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I'm going to speak today about the architecture of American corporate law, the dynamics that produce that architecture, and the implication of those dynamics and that architecture. Generally speaking, the architecture of American corporate law falls into a pyramid consisting of four tiers or levels – private ordering, including soft law, such as the rules of the stock exchange, state judge-made law or common law, state legislative law, and federal law. I begin with state common law. At this level American corporation law is fairly strong.

The courts, in particular, have developed an extremely rich body of judge-made law on the fiduciary duties of directors and officers, both the duty of fair dealing and the duty of care. The judicial development of this rich body of law, which I think does much to promote the American corporate system, is due largely, or almost entirely, to the institution of shareholder suits. It's almost entirely through shareholder suits that this law has been and continues to be generated. So, although shareholder suits are frequently criticised, the fact is that American law would be highly impoverished without them, and with them in the area of fiduciary obligations it is extremely rich.

In contrast to the rich, full-bodied content of state judge-made law, state legislative law is highly impoverished. There are two clusters of reasons why this is so.

The first cluster centres on the idea of the neutrality or non-neutrality of law. A rule of law may be thought of as neutral if when the rule is adopted it cannot be foreseen how it will affect various classes of persons. For example, in contract law if there is a rule concerning what constitutes an offer, you can't know in advance if this helps sellers or buyers, and so forth. The body of corporate law consists of laws that lack neutrality in this sense. That is, the major concerns of corporate law are the rights, powers and responsibilities of managers, shareholders, and – in America, to a lesser extent—creditors. Virtually every rule of American corporation law, virtually every comma and semicolon can be quickly and easily analysed in terms of whether it promotes the interests of shareholders or managers.

Over the great run of transactions, the interests of shareholders and manager coincide. Broadly speaking, shareholders and managers both want to maximize corporate profits. Therefore, it is generally in the interests of the shareholders that the rules of corporate law permit managers to operate the corporation's business with the maximum feasible flexibility, and that these rules do not inhibit entrepreneurial risk-taking in areas where managers' interests and shareholders' interests do not conflict.

Where the interests of managers and shareholders do conflict, the case is very different. For example, when managers are inefficient, the interest of shareholders is to change managers and the interest of managers is to stay in office. I don't think there's been a manager in history who said I'm inefficient and I should retire. When managers transact business with the corporation in a self-dealing capacity, the interest of managers is to benefit themselves and to insulate the transaction from review, while the interest of shareholders is that the transactions be fair and subject to objective review. The list could go on, but the point is clear.

Now, neutral legislative rules can be made, to use a phrase of jurisprudence, or I should say philosophy, in America, from behind the veil, that is, without knowing whose interests are going to be affected on the basis of fairness and policy. Non-neutral rules cannot be. Everybody knows who is going to be affected by these rules, and how, and affected persons therefore have an interest in lobbying for or against such rules. In some bodies of non-neutral law, lobbies are organised on both sides. For example, in labour law employers and employees are both highly organised. In some bodies of non-neutral law, there is some independent governmental agency that is relatively neutral, for example, the SEC in securities law in America. Neither condition holds for state corporation law. Managers are very well organised to lobby, shareholders are not. States rarely, if ever, have an agency with any knowledge about corporation law, and corporation law is much too complex to be understood by individual legislators, with rare exceptions.

What happens then? De facto, state corporation law in the United States is made by committees of the bar. These committees consist either entirely or almost entirely of management lawyers. These committees, so constituted, rarely recommend regulation of any kind.

So one cluster of rules that affects state legislative corporation law is that the way it's made in practice drives it only toward flexibility, and rarely toward regulation. Now, flexibility is very desirable in non-conflict areas. It's not very desirable in conflict areas, and this gives us one reason why state legislative corporation law is impoverished.

The second reason concerns the so-called problem of the race to the top versus the race to the bottom, or what is being called here regulatory competition. Under American law, to the extent that internal affairs of a corporation are governed by state law they are governed by the state of incorporation, and for various reasons, some financial, some not, states have strong incentives to attract incorporations. How are incorporation decisions made? They are not made by shareholders. We heard this morning about shareholder vetos. In theory, shareholders in America have a veto over reincorporation decisions, but they almost never exercise it. These decisions are usually beneath the radar screen for shareholders. So although reincorporations have to be approved by the shareholders, that's pro forma. Reincorporation decisions – and when I say reincorporation I mean migration from one state to another – are basically made by managers.

Well, if a state wants to attract incorporation, and if reincorporation decisions are made by managers, the obvious way to go about fulfilling the state's objective is to make side payments to managers to get them to incorporate – the way a butcher might bribe a servant to use the butcher's meat for the household.

How do the states pay managers? They pay them with rules that are unduly favourable to managers, as compared to shareholders, or by simply making no rules at all where rules are required. Now as we heard to some extent this morning, there's been an intense debate in the United States about whether there is a race to the top, meaning that states try to make the best possible rules, or a race to the bottom, meaning that states degrade their law. This debate suffers from a series of significant defects.

First, the debate has been insensitive to the bifurcated nature of corporate law. Corporate law can do two very different things. It can facilitate or it can regulate. American state corporation law has been terrific at facilitating; it hasn't been very good at regulating.

Second, the debate has ignored the way that state corporation law is actually made, that is by committees of management lawyers.

Third, the debate focuses on only one tier or level of corporation law, when in fact there are four levels, each with its own dynamics and each affecting the other.

There is another factor that's become well known, and that is there is no longer a race in the United States. The race is over. Delaware has won. Delaware now enjoys a monopoly position, and it has various features that form a barrier to competition in the market for charters. Fifteen years ago, I developed the following thesis concerning the implications of Delaware's victory. As a result of Delaware's attainment of a monopoly position through the past adoption of managerial rules—rules that are unduly favourable to managers—it now has a special incentive not to lead in the provision of innovative rules that favour managers. The incentive is that such rules would threaten massive federal intervention, because the incentives of the federal government are much different than the incentives of state government. The incentives of the federal government are to have a strong national market. The states have little interest in a strong national market, they're only interested in their own revenues. Furthermore, the revenues that the states get from incorporation is typically not based on profitability, whereas income taxes in the United States on a federal level are based on profitability. So the federal government has a very strong interest in efficient corporation law, including a proper balance between regulation and flexibility, that the states don't share. If Delaware law got too bad, the federal government would intervene. If the federal government intervened, Delaware law would be less attractive, because it would matter less where you incorporated.

That was my thesis. By and large, time has shown the thesis to be accurate. In the last fifteen years, Delaware law hasn't gotten any worse, but neither has it gotten any better. Delaware law, like other state law, completely fails to address any topic that is significant in terms possible conflict of interests. For example, what does Delaware law do about proxy voting? Nothing. How does Delaware law regulate the relationship between the independent auditor and the corporation? Not at all. What was the reaction of the Delaware legislature to Enron? Zero.

In short, in areas where conflicts of interest require regulation, the states have completely failed, and the strength of American law depends not on state legislation but on the common law, the judge-made law, on federal law, and on soft law. There is a tradition – not a legal rule, but a tradition – in America, of leaving matters to the states in many areas, including corporation law. However, that's not a legal rule, and when things get bad, when corporation law gets bad, the federal government intervenes. It has massively intervened on two occasions – in the 1930s with the Securities Acts, and just now with Sarbanes-Oxley. So it's federal law in the United States, and only federal law by and large, that deals on the legislative level with the most important problems of corporate law, problems like proxy voting, insider trading, the independence of the outside auditor, and so forth. Any important area you could think of that involves potential conflicts between managers and shareholders is almost totally ignored by state legislative law (except by providing safe harbors against liability), and dealt with legislatively only at the federal level and by soft law.

These problems are dealt with in America by soft law because the Stock Exchanges have very similar incentives to the federal government. The Exchanges, the New York Stock Exchange and NASDAQ, also have an incentive to have profitable corporations and a strong market.

We heard a lot this morning about requirements of director independence. In fact Sarbanes-Oxley does not require director independence, except for audit committees. The SEC doesn't require director independence, except for audit committees. Most of the independence requirements in the United States are privately made soft law, that is, the listing rules of the New York Stock Exchange and the listing rules of NASDAQ. These Exchanges, under the pressure of Enron, have adopted very elaborate corporate governance rules, including independence rules. I have to say, however, that while I'm calling these rules soft law, it's the hardest soft law you can imagine because it looks just like legal rules. There are sanctions for violations, just like legal rules, and it's very hard to avoid these rules if you're a large, publicly held corporation. Very few large publicly held corporations can avoid being listed on either the New York Stock Exchange or NASDAQ.

Now, part of the subject for today was implications. Let me discuss very briefly several implications.

First, a very good way to develop a rich body of fiduciary law is to facilitate shareholder suits, with proper safeguards.

Second, one might want to look at American state legislative law as a source of how flexible law can be in non-conflict areas, because American corporate law is, for example, completely flexible about capital structures, dividends and so forth, and it works.

Finally, please do not think that competition among the states in the United States has been beneficial. It's been beneficial only because it's surrounded by all these other tiers of mandatory law – common law, federal law, and hard soft law. In fact there is no regulatory competition among the states in the United States. No state goes onto the market for charters and says "Incorporate here because we will regulate you more." There might be regulatory competition in Europe. There might be regulatory competition between particular agencies in the United States. There is no regulatory competition among American states.