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CHAPTER 16
Ending the Specter of a Federal Corporate Law

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For most of US history, corporation law, or the law governing the interaction between investors and the companies in which they invest, was a function of state law. State corporate law governed the duties that company directors owed to their investors, established the powers of investors to select new directors and managers, and maintained authority for fundamental business decisions in the board of directors. State corporate codes have evolved in the intervening years, increasingly allowing investors and companies to design alternative arrangements to the default provisions contained in these old codes. Steady incursions by federal law into discrete pieces of state corporate law have begun to slowly erode this system, however, and threaten to inhibit innovation in corporate governance at the state level.

In 1933 and 1934, the US Congress passed laws requiring disclosure of financial information to investors in widely traded firms, but left the working parts of state corporate law largely intact. For the first thirty years after the US Securities and Exchange Commission (SEC) was established, it was clearly understood that state law governed traditionally state corporate law matters, such as the duties that boards owed to shareholders or the permitted structural makeup of a

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company and the way its directors and officers were selected. In 1945, for example, the SEC made clear that the propriety of shareholder proposals at annual company meetings would be determined pursuant to state law.[1]

The détente began to change in 1968 when the Williams Act gave the SEC authority to go beyond merely disclosure-based regulation and actually empowered the SEC to regulate the process whereby public companies were taken over by new buyers. In the 1970s, then SEC Chairman William Cary proposed an express federal corporate law that entirely preempted state corporate law when he urged that "a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy."[2]

Bill Cary's express suggestion never happened, but a slow advance of federal incursions into state corporate law continued, culminating with an explosive enlargement of the federal footprint in state corporate law in financial reform legislation in 2002 and 2010. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), for example, included a variety of corporate governance reforms that were in large part entirely unrelated to the financial crisis of 2008. For example, one of them required companies to disclose their use of minerals mined in the Democratic Republic of the Congo. Another required a nonbinding vote by shareholders, which carries no practical consequences, on CEO pay. Still another required companies to disclose the ratio of their CEO's pay to that of the average worker, a suggestion made some ten years earlier by a labor-funded group as a way to increase union leverage in negotiations.[3] Many of the suggested reforms had been proposed long before 2008, yet were included in what was perceived as must-pass financial reform legislation in order to cater to the powerful special interest groups that had long supported those proposals.

As much as the corporate governance reforms of 2008 were misguided, they were the result of many years of regulation by the federal government that has slowly eroded the role of states in creating corporate law. That process began with rules adopted in response to the Enron and WorldCom scandals in 2001 and 2002, embodied in the Sarbanes-Oxley Act that now determines the qualifications for service on company boards of directors. Oddly, the corporate governance rules regarding independence that were codified in 2002 and 2003 largely reflected attributes of the Enron board of directors.[4]

Much of existing corporate law scholarship has been divided into two competing camps. One urges that states "race to the top" and seek to balance the rights of shareholders and the obligations of directors by adopting laws that maximize shareholder value. That side of the discussion tends to argue that the market for publicly traded stock will discipline any excesses by the state that cater to corporate insiders at shareholders' expense. The opposing camp urges that corporate insiders will distort the race into a "race to the bottom" in which the state that designs corporate governance codes that allow insiders to exploit shareholders and destroy firm value will attract the most new incorporators. The latter camp typically urges as an alternative a federal incorporation regime broadly, and also urges discrete preemptions of state law by a more enlightened federal regulator.

This chapter urges that over the last five decades, the race has been distorted by the presence of federal preemption. The supposed race is not much of a race at all. Federal incursions into state law have themselves garnered significant market power to the currently dominant state for public incorporations, Delaware. Proponents of the "race to the bottom" theory have the causal link backwards. Federal preemption of discrete areas of corporate law is not the answer to market failures in the market for corporate law, federal preemption is in fact causing market failures. Federal incursions do this in part by inhibiting innovations, like an arbitration-based corporate code, which could challenge Delaware's dominance in corporate law by challenging one of the principal competitive attributes of Delaware in its predictable court system. As such, a rollback of the federal footprint is the best way to reinvigorate the chartering race in corporate law.

This chapter argues that first and foremost, this federal overlay in corporate governance must be stripped away. Alternately, at a minimum the existing federal corporate governance rule book should at least become part of an optional opt-in regime and thereby allow a firm's shareholders to determine whether the federal arrangement is best for their particular firm. But arguing for removal of current federal encroachments on state corporate law contained in Sarbanes-Oxley and Dodd-Frank is just the beginning. This chapter goes on to explore how other existing federal laws can be molded to empower the states to compete with each other in corporate law. A number of institutional changes will be needed to develop the foundations necessary to facilitate innovation and economic growth in state corporate law.

Dodd-Frank, legislation built on an improper understanding of the factors leading to the 2008 financial crisis, ultimately threatens the competition and flexibility required for consumer benefits created via innovation. Specifically, Title IX, Subsection G, of Dodd-Frank continues the trend of centralizing corporate law by consolidating regulatory power over corporate governance in the federal government, thus preempting the ability of states to be competitive in chartering. State chartering may be competitive within the modes of governance permitted by the federal overlay.[5] This chapter's examination of a range of innovations that would be clearly helpful in experimental environments, like crowdfunding, will demonstrate that the federal footprint in corporate law stifles the chartering race by inhibiting innovation.

Business entity law has been around since the establishment of the firm and has remained an important contributing factor to the economic systems that develop and utilize them. Corporate law was key to building the Roman aqueducts and critical to the Industrial Revolution. The advent and public embrace of innovative business models like Kickstarter's crowdfunding approach and Uber's sharing-economy structure demonstrate demand for a more flexible approach toward corporate governance. With each unique business model comes the necessitation of an equally unique corporate structure. However, the mere fact that the economics of new-age firms suggest a demand for flexible innovation in corporate governance does not mean that states are in a position to make that innovation available.

For example, Stephen Bainbridge at the UCLA School of Law and M. Todd Henderson of the University of Chicago Law School recently designed a novel approach to the structure of boards of directors in which other business entities can themselves serve as members of the board, which would allow board member companies to economize on scale and scope, have more directed compensation and liability incentives than the current model, better expose the market for board membership to market forces, and provide reputational constraints for repeat player board member firms.[6] Bainbridge and Henderson note that federal rules that would prevent their idea were not necessarily even designed to prevent entity membership on the board, but the references to natural persons in the federal rules effectively preclude their innovation from being implemented.[7] Moving forward, a competitive model for the production of corporate law will be critical to make the most of technological advances that are reducing the cost of individual interaction. In this chapter I suggest that the reinvigoration of state law federalism can serve to support such a competitive model.

CORPORATE FEDERALISM UNDER THE THREAT OF FEDERAL PREEMPTION

The corporate codes that govern business entities have been the lynchpin of America's economic development since the start of the industrial age. Business entities with separate existence, able to protect their shareholders from liability for corporate actions, were essential to facilitate the first large-scale industrial investments in the late nineteenth and early twentieth centuries. States competed to offer increasingly accommodative corporate codes, and eventually Delaware became a dominant player in that race by allowing companies to own stock in other companies—something its chief competitor, New Jersey, prohibited until the middle of the twentieth century.

This competitive state system, in which states compete to attract out-of-state entrepreneurs to form corporations in their state, has also been beneficial to shareholders. A study found that firms incorporated in Delaware, the current winner of the incorporation race, experience an increase in shareholder value at the initial public offering (IPO) stage over other firms solely by virtue of being incorporated in Delaware.[8]

Roberta Romano of Yale Law School has described this state system as allowing states to serve as laboratories in which new corporate governance arrangements can be invented and measured against offerings from competing states. While not every state actively competes in this arena, smaller-population states like Delaware have been eager to compete for incorporation fees from newly formed companies.

A more recent innovation in business entity law has been the widespread use of limited liability companies, or LLCs, which have a greater degree of flexibility in designing the range of fiduciary obligations that boards and CEOs owe to their shareholders. While that degree of flexibility is greater than the flexibility afforded CEOs and boards of corporations, it remains somewhat limited. Delaware still maintains an obligation of "good faith and fair dealing" that shareholders are not permitted to opt out of in favor of contractually specified obligations. The late Professor Larry Ribstein also notes a number of cases in which Delaware courts have struggled to uphold the Delaware legislature's intent to promote freedom of contract in LLC agreements.

While Delaware competes to maintain its advantage in new business entity formation, Jonathan Macey of the Yale Law School and Geoffrey Miller of the New York University School of Law suggest that the state may enjoy an extent of market power that allows it to also maximize the litigation fees enjoyed by Delaware law firms that help to craft Delaware's code.[9] That would certainly explain Delaware's reaction in 2015 to a court ruling that companies are allowed to adopt bylaws that force losing plaintiffs to pay a company's legal fees in shareholder actions. The Delaware bar, fearing a loss in litigation business, immediately moved to change the Delaware code to reverse the Delaware Supreme Court's ruling and prohibit such "loser pays" bylaws.[10]

Many of Delaware's critics suggest that it does not actually actively compete for business entity formation any longer, and that the idea of state competition in business entity formation is largely a myth at this point. They argue that Delaware has a hundred years of precedent behind it, and as such its advantage is insurmountable for new states that might attempt to compete with Delaware by improving on its code. For example, if another state wanted to take Delaware's code, improve on it, and thereby compete with Delaware, it would find the Delaware code filled with nebulous concepts like "good faith" obligations and a "duty of care" and "duty of loyalty" that have slowly been defined over a hundred years and thousands of pages of precedent. States may feel Delaware's body of precedent is an insurmountable obstacle in trying to make their own codes work.

Supporters of Dodd-Frank's corporate governance reforms latched on to that argument and urged that Delaware failed investors by not adopting corporate governance reforms they favored. Ann Yerger of the Council of Institutional Investors testified with respect to the proxy access rule included in Dodd-Frank that "the States have failed investors too long, Delaware in particular, and it really only acted when it had to. And I think it is important that the SEC take action on this important reform."[11] Relative to other states in the incorporation race, it is not clear that Delaware is failing shareholders. For example, as noted earlier, companies incorporated in Delaware enjoy a premium in their average market value compared to non-Delaware companies at the time they go public. Relative to the range of options for shareholders that could be observed in a more competitive chartering environment free of a federal footprint, which stamps out more competitive innovations, Yerger may well be right. But relaxing federal incursions into state law is the answer to the problem.

Delaware's critics may certainly have a point that Delaware imperfectly competes in the race to charter new businesses and to innovate in corporate governance. Those critics, however, have made the wrong diagnosis. Federal preemption of state corporate law, and the specter of future federal preemption, discourages other states from challenging Delaware. The state laboratories described by Romano do not really work if the innovators must work under the threat that their innovations may be destroyed by federal action. Indeed, Professor Mark Roe argues that Delaware is uniquely adept among the states at responding to the specter of federal preemption with narrowly tailored changes that outmaneuver some of the goals of blunt federal legislation.[12]

The threat of federal action has important consequences for arbitration as a means to invigorate state competition. The market power that Delaware enjoys in the chartering race could be sidestepped with an entirely new corporate governance system designed to be enforced in an entirely different way. Rather than litigating nebulous "fiduciary duties" in court, like the current model most states use and which was inspired by Delaware, an arbitration-based system could design duties through contract, and rather than relying on judges in states without Delaware's judicial expertise, it could rely on industry veterans specializing in arbitration of complaints. Such an approach would allow other states to break Delaware's market power and shake the very foundations of American corporate law.

And yet, the SEC has strongly discouraged firms going public from requiring that investors arbitrate claims against the company. This restriction should be expected to apply to crowdfunded firms as well. The SEC has refused to approve the offering documents of firms including arbitration in their offering documents, despite the fact that the Federal Arbitration Act provides investors with such a right. This is but one example of how federal preemption of state corporate law actually impedes state competition and thereby provides an advantage to the currently dominant state of Delaware.

Some protection of federalism, and therefore the states' ability to compete via governance innovation, is supposed to be offered via the internal affairs doctrine, a rule of construction created by judges that applies both in interpretation of federal statutes and an interstate choice of law rule. The doctrine holds that the "internal affairs" of corporations, or the contractual relationship between shareholders, directors, and officers of corporations, should be determined pursuant to the laws of the state of incorporation.[13] While many states respect the doctrine, New York and California abandon it in the context of companies not traded on a national securities exchange.[14] And while some federal court interpretations of the securities laws demonstrate respect for the internal affairs doctrine,[15] others do not. At times, Congress will either explicitly preempt matters covered by the internal affairs doctrine through statute or the SEC will infringe on the matters within the internal affairs doctrine through administrative action.

The internal affairs doctrine has been a vital component in sustaining interstate chartering competition. This doctrine has been one by which federal judges, in interpreting the federal securities laws, have tended to read the securities laws as not intending to preempt state law unless such intent is clear from the statute. This doctrine also has been used by state judges to give mutual respect to each other's corporate law (e.g., a shareholder in a Delaware corporation, suing in California, has traditionally seen the claim determined pursuant to Delaware law). And yet the internal affairs doctrine has begun to come apart at the seams, further threatening to limit competition in the state system. This is true both insofar as discrete incursions into state law are occurring at the federal level, and also with respect to states that have refused to fully give deference to the laws of a company's state of incorporation when suits or administrative action are brought in other states.

While the internal affairs doctrine has at some points limited the SEC from undertaking to preempt state law, it has not always served as a binding constraint on the SEC's use of discretionary power to preempt state corporate law. Further, California and New York have adopted statutes that ignore the internal affairs doctrine for companies with a large number of shareholders in their states.

The mere existence of a threat of federal preemption can dissuade states from pursuing corporate innovation. This chilling effect on innovation is not new. Delaware judges William Chandler and Leo Strine previously expressed the frustration of state corporate innovators regarding the prospect of federal preemption when they noted in response to Sarbanes-Oxley, "What's next? A ban on going private transactions? Or on options-based compensation of executives? Or on interested transactions?"[16] This manifestation of concern is not contained to existing innovations, either. The incompatibility and lack of clarity inherent to one-size-fits-all regulation results in a restriction on competition, as it discourages states from deviating from the status quo.

The Sarbanes-Oxley Act, for example, set mandatory requirements for independence of certain committees, mandatory CEO certification of financial systems, and a prohibition on loans to corporate officers. The footprint of preemption is probably wider than originally intended by the drafters of the statute: if, for example, some method of governing firms is stricter than the board-centric model that was in vogue during the passage of Sarbanes-Oxley, states would be precluded from developing it because Sarbanes-Oxley entrenches a board-centric approach.

To this point, Professors Kobayashi and Ribstein note that one prerequisite for a quality sorting model, or interstate competition, to be effective is that "jurisdictions are free to select any set of laws they desire."[17] However, Roe's extensive analysis of the extent to which federal law preempts state corporate law demonstrates the constraints on a full Tiebout model in the corporate federalism context. Roe defines the problem of the federal overhang succinctly:

> Federal authorities can, and do, confine state competition. They have made rules—such as vast parts of the securities laws—that are functionally part of America's corporate law. They could do more, were they so inclined. In nearly every decade of the twentieth century, the decade's major corporate law issue either went federal or federal authorities threatened to take it over—from early twentieth century merger policy, to the 1930s securities laws, to the 1950s proxy fights, to the 1960s Williams Act, to the 1970s going-private transactions. Even if the states never adjust to the federal presence, Washington is a player in American corporate governance.[18]

Roe's conclusion: "Because Delaware players can never be oblivious to the possibility of being displaced, we have never had, and we never could have, a full state-to-state race in corporate law."[19] While Roe is correct that the federal overhang inhibits competition, he overstates the case, particularly with respect to the prospect of significantly enhancing interstate competition through self-enforcing limits on the federal overhang.

Roe notes that federal preemption breaching the internal affairs doctrine frequently occurs both through statute and through the SEC's discretionary authority.[20] Roe generally points to sources of federal preemption such as the SEC, the Congress, federal courts interpreting securities law cases (the existing internal affairs doctrine notwithstanding), and the national exchanges.[21] Romano notes that the SEC typically strongly pressures the national exchanges to adopt uniform corporate governance provisions.[22]

Roe goes on to state that "Presidents Roosevelt, Taft and Wilson each sought mandatory federal incorporation."[23] Each of those attempts failed, however, suggesting that full-scale nationalization of corporate law is constrained by interest group dynamics. Macey described in 1990 that dynamic as one in which "Congress can amass significant political support by refraining from preempting state law in this area. The fact that Congress has not enacted a national corporate law indicates that deference to the states is in fact its political-support-maximizing solution."[24] Though large-scale incursion into state law did not occur, Congress did find discrete incursions helpful, as for instance with the Williams Act's regulation of takeovers. And at times the SEC used authority delegated to it to undertake preemptive actions under its own initiative. Furthermore, since the time of Macey's exploration, a number of large-scale federal incursions into discrete pieces of state corporate law have occurred, usually during times of national attention to corporate governance scandals or crisis.

But even the larger-scale incursions do not preempt completely. For example, proposals to mandate an independent board chairman and impose constraints on executive compensation were pared back in favor of optional approaches for public companies in Dodd-Frank. So while bulwarks against federal incursion can be sustained in part, they must also be built in advance of crisis-induced legislation. Reforms to strengthen additional states' interest in preventing future preemption, and making it difficult for the federal government to selectively preempt and instead leaving full-scale preemption as its only option, may fortify the bulwark against federal incursions into state corporate law.

Roe concludes that one of the earliest forms of preemption in the Securities Exchange Act of 1934 was preemption of shareholder voting disclosure and voting processes, stating, "The wide SEC regulation of proxies determines what goes into the proxy request to shareholders, what gets onto the ballot, who gets access to shareholder lists, and how a proxy fight . . . is waged. . . . Voting is probably the single most important internal corporate affair."[25]

Similarly, Michael Greve of the Antonin Scalia Law School at George Mason University and his co-author Ashley Parrish point out an increasing level of agency delegation by Congress and cite Dodd-Frank as an example.[26]

This delegation provides the SEC with an opportunity to expand the reach of its authority into traditionally state areas. If the internal affairs doctrine were codified and a procedure for states to challenge its violation were adopted, it would be harder for the SEC to unilaterally expand its reach through purely administrative preemption, even if Congress continues to practice excessive agency delegation.

This practice is no longer limited to the SEC, however, as other federal agencies are increasingly seeing preemption of state corporate law as a means to enhance their authority over the entities they regulate. Federal Reserve Board Governor Daniel Tarullo recently proposed the notion of a massive expansion of fiduciary duties for banks regulated by the Federal Reserve, arguing for a change in which:

> the fiduciary duties of the boards of regulated financial firms . . . reflect what I have characterized as regulatory objectives. Doing so might make the boards of financial firms responsive to the broader interests implicated by their risk-taking decisions even where regulatory and supervisory measures had not anticipated or addressed a particular issue. And, of course, the courts would thereby be available as another route for managing the divergence between private and social interests in risk taking.[27]

It was not clear whether Governor Tarullo was suggesting a change to state law or instead was suggesting a federal preemption of state fiduciary duties. At present, the fiduciary duties owed by banks to their shareholders with respect to chartered banks are a function of federal law that itself references state corporate law. It may have represented both: pressure on states to reform their fiduciary duty jurisprudence backed up by an implicit threat of federal preemption. The Roe thesis suggests Delaware may respond to that threat. Certainly this proposal was highly provocative and has not been directly adopted by the Federal Reserve. But it presents an extreme case of the threat of federal preemption. Governor Tarullo additionally suggested federal rules concerning executive compensation, management reporting systems, and board structure as additional corporate governance avenues that federal regulators might regulate.[28]

CORPORATE GOVERNANCE NEEDS OF CROWDFUNDED FIRMS: A MICROCOSM OF THE DAMAGE FEDERAL PREEMPTION CAN DO TO ECONOMIC GROWTH

One development in the capital markets world that promises to renew innovation in methods of business financing is a new regime of crowdfunding that has been facilitated by regulations at the SEC, adopted pursuant to the Jumpstart Our Business Startups (JOBS) Act of 2012, to allow very small and early-stage companies and investment projects to access public markets.[29] This new innovation will of necessity require a new corporate governance system designed for the unique needs of crowdfunding, but unfortunately the existing federal overhang in corporate law threatens to impede the promise of crowdfunding.

The regulatory regime for crowdfunding is relatively new. It remains to be seen whether crowdfunding will reshape startup financing. And if it does not, it also remains to be seen whether crowdfunding will be primarily held up by regulatory constraints that remain despite the JOBS Act. Crowdfunding is nevertheless a helpful microcosm for the experiment.

The questions at the heart of this chapter are simple: In the absence of federal preemption in corporate law, what range of alternative innovations would be possible? And in the absence of federal preemption, how much more competitive would the state system for creating corporate law become?[30]

Answering these questions also calls for a difficult thought experiment, because one must consider a world in which a range of institutional constraints in corporate law and financial markets that presently exist are eliminated, and consider a world in which the path dependencies in the law and the institutional design of the industry itself would disappear.

The environment best suited for this thought experiment is crowdfunding. It is presently at a nascent stage with respect to the regulatory regime that governs it. The financing mechanism also was allowed to grow, in a limited capacity, before the federal regulatory regime went online.[31] The institutional dynamics seen in that early precursor to crowdfunding afford sufficient data to begin the necessary thought experiment.

Crowdfunded firms are expected to be designed around a number of "quasi for-profit" models that will require legal duties and structures very different from those popular in previous models. Some crowdfunded firms, for example, are expected to specialize in funding drug research to find cures for ailments with small patient populations. Such a firm could face difficult choices in the tradeoff between searching out the most profitable drugs and maximizing the odds of finding a cure.

Indeed, one would expect that funders would go into the investment expecting the possibility that the firm might stretch the boundaries of traditional fiduciary obligations, or the residual obligation of good faith and fair dealing, in the initial search for a cure if necessary, but would subsequently seek to maximize profits obtained by successful research. Such a mixed-motive firm will of necessity require a corporate code that maximizes freedom of contract to define the obligations owed by a board to shareholders and one that permits use of arbitration rather than litigation to enforce any contractual duties.

It is already clear that crowdfunded firms, much like master limited partnerships (MLPs), are likely to utilize nontraditional monitoring to protect against fraud. A study by Wharton Professor Ethan Mollick on a platform similar to crowdfunding found that funders of most projects were highly involved and provided ideas from the design of consumer products to the development of business strategy.[32] That study also found that fraud detection was essentially "crowdsourced" with rapid detection of fraudulent projects through user commentary on platform blogs and comment sites.

A large community of users can maximize on the low costs of communication in the era of social networking to better police fraud.[33] This new model of corporate governance is vastly different from the current model, which is based on a theory developed by Berle and Means and premised on an assumption that small shareholders face insurmountable costs in communicating with each other and with directors of the firms they own.[34]

Some crowdfunded firms may find that shareholder participation is useful, although not necessarily through the rigid mandates established by federal law. Other firms may find shareholder participation harmful. Entertainment projects, like fan-based movie funding, have been particularly successful on crowdfunded platforms that predated the new crowdfunding regulatory regime. Those projects tend to center on a specific director or actor as a necessary element in the project and may therefore seek to limit the ability of shareholders to interfere in decisions by that individual. Thus old models of the fiduciary duties that companies owe to their shareholders will be largely outdated for this new model.

An explicit recognition of the right of investors and firms to choose arbitration to resolve claims against public companies, whether through SEC guidance or statutory reform of the Securities Act of 1933, is vital to assist the development of new publicly traded small businesses like those expected to evolve under crowdfunding. One reason arbitration is so important is that firms funded under crowdfunding will have unique designs vastly different from those seen in the publicly traded space thus far. Crowdfunded firms will be much smaller, will be publicly traded much earlier in the innovation life cycle than any firms previously seeking public capital, and will go public with the assumption that multiple rounds of future funding will be required.

The fact that the suggestions in this chapter are designed to facilitate crowdfunding will also serve to generate retail support from individual investors, in much the same way the ride-sharing app Uber has managed to generate strong retail support that has allowed it to successfully challenge the powerful lobby of incumbent taxi cabs. Crowdfunding, like Uber, is a service that directly challenges the incumbent methods of financing and whose most cogent threat is the regulatory barriers to entry supported by incumbent firms. And crowdfunding, like Uber, is poised to utilize technological improvements in the cost of communication that are popular among millennial consumers.[35]

While crowdfunding platforms may escape most of the requirements put into place by Dodd-Frank and Sarbanes-Oxley, those crowdfunded firms that hope to evolve and grow into larger public companies listed on exchanges may nonetheless feel compelled to abide by securities laws' strictures anyway. Furthermore, while crowdfunding is used as an example for how the federal government encroaches on the states, that is merely a microcosm for the broader damage to innovation in the state-based corporate law system caused by federal preemption.

WHEN THE FEDERAL OVERLAY IS ROLLED BACK, INNOVATION SPROUTS: THE CASE OF PUBLICLY TRADED MASTER LIMITED PARTNERSHIPS

The governance of publicly traded master limited partnerships provides a small-scale case study in the adaptability and heterogeneity of businesses' organizational form. MLPs form a small subset of publicly traded companies in which the federal overlay has been moderately lifted by the exchanges. They were created pursuant to a tax exemption for energy companies that allows them to avoid entity-level taxation if they make regular distributions of earnings to investors. Looking more broadly to the MLPs that continue to operate using a limited partnership form, John Goodgame notes that as of 2012, there were eighty-seven energy-related MLPs traded on public markets.[36] While they have traditionally been organized as limited partnerships, more recently some of them have organized as LLCs.[37] These energy firm MLPs make up the vast majority of publicly traded alternative entities on US exchanges.

Under exchange listing rules, MLPs are not required to have a majority of independent directors, a nominating committee, or a compensation committee.[38] MLPs and other public companies are otherwise subject to the same set of federal securities laws.[39] Thus, with this relatively minor exception from the federal overlay, a wide diversity of governance arrangements has evolved.

Goodgame generally describes a great deal of heterogeneity in organizational form, as some MLPs provide for annual elections and some have staggered boards. Some MLPs have poison pills, others do not. Some choose default fiduciary duties, and some opt out of fiduciary duties. But they generally choose to opt out of rules favored in the public context as they have stronger contractual requirements to distribute all their earnings on a quarterly basis. That mandatory quarterly earnings disbursement in the partnership or LLC agreement essentially substitutes for the traditional monitoring mechanisms of corporate law, like fiduciary duty litigation or board committee oversight. And it is structurally a much stronger means of policing against fraud, as equity owners see hard cash flow every quarter (and the firm does not regularly take in large amounts of new capital such that a Ponzi scheme–type fraud would be possible). It is very difficult for these companies to mask losses.

MLPs further have a governance innovation similar in many ways to the organization board member proposal advanced by Bainbridge and Henderson (and referenced earlier in this chapter).[40] MLPs are typically controlled by a sponsoring general partnership, which reserves contractual control of the board of directors for itself by reserving a majority of board seats for individuals selected by the general partnership. Structural heterogeneity in governance tends to adapt to the particular needs of individual firms; those with more dependable and steady streams of cash flow tend to substitute for traditional governance arrangements earnings distribution and regular fundraising from capital markets as agency monitoring measures.[41]

One can readily think of other governance arrangements that could be useful for other types of firms, from crowdfunding to unique industries, which states could develop if freed from the overbroad federal footprint. One could imagine a different appraisal process tailored uniquely to handle the needs of biotech firms that lack cash flow for long periods. This limited innovation leads one to wonder what level of innovation may have been possible in the absence of the full federal overlay. At this point one can only guess the possibilities.

RECOMMENDATIONS

Repeal Federal Corporate Governance Mandates

The struggle of meshing the needs of new business models with rigid federal regulation prompts a larger consideration of the current state of interaction between states and the federal government in corporate law. This leads to the claim of this chapter that state competition is currently not robust enough to support novel corporate structures because states are hindered by an ever-expanding federal overlay of blanket regulation. Title IX of Dodd-Frank perpetuates this federalization of corporate law in the face of the internal affairs doctrine. As noted in the MLP case study, reducing regulation that results in the allowance of innovation can have an immediate beneficial effect in the form of firms' willingness to innovate. Revitalizing state federalism in pursuit of genuine competition, as opposed to the centralization purposes of Title IX's corporate governance provisions, would serve to incentivize states to create and promote innovative and more effective corporate law.

Codify the Internal Affairs Doctrine as a Binding Constraint on Federal Regulatory Agencies, with Express Standing for States to Challenge Federal Action

The internal affairs doctrine has helped to maintain a vibrant competition between the states in the development of corporation law. This has helped to develop a rich body of law that has made it possible for large-scale industrial development through the twentieth century. But the internal affairs doctrine is under siege from regulators who have preempted large swaths of corporate law, and other regulators who continually look to sidestep it. A clear and binding constraint on federal regulators will be necessary in order to allow corporation law to undergo a renaissance for a new and vibrant century of capital markets.

For a federalist system to survive, it must be self-enforcing. In other words, it must be able to survive future attempts to slowly erode the federalist system in corporate governance. The explicit standing of individual states to challenge violations of the internal affairs doctrine helps to create that self-enforcing character.

Give Statutory Recognition to Publicly Traded Companies' Right to Require Investor Arbitration

This chapter has demonstrated that permitting arbitration for shareholder claims against companies, whether under the federal securities laws or pursuant to state corporate law, is a vital component to reinvigorating interstate competition. It is also clear that many crowdfunded firms would benefit from an alternative corporate law model grounded in a more flexible and adaptable arbitration-based approach to adjudicating corporate disputes. The SEC should not prohibit arbitration for investor claims in any instance in which a state's corporate law permits it. Delaware appears to presently discourage an arbitration alternative, but under a more competitive system some state would likely design an alternative that more directly used arbitration as a means of resolving shareholder complaints.

Preempt Authority of State Attorneys General to Bring Investor Claims against Out-of-State Firms

Yet another threat to state chartering competition is in the form of state attorneys general who bring claims on behalf of investors in companies outside of their state. In particular, New York attorneys general have brought many claims under New York's overly broad Martin Act against companies incorporated outside of New York for claims between investors and companies that should be resolved pursuant to the other state's corporate code.

An analyst writing for *Legal Affairs* described former New York Attorney General Eliot Spitzer's use of the Martin Act as follows:

> To win a case, the AG doesn't have to prove that the defendant intended to defraud anyone, that a transaction took place, or that anyone actually was defrauded. Plus, when the prosecution is over, trial lawyers can gain access to the hoards of documents that the act has churned up and use them as the basis for civil suits.[42]

Limiting the authority of state attorneys general for investor fraud actions to companies incorporated in their home state will more faithfully respect the internal affairs doctrine and provide those attorneys general with an incentive to balance any desire to bring meritless litigation against out-of-state firms for political motivations.[43]

In the event state competition for corporate chartering becomes markedly more competitive as a result of the suggestions in this chapter, states may then be tempted to use the power of state attorneys general to engage in unfair competition with other states. Corporate governance practices that give other states a competitive advantage in the chartering race may be deemed “unfair” under a nebulous statute like the Martin Act.

Out-of-state attorneys general could then threaten innovations in other jurisdictions that are otherwise beneficial to shareholders. If instead state attorneys general are limited in their authority to bring investor fraud claims against entities incorporated in their own states, then they will be better incentivized to consider the collateral consequences of any abuse of their authority.

Out-of-state attorneys general have no incentive to consider the collateral consequences of their actions on the broader investing public. One might imagine, for example, the New York attorney general forcing companies as part of settlement agreements to regularly require that all members of the board be independent of the company, thereby discouraging other states from beneficial innovations in the design of boards of directors to leverage the expertise of nonindependent directors.

This is a critical distinction to appreciate in discussions about federal preemption. When states create law, as through the creation of a corporate code, and when states internalize much of the impact of their lawmaking, as through chartering fees, a competitive race is possible and principles of federalism apply. But in the use of state attorney general power, states create law in the use of enforcement actions. They craft new law through enforcement settlements, and the institutional actors with the power to craft that law have no balancing force to discourage abuse of their power.

If a New York attorney general oversteps and presses initiatives that destroy shareholder value, his influence and political standing will be unaffected. Shareholders and incorporators cannot choose to avoid the law effectively created by New York in this way; they cannot choose corporate law created by enforcement action the way they can choose statutory corporate law by selecting a particular state of incorporation. All publicly traded companies have many of their trades routed through the various exchanges that operate in the jurisdiction of the New York attorney general.

The recommendation offered here will encourage a more federalism-based approach to the use of this executive authority. State attorneys general would be more sensitive to the impact of their decisions if the rate of incorporation in their home state were linked to the enforcement environment they provide. Furthermore, any under-enforcement by an attorney general that left shareholders exposed to fraud would result in a discount to the traded value of firms incorporated in that state.

Thus this suggestion creates an institutional environment in which state enforcement actions premised on investor claims are more balanced and responsive to the costs of over- or under-enforcement relative to legitimate shareholder fraud claims.

CONCLUSION

When the SEC was created in the 1930s, the state-based system of corporate law was kept in place. That system had helped to facilitate the accumulation of wealth necessary for large-scale capital investments during the Industrial Revolution. When SEC Chairman William Cary suggested in 1970 that a federal corporate law be adopted, the suggestion was largely ignored. Even in the wake of the Enron scandal and, later, the 2008 financial crisis, the federal response did not include a wholesale preemption of state corporation law. This indicates an enduring, centuries-long respect at the federal level for the vital role of the states as sources of corporation law.

The slow preemption of discrete pieces of state corporate law has, however, taken its toll on the state-based corporate law system. The discrete preemptions have a much larger impact on the state system than the sum of their parts, as they discourage innovation in corporate governance and impede state competition to create new legal and contractual regimes to govern the relationships between investors of capital and managers of capital.

At each major turn in human history, corporate law has served as a foundation for mankind's forward progress. In ancient Babylonia, a version of partnership law helped farmers band together for mutual investments in farming infrastructure. A more sophisticated form of corporate law developed to facilitate Roman-era investments in large capital projects like the aqueducts. America's first major evolution in corporate law facilitated the Industrial Revolution, and the next spurt of ingenious innovations helped America's post–WWII economic boom.

Looking forward, an entirely new era in which investors are likely to interact with their investments in an increasingly low-cost, app-based environment is possible. Crowdfunding in particular promises to allow small-dollar investors to invest in very early stage ventures like never before. Innovation's promise will be lost, however, if the federal overlay in corporate law does not stand aside to allow renewed competition and innovation in the state-based corporate law system.

NOTES

1. See Gallagher and Cook, "Shareholder Proposals."
2. "Triumph of the Pygmy State."
3. Piwowar, "Dissenting Statement."
4. See generally Romano, "Sarbanes-Oxley Act."
5. Roughly half of all publicly traded companies are incorporated in Delaware. Romano describes Delaware's dominance of the corporate chartering market as a feature, not a bug, of a successful race to the top. Bilateral investments by both users of corporate law and by Delaware in the production of corporate law may make it difficult for another small state to compete with Delaware, but at the same time those bilateral investments serve to enhance the quality of Delaware's code. She describes it as "development of transaction-specific human capital [which] establishes what Oliver Williamson terms a 'mutual reliance relation' creating a reciprocal vulnerability on both sides of the charter market that joins the parties together in a cooperative long-term relationship." See Romano, "Law as a Product," 225–26.
6. Bainbridge and Henderson, "Boards-R-Us."
7. Ibid., 1100.
8. Daines, "Does Delaware Law Improve Firm Value?"
9. See Macey and Miller, "Toward an Interest Group Theory."
10. Verret, "Uber-ized Corporate Law," 964.
11. Yerger, Testimony before the Senate Subcommittee.
12. Roe, "Corporate Shareholder's Vote," 9.
13. For a possible definition of the internal affairs doctrine from the Restatement (Second) Conflict of Laws, see "Internal Affairs Doctrine."
14. "Internal Affairs Doctrine."
15. Edgar v. MITE Corp., 457 U.S. 624, 645 (1981).
16. Chandler and Strine, "New Federalism," 953, 974.

17. Ribstein and Kobayashi, “Economics of Federalism,” 3.

18. Roe, “Delaware’s Politics,” 2498. While Roe overstates the case by describing Delaware as thus a “monopoly,” he nevertheless accurately sketches Delaware’s relationship to the federal government. See Roe, “Delaware’s Politics.” In “Delaware and Washington as Corporate Lawmakers,” 10–11, Roe goes on to describe the ways in which the federal government can and has preempted state corporate law:

    > “Washington makes corporate law. From 1933 to 2002, that is, from the passage of the securities laws to the passage of Sarbanes-Oxley, Washington has made rules governing the voting of stock and the solicitation of proxies to elect directors. It has made the main rules governing insider trading, stock buybacks, how institutional investors can interact in corporate governance, the structure of key board committees, board composition (how independent some board members must be), how far states could go in making merger law, how attentive institutional investors must be in voting their proxies, what business issues and transactional information public firms must disclose (which often affect the structure and duties of insiders and managers to shareholders in a myriad of transactions), the rules on dual class common stock recapitalizations, the duties and liabilities of gatekeepers like accountants and lawyers, and more. Even when the SEC cannot, or does not, make the substantive rule, its capacity to force disclosure of numbers and transactions can turn a spotlight onto those transactions and numbers, thereby affecting whether or not they happen.”

19. Roe, “Delaware’s Competition,” 592.

20. Ibid., 597.

21. Ibid., 598–99.

22. Romano, “States as a Laboratory,” 209, 220.

23. Roe, “Delaware’s Competition,” 601.

24. Macey, “Federal Deference to Local Regulators,” 279.

25. Roe, “Delaware’s Competition,” 611.

26. Greve and Parrish, “Administrative Law without Congress,” 501, 505.

27. Tarullo, Speech at the Association of American Law Schools.

28. Ibid., 7.

29. A corollary regime of state-based crowdfunding has also sprung up (though the state version requires that investors be circumscribed within a particular state or geographic area).

30. Note that this chapter considers the damaging effects of preemption of corporate governance rules. Preemption of state securities regulations of out-of-state offerings, as was necessary in the crowdfunding context, is subject to a different set of institutional incentives in which states do not internalize the effect of their regulations on out-of-state offerings. This costly effect at the state level is similar to that analyzed below in the attorney general context.

31. Crowdfunders were allowed to raise money by offering benefits like advanced purchases or participation in the project, but prohibited from selling actual stock. For more detail on this question, see Verret, “Uber-ized Corporate Law.”

32. Mollick, “Dynamics of Crowdfunding.”

33. Agrawal, Ajay K., Christian Catalini, and Avi Goldfarb. “Some Simple Economics of Crowdfunding.” NBER Working Paper 19133, National Bureau of Economic Research, Cambridge, MA, June 2013.

34. See Berle and Means, *Modern Corporation and Private Property*.
35. For additional discussion about how crowdfunding bears similarity to Uber, see Verret, "Uber-ized Corporate Law."
36. Goodgame, "New Developments," 81, 83.
37. Ibid., 84.
38. Ibid., 98.
39. Ibid.
40. Bainbridge and Henderson, "Boards-R-Us."
41. Goodgame, "Master Limited Partnership Governance," 471, 480.
42. Thompson, "Sword of Spitzer."
43. For an extended argument about how many of Eliot Spitzer's prosecutions under the Martin Act were based on questionable assertions of fact and politically motivated, see Greve, "Federalism's Frontier," 93. See also Greve, "Business, the States," 895.

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