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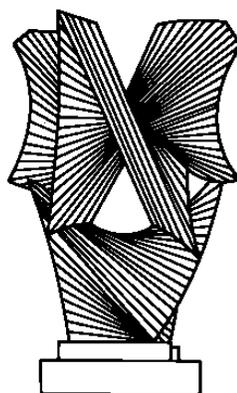
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Two Visions of Corporate Law

M. Todd Henderson

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Two Visions of Corporate Law

M. Todd Henderson[‡]

I. Introduction

What explains the persistence of certain debates in corporate law? Many fundamental questions remain unresolved despite dozens of years of research, countless conferences, and innumerable studies, both theoretical and, more recently, empirical. This is puzzling, since one would expect time and evidence to move us toward a resolution of debates about what is the most efficient way of doing something. This essay argues that these long-standing and unresolved debates are such because they are not really debates about the merits of the issues but rather what Thomas Sowell called “a conflict of visions.”¹ The real debate is a behind-the-scenes tussle between those with a faith in processes (like markets) and those with a faith in expertise. Until this debate is had in the forefront, these other debates will remain unresolved.

The most long-standing and hackneyed debate in corporate law,² and the one that I will use to illustrate my argument, is whether the American way of making corporate law – a state-based approach allowing choice of law not tied to physical location of people, plants, or equipment in any way – is one that will lead toward good rules (states compete in a “race to the top,” developing rules good for shareholders and society at large) or bad ones (states compete in a “race to the bottom,” developing rules good for managers or special interests within society). Hundreds of academic articles have been written on both sides without resolving the question.³ The intractability of the debate has persisted despite dozens of sophisticated and seemingly neutral empirical analyses that have tested the impact of corporate law rules on firm value. One might think that empirical research could “answer” the question, but it seems to have only emboldened the opposing camps.

One answer to the persistence puzzle might be politics. In general, defenders of corporate law federalism are on the right of the political spectrum and critics are on the left.⁴ These political commitments, be they to party, group, class, or whatever, may be sufficient to trump any evidence or analysis. There is some evidence to support this view. The modern debate started with a classic exchange between a Kennedy-appointed SEC chair, William Cary (a bottomer),

[‡] Assistant Professor of Law, The University of Chicago Law School.

¹ See THOMAS SOWELL, *A CONFLICT OF VISIONS: IDEOLOGICAL ORIGINS OF POLITICAL STRUGGLES* (Basic 2007).

² Professor John Coffee has called the race-to-the-top versus race-to-the-bottom debate “the most overwritten theme in academic literature on corporate law.” Remarks of John C. Coffee, Jr. in Symposium, *The Direction of Corporate Law: The Scholars’ Perspective*, 25 *J. CORP. L.* 79 (2000).

³ A Westlaw search for “race to the top” and “race to the bottom” and Delaware reveals over 900 articles as of December 2008.

⁴ See *id.* (“Delaware’s hegemony in the market for corporate charters represents neither the victory for regulatory arbitrage and efficiency that ‘conservative’ scholars have proclaimed nor the defeat for public policy that ‘liberal’ scholars have bemoaned.”).

and a Reagan-appointed federal judge, Ralph Winter (a topper).⁵ It carries on to this day with “conservatives” generally carrying the banner of state competition for corporate charters (and Delaware), and “liberals” advocating for reforms or more federal intervention in corporate law.⁶ But politics doesn’t seem to align perfectly with views on the debate, since some prominent conservative or libertarian law professors have written pieces critical of the state-based model and empirical evidence is supposed to be apolitical.⁷

Going backward a step, political views about federalism in general might be a piece of the puzzle. But there is nothing sacrosanct about state-based law on the right or faulty about it on the left. History is replete with examples in which conservatives have supported federal law over state law (tort law, criminal sentencing, and marriage are all recent examples) and in which liberals have supported state-based law over federal law (euthanasia, medical marijuana, and stem cell research are all recent examples).⁸ Saying one side believes in local control or state law generally does not answer the question about how one will view the law making process for the law governing corporations.

Another related explanation might be that favored political constituencies of the two ends of the political spectrum align in ways that predict the outcome – maybe Republicans favor managers (over shareholders), and state law favors managers, while Democrats favor employees (over investors), and federal law would favor them. But these assumptions are specious on both ends – the linkage between interest group and party,⁹ and between the locus of lawmaking and the outcome.¹⁰ There must be something more than that going on that explains the political choices.

This essay offers a different and more fundamental explanation for the persistence and political alignment of the debate using a recent contribution to

⁵ See William L. Carey, *Federalism and Corporate Law: Reflections upon Delaware*, 88 YALE L.J. 663 (1974); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

⁶ See Coffee, *supra* note 2 at 88. An informal survey bears out this intuition: the leading proponents of a race to the top are all politically more or less conservative (Judge Ralph Winter, Judge Frank Easterbrook, Daniel Fischel, Stephen Bainbridge, Larry Ribstein, and Roberta Romano are prominent examples); while the advocates of a race to the bottom are all more or less liberals (Justice Louis Brandeis, William Cary, Lucian Bebchuk, Melvin Eisenberg, and Ralph Nader are examples).

⁷ For example, Allen Ferrell, a conservative scholar at Harvard Law School, has written papers critical of Delaware and the state-based model. See Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 Cal. L. Rev. 1775 (2002).

⁸ See, e.g., Richard Thompson Ford, “The New Blue Federalists,” Salon.com, Posted Thursday, Jan. 6, 2005, at 5:56 PM ET, available at <http://slate.com/id/2111942/> (“Federalism is not just for conservatives, anymore. . . . Local and state governments can be more innovative, daring, and proactive—in short, more progressive—than even the liberal Congresses of distant memory.”).

⁹ Investors are just as likely to be Republicans as CEOs, and Democrats count among their constituencies labor unions, large pension funds, wealthy investors, and Silicon Valley CEOs.

¹⁰ Firms have many divergent constituencies, and there is no easy or theoretical answer as to whether managers, shareholders, employees, or other corporate stakeholders are more likely to get what they want from the Congress or state legislatures competing with each other. Each type of jurisdictional entity is subject to capture by different political forces, and there is no reason why a stakeholder behind the veil would, if trying to maximize their slice of the firm at the expense of others, choose one form of law making over another.

the debate by Professor Robert Ahdieh as a foil.¹¹ Ahdieh's goal is to break the deadlock in this debate by trying to convince the opposing factions that the debate is based on a misunderstanding about the role played by state competition. Simply put, the race doesn't matter for corporate governance, so everyone should stop talking about it. He argues that corporate governance is determined by markets, not state law.¹² Specifically, the markets for managerial talent and corporate control, not state competition for corporate charters, are responsible for the ability of corporate law to restrain the inevitable agency costs arising when ownership and control are separated. If true, not only is the race debate pointless, but there is nothing special about state-based law. Federal law would do just as well in policing intrafirm governance, assuming the "right" answers as to optimal corporate law can be discovered by federal regulators.¹³

This essay shows why Ahdieh's argument is unpersuasive, then offers an alternative explanation for the persistence of the debate. On the substance, Ahdieh's argument that "markets" do the work of law avoids the fact that state law is ultimately determinative of the nature of the markets. While the market for corporate control disciplines managers, it is competition among states that disciplines states from distorting the market for corporate control. For instance, some important states, like California and New York, have tried to impose judicial review of merger contracts or tried to rewrite them to achieve substantive fairness.¹⁴ Delaware has offered an alternative for firms looking to avoid these doctrines. We don't see more mandatory rules, for good or bad, because of corporate federalism.

After showing why there really is a debate and why it matters, the essay then offers an alternative explanation for its perseverance based on the insight of Thomas Sowell about individuals' competing visions of what makes effective public policy. Sowell describes a conflict between a "constrained" and an "unconstrained" vision of the world. Those with a constrained vision are skeptical of top-down solutions imposed by experts of various kinds, relying instead on systemic processes, like markets, families, or tradition, to deal as best as they can with social problems. These people tend to be political conservatives and toppers. To them, getting the right corporate law rules, be it the rules about takeovers or the optimal composition of the board of directors, is something that only can be achieved through a process designed to filter good rules from bad. In fact, good rules are defined as those that survive such a process.

In contrast, those with an unconstrained vision believe in solutions, instead of second- or third-best tradeoffs, and have more faith in social innovations based on expert analysis. These people tend to be political liberals

¹¹ See Robert Ahdieh, *Trapped in a Metaphor: The Limited Implications of Federalism for Corporate Governance*, ___ G.W. L. REV. ___ (2009).

¹² Ahdieh does see state competition doing some work in restraining states from too much rent seeking vis-à-vis firms—franchise tax rates are kept low because of the threat of reincorporation. *See id.* at ___.

¹³ Ultimately then, Ahdieh, who claims agnosticism about the federal versus state issue, *see id.* at ___, may provide Delaware's enemies with the ammunition they need to win the war against state corporate law, although for reasons having little to do with manager domination of incorporation choices or Delaware's legislators and judges.

¹⁴ See *infra* notes ___ and accompanying text.

and bottomers. To them, there are obviously right and obviously wrong rules, and the existence of obviously wrong ones can be explained by nothing else than a failure in process that must be remedied. The race to the bottom is proved by evidence of things that the experts believe don't make sense. Staggered boards, Soviet-style elections for corporate boards, permissive review of takeover defenses, asymmetric reimbursement of takeover expenses, the ubiquitous use of non-indexed stock options, and limited shareholder access to the proxy are just a few of the "defects" of Delaware law that experts point to as evidence that the state-based system is suboptimal. Those who hold an unconstrained vision of the world then propose reforms – usually to simply reverse each of these policies – that would, in their view, improve governance for all firms.

There is, of course, something to be said for both expertise and competition; the relevant question is how much of each lead will us to the socially optimal result. The debate about how corporate law is made thus boils down to how much choice and competition there is for consumers of corporate law. The more choice is real and readily available, the less work there is for experts to tinker at the edges. It follows, of course, that the less choice available in the market, the more intervention that may be needed. The intervention could come in two forms: either reforms to the process to enhance competition or choice (favored by holders of the constrained vision); or using expertise to make ad hoc improvements (favored by holders of the unconstrained vision). In this way, Ahdieh is right that the race debate is, unto itself, neither here nor there, but not for the reasons he suggests. The question isn't whether states are racing but whether the market for law is working. This is an antitrust-like analysis, since the measurement is one of competition and choice. If there are low switching costs, ease of entry, no legal barriers, abundant choice, and so forth, or if the market for law can be improved by adjusting the process of law making, then it is much harder to justify substituting expertise. And vice versa.

Professor Ahdieh is to be commended for trying to resolve the race debate, but since the debate is premised on a conflict of fundamental points of view, it is unlikely that a single argument, no matter how interesting and persuasive, is likely to achieve this goal. The battle is bigger than corporate law, since these points of view clash on innumerable other policy issues. The battle over these competing visions was fought by Hayek and Keynes, by Reagan and FDR, and countless politicians, economists, and philosophers. Without solving all of politics and social policy, there is little hope for solving the race debate.

The work-a-day world of law professors and policy makers, however, can still be valuable, since it is not their job to resolve our most base differences, but to tweak the rules slightly here or there. Although beyond the scope of this essay, it is possible to look for locus of agreement. Common ground might be found on the question of how effective the market is in any particular environment. This may be the best hope for empirical scholarship in this field, since it brings the debate down to the level of the real-world merits and applicability of the two conflicting visions of corporate law.

II. Two Tales of State Competition

The great innovation of American corporate law is the “internal affairs doctrine,” which gives a firm a choice of the state in which it incorporates and thus the law that will apply to it on matters of corporate governance. Thus, a firm started in California with all its employees, facilities, shareholders, and customers there can nevertheless chose to be subject to the corporate law of, say, Delaware. This means firms anywhere have the option of at least 50 different corporate law regimes.¹⁵ Thus whether states vigorously compete with each other to attract incorporations and reincorporations (and the franchise taxes, prestige, and legal work that flows from them) or simply provide alternative law, state law can be expected to be relatively responsive to firms’ demands for law. The jurisdiction that currently best meets corporate needs is tiny Delaware, home to less than 0.3% of the US population and accounting for about 0.4% of US GDP,¹⁶ but providing the basic corporate law for over 60% of large US companies. The fact that Delaware does not have 100 percent of the market means there is choice and some competition. There is also the threat of departure that exists whether or not it is exercised regularly.

There is, of course, nothing inevitable about any of this, either in terms of the model or the winning jurisdiction.¹⁷ Corporate law could be tied to the center of gravity of physical assets (the so-called “real seat theory”) or made by a single provider, like the federal government. In both of these alternatives, the lawmaker looks more like a monopolist, since in the former case switching costs are much higher for firms and in the latter one firms have no choice. And the history of corporate law (both old and recent) shows states that make laws firms do not want find that firms flee to other jurisdictions.¹⁸

The debate about these two primary alternatives – competitive or monopoly provision of law –has carried on in the same terms for decades. Defenders of the status quo claim that the state-based model creates a process for making law that is likely to minimize the sum of decision costs and error costs. Professor Roberta Romano argues that “[s]tate competition for incorporations has spurred an innovative legal process that is responsive to a rapidly changing

¹⁵ Not all states have entirely different corporate codes, since many have adopted different vintages of the Model Business Corporation Act. Each state does have a different judiciary, however, so this means even states with the same corporate law statute will have different corporate law.

¹⁶ This data can be found at: <http://quickfacts.census.gov/qfd/states/10000.html>; <http://www.localcensus.com/state/Delaware>; and <https://www.cia.gov/library/publications/the-world-factbook/geos/us.html>.

¹⁷ For a fascinating history on the origins and survival despite political economy story that makes it unlikely, *see* Tung, *supra* note ____.

¹⁸ New Jersey once dominated the market for corporate law, but after reforms to it instituted by then-governor Woodrow Wilson that were undesirable to firms, firms left New Jersey in droves for Delaware. *See id* at _____. Today, firms most often incorporate in either their home jurisdiction or in Delaware. The difference between the percentage of overall firms by state and the percentage incorporated in that state tells us something about the desirability of that state’s corporate law. Along this dimension, California, New York, and Massachusetts, three states that try to impose the most judicial and statutory intervention on business decisions perform the worst. (Data on file with author.)

business environment to the benefit of firms and their investors.”¹⁹ Very few empirical studies are offered in support of these claims.²⁰ Toppers instead rely largely on the existence and persistence of the model and the ability to and incentives for changing it if it is inefficient. Competition is enough to ensure good results, since only efficient laws will survive the Darwinian process.²¹ The important goal for these scholars is ensuring that the process, in this case, a market for law, works well and is not systematically biased. As a result, corporate law for these scholars starts to look like antitrust, with the inquiry being about whether the market (in this case, for law) is competitive.²²

Critics point to failures of the competitive model to deliver the “optimal” corporate law as evidence that the race is not one to the top, but rather the bottom.²³ These shortcomings are then used to justify either targeted reforms²⁴ or, more ambitiously, federal intervention or preemption.²⁵ According to bottomers, states don’t compete to offer shareholders what they want (a low cost of capital) but instead to offer managers, who, after all, make the decision about where to incorporate, what they want, which may in fact be a larger share of the firm’s surplus at the expense of the shareholders. Professor Lucian Bebchuk alone has written nearly 20 papers, most empirical, showing the ways in which Delaware law deviates from his view of the optimal law.

Both sides in the debate likely agree that process for making corporate law is imperfect, but differ over what to make of that fact. As discussed below, the toppers elevate the process of making law above anything else, believing that the right “answers” about corporate governance are beyond the ken of any individuals or experts and can only be discovered through the market. Any

¹⁹ See Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE L. J. 209 (2006).

²⁰ Toppers do, of course, argue with data too, but these are fewer and far between. For a recent example, see Murali Jagannathan and Adam C. Pritchard, "Does Delaware Entrench Management?" (December 2008). University of Michigan Legal Working Paper Series. University of Michigan John M. Olin Center for Law & Economics Working Paper Series. Working Paper 93. <http://law.bepress.com/umichlwps/olin/art93> (finding Delaware directors are superior to other states’ directors on many dimensions).

²¹ This is a strongly Burkean notion of efficiency, and as we’ll see, one attractive to a limited number and particular type of individual.

²² Romano and like-minded scholars believe so passionately that competition makes better law than monopoly, say of the federal government, that they want to use the process in other areas of law, like the regulation of securities. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998).

²³ See Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002) (“Because managers have substantial influence over where companies are incorporated, a state that wishes to maximize the number of corporations chartered in it will have to take into account the interests of managers. As a result, state competition pushes states to give significant weight to managerial interests.”).

²⁴ See Lucian Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (proposing eliminating staggered boards).

²⁵ See, e.g., Symposium, *Federal Chartering of Corporations: An Introduction*, 61 GEO. L. J. 71 (1972) (asserting that state chartering has failed); see also Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 585-95 (2002) (arguing for a federal role in corporate law since there is not much competition and Delaware has an incentive to favor managers at the expense of shareholders).

defects should be tolerated because the tradeoffs are too complex to make using an ad hoc process (if they are defects at all). The risk from tinkering with the process is a game that isn't worth the candle. The bottomers, by contrast, believe in expert intervention based on evidence and are distrustful of relying entirely on processes to deliver optimal outcomes, especially in the face of the application of power by particular interests. This essay argues, in section III below, that it is this difference in vision of the world and of law that drives the debate.

In contrast, Professor Ahdieh argues that the reason for the debate's persistence is a misunderstanding among the debaters about what the debate is about. Ahdieh thinks there is little or no role for state law in determining the optimal allocation of rights among managers, shareholders, and other constituents of the firm, claiming that "the quality of corporate governance is determined by efficient markets, not efficient competition among states." Let us consider this explanation before offering an alternative explanation.

III. Law Influences Markets

According to Professor Ahdieh's argument, managers allocate rights within the firm efficiently not because law tells them how to do so, but rather because markets (for labor, products, and capital) demand that they do. This must be at least partially true, since markets and law work together to achieve optimal governance arrangements. But in rightfully elevating the role of markets to an essential role in corporate governance, Ahdieh overplays his hand. The markets on which he relies on are not independent of law,²⁶ but rather determined by the details of state law, which in turn are dramatically influenced by the process in which that law is made.

Many state law doctrines determine the relative efficiency of markets. Laws banning certain types of merger structures, permitting judicial review of transactions for substantive fairness, imposing fiduciary duties on shareholders, and banning the sale of control for a premium are all examples of state laws that dictate how corporate governance is played out in markets. For example, a state that (by statute or precedent) gives judges a greater role in reviewing merger or compensation contracts or that has a more competent judiciary or requires sharing of takeover expenses will have a different markets for labor and corporate control than a state that has the opposite rules. The market for corporate control works differently in California than it does in Delaware. Ahdieh glides past this important point because of two faulty assumptions about corporate law.

First, he assumes that state law is comprised primarily of default rules that managers and shareholders can opt into or out of by contract. In Ahdieh's hypothetical world, managers and shareholders can avoid bad state law "simply [by] waiv[ing] the relevant statutory authorizations . . . in their corporate charter or bylaws."²⁷ Much state law, and nearly all controversial state law, however, is mandatory and cannot be waived. In that case, the only refuge for managers and shareholders wanting different rules is to incorporate in a jurisdiction that offers

²⁶ Ahdieh believes state competition for law impacts only the amount of corporate wealth that the state can take for itself through taxes. See Ahdieh, *supra* note ___ at ____.

²⁷ Ahdieh, *supra* note ___ at ____.

different choices. If there aren't such places, one can expect much worse corporate law. States have tried over the years to impose on firms a litany of mandatory obligations, including: a judicially reviewed "business purpose" for transactions and deal structures,²⁸ a requirement that firms pursue only lines of business approved by state legislatures,²⁹ judicial approval of executive compensation contracts,³⁰ a requirement for controlling shareholders to share merger premia with minority shareholders,³¹ and a ban on certain takeover defenses.³² This last example illustrates the point. Simply comparing a state like Delaware, where courts have authorized firms to legally deploy a poison pill as an anti-takeover device, and California, where the courts have not, allows one to see how different the market for corporate control will be for firms incorporated in these two states. Each of these mandatory rules would impact firms and the markets in which they operate (for better or worse).

Consider a prominent example. Courts in some states have held that shareholders owe each other fiduciary duties like those owed by partners. In *Wilkes v. Springside Nursing Home, Inc.*, the Massachusetts Supreme Judicial Court disregarded the fact that the four founding shareholders opted for the corporate form, where shareholders qua shareholders owe no special duties, and imposed on them partnership-like fiduciary duties.³³ The ruling had the effect of collapsing the available business form choices for entrepreneurs by one, since there was now some possibility that even though one deliberately chose the corporate form, a court would later rewrite the contract in favor of another form that would achieve the court's preferred allocation of justice in a particular case. The impact of this rule could be, if widely adopted, significant, since it would presumably raise the cost of capital for firms at the formation stage, and could implicate change of control transactions at later stages. The rule did not persevere in the market. Courts in Delaware and elsewhere reject the doctrine, holding that shareholders are bound by the contracts they write, and that no amount of sympathy for the plaintiffs can trump this free contracting model of corporate law.³⁴ Whatever one's view of the efficiency or desirability of this doctrine and the others described above, it is undeniable that they would have a big impact on the markets for labor and control.

²⁸ See *infra* notes ___ and accompanying text.

²⁹ See, e.g., *Oliver v. Rahway Ice Co.*, 54 A. 460, 461 (N.J. Ch. 1903) (holding that a corporation that repurchases its stock for "legitimate corporate purposes" is not acting "controlultra vires").

³⁰ See, e.g., *Gallin v. National City Bank of New York*, 273 N.Y.S. 87, 114 (1934) (establishing judicially reviewed "rule of reason" for executive pay: "To come within the rule of reason the compensation must be in proportion to the executive's ability, services and time devoted to the company, difficulties involved, responsibilities assumed, success achieved, amounts under jurisdiction, corporation earnings, profits and prosperity, increase in volume or quality of business or both, and all other relevant facts and circumstances; nor should it be unfair to stockholders in unduly diminishing dividends properly payable.").

³¹ See, e.g., *Ervin v. Oregon Ry. & Nav. Co.*, 27 F. 625, 631-32 (1886) (requiring majority shareholders to share "the fruits of the sale" equally with minority shareholders).

³² California, for instance, is the only state that has not validated the use of the "poison pill" takeover defense. See Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 Yale L. J. 621, 629 (2003).

³³ 370 Mass. 842 (1976).

³⁴ See *Nixon v. Blackwell*, 626 A.2d 1366 (Del. 1993).

These doctrines are largely passé as a result of firms opting to incorporate in Delaware, which has none of them. We don't see more mandatory corporate rules, like those prominent in Massachusetts (and California and elsewhere), precisely because of the state competition model that allows firms the exit option of Delaware. Whether Delaware and the other states could be said to be "competing" or the different jurisdictions simply provide choice is beside the point, since either provides discipline on the quality of law provided by a particular state.

A second and related faulty assumption that Ahdieh makes is that state law is mostly statutory. While some states do have detailed corporate statutes, Delaware law is primarily based on judicial precedent layered over a bare bones code. When firms choose to incorporate in Delaware (and elsewhere), they are choosing not only the existing law (statutes plus cases), but also to delegate the resolution of future disputes to the state's court.³⁵ Given the ease of exit for firms, either through incorporation choice or by contract, one can reasonably conclude that the behavior of the delegatee is highly dependent on the possibility that bad decisions will drive businesses from the state. Thus whatever competitive or choice pressures operate for statutes also operate for case law. If a court innovates too much or too little companies may choose to incorporate or reincorporate elsewhere, or, as has often been the case recently, the federal government will intervene.³⁶

Emblematic of the choice offered by case law is the fact that Delaware courts have resisted the tendency of other courts to intervene in business decisions. Consider, for instance, the treatment of mergers in which majority shareholders cash out minority shareholders. In *Coggins v. New England Patriots Football Club, Inc.*, the Massachusetts Supreme Judicial Court (again) held that the merger in question "was a freeze-out merger undertaken for no legitimate business purpose" and thus awarded damages to the minority shareholders.³⁷ Delaware rejects any role for courts in evaluating the reason for mergers or their structures. In *Weinberger v. UOP, Inc.*, the Delaware Supreme Court overturned prior precedents in accord with *Coggins*, holding that "the business purpose requirement of [prior cases] shall no longer be of any force or effect."³⁸ A business purpose requirement raises the costs of takeovers by increasing the risk of litigation and giving minority shareholders hold-up power.³⁹ This means the market for corporate control will be fundamentally different for Massachusetts firms than Delaware firms. This hands-off approach undoubtedly distinguishes Delaware corporate law from other jurisdictions.

³⁵ In the case of Delaware, a specialized and expert business court, known as the Chancery.

³⁶ See, e.g., the Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (July 30, 2002) (federalizing substantial portions of corporate governance, such as the composition of the board of directors).

³⁷ 397 Mass. 525, 534-5 (1986).

³⁸ 457 A.2d 701 (1983).

³⁹ Unrestrained courts can impose costs on firms by virtue of the creation of uncertainty, the elimination of certain mutually beneficial value-creating transactions, the ability of competitors or interest-groups to use the law to hold up the firm to extract rents or achieve business advantage, and simply through the imposition of deadweight legal costs.

It seems uncontroversial to suggest that the rule governing mergers and other corporate transactions would be different, perhaps strikingly so (for better and worse), if law was made by a monopolist. Support for this can be found in the way in which law makers have acted in the current environment. States that have more restrictive corporate law have tried to impose these rules on all firms that have “significant contacts” with the jurisdiction, regardless of the state of incorporation. For example, California law requires firms to have a legitimate business purpose for transactions and looks past the form of corporate transactions to equilibrate substantive outcomes – it tries to extend *Coggins*-like protections to shareholders of firms incorporated in other jurisdictions, like Delaware.⁴⁰ The ability to do this is untested but unlikely under current Delaware law, and therefore this example shows how the law would be different but for the choice of Delaware.

Federal corporate law, like the Sarbanes-Oxley Act, is an example of law that is set by a monopolist, since no US firm can opt out of this law.⁴¹ The process for writing and passing SOX, as well as its application have been widely criticized, and yet there has been no substantial reform or repeal of its provisions.⁴² Whether SOX is good or bad, however, is beside the point. The issue is that we cannot know for sure whether it is good or bad without the market test provided by exit.⁴³ In fact, the most significant call for reform has come from those – like New York financial interests and politicians – who would be hurt by firms opting to incorporate or raise money outside of the US.⁴⁴ They cite, as evidence of the law’s demerits the fact that firms are doing just this.⁴⁵

⁴⁰ California Corporate Code § 2115(b)-(c) (requiring shareholder voting and appraisal rights provisions (among others) apply to foreign corporations with minimal contacts in California).

⁴¹ It is possible to opt out by incorporating abroad, but this is much more costly.

⁴² See, e.g., Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 Yale L. J. 1521 (2005). Another monopolist-imposed regulation that has garnered widespread criticism but is nevertheless mandatory is the Williams Act of 1968. See Frank Easterbrook & Daniel Fischel, *Auctions and Sunk Costs in Tender Offers*, 35, Stan. L. Rev. 1, 16-17 (1982) (criticizing how the Williams Act replaced a private law model that worked).

⁴³ The interlinking of corporate law and corporate finance, and the impact on the market for corporate control, can be seen in the recent experience in Europe where Germany, among others, moved away from the real seat doctrine to an American-style internal affairs doctrine. For example, German companies can now incorporate elsewhere in Europe, and a large percentage of start-up firms are choosing the United Kingdom. This is not because UK “markets” or “finance” are different or that UK franchise taxes are lower, but rather that the corporate law rules and precedents allow firms to offer investors (and other stakeholders) a more optimal set of contracting arrangements. The exit threat for German firms can be expected to have an impact on German law. If Germany (meaning, its people, legislators, judges, lawyers, or fisc) wants to maintain the importance of German corporate law, it must compete with UK law by abandoning those policies that are driving away firms.

⁴⁴ New York Mayor Michael Bloomberg and Senator Charles Schumer commissioned a study by McKinsey & Company on the subject of financial services competitiveness in the wake of increasing federal involvement in corporate governance. See McKinsey & Company, *Sustaining New York’s and the US’ Global Financial Services Leadership*, available at http://www.senate.gov/~schumer/SchumerWebsite/pressroom/special_reports/2007/NY_REP_ORT%20_FINAL.pdf. The Committee on Capital Markets Regulation has issued a series of reports on improving the regulation of US capital markets detailing the flight of capital raising outside of the US borders. The reports are available at <http://www.capmksreg.org/>.

⁴⁵ *id.*

Having shown that state law matters and that the debate about state competition is not based on a mistake, the next section offers an alternative explanation for the persistence of the debate.

IV. Two Visions of Corporate Law

The field of academic corporate law is conceived entirely differently by holders of two different social visions of the world. The reason the race debate continues is because it is really a debate about the validity of these competing visions. The two sides aren't mistaken, as Ahdieh argues, but are merely talking past each other. Without reconciling these visions, the debate will persist in the face of any and all evidence one way or the other.

According to Thomas Sowell, many of our modern policy debates boil down to a question of one's view of the capacity of the human mind and the institutions it develops to solve problems. It is a debate about experts versus markets.⁴⁶ In one camp, we find those who believe that optimal social policy is something that can be discovered by experts based on an analysis of data and argument. The problem with schools or health care or crime policy,⁴⁷ they say, is that the right people aren't in charge, or we don't have enough money to implement the right solutions, or we just need more research on the questions to determine the correct approach. The right answers, the socially optimal answers, are there for the getting. Those holding this vision—what Sowell calls the “unconstrained vision”—believe there are solutions to policy problems that are discernable from the reason and logic of smart people. They believe in experts. Sowell describes the “unconstrained vision” as follows: “the conviction that foolish or immoral choices explain the evils of the world – and that wiser or more moral and humane social policies are the solution.”⁴⁸ The French Revolution and the Administrative State are manifestations of the unconstrained vision. So too are the arguments of Ronald Dworkin, Jean-Jacque Rosseau, Thorstein Veblen, and Franklin Roosevelt.

In the other camp, we find those who believe that social problems are not comprehensible by the human mind and that no amount of conferences, policy papers, or deep thinking will find solutions for them.⁴⁹ There are no solutions, just tradeoffs. Sowell describes the “constrained vision” as seeing “the evils of the world as deriving from the limited and unhappy choices available, given the inherent moral and intellectual limitations of human beings.” The constrained vision sees natural processes, like competition in free markets, as a superior way of revealing socially efficient answers to policy questions. Unlike those

⁴⁶ This obviously oversimplifies things. Experts matter. Markets matter.

⁴⁷ The debate between the two predominant approaches to crime reduction—rehabilitation versus punishment—is an archetypical example of the conflict of visions. Those believing in rehabilitation generally view man as good but corrupted by society, while those believing in punishment view man as inherently evil and must be civilized and controlled by incentives.

⁴⁸ THOMAS SOWELL, *A CONFLICT OF VISIONS: IDEOLOGICAL ORIGINS OF POLITICAL STRUGGLES* 32 (Basic 2007).

⁴⁹ This is not to say that academic inquiry is irrelevant. For instance, study and data can support the analysis of the tradeoffs that must be made by market participants, as well as if the market is working or is plagued by market failures.

subscribing to the unconstrained vision who believe in solutions passed down by experts, the constrained vision “rely[s] on the systemic characteristics of certain social processes such as moral traditions, the marketplace, or families.”⁵⁰ They believe in the wisdom of crowds and evolutionary processes.⁵¹ Perhaps the most succinct summary of the constrained vision is Justice Oliver Wendell Holmes’s aphorism that “[t]he life of law has not been logic: it has been experience.”⁵² The American Revolution and faith in Adam Smith’s invisible hand are manifestations of the constrained vision. So too are the arguments of Edmund Burke, F.A. Hayek, and Ronald Reagan.

In corporate law, a holder of the constrained vision will be suspicious of studies or arguments purporting to offer solutions or obvious improvements in the way corporations are run or governed. They will be skeptical of the perfectibility of the behavior of firms or individuals or law by expert-based reforms. They will rely instead on processes, like a market for law and products, to ensure that the optimal law is produced. If asked “What is good corporate law?”, one holding this vision would reply, “Why the law that survives in free markets, of course.” Paraphrasing Holmes, Frank Easterbrook and Dan Fischel claim that “[t]he best [corporate law] structure cannot be derived from theory; it must be developed by experience,” and that competition and choice are essential to develop this experience.⁵³ Holders of the constrained vision are more concerned about ensuring that the market works than for looking for defects or expressions of power. This means that these scholars will be specious of arguments about how powerful individuals or groups can dominate others despite the existence of robust markets.

In the unconstrained camp, many lawyers, professors, and politicians purport to offer proof of what the law should be, that is, how Delaware could be more efficient. Law and finance journals are filled with claims of this sort. For example, Lucian Bebchuk (a lawyer) and Alma Cohen (an economist) claim that firms with staggered boards (that is, where the entire board cannot be replaced in a single election) are valued less than firms without staggered boards by 3 to 4 percent.⁵⁴ This is a staggering figure, and if true, would suggest that the firms with staggered boards—about half of those incorporated in Delaware—are leaving serious money on the table. In fact, one recent paper estimates the impact of destaggering boards of Delaware firms at over \$40 billion in shareholder value, and argues for a law requiring firms to destagger their boards.⁵⁵ Bebchuk and others therefore argue that Delaware should ban staggered boards.

⁵⁰ *Id.* at 33.

⁵¹ See JAMES SUROWIECKI, *THE WISDOM OF CROWDS* (Anchor 2005).

⁵² OLIVER WENDELL HOLMES, *THE COMMON LAW* (1881).

⁵³ FRANK EASTERBROOK AND DANIEL FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (Harvard 1996) (“The history of corporations has been that firms failing to adapt their governance structures are ground under by competition. The history of corporate law has been that states attempting to force all firms into a single mold are ground under aw well.”)

⁵⁴ See Lucian A. Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 *J. Fin. Econ.* 409, 428 (2005).

⁵⁵ See Bebchuk & Cohen, *supra* note ___, at 422 fig.3; Michal Barzuza, *Delaware’s Compensation*, 94 *Va. L. Rev.* 521, 543 (2008) (arguing that Delaware should change its franchise tax structure to give legislators incentives to create this value).

These empirical studies and the normative analyses that flow from them are classic examples of the unconstrained vision of the corporate world. There is an observation of reality that is linked with a deviation from an idealized perfect world coupled with a suggested solution to remedy the problem. Smart people have considered the issue and proposed a solution consistent with an analysis of data. This leap from description to proscription is based on a belief in expert-based solutions to discrete problems. The belief in these solutions relies not only the claim that the researchers possess greater knowledge than the rest of society, but also that the knowledge they possess can isolate solutions that make perfect tradeoffs with other considerations.⁵⁶

The constrained vision, in contrast, sees many forces at work beyond the ken of corporate scholars or even participants in the decision making in question. These may justify the status quo notwithstanding what the data say. This is an argument for what F. A. Hayek called favoring “custom over understanding.”⁵⁷

A constrained vision doesn’t mean ignoring facts or data, but it expresses a preference for what Sowell calls “social processes,” rather than expert opinions, to act as the judge of what is and what is not efficient and optimal.⁵⁸ In short, the constrained vision is about “analyz[ing], prescrib[ing], or judg[ing] only process,” while the unconstrained vision seeks to “analyze, prescribe, and judge *results*.”⁵⁹ In corporate law, this means that those with a unconstrained vision will be concerned with outcomes, criticizing results that seem contrary to wisdom, logic, or data. Those with the constrained vision will be unmoved, being concerned only with ensuring processes, like the market, exist to help achieve the best results possible.

A key operative social process in corporate law is the market for state charters, which restrains regulatory overreach and yields the relatively bare bones corporate codes, the enabling/free contracting model, the business judgment rule, and relatively light judicial intervention in policing corporate transactions. (Professor Ahdieh believes the relevant process is the market for

⁵⁶ “Nothing is good but in proportion and with reference.” EDMUND BURKE, THE CORRESPONDENCE OF EDMUND BURKE, VOL. VI, 47 (Chicago 1967).

⁵⁷ F. A. Hayek, Law, Legislation, and Liberty 157 (Chicago 1979) (“[M]an has certainly more often learnt to do the right thing without comprehending why it was the right thing, and he is still better served by custom than understanding.”).

⁵⁸ Critics of the unconstrained vision have empirical studies of their own. In a recent paper, Murali Jagannathan and Adam Pritchard find that managers in Delaware are less entrenched, of higher quality, and more accountable than directors in other states. Murali Jagannathan and Adam C. Pritchard, “Does Delaware Entrench Management?” (December 2008). University of Michigan Legal Working Paper Series. University of Michigan John M. Olin Center for Law & Economics Working Paper Series. Working Paper 93. <http://law.bepress.com/umichlwps/olin/art93>. These findings are inconsistent with claims about a race-to-the-bottom. More importantly, they point indirectly to the claim that there is inevitably a tradeoff between governance mechanisms in a firm. So Bebchuk and Cohen may be right that staggered boards are a management entrenchment device, but this is only part of a more complex tradeoff in firm governance that is unknowable to anyone in the process, either insider or outside of a particular firm. Disrupting it would be counterproductive, since it would be premised on claims of efficiency based on limited science instead of long-standing practice and custom. It also might cause increased uncertainty about other elements of governance, which would then create costs on the system.

⁵⁹ Id at 94.

corporate control, but, as shown above, this is derivative of the state competition model.) For those with a constrained vision, maintaining the integrity of this market and ensuring it is not prevented from working is paramount. Claims that it is not working and should be abandoned because of unjust or seemingly unreasonable outcomes based on things like “power” are treated with skepticism.⁶⁰

A nice example of the difference can be seen in the debate about executive compensation. Professor Lucian Bebchuk and Jesse Fried argue that managers control the pay setting process, and that as a result pay is excessive and delinked from performance.⁶¹ Managerial power allows CEOs to cheat shareholders by hiding pay and entrenching themselves in office. Critics find these “beat the market” claims hard to believe, since CEO pay is widely disclosed and CEOs operate in robust and highly competitive markets for labor (as well as capital and products).⁶² The criticism is something like: if asked to trust a robust market for labor with thousands of firms and smart investors betting their own money or two academics, which one is more likely to have the right answer about the best way to pay? Critics also offer other descriptions more consistent with a benign explanation of the practices,⁶³ as well as concern that the proposed reforms of executive compensation may have unintended consequences that would do harm that exceeds any benefits they might offer.⁶⁴ Perhaps more fundamentally, however, is the concern that giving others – in this case, shareholders, plaintiffs’ lawyers, and judges – the power to set pay may shift the power in firms generally, allowing these groups to do other things that might be disrupt the social utility firms provide.

These two visions describe the two rival camps in the race debate. One side is largely composed of those with faith in experts and the ability to determine optimal governance through ad hoc examination of data, while the other side believes in establishing processes, like the market, which will be used to determine what the best rules are based on perseverance not logic. Although this

⁶⁰ “The constrained vision, in which systemic processes produce many results not planned or controlled by anyone, gives power a much smaller explanatory role, thus offering fewer opportunities for moral judgments and fewer prospects for sweeping reforms to be successful in achieving their goals.” SOWELL, *supra* note ___ at 156.

⁶¹ LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (Harvard 2004).

⁶² See, e.g., Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 Tex. L. Rev. 1615 (2005) (“In competitive capital markets, if managerial power and the resultant capture of rents by management were serious concerns, we would expect to see firms opting out of the default rules that allegedly permit management capture of the board.”); M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543 (2007) (casting claims of managerial power explaining executive pay into doubt by finding CEO pay is similar in terms and amounts in high and low agency costs environments).

⁶³ See, e.g., Saul Levmore, *Puzzling Stock Options and Compensation Norms*, 149 U. Pa. L. Rev. 1901 (2001) (arguing that proposals for firms to adopt indexed stock options would raise managerial risk seeking levels to socially inefficient levels).

⁶⁴ “The unconstrained vision seeks the best individual decisions, arrived at seriatim and in an ad hoc fashion. By contrast, the constrained vision trades off the benefits of both wisdom and virtue against the benefits of stability of expectations and standards.” SOWELL, *CONFLICT OF VISIONS*, *supra* note ___ at 84.

is the foundation of the debate, it is not explicitly recognized as so.

V. Resolving Conflicting Visions

The rise of empirical corporate law scholarship might have been expected to resolve the race debate, but multivariate regressions purporting to show the optimal corporate governance arrangements have yet to substantially move policy makers. There have been literally hundreds of studies showing how staggered boards or unified chair and CEO roles or some other feature of Delaware corporate law is destructive of firm value, and yet Delaware and its defenders are unmoved. Why?

We can guess that resistance is based not just on a technical refutation of the data, methodology, or analysis in these studies, but is based on the nature of the project itself. Scholars aren't reaching different conclusions, they are arguing on entirely different ground. For defenders of Delaware, there are no models big or sophisticated enough to answer the questions about optimal corporate governance. The constrained vision of corporate law suggests that the best way to do things is discovered only through trial and error in the market. States (meaning, legislatures and judges) and firms that choose well in corporate governance will survive, while those that do not will face the choice of copying or extinction. For these individuals, the danger of empirical analysis of the sort so popular today is that changes will be made to systems and arrangements beyond the ken of any expert or policy maker, and that the losses from unintended consequences will dwarf any gains from the reforms.⁶⁵

But, as this essay has shown, this view is contested by those holding a different vision of corporate law. These individuals believe in expert analysis either as a substitute for or compliment to markets, and the data show that the markets relied on by those with the constrained vision are not working well enough. For example, they argue that the persistence of staggered boards, the use of poison pills, the largess of executive pay, and so on can only be explained by a market failure sufficient to justify large reforms of the process or its outcomes.

Although these competing visions are in some ways irreconcilable, there is a way forward in the debate. The first step is to recognize the debate as it is waged today is mostly between two competing visions, and that this distorts the analysis and perception by both sides. Once these priors are surfaced, the second step is to acknowledge the obvious: there is room for both expertise and markets to play a role in creating optimal social arrangements. Even the most ardent fans of market-based solutions will recognize that markets don't always work and that there is sometimes room not only for improved market processes but also for

⁶⁵ This may be because they are part of a package of law that cannot be readily disaggregated, and the package as a whole is the best we can expect net of transaction costs. Powerful boards may indeed lower takeover premia, but they may do other things, like better oversee the firm's managers or provide long-term focus, that compensate for this cost but that aren't captured by the models. As a matter of law making, the same tradeoff may be present: the attitude in Delaware's courts and legislature that permits staggered boards (perhaps wrongly) may be essential for reducing the sum of decision costs and error costs when it comes to judicial review of corporate transactions.

experts to tinker at the edges of what markets can do. And, likewise, the most extreme critics of markets and believers in experts will recognize that competitive processes, if well designed and functioning, can help us figure out what the socially optimal answers are. The question is where to exercise markets and experts and in what proportions. Each of these sides in the debate will start from different presumptions about the effective way to make corporate law, and it is in the middle where they meet where the real work of corporate law is to be done.⁶⁶

This is where the final step can occur. Corporate law scholarship can look like antitrust by defining what a successful market for law would look like, and then addressing the question of whether the market is working against that metric. Measuring success would not be based on whether some shareholders, firms, or CEOs do well or poorly, but on whether corporate law is designed effectively to create competition. Are barriers to entry for alternative law makers low or high? Are switching costs for firms high or low? Is discrimination or exclusion through control possible? Do consumers (in this case, firms, shareholders, entrepreneurs, and so on) have many options or few? If the market is free, so to speak, the calls for expert tweaks will be much weaker. If it is not, the question can then be about the best way to remedy any market failures.⁶⁷

Even if everyone agrees that there is a market failure, however, the holders of different visions of corporate law may have different opinions about the best solutions. Believers in the unconstrained vision will call for reforms to substantive outcomes (e.g., cap CEO pay), while believers in the constrained vision will prefer tweaks to the process to make it more efficient (e.g., increase the efficiency of the labor market for CEOs). Although the conflicting visions will still argue about what to do, this will at least be a starting point from which competing proposals for reform can be measured. Knowing where each side is coming from—competing visions about the relative importance of expertise versus markets—is a step toward better understanding the debate and someday resolving it.

Readers with comments should address them to:

Professor M. Todd Henderson
 University of Chicago Law School
 1111 East 60th Street
 Chicago, IL 60637
 toddh@uchicago.edu

⁶⁶ These presumptions will undoubtedly influence how easily one moves to the middle, and what one thinks should be done there. See Aaron Director, *The Parity of the Economic Market Place*, 7 J. L. & Econ. 1, 2 (1964) (“Laissez faire has never been more than a slogan in defense of the proposition that every extension of state activity should be examined under a presumption of error.”).

⁶⁷ For a recent (but unpersuasive) paper in this spirit, see, e.g., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679 (2002).

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