee on Capital Markets Regulation stressed the declining competitiveness of U.S. markets in *The Competitive Position of the U.S. Public Equity Market* (2007).

bade all trading in single-stock futures contracts, which are direct substitutes for options and physical securities. These rules all have gone away.

It would be nice to think that they vanished because data showed that newspaper-ish tales about derivatives markets—such as that they increase volatility, that program trading with derivatives caused the crash of October 1987, that they injure farmers or small investors, and so on—have been punctured by data. These tales *have* been punctured: Derivatives *reduce* volatility; they are great ways to trade because they have lower execution costs; they can be used to hedge against risk of both physical and financial commodities; they supply liquidity to markets; derivatives traders also supply information that makes prices more efficient. (The credit-risk derivatives that brought down AIG were not market traded, and AIG failed to balance its portfolio. It took a risk, and taxpayers lost. But that's a different story.) Still, it would be foolish to suppose that scholarly studies change national legislation. If that were so, Sarbanes-Oxley would never have been enacted.

What happened in the regulation of derivatives is that international competition undid U.S. regulation. Trades moved from the Chicago Board of Trade, which had to wait for regulatory approval, to exchanges in London, Frankfurt, and Hong Kong that were not so hobbled. The loss of business led U.S. exchanges to beg for statutory change—and it also meant that there was no U.S. interest group that could gain from holding onto the old rules or adding another layer of regulation. That changed the political market, and the Modernization Act of 2000 was the result. Even the 2000 legislation gave the SEC a power to put *some* brakes on change, to protect stock exchanges at the expense of futures exchanges. Thus the margin on narrow-based indexes and single-stock futures has been set much higher than the clearing corporations wanted to protect themselves from counterparty risk. But these remaining works of the Handicapper General are bound to be undercut by both international competition and the professional-only markets that the 2000 Act authorizes.

One can hope that a similar process will promote efficient corporate governance, but as long as the United States rejects a system of international corporate movement—so that Singapore or Poland can be tomorrow's Delaware—this will be a slow transition. Per-

haps it will be expedited if investors move beyond unincorporation to dis-integrate the firm itself. I have suggested in other work—too tedious to be repeated here—that just as Coase saw the firm as a response to high costs of market transactions, so when market organization becomes cheaper, as computer auctions and derivatives are making it cheaper, the firm will contract.³⁸ Again we should expect this transition sooner if national rules for corporate governance are too costly. But the transition will not be fast, or cheap, or even possible for many kinds of business; and we still should care about governance while the other forms of competition work their slow ways.

Finally, we should be thankful that rent-seeking at state levels sometimes has its comeuppance at the national level in a way that assists investors. From any state's perspective, most investors live elsewhere and therefore are targets for expropriation. Securities litigation at the state level—which is possible for firms incorporated in other jurisdictions, and thus outside of the competitive pressures Ralph Winter discussed—has been prey to this impulse to redistribute to in-state plaintiffs. The Securities Litigation Uniform Standards Act brings this up short.³⁹

How effective that legislation will be may depend on whether courts embrace or frustrate the Supreme Court's understanding of the 1995 Private Securities Litigation Reform Act in the *Tellabs* case.⁴⁰ All I want to say now is that federal legislation is not always competition defeating. Perhaps we need an extension of the 1995 Act to cover litigation by state attorneys general as well as by the class action bar: the payoff for state politicians does not always match investors' interests, and when AGs of *all* states can litigate the competitive effect of the internal-affairs doctrine is defeated.

Let me close where I began. Ralph Winter's great article of 1977 brought light to a dark corner of the law and set the stage for scholarship for the next generation. We must carry on the worthy

³⁸ Frank H. Easterbrook, *Derivative Securities and Corporate Governance*, 69 U. Chi. L. Rev. 733 (2002).

³⁹ See *Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 74 (2006); *Kircher v. Putnam Funds Trust*, 403 F.3d 478 (7th Cir. 2005).

⁴⁰ *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 127 S. Ct. 2499, 2510 (2007).

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tradition he began by asking whether federal regulation creates the very problem that Professor Cary feared from the states.