Four Pillars To Build A New Corporate Law
Federalism: Crowd Funding Exchanges, A
Codified Internal Affairs Doctrine, City-Based
Incorporation, And An Arbitrated Corporate
Code

J.W. Verret
Four Pillars To Build A New Corporate Law Federalism:

Crowd Funding Exchanges, A Codified Internal Affairs Doctrine, City-Based Incorporation, And An Arbitrated Corporate Code

J.W. Verret¹

Abstract:

This article examines the event window opened by the pending creation of new crowdfunding platforms, a new means of creating publicly traded equity for smaller, early stage firms than have ever been permitted by the Securities and Exchange Commission to access the public securities markets. This article considers the economics of crowdfunding precursors which share some of the attributes of equity crowdfunding, and also considers the expected attributes of equity crowdfunding, to demonstrate that crowded firms will require a level of corporate governance flexibility that is not presently seen in corporate law. This article then points to federal preemption as the central cause of that inflexibility and presents suggested reforms to enhance competition in the state based corporate entity formation process. Among those reforms, this article’s most important suggestion is that a company’s right to demand shareholder arbitration of corporate governance claims, both arising under state law and under federal law, should not be inhibited by the SEC. That particular reform will be key to challenge existing network effects arising from 100 years of Delaware precedent in interpreting its corporate code. This article then hypothesizes about some particular modes that new governance competition may take under an enhanced state competition free from the overlay of federal preemption, including city based incorporation and regional crowdfunding platforms organized as contracts between states offering state-based crowdfunding regimes. Many of the new corporate governance innovations that are expected to evolve from the model presented in this article can also spillover into the larger public company space as well.

¹ Assistant Professor of Law, George Mason University School of Law. The author
# Table of Contents

Introduction........................................................................................................................................... 3

Prelude: A Window Into The 21st Century World of Corporate Governance ......................... 4

Part I: Crowd funding: An Event Window to Renew Corporate Federalism ...................... 6
  Section A. What is Crowd funding? ....................................................................................................... 8
  Section B: The Economics of Crowd funding Demonstrate that Crowd funding Will Require
  A Level of Flexibility That Current Federal Preemption Would Not Facilitate .......... 17
    Subsection 1: Expected Demand for Arbitration .............................................................................. 17
    Subsection 2: Expected Demand for Non-Traditional Governance Structures .......................... 21
    Subsection 3: Expected Demand for Novel Shareholder Participation for Some Crowdfunded
    Firms, Particularly Public Hybrid Firms with Constraints (Enduring or Limited) on The Profit
    Maximization Objective ...................................................................................................................... 24
    Subsection 4: Expected Demand to Facilitate Adaptive Funding Methods .............................. 27
    Subsection 5: Expected Demand To Facilitate Their Organic Growth ....................................... 31
    Subsection 6: Expected Demand for Unique Dissolution Procedures ................................. 36
  Section C: One Perspective On Uberization: An Interest Group Story Suggesting
  Crowd funding Can Make Corporate Federalism Stick ............................................................... 37
  Section D: A Second Perspective On Uberization: App-Based Interaction Changes the
  Information Cost Conventional Wisdom of the Collective Action Story of Corporate Law .. 41
  Section E: Analogue to Crowd funding?: the US Over the Counter Pink Sheets Market .... 44
  Section F: Analogue to Crowd funding: The London AIM Market .............................................. 48

Part II: The State of Corporate Federalism And The Need for a Codified Internal
Affairs Doctrine .................................................................................................................................. 50
  Section A: Federalism in State Chartering, Romano’s “Genius of American Corporate Law” ................................. 53
  Section B: The Internal Affairs Doctrine ......................................................................................... 59
  Section C: Federal Preemption By Statute, Discretionary Agency Power, and The National
  Exchanges .......................................................................................................................................... 63
  Section D: Other Federal Agencies Get Into the Internal Affairs Preemption Game ............. 66
  Section E: Prior Federal Statutes Encroaching on State Internal Affairs Should Either Be
  Abolished or Become Optional ........................................................................................................ 69
  Section F: Public Choice Analysis of Federal Pre-emption ............................................................. 73
  Section G: Interest Group Politics in Delaware ............................................................................... 75
  Section H: Preemption of the Martin Act to Forestall Abuse ......................................................... 80
  Section I: When The Federal Overlay Is Rolled Back, Innovation Sprouts: The Case of
  Publicly Traded Master Limited Partnerships ................................................................................. 81

Part III: Arbitration of Disputes Between Shareholders and Boards, and A Code
Adapted For That Purpose to Compete With Delaware ................................................................. 83
  Section A: Arbitration is Key to Challenging Delaware ............................................................... 83
  Section B: Delaware’s Mode of Corporate Governance Creation Maximizes Lock-In
  Through Indeterminate Code Matched With Predictable Courts .............................................. 87
  Section C: Does Ribstein’s Uncorporation Thesis Fill the Gap in Demand? ........................... 90
Introduction

This article begins with a thought experiment about how corporate governance of small public companies trading on new platforms, like crowdfunding portals (or alternatively, “crowdfunding exchanges”), might be expected to evolve to make corporate governance easier and more flexible for users. New opportunities could involve increased use of default rules whereby shareholders or owners defer participation in governance (in line with the Bainbridge director primacy argument), subject to default participation rules they might follow (developed on crowdfunding platform apps in a multitude of ways, including through open source methods). It could also include more shareholder empowering regimes. In any event, the general logic of the exit/voice dichotomy of shareholders, based on the firm specific nature of their investments, developed by Baysinger/Butler will continue to inform shareholder and firm choice, and code development, in chartering competition even in this new environment. In examining the heterogenous corporate governance needs that crowdfunded firms are likely to have, this article
will link contributions from the New Institutional Economics or Firm Theory Literature to corporate entity formation to provide a flavor for the range of innovations “outside the box” that may be possible in a new and more competitive corporate chartering race free from the federal overlay.

This examination will focus on the needs of crowdfunded firms, but some of the innovations developed in the crowdfunding space may spill over into the large public company space as well. An examination of the needs of crowdfunded firms prompts a larger consideration of the current state of interaction between states and the federal government in corporate law (general references to corporate law hereinafter include both competition for corporate charters and competition for alternative entities like LLCs) and consideration of whether state competition is actually competitive enough to make the most of new crowdfunding developments. Finding that state competition is presently insufficient to meet the needs of crowdfunded firms, this article will then consider institutional changes to the federal overlay that are required to re-invigorate state chartering competition to better facilitate that purpose.

This article will argue that key changes vital to enhance chartering competition include:

i) codification of the internal affairs doctrine (or “IAD”) as a binding constraint on discretionary rules and enforcement actions by the SEC and all other federal agencies, accompanied by a right of action for states to sue federal agencies that violate the requirement (public choice analysis will be offered in part as justification for this recommendation), and

ii) statutory reform to recognize an explicit right for public companies to require investors arbitrate claims against the company, and

iii) repeal, or at a minimum a shift to opt-in, for corporate governance items included in Title 9
of Dodd-Frank, in Sarbanes-Oxley, and in the Williams Act.

Other helpful reforms might include:

i) federal pre-emption of state Martin Act claims covered by the IAD to prevent states from using versions of the Martin Act to unfairly stifle chartering competition, and

ii) reform of the SEC’s 34 Act intrastate offering exemption to also include an exemption for regional compacts between states that might provide crowdfunding platforms on a regional, rather than merely single state, basis that should then be fully exempt from the federal overlay.

Once the institutional requirements necessary to reinvigorate chartering competition to make the most of crowdfunding’s promise are established, this article will hypothesize about how chartering competition might be expected to evolve under the new environment.

Of all the claims made in this section, the strongest is that increased use of arbitration, rather than litigation, to resolve shareholder claims against company defendants will be a necessary element to reinvigorated charter competition. Development of an arbitration-based, or alternatively a hybrid class-arbitration based, model of adjudication is the clearest path for a competitor to overcome any network effects present in the current Delaware-dominant model and build up a completely new paradigm for corporation code enabling provisions, interpretation, and adjudication. I note that interpretation and adjudication may in fact be separate concepts in this context because firms may see a benefit in a model that both provides a mechanism to adjudicate disputes and also provide some form of regular advisory opinion, akin to federal no-action guidance, given the literature's focus on how corporate entities prefer clear guidance to optimal rules in contract law. Delaware judges flirt with an advisory mechanism through increased use of dicta and speeches, etc., but a more formal mechanism for this form of advisory opinion not fully utilized by the Delaware model may give a competitor state or city a distinct
advantage. The SEC currently prohibits full use of arbitration of shareholder claims against companies. This article argues that since federal 34 Act claims and state corporate governance claims are largely interchangeable now, the SEC’s intransigence, in spite of federal case law to the contrary favoring arbitration generally, must be addressed to make state law arbitration a viable alternative means of adjudication for states competing with Delaware.

This article also argues that, in light of the Macey/Miller interest group analysis of Delaware, the new era of chartering competition explored under these federal modifications is not likely to remain a Delaware dominated world. The article then hypothesizes that the new era of corporate federalism might include cities entering the chartering race. The dynamics which have made Delaware so successful, including a smaller state more responsive to the benefits of increasing franchise tax revenues and more insulated from disruptive non-corporate interest group political pressures seen in larger states, may also play out well if a few states empowered their cities to form corporations under their own codes. The agglomeration economics of cities explored in prior work by Schleicher also suggests that some cities may be particularly suited to create innovative corporate codes and code-adjudication procedures. If regional state crowdfunding platforms are permitted by the SEC, the new dynamic of corporate federalism might also include interstate-compacts by which states could mutually recognize rights to intellectual property in new corporate governance codes (and exclude rival firms incorporated in states that fail to subscribe to governance IP protections from participation on the exchange) and thereby reduce a problem recognized by Kobayashi/Ribstein.

This article’s focus on development of new corporate governance regimes at the small scale crowdfunding level also offers a route to innovation in corporate law that could spill over into the larger public company environment. New corporate governance arrangements, new off-
the-rack entity forms or hybrids of existing forms, and novel methods of both adjudicating disputes and providing non-adjudicatory interpretations of the corporate code may spill over into useful tools for larger public firms. This new small-scale laboratory may build a foundation to reduce network effects and other constraints on state competition to produce more heterogeneous and adaptable corporate governance methods for larger public companies.

**Prelude: A Window Into The 21st Century World of Corporate Governance**

Imagine downloading a “crowdfund app” and selecting a few dozen companies for purchase of shares costing roughly $100 each. When you set up your crowdfund app, you are prompted with a series of questions with choices. One might read: “Do you wish to 1) receive updates about company elections and participate in shareholder votes for the board 2) select a default of voting for the management recommended slate of nominees in all elections or 3) vote for management nominees unless a list of material negative events recommended by Crowdfund Inc. has occurred?” You may be notified that “You may change your voting defaults under the settings tab at any time” and possibly “Do you want to be reprompted with this question any time you purchase new shares through Crowdfund App?”

Periodically, you may receive updates on your app. You check the app a few months later and find an update which states: “A bidder has made an offer of $120 for your share in Techmarket Inc., and will cease purchases when he has acquired 90% of the shares. If the bidder is successful in acquiring 90% of the outstanding shares, your interest may be frozen out and you may be required to accept an offer that may be lower than the tender offer. If so, you may also submit a request for appraisal at that time (see here for more about the appraisal process.) The most recent closing price for one share is $110. Do you wish to accept?”
You select “no.” A few days later, you receive another update: “The bidder has acquired a 90% stake in Techmarket Inc. and has invoked the freezeout statute. You may either accept the freezeout price of $105, or choose to join an arbitrated appraisal process. Pursuant to arbitrated appraisal, over a 24-hour period an independent accountant will determine whether to award you the freezeout price, or to award you an amount either higher or lower than the freezeout price. If select arbitrated appraisal, and you wish to register your preference for the arbitrator (which includes an algorithmic weighting incorporating preferences submitted by both the controlling shareholder and frozen-out shareholders), a list of eligible arbitrators can be found at the link below accompanied by user ratings of those arbitrator candidates.” Periodically, you check your crowdfund app to track the status of your investments, at which point you examine updates about other pending litigation and/or elections and select from menus if you choose to participate.

You may later open the crowdfund app to find an update stating “Techmarket Inc.’s annual election is taking place in 30 days. You may access the proxy statement filed with the SEC at the following link. Your default settings are to vote with management unless the company has issued a restatement of its financials due to a significant prior fraud or error discovered in its quarterly reporting. The company has issued such a restatement in the last year. Please vote for a maximum of 12 candidates from the nominees provided by the Board of Directors, or those nominated by shareholders with a greater than 5% stake in the company who are allowed to nominate candidates pursuant to the company’s corporate charter, included in the list below.”

It might also prompt: “You have subscribed to voting recommendations from Corporate Governance Analytics Inc. That Crowdfunding portal analysis provider recommends you vote for eight candidates from management and four candidates recommended by shareholders listed
below. To follow that recommendation, click this button.” Or, alternatively, if you don’t have time or inclination to participate in that way, those decisions could all be made for you according to default actions you can choose per stock, or for all stocks, in your settings tab.

And, to further the tech development analogy in this context, the defaults provided via an app based platform for your decision-making could be developed via an open source method, in which corporate governance professionals like corporate lawyers design the defaults and thereby attempt to augment their professional reputations.

**Part I: Crowd funding: An Event Window to Renew Corporate Federalism**

Investors and entrepreneurs will soon face corporate governance challenges as crowdfunded companies, traded on small crowdfunding portal exchanges, which will soon go online pursuant to a pending SEC rule. Corporate governance entity forms created for large public firms may not be best for this novel, ultra small scale public firm, existing LLC off-the-rack options intended primarily for non-public private firms may not exactly fit (particularly Delaware’s model), and powerful interest groups controlling corporate innovation in the leading state of entity formation may have conflicts that limit innovation sufficient to meet required needs. In any event a federal overlay that selectively pre-empts corporate governance, and could pre-empt it further in unexpected ways, further limits incentives of states active in chartering competition to further innovate.

This article argues that unless a complete rethinking of the federal overlay in corporate governance is undertaken, we may miss our “Uber moment” in business entity formation competition as crowdfunding portals go online in coming years. Imagine if the Romans were prohibited from recognizing the separate entity formation that facilitated the creation of the
aqueducts, or if the business entity formation model in which state legislatures were required to pass a new bill to create every business entity was still in effect as the nation’s economy entered the 20th century. That is the precipice on which business entity law currently sits.

In part, the new crowdfunding platforms are interesting for the simple fact that it opens up the possibility for a new experiment in corporate governance. It may be the case that crowdfunding firms have unique dynamics very different from the type of firms currently traded on public platforms, and this article will explore why that may be the case. But even if it is not, crowdfunding nevertheless opens up an opportunity to apply corporate governance innovation to a totally new public exchange platform.

O’Hara and Ribstein note that “amending a public corporation’s charter is costly and cumbersome” and therefore incumbent public firms may find it costly to change their individual corporate charters to reflect economic need and must rely on new provisions in codes developed by jurisdictions for innovative changes. While this doesn’t entirely limit innovation, for example Grundfest2 notes that many firms adopted new forum selection bylaws prior to Delaware’s specifically recognizing that option, it does suggest that particularly paradigm shifting corporate governance innovation will require new initiative. Thus the advent of crowdfunding in itself may open an event window for some of the ideas presented in this article. But there are network effects flowing from the Delaware based model’s dominance, and to the extent the risk of federal preemption inhibits innovation, a paradigm shift may be required in order to optimize corporate governance structures at crowdfunded firms. This article’s Part II presents a roadmap for such a paradigm shift.

---
The difficulty of changing paradigms for large publicly traded firms suggests that innovation is more likely to begin with new firms entering the market, particularly with respect to smaller firms funded by entirely new methods that are not subject to the path dependent pathologies\(^3\) that may drive choice of forum and choice of law at present for large public companies.

Part I of this article below will explain what crowdfunding means and explore the unique economic attributes for small public firms to argue that crowdfunded firms will require innovative and heterogeneous options not presently permitted by the federal overlay in corporate governance. Part I will also explore two smaller firm, lightly regulated exchanges in the US and Britain to develop useful insights for the crowdfunding platform world. Part I will also consider how crowdfunding’s interaction with app-based user interaction will lower the costs of shareholder interaction with firms. Finally, Part I will explore how unique attributes of crowdfunding are likely to help make federalism reforms in this space likely to endure based on a public choice analysis.

\textit{Section A. What is Crowdfunding?}

Mollick defines crowdfunding as: “an open call, essentially through the Internet, for the provision of financial resources either in form of donation or in exchange for some form of reward and/or voting rights in order to support initiatives for specific purposes….\[including\] internet-based peer-to-peer lending….and fundraising drives initiated by fans of a music group….Crowdfunding refers to the efforts by entrepreneurial individuals and groups – cultural, social, and for-profit – to fund their ventures by drawing on relatively small contributions from a

relatively large number of individuals using the internet, without standard financial
intermediaries."

In a sense, crowdfunding in the United States has not really happened yet. Thus far, the
SEC has prohibited sales of ownership in firms through this technology without registration as a
securities exchange and without each individual project or firm on the platform registering as a
public company (a multi-million dollar proposition outside the range of possibility for the small
scale projects and most firms contemplated on crowdfunding platforms.)

In the USA JOBS Act, signed into law in 2012, Congress recognized the growth possibilities of
crowdfunding and ordered the SEC to approve a light-touch regulation regime for crowdfunding
platforms. Once the SEC adopts a rule implementing crowdfunding exchanges, then some
version of what has previously evolved in stunted quasi-crowdfunding platforms will be
expected to thrive. But in advance of the rule’s implementation, crowdfunding has been limited
in that funders are prohibited by law from obtaining a direct monetary interest in the firms they
fund.

Prior to crowdfunding going online with adoption of a final SEC rule, most crowdfunded
projects do not include an equity ownership component, but instead consist of contributions in
exchange for in-kind benefits. Kickstarter is the largest operator of such a pre-crowdfunding
platform in the United States.

One open question will be whether attributes seen on the crowdfunding pre-cursor
Kickstarter will continue to hold as Kickstarter firms transition to crowdfunding platforms able
to sell ownership equity. Agrawal et al posit that, though crowdfunding platform Kickstarter
does not permit the issuance of equity shares, and indeed crowdfunding will not involve the sales

---

of equity until the SEC’s rules for crowdfunding pursuant to the JOBS Act are finalized, the
dynamics of crowdfunding on the pre-cursors Kickstarter and a European analogue Sellaband
can inform how some of the economics of equity crowdfunding are likely to play out.  

Kickstarter is the most popular of the pre-crowdfunding sites. Crowdfunding on
kickstarter has resulted in funds as small as $1,000 to fund an event, clearly not what one would
classically define as a firm, but for the top 50 largest projects funded by kickstarter 45 of them
have become surviving business entities.  

Mollick describes projects funded on kickstarter as encompassing a wide variety of
heterogeneous objectives. He generally divides those into those encompassing a “patronage
model” whereby funders act as philanthropists and don’t expect a financial return, “reward-
based” model where funders expect some in-kind benefit such as preferential access to a funded
product, and an “investment model” through which funders seek to obtain profit. The profit
model on kickstarter is somewhat limited, in that federal securities laws prohibit the sale of
equity securities with registration absent some exemption (and the exemption for crowdfunded
equity securities required by the JOBS Act hasn’t been finalized yet).

Mollick’s study of crowdfunded firms suggests they often combine these objectives.
Mollick notes one odd example of a kickstarter project in which a user posted, as a joke, a
proposal to fund a statue of Robocop to install in Detroit, which subsequently went on to raise

---

6 Mollick, supra note 3, at 2. The Veronica Mars Film Project is one of the largest funded projects on kickstarter. It was a fan funded movie, continuing a story line from a canceled series, and raised $5.7 million by offering funders in-kind benefits ranging from regular movie productions updates (for $1 dollar contributors) to a role in the movie (for a single $10,000 funder) and a range of other benefits for funders in between. The Veronica Mars Project (Rob Thomas Kickstarter campaign), KICKSTARTER (2013), https://www.kickstarter.com/projects/559914737/the-veronica-mars-movie-project/description.
7 Mollick, supra note 3, at 3.
8 The third model thus can only offer funders preferential access to purchase securities at a later date, some form of royalty sharing, or other close approximation of a future stream of revenue, while carefully avoiding the SEC’s test for an equity security which is largely dependent on the presence of direct revenue sharing.
$67,000 in six days, and was subsequently completed. This suggests a somewhat organic quality to crowdfunded projects, with initiators at times unsure of the ultimate evolution of their project (and indeed, whether their proposal will be a one time discrete project or will evolve into a full fledged firm.)

Mollick posits that a number of features unique to kickstarter help to police fraud, such as “including threshold funding, active participation by large communities, frequent interaction between founders and potential funders, and the ability of founders to broadcast signals of quality through rich descriptions and biographic information.”

Mollick conducted a study of 48,500 crowdfunded projects with combined funding of $237 million on the Kickstarter website, and found that personal networks like number of Facebook friends, geography, and underlying project quality are the key drivers of success in crowdfunded firms. Mollick describes the geographic component as “founders proposing projects that reflect the underlying cultural products of their geographic area (such as country music in Nashville, Tennessee).”

Mollick notes that among crowdfunded projects on kickstarter, “the project mix of founders echoes the cultural products of the cities in which they are based….Nashville has an outsized number of projects for its population, the majority of which are music-based. Los Angeles is dominated by film, while San Francisco has many more technology, games and design products.” This reinforces the argument in this Article’s Section IV below that city based business entity formation could be a highly successful means of designing heterogeneous codes to meet needs of heterogeneously developed crowdfunded firms. This also suggests that

---

10 Mollick, supra note 3, at 14.
11 Mollick, supra note 3.
12 Id. at 2.
13 Id. at 9.
regional based platforms operating at the state level explored in Section IV below hold promise of catering to the needs of local funders and firms.\(^\text{14}\)

Mollick notes that crowdfunded ventures “the money is raised up front, and, in the case of reward-based crowdfunding, without any clear legal obligation from the project initiator to deliver their promised rewards. For the dishonest, this creates an opportunity for fraud.”\(^\text{15}\) This article will consider the potential corporate governance innovations which may serve to reduce agency costs the flow from this problem. And yet he does not find a significant rate of fraud with respect to kickstarter projects.\(^\text{16}\) He does however find a significant delay rate, which could be merely a result of the unique risks and challenges of crowdfunded firms or which could result from opportunities for shirking created by the crowdfunding environment.

This suggests that a corporate governance modification or innovation which would be quite useful in this context would be a rule of review which focused on the initial intent of the entrepreneur as intended toward a legitimate business venture, albeit fraught with risk, as opposed to a purely fraudulent project. By contrast the focus of fiduciary duties in traditional corporate law is on the day to day business decisions of the executives. It also suggests a role for arbitrators in engaging in the fact-based inquiry of whether a project’s goals have indeed been

\(^{14}\) Not all funded projects bear a geographic component however, and in fact Agrawal et al find that, with respect to most crowdfunded music projects, crowdfunded firms actually challenge the prior conventional wisdom that venture capital financing required close proximity between investors and firms. See Ajay K. Agrawal, Christian Catalini & Avi Goldfarb, The Geography of Crowdfunding 3 (Nat’l Bureau Econ. Res., Working Paper No. 16820, 2011), http://www.nber.org/papers/w16820.pdf. Agrawal et al argue that “the crowdfunding platform eliminates most distance-related economic frictions normally associated with financing early stage projects, such as acquiring information (e.g., local reputation, stage presence), monitoring progress, and providing input. However, it does not eliminate frictions associated with the type of information about the entrepreneur that is more likely to be held by personally connected individuals (e.g., tendency to persevere, recover from setbacks, succeed in other endeavors).” Agrawal et al describe some fundamental economic attributes of Sellaband and Kickstarter, including that 1) funding is not constrained by geography for the average investor, as Sellaband’s average distance between investor and project is 3,000 miles, 2) successful funding is skewed to a very small percentage of proposals, as on Kickstarter 1% of projects account for 36% of funding and 10% of projects account for 63% of funding 3) funding is characterized by a significant momentum, as within a one week period entrepreneurs became twice as likely to meet their funding goal when they obtain 80% of the goal rather than at 20% of net funding, 4) friends and family play a role in accumulating an initial critical mass for most crowdfunded firms, 5) funding tends to flow to particular regions with specialization benefits or proximity to follow up funding 6) over half of projections of delivery date tend to be late, and 7) crowdfunding tends to substitute for alternative means of financing like home equity loans. See Agrawal, supra note 4. So the evidence suggests that crowdfunding will allow a component of distant, early state investing previously seen only for very large firms, but it also suggests that for some industries personal social networks and geographic specialization will continue to play a role.

\(^{15}\) Mollick, supra note 3, at 11.

\(^{16}\) Id.
met, and perhaps a default option then triggered to give the original funders an statutory referendum on whether to continue the firm’s existence or liquidate it.

Agrawal et al examine a precursor to Kickstarter based in Amsterdam called Sellaband, which funded new music bands. Sellaband operated free from US federal securities laws and was therefore been able to share profits with funders.\(^\text{17}\) The Sellaband platform took a role in the governance of funded projects, and after posting a profile of the band and demo, would collect $10 futures investments in the band.\(^\text{18}\) If the band failed to raise $50,000, funding was returned to investors. If it did, the money was used to fund production of an album recording, pursuant to a budget approved by the Sellaband platform. Kickstarter’s role in reviewing projects on its platform was more limited, public disclosure indicates its diligence is limited to rooting out fraud, not to meter investment quality.\(^\text{19}\) To the extent that crowdfunding platforms themselves could potentially invest in some of their projects it could serve to minimize agency costs along the Sellaband model, but they are prohibited from doing so by the JOBS Act statute. This will not however necessarily be true of state or interstate compact crowdfunding platforms explored in Part IV.

Agrawal et al describe how crowd-based diligence can also be effective, as a large community of users can pool resources, and often do on Kickstarter, in communication with each other to root out fraud.\(^\text{20}\) As crowdfunding platforms go online, crowdfunding investors or analysts could seek to build reputations as star pickers and thereby serve as repeat players, or informational intermediaries could evolve. Agrawal notes that another solution to reputational

---

\(^\text{17}\) Agrawal, supra note 13, at 7.
\(^\text{18}\) Id.
\(^\text{19}\) Id. at 25.
\(^\text{20}\) Id. at 28.
constraints and adverse selection problems on crowdfunding platforms is to break up the project financing in a series of milestones.\textsuperscript{21}

Information problems not resolved by intermediaries could be resolved by the signal of an initial anchor investor. For example seed funding from a VC could be a vitally important initial signal for crowdfunded entities. This way crowdfunders could free ride on the initial investment of diligence by the VC, but on the other hand the VC has a chance to observe what the firm does with the crowdfunded money to determine whether additional funding is worthwhile. They would also have a valuable signal in the publicly traded price of the crowdfunded firm they might use to gauge the value of their investment through a market process.

Focusing on Sellaband again for a moment, invoices were sent to Sellaband for payment of band expenses, and any profits were split equally between funders (who also get a free CD), artists and Sellaband. During the three-year period of the Agrawal study 34 albums obtained $50,000 in funding. Agrawal et al observe that crowdfunded investments under the Sellaband model are highly path dependent, and that as amount invested previously grows the propensity of investors to invest tends to accelerate quickly.\textsuperscript{22} This suggests crowdfunding platforms may find value in more variability in the disbursement and control rights of different groups of shareholders, and may value a structure that facilitates giving different stages of preference to multiple classes of shares to attract large blocks of shares initially. Delaware’s corporate law code is far too rigid to accommodate such a level of flexibility in shareholder control rights, and the residual obligation of contractual good faith and fair dealing in Delaware’s interpretation of its LLC code would similarly threaten full utilization of an entity form with necessarily fluid and

\textsuperscript{21} Agrawal 2, \textit{supra} note 4, at 25.
\textsuperscript{22} Agrawal, \textit{supra} note 13, at 16.
variable control rights. Agrawal also notes how an initial tranche of “friends and family”
investment tend to be local, and tends to signal to other more distant investors the entrepreneur’s
commitment to the project.23

If investments by large block investors can serve the same signaling function for
crowdfunded firms (as if, for example, a VC fund offers a small slice of funding to a startup, but
awaits further funding on a crowdfunded platform contingent on the firms ability to raise a block
of funding via the crowdfunding portal) then that same signaling effect could facilitate
crowdfunding. VC’s are typically thought of as pre-IPO funders, but small tranches of
crowdfunded capital could be contemplated betwixt rounds of funding from a VC firm. This
may call for variability in share class rights, and indeed for an element of contingency in share
class rights which could change upon subsequent rounds of funding. This suggests a need for
more variability than can initially be expected from the Delaware corporate code or is permitted
by the residual obligation of good faith and fair dealing in Delaware’s LLC code. And it may
demonstrate the folly of the NYSE’s prohibition on dual class share issues for post-IPO firms as
a rule which crowdfunded exchanges should certainly not emulate (though, since the exchange’s
limits on dual class shares was a result of pressure from the SEC, there is reason to suggest they
will similarly be pressured to do so).

This sort of variability could be evidenced by, for instance, a right to issue shares with
voting or outright control rights that trump the rights of existing shareholders, and to issue shares
that have dividend rights that trump the rights of existing shareholders, and that potentially water
down other rights of existing shareholders, upon a subsequent opportunity to obtain VC
financing, all of which would be prohibited by nearly all national exchanges, including the
Nasdaq’s new venture exchange.

23 Id. at 19-20.
Agrawal, Catalini and Goldfarb describe what has thus far been by far the greatest success story on Kickstarter, which was the development of the Pebble watch. An entrepreneur had secured $375,000 from an angel investor to produce a watch which could synch with blackberry and iPhone devices, but needed another $100,000 to finish production and was unable to obtain it. He turned to kickstarter, where he promised funders a watch in exchange for every $120 contributed. He raised $100,000 within 2 hours, and an additional $10 million within 37 days. He promised delivery by September of 2012, but production fell behind and he was unable to deliver until May 2013 (though he did eventually fill all orders). The competition of the Pebble watch eventually led Apple to respond by offering a smartwatch of its own. This example suggests the value of linking tranches of venture capital investments with crowdfunding tranches in an early stage startup.

Some of the benefits of crowdfunding to issuers include an ability to bundle funding in-kind benefits, including participation in the underlying project itself and recognition for funders, as well as obtaining information such as the strength of a consumer preference for future production by their participation in equity funding. Agrawal et al note, for example, how funders were highly involved in the initial design of the Pebble watch, and suggested numerous modifications that were subsequently included in the watch. This suggests that investors may need new means of communicating with entrepreneurs other than the classic modes of shareholder voting and shareholder proposals. It also suggests that potential for misapplication of controlling shareholder, equitable subordination, or veil piercing doctrine in this context to inhibit shareholder participation in idea development at crowdfunded firms.

---

24 Agrawal 2, supra note 4, at 3–4.
25 Id.
26 Agrawal posits that some firms may actually prefer non-equity based crowdfunding to equity crowdfunding, as it could limit the dilution of subsequent rounds of financing to venture capital firms, and they note that after Pebble’s successful crowdfunding venture it chose to obtain additional capital through a more traditional Reg A offering. Additional flexibility and heterogeneity in share class differentiation could help to bridge that gap. See Agrawal, supra note 13.
27 Agrawal, supra note 13, at 11.
Section B: The Economics of Crowdfunding Demonstrate that Crowdfunding Will Require A Level of Flexibility That Current Federal Preemption Would Not Facilitate

The last subsection made some initial suggestions about corporate governance innovation which would be useful at crowdfunded firms, but this subsection will explore the range of corporate governance flexibility which will likely be required by crowdfunded firms in more depth based on application of the NIE or firm theory economic literature. It will particularly explore innovation which would not be easily accommodated by the federal overlay present in the current corporate governance system. Some of these suggestions are speculative and may not ultimately prove in high demand for crowdfunded firms, other unexpected innovations may develop in a corporate governance system freed from the federal overlay. Nevertheless speculation about useful corporate governance innovations in this space may help to convince readers of the range of potential innovations that will be precluded in the crowdfunding space as a result of the federal overlay.

Subsection 1: Expected Demand for Arbitration

The fractionalization of ownership on crowdfunded platforms may be such that arbitration of claims may be a more useful means to determine the fact question of whether the crowdfunded entity operated within the boundaries of its stated objective. Fractionalized shares may be so small that shareholders in a class may be unable to monitor conflicts between attorneys and the represented class for example, and thus they may require means of adjudicating their rights which represent a low cost to firms. Thus traditional class actions may be expected to destroy the fledgling firm with long delays and expensive litigation, and thereby prevent accomplishment of some objective which the initial investors value highly. This may generate interest in an entity form that combines features of default corporations with features of LLCs,
and may be more usefully enforced through an arbitration method of business code enforcement.  

Schramm notes that particular emphasis on defining donor intent in the non-profit context can facilitate separate of ownership from control such that something resembling more of a classic firm becomes possible. Therefore in lieu of nebulous fiduciary duty type standards, non-profit crowdfunding firms may find it helpful to more clearly explicate the parameters of their mission, or the contours of a specific project or groups of projects, such that agency costs can be policed through arbitration fact-finding to determine whether the contractual specification has been met.

Alchian and Demsetz and Fama and Jensen探索角色的残余权益所有者在监视公司员工中的作用。在某种程度上，众筹项目上的创业活动，混合动机型企业，可能会被视为融合了残余所有权监视者的存在与部分非营利组织。如果公司初始目标可以完成以达到一个固定的目标但将时间表置于不确定的期限内，那么混合动机型众筹企业的所有者可以被认为是残余权益拥有者的附属权益。一旦公司的初始目标已经被实现，任何后续的利润都则受到公司章程中规定的合同义务约束。在那之前，公司的义务可以被认为是不受约束的。如果初始项目已经完成，并且在过程中清楚地知道一次性项目已经产生溢出价值，

28 Some may argue that a new quasi non-profit business organization form which limits the profit maximization objective may be applicable for firms in this space, such as the LC3 organization form developed in Oregon and Washington state. The LC3 business entity form will not likely fit this model well, as that code form takes an already nebulous concept like the duty of good faith, loyalty, and care, which is currently interpreted within a loose profit maximization norm, and makes it even more nebulous. Bainbridge describes how stakeholder based duties for corporate directors would only make accountability problems worse, as directors would be able to “play off one constituency against another...” Stephen M. Bainbridge, Director Primacy: The Means and Ends of Corporate Governance, 97 NW. U. L. REV. 547, 583 (2003). Thus a contractual based obligation drafted more specifically to the goal of the project is likely to prove far more useful in this context, particularly if it also utilizes an arbitration based framework for interpretation.

become an enduring firm, shareholders may find value in a code that has a default means for the shareholders to reassess whether they want to firms separate existence to continue.

For example, consider the investor in a biotech development for a drug to cure an ailment affecting a very small number of victims, one of whom happens to be a distant relation or contact (or Facebook “friend”) of the investor. This model is expected to grow upon the SEC’s approval of crowdfunding platforms.\(^{32}\) For an investor/donor at the margin the lack of potential profit may have otherwise limited their interest. Investors then may buy in who with a preference for some hope of profit, but which hope is seconded to a primary purpose of spending the maximum amount toward R&D required to cure the disease, even if it maxes out their investment.

A business entity charter for such an institution will likely not be well served by a broad, indeterminate fiduciary duty obligation of managers to owners with all its attendant doctrinal baggage. It may also be ill served by a pure fiduciary opt-out in an LLC form, as some intermediate third part review could reduce agency costs and thereby prove helpful to both managers and investors, particularly with respect to the question of when it is necessary to continue a project’s separate existence or require dissolution. And, in any event, this article in a later section will demonstrate that the dominant Delaware LLC entity form does not actually permit full fiduciary opt-outs for those firms that would seek a full opt-out.

These firms may be better served by a fact-based inquiry into whether the initial objective has been met should a shareholder challenge a firm seemingly dragging its heels to maintain discretion over the firm by delaying accomplishment of its objective. And it may be better served with a mode of arbitration that is not administered by judges, but instead is administered

---

by professionals in that particular business, such as for our example medical industry researchers.

Some have argued that the broad fiduciary duty obligations imposed by Delaware corporation law are gap fillers for contractual arrangements between shareholders and boards that cannot anticipate every contingency. Bainbridge describes the role of fiduciary duties as gap fillers for corporate contracts.\textsuperscript{33} This may be true, but Delaware’s fiduciary jurisprudence is not the only form of useful gap filler. The more specific goal based review explored in this article could prove a more effective alternative. There may also be some expected demand for conflicts policies for board members serving in multiple business endeavors or methods of defining whether a non-profit “objective” has been met both would appear useful in this context and await legal innovation and interpretation.

Note also this analysis does not suggest utilizing the Delaware corporate code or LLC code, or some variant, and merely arbitrating it with reference to Delaware precedent. Instead it suggests an entirely new form of code, with duties and obligations of corporate officers designed to be optimally determined via an arbitration model.

Williamson describes arbitration as a frequently superior means of enforcing contracts as, when it employs specialized arbitrators, can make use of superior information to slower and less efficient court based systems (particularly when a court will subsequently enforce the arbitrated award.)\textsuperscript{34} Williamson also notes that arbitrators have means of learning information during a controversy that are not as constricted as those in litigation.\textsuperscript{35} Crowdfunding may well prove Williams right, if the federal overlay in corporate governance can be rescinded to allow arbitration-based alternatives to blossom.

\textsuperscript{33} Bainbridge, supra note 28, at 586.
\textsuperscript{34} Oliver E. Williamson, The Economics of Governance, 95 AM. ECON. REV. 1, 14 (2005).
\textsuperscript{35} Oliver E. Williamson, Credible Commitments: Using Hostages to Support Exchange, 73 AM. ECON. R. 519, 527 (1983).
Subsection 2: Expected Demand for Non-Traditional Governance Structures

Another characteristic typical of projects operating on kickstarter is that a small number of entrepreneurs work for the organization, which would serve to minimize the incidence of internal rent seeking within organizations between division directors in a large public firm. So while crowdfunded firms will not obtain the same scale efficiencies as larger public firms, they will minimize some of the internal organizational monitoring costs typical of larger firms.

A case study of the largest profit-based crowdfunded project in the Pebble watch suggests that funders provided funding to the only verifiable aspect of the firm, meaning the biography of the inventor and the signal that he had been provided funding for his idea by a VC, but the production itself was almost exclusively outsourced.

If that dynamic holds true for crowdfunding as ownership in the new model, crowdfunded firms may stay especially tight and small, merely internalizing the discovery of an idea and an individual’s ability to utilize their networks in obtaining subsequent VC financing, and otherwise rely in large part on outsourced production. While this article explores below that non-profit crowdfunded firms are likely to demand significant participatory rights, in cases as these the identity of the entrepreneur may be a substantial portion of the value of the organization, and so the entity may require strict limitations on shareholder participation rights.

If that is true however, then contractual counterparties like suppliers may face significant hold up problems. Klein, Crawford and Alchian note that contractual counterparties in the development of firm-specific assets can have incentives to engage in opportunistic behavior once production has begun to appropriate quasi-rents.37

Klein and Leffler suggest that sunk investments like advertising to obtain brand name capital, combined with premium revenue streams, can serve as a signal that firms will not engage in such opportunistic behavior, but for a brand new startup like those anticipated on crowdfunding exchanges this may prove difficult. For those crowdfunded firms for which potential appropriable quasi rents are high, such as a new startup that has a totally new product which requires a unique production process and which outsources all of its production, Klein Leffler solutions will prove difficult for as long as the firm is unable to generate significant brand name capital.

Klein, Crawford and Alchian suggest that vertical integration is a solution to this problem. Thinking along a continuum of solutions it may be the case that partial integration, through partial sharing of control rights, could also serve to either minimize opportunistic behavior or, in the case of board seats, provide a low cost means of monitoring opportunistic behavior.

Williamson argues against the utility of suppliers placing monitors on corporate boards, in part because they can themselves use their positions to appropriate quasi-rents. Williamson describes providing seats on the Board of Directors as a cumbersome instrument to provide contractual enforcement to stakeholders, in that it “such protective powers as it possesses are compromised by inviting broad participation on the board.”

While this may be true in the standard case, crowdfunded firms with a small number of large firm specific production contracts may find board placement of large suppliers a valuable tool of contractual bonding. Williamson warns that once a partisan constituent of the firm has obtained a board seat, they can use that position act opportunistically or log roll their votes with

---

other members of the board.\textsuperscript{39} If two firms have members on each others boards, however, it could serve a hostage taking function that could facilitate contractual enforcement for each side.

In the general case if a single long-term supplier is the only constituent serving on the board the log rolling problem is limited, and in any event Williamson’s critical analysis of constituent board members responds to a suggestion that constituent board membership should be mandated to serve some social democracy objective, not to board memberships contracted for by counterparties of startups. A member joining a board to serve a monitoring role would notably have an interest in significantly limiting their exposure to liability for disruptive action under whatever corporate governance duties they owe to the firm and its shareholders (which is as yet up for debate). Also note that Williamson assumes the standard board of directors, not one in which innovative changes in board structure and powers have been implemented.

This may provide some value to provision of board seats that have some permanency, as joint monitoring mechanisms to limit hold up on firm specific contracts. If a contractual counterparty has a seat on the board, the firm’s ability to engage in opportunistic behavior would be quite limited. For that to work, however, the ability of owners to select board members would need to be significantly limited. It also suggests that director independence requirements mandated by federal law would be counterproductive for these firms.

Even if it isn’t a question of board seats, but some other contractual control right, perhaps one that only kicks in upon a firm’s inability to make good on a contractual commitment to a significant supplier, it nevertheless another reason for potential demand for governance flexibility.

Subsection 3: Expected Demand for Novel Shareholder Participation for Some Crowdfunded Firms, Particularly Public Hybrid Firms with Constraints (Enduring or Limited) on The Profit Maximization Objective

Spulber notes that non-profit firms are defined as firms in which objectives cannot be separated from those of owners, and thus free transferability of ownership is not a function of non-profit structure. Crowdfunded firms are likely to challenge this conventional wisdom, as the information efficiencies created by crowdfunding platforms economize on the costs of search and can better match funders with similar objectives. Thus part of what makes crowdfunding unique is that reductions in the cost of search can actually make publicly traded non-profit firms a possibility.

A unique feature of crowdfunded firms, that otherwise share some characteristics of non-profit firm objectives, is that the group of owners may be so large (and search costs of owners finding each other who share the same objective are reduced by the crowdfunding platform innovation) that transferability of interests among that group may be possible. This could allow for both market-based valuation of the firm and provide liquidity benefits to the individual funders. In order to enforce objectives, those firms may be designed to provide unique control rights to those owners.

For example, with respect to the Kickstarter financed fan film the “Veronica Mars Film Project” explored above, the entrepreneur financing the project was the director of the original TV series. If, after crowdfunding goes online, such a project were organized as a for profit firm operating over a crowdfunding platform, it is unlikely that shareholder participation in governance would fit. The relationships and creative capital are all unique to the project’s originator.

40 Spulber, supra note 36.
For other publicly traded non-profit projects operating on crowdfunding platforms, the identity of the initial entrepreneur may not be as firm specific, and funders may highly value the ability to participate in the selection of managers or board members to maintain the character of the firm. Kuaan models non-profit firms as an example of consumers integrating into the production process of the firm. This appears to characterize many projects funded on kickstarter. Thus a part of what is being traded is the right to proportionate shareholder control of the non-profit firm (and also, for some firms, the right to profits for value created by the non-profit if it subsequently “converts” to a for profit firm.)

This suggests a departure from the board-centric model of Bainbridge, which would otherwise typically be associated with the contractarian analysis utilized in this article. The Bainbridge model is one centered in the neoclassical firm with a wealth maximization objective. This as we’ve seen is likely to be modified should the type of projects seen on kickstarter also transition over to crowdfunded platforms.

Bainbridge’s director primacy model provides tremendous descriptive power for large publicly traded firms. He notes that one of the primary reasons why his board centric model describes many public firms is that it “provides a hierarchical decision-making structure well suited to the problem of operating a large business enterprise.” This function of the director primacy model may have limited application to crowdfunded firms as they may simply be too small and operate by horizontal consensus. Then again, some firms seeking to grow and move to large securities exchanges may adopt governance models based on the Bainbridge director primacy model out of recognition that path dependencies could develop that make transition to another governance structure costly down the line.

---

41 Id. at 50.
42 Bainbridge, supra note 28, at 558.
43 Id.
44 Id. at 572.
Bainbridge also focuses on conflicts of interest among groups of shareholders like Union pension funds, which may justify limits on shareholder control rights for some firms. While some of the shareholders he observes in the large public company context may be restricted from investing in crowdfunding ventures, there are still other conflicts we might expect that would cause the same problem. For example, if there is asymmetry of information between shareholders and competitors about the value of a new innovation, then competing firms may obtain control of crowdfunded startups in order to vote to replace the managing entrepreneur and stifle the competitive innovation that might threaten their competitive advantage in the market.

Bainbridge’s argument is at heart a contractarian one, and as such the general arguments in favor of director primacy for large public companies does not preclude the utility of alternative arrangements for firms with different unique needs who contract for alternative arrangements. In particular, those smaller and early stage firms likely to trade on crowdfunded exchanges may have unique requirements such that shareholders and boards will demand more shareholder empowering methodologies.

Fama describes reasons why security holders may want to abdicate their control rights to managers, including their ability to diversify risk, and that manager’s opportunity wages may depend on the success of the firm, suggesting there may be many situations in which managerial control and the separation of shareholder ownership from control could be optimal.45 Some crowdfunded firms may reflect this description, others in which shareholder interests are firm specific and less diversifiable like fan-financed entertainment projects may be better paired with voting control depending on whether there was substantial firm specific quality to the entrepreneur.

---

45 Putterman, supra note 37, at 305.
In sum, we can expect some instances in which the Bainbridge director primacy model will continue to have force in the crowdfunding context. But even in those instances, the types of shareholder conflicts necessitating limits on shareholder control rights is likely to be unique, and innovation inhibited by the federal overlay will prove a challenge. For other firms more shareholder participation will likely be demanded, but rigid shareholder participation approaches favored by the federal overlay like voting for directors and voting for shareholder proposals may also prove to be a poor fit.

**Subsection 4: Expected Demand to Facilitate Adaptive Funding Methods**

Delaware corporate law and Delaware alternative entity law both stand for the proposition that, even though a board or manager may be permitted to take an action by the state’s code, they may be found to have violated either their fiduciary duties (or in the case of an LLC that has opted out of fiduciary duties, their still enduring “duty of good faith and fair dealing”) in so doing. Further, the SEC has pressured the large national exchanges to limit the ability of listed firms to issue dual class shares with unique control rights once a firm has gone public. This subsection will show how those constraints contained in the federal overlay, and within the Delaware dominant business entity model, will ill serve crowdfunding firms.

Prior literature on the economics of entrepreneurship considers the agency costs that arise when performance is unobservable.46 Some have observed that venture capital firms have developed mechanisms to address these costs, as in the allocation of control rights or in the form of unique combinations of convertible securities.47 In additional to specialized monitoring,

---

46 Spulber, supra note 36, at 172.
47 Id. at 173.
venture capital firms can also provide human capital to new entrepreneurs in the form of unconflicted consulting advice. 48

Fama and Jensen in “Separation of Ownership from Control” argue that one mitigating factor in larger organizations, in which decision management and decision control are disaggregated, is that agency costs are lower because of monitoring among and between employees, creating internal systems of checks and balances. 49 For a crowdfunded entity mirrored on the Pebble model, that would not be the case, suggesting another reason why the joint VC funding and crowdfunding model is likely to be replicated on many crowdfunded firms, particularly those like Pebble which rely on a small number of employees for large scale and outsourced production.

Utilizing a firm structure for venture capital investments in projects allows use of the signal provided by a venture capital investment to provide information to much smaller investors who can minimize their risk through diversification, but also are as a result of their greater diversification not interested in expending much monitoring costs. Crowdfunding investors also minimize their risk through fractionalized investments. The crowdfunding participants may have different risk preferences and/or different budget constraints from the VC firms, but the signal of an initial VC investment provides value to them, and the VC can minimize its up front investment to a little less than the amount required by the firm.

One of the benefits of publicly traded securities identified by Fama as a means to minimizing agency costs is the signal that publicly traded equity serves in evaluation of managerial performance. 50 For a venture funded enterprise, adding a layer of crowdfunded equity provides venture capital firms with such a signal to evaluate their investment, determine

48 Id.
49 Fama & Jensen, supra note 30, at 11.
whether to exercise any contractual control rights they possess or exercise conversion rights in their securities, and allows them to assess the viability of future investments.

This dynamic was exactly how the most successful venture on kickstarter operated. This suggests that corporate governance needs unique options for crowdfunding firms that make use of this dynamic may include dealing with transition problems as firms obtain small initial investments from VC firms with high specialized monitoring, then obtain rounds of capital from crowdfunded finance, then perhaps obtain additional rounds of funding from a VC. Negotiations expected to take place with VC firms during these transitions should be expected to include changes in control rights that may be restricted by Delaware’s residual obligation of good faith and fair dealing and by the federal overlay.

As one example, the ability to issue multi-class shares, after initial shareholders are issued with specified rights, without fear of fiduciary duty litigation or “duty of good faith and fair dealing” litigation, which are risks inherent in Delaware corps and LLCs, could present a problem. And the listing requirements of exchanges that limit your ability to do so should not be replicated as a SEC mandated element of crowdfunding platforms, though it is as yet unclear whether that will be the case.

Preferred stock has been one way to traditionally limit conflicts between different classes of investors.\(^5\) But in this instance multiple rounds of financing that move between VC block investor, and public funding, and back and forth may require highly contingent residual control rights for crowd investors which is not favored by the equitable principles in the Delaware code.

Fama and Jensen describe capital markets financing in publicly traded companies as uniquely designed for “activities optimally carried out with large quantities of long-term assets that are difficult to value and that are more efficiently purchased by residual claimants rather

---

\(^5\) Spulber, supra note 36, at 173.
than rented” and as projects financed through proprietorships or partnerships with restrictions on withdrawal rights for residual claimants as “when the important asset in an activity is the human capital of existing decision agents.”52 They also note “at various stages in the life of a venture it may be best carried out under different organizational forms. For example, it may be first organized as a proprietorship and then, with increasing demands for financing risk investments, converted to a partnership or a closed corporation, and then to an open corporation.”53

The transition they describe is not costless however, and there may be path dependencies that limit the freedom to convert costlessly. Members of the partnership, having what Fama and Jensen describe as potentially widely different consumption preferences, may not be predisposed to support the conversion, and so perhaps what crowdfunding will do is create a transition space for firms that may be otherwise constituted as partnerships but which are facing increasingly intense capital financing needs. This may also characterize some of the smaller firms trading on the pink sheets.

This further suggests a need for contractual flexibility in crowdfunded firm governance, as there may be a wide heterogeneity in the relative mix of capital intensive vs. human capital elements of the firm’s investments, and therefore a wide range of optimal levels of restrictions on the rights of residual owners.

Some theorize that firms can create managerial tournaments to incentive managers within firms.54 Fama describes this function as a means of limiting agency costs that flow from the separation of ownership and control.55 To the extent that crowd funded enterprises will be relatively small startups with a relatively flat management structure, this is not likely as much significance as it does for large publicly traded firms.

52 Putterman, supra note 37, at 342.
53 Putterman, supra note 37, at 344.
54 Spulber, supra note 36, at 273.
55 Fama, supra note 50, at 295.
However, if the crowdfunded startup’s best alternative is instead a proprietary owner fully funded with debt, the possibility of obtaining future equity interest in the firm may serve to provide a cost effective means of financing despite the presence of residual agency losses. Jensen and Meckling note the constraints that a market for managerial talent, and a market in the company’s stock, both serve as constraints on agency costs.\textsuperscript{56} Crowdfunding for smaller startups will, many of them, be characterized by a relatively higher level of firm specific executive talent and by a relatively illiquid secondary market for the firm’s securities relative to larger firms on public markets. This suggests that the traditional importance that Delaware law and the federal overlay place on shareholder voting rights as agency cost monitoring mechanisms is misplaced for many firms in the crowdfunding context.

\textit{Subsection 5: Expected Demand To Facilitate Their Organic Growth}

Agrawal describes the shift from non-equity crowdfunding to equity crowdfunding as associated with the question of whether investors want to merely pre-order a single, specific product, or instead want to invest in future projects due to “the creator’s ability to generate equity value by building a company rather than just delivering a product.”\textsuperscript{57}

For some entrepreneurial projects, crowdfunding could be thought of as a form of purely pre-order contract through which a group of entrepreneurial consumers could seek financing for production of an item they wish to see invented and which they hope to purchase in the future. That partial bundle could grow on a crowdfund platform into the sort of bundle of contracts that characterize a firm. In this instance as well the firm may need to substantially limit the control rights of residual claimants, otherwise the pre-order customers could strategically vote to vitiate


\textsuperscript{57} Agrawal, \textit{supra} note 13, at 8.
their contracts through voting to dissolve the firm once production had begun and then later renegotiate the price once the product specific investments had been made.

In order to limit that sort of strategic behavior, the control rights of owners would need to be limited by the firm’s organizational structure. And yet, at the same time if production is never achieved, such a firm may require some means of dissolution, which may then require arbitration of whether dissolution is appropriate. Or it may involve set time limits on the life of the firm, subject to production quotas. We should expect corporate governance innovations demanded for this subset of crowdfunded firms to reflect the fact that what is being traded initially on crowd platforms is not ownership in a firm, but ownership in a set of multilateral contracts, which could eventually become a firm.

The nexus of contracts that firms represent have historically been a bundle of contracts that have as a first mover an entrepreneur as its center establishing relationships with employees, suppliers, customers, and capital. But crowdfunded projects can begin as a collection of promises by consumers to pay for a particular good and agglomerate, such that they can catch the attention of entrepreneurs and providers of additional capital, and then grow from a bundle of customer pre-orders to an entrepreneurial project to a full fledged firm.

As Coase talks about the boundaries of the firm being grounded in the utility of the price system, we can thing of some crowdfunding entities and projects as a more organic method of growth around the boundaries of the effectiveness of the price system. It can be viewed as a means of delineating firm boundaries more efficiently than large initial investments to entrepreneurs who are making educated guesses about whether the scope of their production represents the efficient frontier of their firm or not based on their educated guesses about the operation of the price system. As just one example, a crowdfunding project could also be
structured as a form of research tournament, with control of the firm acceding to whomever fulfills the contractual requirements as defined in the contract and interpreted by a designated arbitrator.

The Penrose effect explains that managers learn through the strategic deployment of resources, and can redeploy their attention as they master the strategic needs of existing projects, but the boundaries of multi-project firms are seen through the Penrose effect as a function of the diminishing returns to the rate of re-deployment of additional managers. Crowdfunding might be viewed as a more organic means of growth for Penrose effect problems in early stage firms whose only alternative means of financing is solely VC investment.

Consider a fan based start trek film being developed on Kickstarter. The development of that project may create a firm that is good at doing those types of projects, and the initial funders of the project may want to capture some of the subsequent agglomeration benefits of the project as a full fledged, multi-project firm develops out of the project.

As the crowdfunding industry integrates a for-profit character to some projects on the crowdfunding platforms, it may be that the collective inputs of the firm, and the governance of the individual project, develops spillover value that crowdfunding entities want to capture. Blair noted that a distinct attribute of firms facilitated by corporate organizational law is a firm’s ability to facilitate firm-specific investments of capital by firm contractual counterparties. The independent life of the firm allows free entry and exit of investors and managers without threatening the independent existence of the firm and thereby facilitates longer-term contracts between the firm and contractual counterparties. As a current project-based model of funding

\[58 \text{ Spulber, supra note 36, at 184.}
\]
\[59 \text{ Puttermann, supra note 37, at 180.}
\]
\[60 \text{ Spulber, supra note 36, at 69.}
\]
projects on kickstarter morphs into ownership, unique corporate governance innovations geared
toward crowd-funded firms will likely take this into account.

Demsetz saw economization of specialized information in the production of goods as
defining the contours of firms, and described how “continuing association of the same persons
makes it easier for firm-specific and person-specific information to be
accumulated….Knowledge about the objectives and organization of the firm is learned ‘cheaply’
through continuing association, and so is knowledge about the capabilities and limitations of the
persons involved in this association.”\(^\text{61}\)

But for small novel projects at the earliest stage, it may be unclear whether this is the
case, and whether therefore a firm will arise from the specialized knowledge acquired via the
initial project. Crowdfunding ownership for such projects can help a crowdfunded projected
obtain a premium for the possibility that this will be the case by proving funders of the project an
equity claim on a potential future firm. Thus crowdfunding has the potential to allow large scale,
diversified equity funding of innovation at a stage so early that it isn’t yet clear whether a fully
fledged firm will develop from a single team project.

There may be an in between where equity crowdfunding projects could include purchase
of rights to a succession of projects, with some mechanism for return of the investment in the
event of failure and/or a contingent claim on the firm that results from the individual project. In
the spectrum between the crowdfunded project as merely a form of “pre-order” and a fully
functioning crowdfunded firm as a “nexus of contracts”\(^\text{62}\) in the traditional sense, some
crowdfunded equity could be thought of as a “bundle of projects” in succession. The rights of

---
\(^\text{62}\) Fama, *supra* note 50, at 290.
shareholders could be variable based on how the succession of projects proceeds, and could be highly contingent based on subsequent rounds of equity financing.

Equity claims could be contingent and become debt upon failure to meet a delivery date, for example. If funding is that tightly tied to rounds of projects, then shareholder duty litigation in state and federal court could risk destroying the ability of the firm to finish the bundle of projects. This suggests a heightened need for limited and predictable arbitration based remedies.

Williamson elaborates on the boundaries of firms as alternatives to private exchange and to account for evolving bilateral exchange conditions as “the degree to which the transaction in question is supported by durable investments transaction specific assets—by which I mean assets that can only be redeployed to alternative uses and users only at a loss of productive value.”

63

The initial investors in projects funded on kickstarter or on new crowdfunding exchanges may eventually evolve into firms with these transaction specific assets, or not, at the initial startup stage for a small firm with a speculative plan for growth it may be unclear, and investors may simply want an ownership structure that allows them to capitalize on value in the eventuality that the one-time project evolves into a firm with indefinite life. But cookie cutter application of governance structures applied to larger, established firms, or mandated by the federal overlay, could risk destroying these projects through bureaucratic management or abusive litigation. In essence, the transition from individual projects funded on kickstarter as a form of consumption expenditure to crowdfunded projects can allowing packaging of consumption of an individual project with speculative investment in the potential that a firm will arise out of the project.

Thus we see that the organic growth character to crowdfunded firms ties into all of the particular needs recognized for crowdfunded entities explored in this section.

63 Williamson, supra note 34, at 8.
Subsection 6: Expected Demand for Unique Dissolution Procedures

Coase describes the organization of activities within firms as a function of the cost of using the pricing mechanism to allocate goods and services in production. The managers of individual projects on a crowdfunded platform will be uniquely situated to determine the value of whether project specific contracts and assets can be utilized repeatedly in additional projects.

As crowdfunded firms are able to provide ownership interest to dispersed owners, they will be better able to agglomerate projects that share a similar objective into the same firm and economize on the costs of production through centralized management of activities for which managerial coordination is more efficient than market allocation. If the evolution of the Kickstarter platform is any guide, the boundaries of these firms will likely develop through a fairly fluid and evolutionary process that managers may be tempted to abuse. As such, particularized innovations in methods for dissolution of projects that have lost their ongoing value are likely to be needed in the crowdfunding context. This unique means of dissolution may also require an off-the-rack option for third party appraisal of the value of the firm or project. In a later Part this article explores how the mandatory appraisal process utilized in Delaware is flawed, and thus some means of challenging network effects unique to Delaware, and made worse by the federal overlay, will be required in order to meet this need.

The goal of this subsection was not to accurately predict all of the unique corporate governance attributes that investors and entrepreneurs will require in the crowdfunding space. It has merely been to demonstrate that a simple economic analysis of crowdfunding suggests it will require a highly heterogeneous set of options, some of which will need to be newly designed. When combined with the next major section of this paper, analyzing the current state of competitive corporate federalism, the analysis will demonstrate that without significant

64 Spulber, supra note 36, at 92.
limitation on the federal overlay in corporate governance, it is unlikely the corporate governance will evolve and innovate sufficiently to make the most of crowdfunding’s potential.

Section C: One Perspective On Uberization: An Interest Group Story Suggesting Crowdfunding Can Make Corporate Federalism Stick

There is reason to believe that, should competitive, state based incorporation receive a new jolt of energy from the reforms suggested in this article, they may just have staying power to survive any future attempts toward federalization. Rauch and Schleicher describe how a key determinant of “sharing economy” firms is that they have been able to rally local citizens to their support because of highly popular services.65 The characteristics of crowdfunding seem to share some of these attributes that have helped Uber and AirBandB become successful despite the presence of powerful interest groups interested in maintaining the current system. The fact that there is a federalism aspect to the reforms offered here to preserve the benefits of crowdfunding innovations also offers hope, Greve argues that the American citizenry is uniquely comfortable with the key attributes of federalism, particularly as compared to Europe, and so he expresses hope for the future of competitive federalism in the US.66

Weingast notes that in order for a federalist system to survive it must be self-enforcing, meaning that the architecture of the underlying interest group coalitions most ultimately supporter maintaining a federalist structure.67 In light of the Weingast thesis, there is reason to doubt that Delaware, the dominant domicile of incorporation for half of all public firms, alone will sufficiently discourage an inefficient Federal overlay.

It is instead more likely that a balance incorporating challengers to Delaware will more effectively preserve a federal system. If a federal overlay serves to inhibit other states from challenging Delaware's dominance, Delaware would not have an incentive to reduce federal preemption but would instead appreciate how Federal preemption preserves its dominant position in the market. But if instead federalism reforms actually make the system more competitive, then it may be more likely to stick. Parts II and III of this article make precisely that argument.

One mechanism Weingast describes to preserve Federalism is citizen consensus; he presents a historical anecdote in the use of Citizen consensus to maintain local power during England's Glorious Revolution.\(^68\) If crowdfunding manages to obtain a critical mass of retail popularity then Federalist structures that support organizational innovation for crowdfunded firms, then that retail popularity might be expected to serve the market preserving mechanism that Weingast describes its context (as retail popularity has helped Uber at all levels of govt.).

Weingast also suggests a balance between coalitions can serve as a mechanism of market-preserving federalism as well.\(^69\) He notes that during conflicts between the North and South during an era of Jacksonian democracy, the conflict resulted in a balanced respect for federalism, as “each worried that the other might come to dominate the national government, allowing it to use national power for its own regional purposes. Because the problem was symmetric, both sides agreed to limits on national authority as a means of limiting the ability of other to dominate.”\(^70\)

In this context, if the interest groups interested in the federal overlay, both supporters and critics, replicate a balanced conflict in new organizational forms at the state level (as for example

---
\(^68\) Id. at 18.
\(^69\) Id. at 21.
\(^70\) Id.
one successful, shareholder rights focused state competed with a high-entrenchment state) the interest group balance mechanism could be replicated as a market preserving institution of federalism. Thus far this article has explored how many crowdfunded firms are expected to have some non-profit character to them. Thus the traditional interest groups supporting corporate federalism, like the managers of large companies, may be augmented by an unlikely coalition of non-profit groups and thereby help to achieve a Weingast market-preserving federalism.

Weingast credits federalism and decentralized government authority in China as a key institutional condition for its unprecedented growth in recent times. Weingast notes, consistent with Macey’s public choice analysis of federalism, that as China’s regional government’s became increasingly successful, and as the rents provided to federal officials were maximized by merely restraining their urge to federalize, the regional governments were increasingly able to maintain their autonomy. Weingast notes that major economic upheaval can upend the institutional dynamics that support federalism.

One example of such a broad delegation of power to the states, which endured for a long time and has only come under fire relatively recently, was the McCarran-Ferguson Act delegating the regulation of insurance companies to the states. As evidence that codification protecting state corporation law is possible at the federal level, consider the Securities Litigation Uniform Standards Act, which preempted state litigation of shareholders claims under the 34 Act. It explicitly carved-out state litigation of shareholder claims under state corporate law from its preemptive action in what Ribstein describes as “to preserve the expertise and efficiency of

71 Id. at 22.
72 Id. at 23.
73 Weingast, supra note 67, at 27.
Delaware courts and case law.”75 This suggests that federal laws preserving aspects of state business entity law can at times endure if the interest group calculus is just right.

Macey’s theory of why federalism can endure is that the federal government can obtain rents solely by virtue of “permitting independent or concomitant state regulation at little or no political cost to itself” And he predicts that “Congress will delegate to local regulators only when the political support it obtains from deferring to the states is greater than the political support it obtains from regulating itself.”76 According to Macey’s theory, any federalism legislation will endure only so long as it is able to created sufficiently interest groups quickly enough before the next major impetus at federal regulation, such as a future financial crisis or scandal, such that interest group pressure from the delegated state and local formation entities can limit the impetus to develop a federal response.

In that way, this inquiry is analogous to Uber’s challenge to the established rent seeking networks created and support by Uber’s competitors. Uber is essentially a self-regulator of the relationship between drivers and riders, and in most jurisdictions it has been able to endure only because of the out spring of support from dedicated users being more significant than the rents obtained by taxi regulators.

Macey describes this support as either coming from regulated entities directly, or as through a conduit.77 That may mean newly competing states will challenge, it may mean that cities, or incorporation businesses, or even crowdfunded company exchanges and the crowdfunded firms that trade on them (if crowdfunding is designed in such a way as to facilitate enhanced chartering competition as explored in this article.)

76 Macey, supra note 74, at 267.
77 Macey, supra note 74 at 268. Macey’s explanation may demonstrate the differences between the initial “Schumer bill of rights” introduced prior to Dodd-Frank and the subsequent legislation that was adopted, in which some provisions were shifted from mandatory to permissive opt-in approaches (such as independent chairman for public company boards.) The changes explored in this article may enhance these existing interest group pressures, and add new interest groups, such that the reforms may stick.
One can imagine if banks, entertainers, non-profit charities, all who have right to residual interests in their future revenue traded as part of crowdfunded firms organizing a “save crowdfunding” campaign similar to the Uber campaigns organized at the grass roots level is more likely than a “save Delaware corporate law” campaign targeted to all shareholders of Delaware companies. So perhaps the Olsonian interest group dynamics of crowdfunding will allow for a more cogent defense against future federal overreach. One way to consider how this would work is the repeal of an explicit federal law protecting the internal affairs doctrine advocated by this article, in an all or nothing way, may be more difficult to get past interest groups than piecemeal, creeping, or implicit preemption of individual slices of the doctrine and the state corporate codes by indirect agency action.

Macey notes that the fact that the federal government has not already created a federal corporation law, and fully preempted the states, is evidence that to some extent there are already interest group pressures that insulate state corporate law from complete federal preemption. And yet, the analysis in the next Part of this article demonstrates that those interest group pressures are not always successful, and have allowed federal law to inhibit some of the available field of innovation, and future partial preemption presents a risk that the returns to any new innovation may see subsequently dissipated by federal intervention.

Section D: A Second Perspective On Uberization: App-Based Interaction Changes the Information Cost Conventional Wisdom of the Collective Action Story of Corporate Law

Rauch and Schleicher attribute to “sharing economy” firms the general attribute of “a stark reduction in transaction costs that allows for radically disaggregated consumption” with

78 Id. at 279.
that reduction in costs often resulting from a combination of new digital means of information transmission and app-based interaction.\textsuperscript{79}

Bainbridge notes that one of the principal attributes of the corporation is a collective action problem, citing Arrow, and shareholders are rationally apathetic.\textsuperscript{80} Indeed, much of corporate law scholarship in some way references the Berle-Means vision of corporations as characterized by overwhelming collective action problems that many corporate commenters either urge requires a strong federal hand in governance, requires deference to manager-centric governance models like the Bainbridge director primacy model, requires shareholder empowering regimes, or argue requires particular mandatory provisions in state corporate laws. Scholars on different sides of these debates all tend to reference in some way the Berle Means hypothesis as a starting point. And yet the Berle Means collective action problem hypothesis is likely to part of its explanatory power in the crowdfunding world.

\begin{quotation}
Note that though this paper observes that crowdfunding will decrease the costs of shareholder participation, it is nevertheless neutral on the question of shareholder primacy vs. board primacy. If Bainbridge’s observation about boards as necessary intermediaries between shareholder participation and executive action endures in this technology, then we’d expect those firms in which shareholders have chosen defaults to delegate authority more highly to be more successful, and crowdfund portals to strongly recommend board-centric defaults via their app.

Agrawal et al point to three elements of internet based interaction that explain the rise in crowdfunding, as search costs for projects decrease and communications costs decrease, which
\end{quotation}

\textsuperscript{79} Rauch & Schleicher, \textit{supra} note 65, at 11.
has a follow on effect of allowing for greater funding in much smaller increments.\textsuperscript{81} That has a further follow on effect, which reduces risk exposure through diversification.

We might expect that crowdfunding could link well with app-based user experiences. Indeed, the crowdfunding pre-cursor Kickstarter utilizes app-based interaction that is popular among its users. Konsynski and Bush explore the platform-based development model that has evolved in software development in the last decade for new web browsers and IPhone applications (apps).\textsuperscript{82}

Mollick notes that

“The innovative ability of online communities has been of increasing interest to scholars (Baldwin et al., 2006; David and Shapiro, 2008; Von Hippel, 2005), and crowdfunding represents a concrete way in which online communities can influence the creation of new ventures. Crowdfunding also suggests a path by which user innovators, who are often the sources of radical innovations, might transition to entrepreneurship (Franke and Shah, 2003; Shah and Tripsas, 2007).”

This suggests that for a subset of firms in which donors tend to get highly involved in projects via some crowdsourced method, as was the case with development of the Pebble watch on Kickstarter, investors will want a high level of interaction with entrepreneurs. This may be best achieved through traditional corporate governance like shareholder voting or shareholder referendums, but likely for many firms those traditional methods may be outdated for this purpose, which suggests again that the more flexible and adaptive means of corporate

\textsuperscript{81} Agrawal 2, supra note 4, at 7.
\textsuperscript{82} See Amrit Tiwani, Benn Konsynski & Ashley A. Bush, Platform Evolution: Coevolution of Platform Architecture, Governance, and Environmental Dynamics, 21 INFO. SYS. RES. 675 (2010).
governance innovation will be required than the federal overlay in corporate governance presently permit.

Kobayashi and Ribstein note how limits on intellectual property protection for corporate governance innovations can inhibit private production of law. Open source production can serve as a solution to the problem of insufficient intellectual property protection, explored under certain conditions. In this instance we might expect, for example, corporate attorneys to participate in the creation of new governance arrangements via an open source platform in order to establish or maintain their reputation with potential advisory clients. Or crowdfunding exchanges and their participants may collaborate to solve problems in crowd fund governance. Rauch and Schleicher note the benefits of digital ratings systems as a substitute for reputation, and we should also expect that technology will have important implications for minimizing agency costs in the crowdfunding environment, including by facilitating the development of informational intermediaries.

Section E: Analogue to Crowdfunding?: the US Over the Counter Pink Sheets Market

An examination of the American Over the Counter (“OTC”) Market shows that, for the most part, the persistence of various elements of the federal overlay ultimately makes study of this market of limited value for understanding crowdfunding. One exception is that, in the absence of some of the federal overlay in this space, exchanges are observed to take an interest in limiting agency costs for investors on their exchange consistent with Mahoney’s argument in “Exchange as Regulator.” Otherwise there appears at present, in the absence of additional

---

85 Rauch & Schleicher, supra note 65, at 9.
empirical work, little to suggest that corporate governance attributes present on OTC exchanges can inform expectations for crowdfunding.

Mahoney argues that private exchanges can have incentives to develop governance arrangements suitable for the firms that trade over its platform, and thereby internalize the benefits of increased comparability between products by shareholders. This stands in contrast to the Easterbrook/Fischel argument that national securities regulation is required to facilitate optimal disclosure rules because of comparability externalities. In the same way, we could expect exchanges to also share an incentive to develop corporate governance rules for firms listed on the exchange, and indeed exchanges have a history of doing so. Thus under the right circumstances crowdfunding exchanges may end up playing a role in the creation of corporate governance arrangements.

Mahoney notes that exchanges face a challenge in capturing the return to their innovations in so far as information like public price discovery over the exchange is non-excludable, but he argues that exchanges have restrictive rules that substitute for intellectual property rights to accommodate that challenge.

However since the dual class share litigation and since Sarbanes Oxley, it has become clear that at least with respect to large national exchanges regulated by the SEC, it may be the

---

87 Id. at 1461-62.
88 A majority of OTC firms are incorporated in Delaware and Nevada. Bruggemann, supra note 89, at 9. To date there has been no comprehensive study in the literature examining corporate governance attributes among pink sheet firms, suggesting an important avenue for further empirical study. If pink sheet and grey market firms make use of heterogeneity, how do they do it? If not, why? Could it be because of path dependencies for those firms that were previously listed on NYSE or NASDAQ and were delisted, that have trouble subsequently reorganizing their firms into an LLC structure with more freedom? Could it be because you hope to get back onto NYSE of NASDAQ, and you expect that changing your corporate governance choices to non-compliant would be a bad signal to investors or to those exchanges? Bruggemann’s Table 2, Panel D suggests an avenue for possible future empirical work, as it suggests Nevada might be challenging Delaware as a domicile for some publicly traded OTC firms. Notably Bruggemann et al find that a majority of new firms operating on OTC exchanges, who remain on the exchange over the sample period, are formed in Nevada. Bruggemann, supra note 89, at 23. Future data collection should further break down their chart into out of state vs. in state, corporate vs. LLC, and further breakdown into choices for LLC charter, presence of a control shareholder, industry, size, etc. Those breakdowns should occur by exchange. You have one exchange with no exchange listing requirements, another with no exchange listing requirements but with SEC registration, and a third with both corporate governance listing requirements and SEC regulation. If there are differences in out of state formation or entity choice that are solely attributable to which platform you use, then you may have 1) evidence of federal overlay inhibiting entity formation competition or 2) a torney or underwriter bias, if they markedly differ for platforms, or you may have evidence of situations in which Delaware’s network effects are not insurmountable for smaller publicly traded firms.
89 Id. at 1456.
case that the SEC’s views the exchanges as a tool through which to expand the reach of its regulatory authority into state corporate law. Trading regulations like the “trade through” rule adopted by the SEC further limit the incentives of national exchanges to compete on quality of productions of services like listing standards; thus, for large national exchanges like the NYSE, listing standards are developed by regulatory fiat from the SEC and the Congress rather than as a quality signaling mechanism for exchange customers.

The OTC facilitates quotes for shares on a “Bulletin Board” that are registered and regularly file with the SEC, and though the OTC doesn’t have its own corporate governance requirements90 Bulletin Board firms are nevertheless subject to the constraints of Sarbanes-Oxley, Dodd-Frank and the Williams Act.91 Thus the traditional bulletin boards are more like national exchanges like the NYSE than how we expected crowdfunding platforms to operate.

“Pink Sheet” shares traded over-the-counter however operate with some of the same freedoms from the federal overlay that we might expect to occur on a crowdfunding platform.92 In 2010 the Over-the-counter markets traded 8,000 securities, of which 4,500 were not registered with the SEC.93 Those not registered with the SEC are nevertheless subject to state blue sky regulation.94

The Bulletin Board firms are all required to register with the SEC, but Pink Sheet firms are only required to register in certain circumstances.95 For those Pink Sheet firms which are not

---

91 A new NASDAQ exchange called BX Venture Market would seem to be another useful analogue, but that exchange will be subject to the full panoply of the federal overlay (with the one exception from NASDAQ’s corporate governance listing standards being firms will not be required to have a majority independent board). See Jeff Schwartz, The Twilight of Equity Liquidity, 34 CARDOZO L. REV. 48 (forthcoming Dec. 2012) (proposing a lifecycle model in which regulations would adapt to firms as they age), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2066934.
92 Bruggemann, supra note 89.
93 Id. at 6.
94 Id.
95 Id. at 7. Bollen and Christie describe four distinct types of firms trading exclusively on the Pink Sheets, including highly distressed firms or firm equity recently issued after a bankruptcy proceeding, microcap stocks too small for larger exchanges and trading in very small increments (or “penny stocks”), large foreign issuers who want to access US liquidity but want to bypass more heavily regulated exchanges (Nestle or
required to register with the SEC, and therefore required to comply with state Blue Sky laws, Bruggemann describes blue sky regulation in this context as fairly light touch.96

Consistent with the Mahoney hypothesis of exchange regulation, the OTC exchanges provide transparency rules for even pink sheet and grey market firms, including through a rough classification system that rates them as “current information available, limited information available, no information available” and a fourth warning signal for firms labeled “caveat emptor” which have both failed to provide information to investors and which engage in unusually high levels of unsolicited communication to potential investors.97 Jiang et al find that the introduction of the OTC categories resulted in a shift of liquidity away from firms in the lower tiers and toward firms in the higher tiers, and they argue that indicates exchanges can provide useful governance innovations despite cost constraints.98

Schwartz argues that the pink sheets are dogged by their reputation as a haven for firms that have been delisted from other exchanges for poor performance.99 Even if Pink Sheet firm governance were more readily available, it may be that the exchange’s reputation as a haven for troubled, delisted stocks drives potential emerging firms to other forms of financing, such as private placements, and therefore the Pink Sheets do not serve as an informative model for crowdfunding.

But a majority of firms on the pink sheets are not delisted. Bruggemann et al find that over a ten year sample, only 17% of them were previously delisted from an exchange requiring

---

96 “In 42 states, issuers are exempt from registration and “blue-sky compliant” if they are published in “a nationally recognized securities manual” such as Mergent’s (formerly Moody’s) Manuals, Standard & Poor’s Corporation Records, and others. The providers of manuals perform a (basic) review of documents supplied by the issuer, e.g., examine business description, corporate history and financial statements.” Id. at 8.
97 Id. at 8-9.
99 Schwartz, supra note 90, at 47.
SEC registration, and roughly 10% eventually rise to the traditional exchanges.\(^{100}\) OTC exchanges can include firms incorporated outside of the United States, as they find that roughly 10% of new firms incorporate outside of the U.S. or Canada.\(^{101}\) Schwartz’s argument also does not explain why large firms disclosing a wealth of information choose to list their American Depository Receipts on the pink sheets.

Pink Sheet issuers are still subject to the general prohibition against fraud.\(^{102}\) Thus the 34 Act overlay described in the next Part may still be present on these markets in part to the extent that they provide voluntary disclosures that open up potential corporate governance litigation, though certainly not to the same degree given how little they end up disclosing merely to achieve compliance by being listed in the S&P or Moody’s book. Also the fact that the 34 Act prohibition against fraud applies to the Pink Sheets, and therefore the SEC’s reluctance to permit shareholder arbitration for corporate governance claims still applies, suggests that the OTC markets provides at best a very limited window into the possibilities available for small publicly traded firms free from the federal overlay.

**Section F: Analogue to Crowdfunding: The London AIM Market**

The London AIM Market provides evidence that new era of chartering competition on crowdfunding platforms freed from the federal overlay might then also evolve symbiotically with new crowdfunding platforms that serve a gatekeeper rule to crowdfunded firms and which may play a role in entity formation as well, and possibly thereby involve private entities more directly in the business entity formation and code production process in some way.

\(^{100}\) Most OTC firms are below $20 million market cap, a quarter of them are below $5 million, they tend to be much more volatile and have much lower liquidity relative to other exchanges, average annual returns of -27%, and individuals firms have outsized annual returns ranging from +100% to -95%. Bruggemann et al find that OTC firms filing disclosures with the SEC have higher liquidity and more efficient price discovery than firms that do not, and they find the same with respect to non-listed firms that publish in Moody’s or Standard and Poor’s, which they suggest indicates that shareholders in OTC firms are efficiently taking into account information provision by OTC firms in their pricing. Bruggemann, *supra* note 89, at 9.

\(^{101}\) Bruggemann, *supra* note 89, at 23.

The London AIM market was created in 1995 and was designed to attract listings from smaller companies in the U.K. and overseas by offering with less stringent listing requirements for particular corporate governance arrangements than those required for larger companies on U.K. exchanges. 103 3,610 companies have listed on AIM since its inception and have raised 92.6 billion euro in the process. 104

On London’s AIM Market, corporate governance is a much more flexible and firm specific affair. It includes a significant role for a company’s nominated advisor (or “Nomad”) to help determine which provisions otherwise required for larger companies should be adopted by the AIM listing. 105 Notably, the London AIM market has very few mandatory corporate governance requirements, but each listing on the AIM market has a Nomad, most of whom also serve as a broker in the issuer's securities, which advise the new issuer about its corporate governance choices. That dynamic suggests the possibility for useful vertical integration in the provision of unique corporate governance arrangements for operators of exchanges or brokers on lightly regulated exchanges if freed from a strong federal overlay.

A firm serving as a NOMAD for an AIM listed company may also serve as a broker for the company’s securities. 106 Most NOMADS serve both roles on the AIM exchange. 107 Most of the companies listed on the AIM exchange are less than $25 million market cap, and only a handful have a market cap of greater than $100 million. 108 Thus the AIM market is roughly

104 Id. at 3.
105 The London Stock Exchange describes the process for becoming a “NOMAD.” Approval as a Nomad demonstrates that a firm has fulfilled the strict eligibility requirements set by the London Stock Exchange. A Nomad is the primary regulator of an AIM company, making the role demanding yet rewarding. An applicant seeking approval as a Nomad must: be a firm or company, not an individual; have practiced corporate finance for at least the last two years; have acted on at least three relevant transactions during that two year period; and employ at least four “qualified executives.” The AIM Rules for Nominated Advisers also detail the ongoing responsibilities of a Nomad and set out the review and disciplinary procedures. Becoming a Nomad, London Stock Exchange (2015), http://www.londonstockexchange.com/companiesandadvisors/aim/advisers/becoming/nomad.htm.
106 AIM, supra note 105, at 11.
107 Id. at 18.
108 Id. at 13.
characterized as hosting firms somewhat larger than expected crowdfunding firms, but somewhat smaller than the expected size of the Reg A market under the newly enhanced JOBS Act.

This indicates that, generally speaking, the benefits that Mahoney ascribes to exchanges may also apply to active brokers on crowdfunding exchanges, and may thereby afford a role to private parties in the corporate governance innovation process. The limited availability of data about the corporate governance choices that AIM firms actually make otherwise does not currently help with understanding the expected needs of crowdfunding firms, but nevertheless might afford a ripe area for future empirical inquiry.

**Part II: The State of Corporate Federalism And The Need for a Codified Internal Affairs Doctrine**

Business entity law has been around for some time and has been 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, and now a newly competitive and innovation 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 seen in crowdfunding platforms that will soon go online once the SEC’s final rule on federal crowdfunding is finalized.

The mere fact that the economics of crowdfunded firms explored in Part I suggest a demand for more flexible innovation in corporate governance does not mean the states will be in a position to make that innovation available to firms and investors. For example, Bainbridge and Henderson 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.\textsuperscript{109} Bainbridge and Henderson note that federal rules which would prevent their idea weren’t necessarily even designed to prevent entity membership on the board, but the effective consequence to references to natural persons in the federal rules effectively precludes their innovation for being implemented.\textsuperscript{110}

Delaware judges Chandler and Strine note the frustration of state corporate innovators about how the prospect of federal pre-emption discourages innovation when they note in response to Sarbanes-Oxley “[w]hat’s next? A ban on going private transactions? Or on options-based compensation of executives? Or on interested transactions?”\textsuperscript{111} But that frustration is not limited to existing innovations. This article argues that even those who would argue that the extent of federal preemptions explored below are quite limited must accept that the prospect of future preemption itself substantially inhibits innovation in corporate governance.

Thus this Part II will show that in some ways the corporate federalism debate has thus far focused on the wrong problem. While state chartering competition may be competitive within the modes of governance permitted by the federal overlay, it is nevertheless not highly innovative to new corporate governance innovations. This paper’s window into the needs of crowdfunding firms demonstrates that fact, and we may expect the problem to be just as cogent with respect to larger public firms.

Part II below explores the culprits in the federal overlay that inhibit state competition in corporate governance, including the Williams Act, the Sarbanes-Oxley Act, and corporate


\textsuperscript{110} Id. at 1100.

governance provisions contained in Title 9 of the Dodd-Frank Act. It also points to discretionary regulatory activity by the SEC as well as by other federal agencies that evidences a desire to meddle in the internal affairs of states in regulating the relationship between shareholders and firms.

Part II below explores a rule of construction in securities and corporate law called the “internal affairs doctrine.” That rule of construction interprets federal securities laws as not preempting state corporate law unless evidenced by an explicit desire of Congress to do so. It also represents what O’Hara and Ribstein describe as a bargain between the states to recognize each other’s corporate law. There are sizeable holes in that doctrine however, and even at its best it does not represent a binding constitutional doctrine. This Part II will explore codification of the internal affairs doctrine as a partial remedy to the problems explored in this article.

With respect to statutes passed by Congress that affirmatively preempt state corporate governance, like the Williams Act or Sarbanes Oxley, Part II below argues that they should be abolished, or at a minimum they should become optional arrangements which firms could opt-into, subject to limitations on such opt-in to be framed by the states of incorporation. It may be that some federal rules could represent value enhancing regimes, in which case we’d expect some opt-in to obtain signaling benefits, but in any event this Part does not preclude an analysis that these federal rules overall reduce shareholder wealth.

Part II below considers the interest groups affecting the development of Delaware law through a prior lens developed by Macey and Miller, and argues that corporate governance innovations which make the state chartering system more competitive, and repeal of the federal overlay which makes the system more competitive, should likely be resisted by Delaware. This lays the groundwork for the argument in Part III that the availability of arbitration is a likely a
vitally important piece of the puzzle in making the system more competitive. Arbitration as a means of applying a corporate code, and a code designed for that purpose, may be the only way to fully challenge the Delaware model with its attendant network effects. The Macey Miller analysis suggests that Delaware’s interest in fully actualizing the needs of crowdfunding firms will be limited to the extent they result in a decrease in litigation costs for publicly traded firms.

Finally Part II below considers a natural experiment in which the federal overlay for public firms was peeled back just a little, in the case of a few marginal exemptions from NYSE listing requirements regarding board structure for publicly traded master limited partnerships, and finds a wealth of innovation and heterogeneity.

Section A: Federalism in State Chartering, Romano’s “Genius of American Corporate Law”

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.\textsuperscript{112} 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.\textsuperscript{113} 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.”\textsuperscript{114} One of the problems cited with federalism is spillover effects in which local jurisdictions do not internalize the effects of their regulation outside the

\textsuperscript{113} \textit{Id.} at 276.
\textsuperscript{114} \textit{Id.}
jurisdiction. In this context, the existence of a market that prices the effectiveness of the state system into the value of shares minimizes the impact of any spillovers.

There is for example a significant vein of literature suggesting the firms obtain a premium from incorporating in Delaware. Romano notes that though Delaware is not always the most innovative in developing new ideas, it is highly responsive to new corporate governance innovations developed in other states. Romano shows that Delaware’s success in the reincorporation market is correlated to firms contemplating mergers, for which they are assumed to appreciate unique characteristics of Delaware law.

Romano shows that Delaware enjoys a dominant position in the market for reincorporation. Because both boards and shareholders must approve reincorporation, this indicates a competitive market racing to the top. Romano reminds that the presence of a single dominant player in a market does not by itself prove that the market is not competitive. The fact that Delaware stands ready to respond to other states means that market forces still discipline Delaware’s development of the corporate code to the needs of firms and shareholders, but that does not mean the state system couldn’t become still more competitive if the suggestions in this article are implemented.

Daines notes that most firms incorporate in either their home state, or in Delaware. This suggests a sizeable market for lawyers seeking to keep business formation locally. Bebchuk

---

117 Romano, supra note 114, at 240.
118 Id. at 261.
119 Id. at 244.
120 Id. at 261.
argues that competition to keep firms incorporated in state may be a function of local lawyers seeking to keep an ongoing corporate advising relationship with a firm.\textsuperscript{122}

In addition to an empirical analysis of the level of competition in chartering competition, the debate about corporate federalism has also focused on particular corporate governance choices that states like Delaware have encouraged and firms have selected. For example, much of the debate about corporate federalism has focused on corporate governance features that are friendly to incumbent managers like the poison pill and the staggered board.

Butler and Baysinger suggest that for firms in which a concentrated block of shareholders have firm specific investments, they may seek alternative means of reducing agency costs, such as methods that enhance their voice rather than increase opportunities for exit.\textsuperscript{123} In the 30 years since Baysinger Butler’s theory was published, the remedial mechanism that antitakeover vehicles presents has become increasingly important, as conflicted shareholders with social agenda’s have distorted shareholder voice mechanisms to advance social policy issues on the corporate ballot.

Baysinger and Butler argue against the notion of a need for uniformity in State corporate law and instead suggest variability between strict jurisdictions and liberal jurisdictions indicates a market that is actually working quite well at catering to the heterogeneous needs of firms and their shareholders.\textsuperscript{124} Baysinger and Butler describe an evolutionary process in which organizational law evolves according to its ability to sustain competitive advantage in competition for capital.\textsuperscript{125}

\begin{thebibliography}{99}
\bibitem{124} \textit{Id.} at 435.
\end{thebibliography}
Baysinger and Butler describe another possible reason for the Persistence of anti takeover amendments in that it reduces the potential for conflicts of interest among shareholders to diminish firm value. Basinger and Butler ask an important question: if anti-takeover provisions reduce value than why do shareholders continue to approve them other by buying stock in firms that have adopted them or otherwise voting for them? 

Bebchuk questions the assumption the investors in IPOs will rationally price the effect of legal structures and organizational choices into the stock price of the firm. But it is internally inconsistent to both question market rationality on the one hand, and on the other hand advocate changes in the federal securities regulatory system (a disclosure system premised on the ability of investors to rationally process required disclosures) to empower those same irrational investors. Therefore his critique of this contractual argument is unavailing. Macey also notes however that one reason for the persistence of antitakeover protections is that it can provide the firm with additional negotiating leverage, and therefore help to negotiate a higher deal premium for targets being sold.

Butler and Baysinger provide an alternative theory to explain the persistence of antitakeover protections at some firms, but not others, as reflecting that fact that they will “likely be 1) adopted by firms with a substantial number of owners who wish to preserve the status quo, and 2) accompanied by the reinforcement of other governance structures to economize on transaction or agency costs, such as more independent directors, adaptive internal structure, and profit sharing among decision agents.”

127 Id. at 1282.
129 Id. at 1297. Baysinger and Butler describe one benefit to anti-takeover protections being that they can help preserve relationships for which firm specific information by shareholders is valued at in which the market for corporate control is less important. Baysinger & Butler, supra note 128, at 1288. Baysinger and Butler describe how anti-takeover amendments are adopted on a differential basis and therefore a pure entrenchment theory of corporate federalism is necessarily incomplete. Their theory continues to hold force today, as a similar dynamic is displayed in which
While they present a forceful critique of the anti-corporate federalists that continues to hold force today, one still wonders how much more effective state chartering competition could be for publicly traded companies if the federal overlay into the traditionally internal relations between shareholders and boards were lifted. The governance features they explored were drawn from a very limited menu of options, which this article suggests is a function of the federal overlay in corporate governance. At the time of the Baysinger Butler debates, for example, the Williams Act served as a powerful constraint on the market for corporate control, which suggests that for those firms at which the firm specific shareholders explored by their theory were not extant, a corporate code more friendly to the market for corporate control may have been in demand if it hadn’t been for the innovation crushing footprint of the Williams Act.

To some extent the current literature on corporate federalism focuses on precisely the wrong problem in obsessing about whether state entity formation is competitive or not, and arguing about how competitive it is. A better question is how innovative is the state system. That consideration would require an examination of constraints on innovation, particularly at the federal level, and requires some inference about the types of innovations that firms may find useful if the range of innovation available at the state level were greatly enhanced. This article provides just such an examination.

This provides a key reason why the federal overlay is so damaging to competitive federalism. The evolutionary process we might otherwise expect to play out in organization form is inhibited. New innovations are discouraged because of the threat of federal preemption. New innovations are not expected to become widely adopted overnight, but instead

\[\text{roughly half of firms maintain staggered board entrenchment protections, and half have eliminated their staggered boards, which suggests more is going on than a pure entrenchment purpose in adoption of the protection. Id. at 1290.}\]
must survive the evolutionary process for organizational evolution, and therefore the incentive to innovate is compromised if the threat of federal preemption always hangs over the innovator.

The challenge that the federal overlay poses to Romano’s laboratory of innovation is that, in addition to current constraints on the space of available contractual innovation, the prospect of uncertain future pre-emption limits incentives of incorporating jurisdictions to invest in corporate organizational innovation. This is in part because jurisdictions know that, even if they were willing to take the risk and expend the upfront costs, firms would similarly be disinclined to make investments in new corporate governance technologies out of the some concern for prospective preemption.

Labs of innovation work best when a successful innovation captures a large revenue stream of future revenues because of the fact that most new experiments fail. The prospect of federal preemption significantly discounts the net present value of future innovations within large areas of governance innovation that have thus far gone undeveloped, such as a corporate code that primarily depends on arbitration or some other non-judicial forum for code interpretation and enforcement.

Bebchuk and Hamdani note how federal intervention in state law corporate governance has been increasing over the last 70 years. Bebchuk misses the point that any flaws he sees in the competitive state chartering system could actually be caused by that federal intervention, as current pre-emption, and the threat of pre-emption of new innovations, inhibits the incentives of other states to compete with Delaware. He emphasizes the market for corporate control, but it is reasonable to assume that as mandatory board structures and indeterminate litigation risk are eliminated in alternative systems using arbitration and more flexible organizational structures,

---

130 Bebchuk, supra note 130, at 1812.
the market for corporate control could also become an alternative mechanism used to reduce agency costs for firms formed under new codes that compete with Delaware.

Baysinger and Butler do not suggest state competition in corporate chartering will appear perfect at any individual slice in time but instead argue that jurisdictional competition will be the most adaptive to the changing needs of shareholders and firms. Even assuming Bebchuk may be right to point out inefficient outcomes in the state competition system, like if there is an overrepresentation of antitakeover provisions above the needs suggested by Baysinger Butler, the Baysinger and Butler thesis nevertheless provides powerful evidence that when Bebchuk and other critics of chartering competition turn to a federal solution they neglect to appreciate they are actually making the state competition system less competitive, less adaptive, less innovative, and thereby advance a suggestion that may ultimately make the situation worse.

Section B: The Internal Affairs Doctrine

The internal affairs doctrine is a rule of construction created by judges that applies both in interpretation of federal statutes and an interstate choice of law rule which 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. While many states respect the doctrine, New York and California abandon it in the context of companies not traded on a national securities exchange. And while some federal court interpretations of the securities laws demonstrate respect for the internal affairs

---

131 Baysinger & Butler, supra note 125, at 436.
132 For a possible definition of the internal affairs doctrine from the Restatement (Second) Conflict of Laws, see The Internal Affairs Doctrine: Theoretical Justifications and Tentative Explanations for Its Continued Primacy, 115 Harv. L. Rev. 1480 (2002). A statutory definition of the internal affairs doctrine could follow the explicit recitation approach taken in the Restatement, or it could instead take an intent based approach and describe the contractual justification of the internal affairs doctrine (Id. at 1438) and the reason for the codification. As in “this statute is intended to promote freedom of contract in organizational charters and to promote state-based competition for chartering through mutual recognition of each state’s right to regulate the internal affairs of its business entities."
133 Id. Santa Fe v. Green provides one court’s articulation for the purpose of the internal affairs doctrine as:

"It is thus an accepted part of the business landscape in the country for states to create corporations, to prescribe their powers, and to define the rights that are acquired by purchasing their shares. A state has an interest in promoting stable relationships among parties involved in the corporations it charters, as well as in ensuring that investors in such corporations have an effective voice in corporate affairs." Ribstein, supra note 75, at 156.
doctrine, others do not, and at times either Congress will explicitly pre-empt 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.

Commentators have suggested that while the dormant commerce clause, the due process clause, or the full faith and credit clause of the constitution may appear to be likely candidates for cementing the internal affairs doctrine for the purposes of interstate choice of law, they conclude the internal affairs doctrine is not constitutionally mandated under any of those provisions. O’Hara and Ribstein offer a similar observation.

Ribstein and O’Hara find that there are distinct policy reasons why states generally respect the internal affairs doctrine even in the absence of formal doctrinal constraints, such as the fact that different rules for voting or liability for the same individual firm don’t work if different states don’t respect the internal affairs of other states. In short, “firms gain so much from being able to contract for corporate governance law that noncompeting states fear firms’ moving their home offices or avoiding contacts with them if they impose a connection requirement [to recognize incorporation].”

Ribstein and O’Hara also note however that the scope of the internal affairs doctrine functions as a sort of “optical illusion” since it’s coverage is essentially functionally limited to those items for which states find it convenient to mutually recognize each other’s law. Ribstein and O’Hara predicted possible federal rulemaking regarding the internal affairs doctrine “either in response to state super-mandatory laws or to the perceived inadequacy of state

---

137 Id. at 692.
138 Id. at 694.
regulation.”

This article suggests something different, a federal codification of the internal affairs doctrine principally to limit Congress interest in, and the agencies’ ability to, pre-empt state laws, and secondarily to limit any ability of states to impose restrictions on the corporate governance codes of other states.

In an era of unprecedented agency delegation of power by the Congress it will be necessary to design a codification of the internal affairs doctrine very carefully to ensure it achieves its purpose as a constraint on agency action. Greve and Parrish note the increasing reluctance of private regulated parties to challenge agencies, fearing retribution and regulated increasingly through more informal guidance.

This codification should provide a clear right of action to states to challenge the SEC and other federal agencies if agency action infringes on the internal affairs doctrine, including the power to intervene in enforcement actions. States may be less fearful of retribution by agencies since they are not regulated by them, and may have a cogent interest in protecting the value of their entity formation role.

Delaware’s position in relation to the federal government, which Roe describes as essentially a dog out-maneuvering other states for the scraps that fall from the federal government’s table, risks the dangers of cooperative federalism explored by Greve. The result is likely to be diminished accountability, transparency, and responsibility at both the state and the federal level. The antidote he urges is by “confining the states and the national government to distinct spheres: by giving ambitious, turf-conscious institutional actors incentives to resist and rat on each other; and by allowing citizens, in the domain beyond the national government’s

---

139 Id. at 697.
140 Id. at 571.
142 Greve, supra note 66, at 567-68.
reach, to vote with their feet, thus adding the disciplining force of exit to the often ineffectual option of voice.” ¹⁴³

It might be expected that Delaware alone will not be a sufficient protector of corporate federalism, but if the reforms suggested in this article are implemented it may be expect that other states could work to enforce their rights. In order to implement a solution to Greve’s threat of cooperative federalism in this sphere, it will be important that the federal codification of the internal affairs doctrine described in this article provide an explicit right of action to the states to challenge agency action on the ground that it violates the internal affairs doctrine. ¹⁴⁴

While informal guidance would be difficult to challenge through litigation, the threat of state challenge might make the implicit threats agencies may make through informal guidance less threatening to industry. However, in order to ensure that agencies do not effectively regulate through enforcement settlements, the codification should also provide that any terms in an enforcement settlement that infringe on the internal affairs doctrine are non-binding on the defendant.

To the extent that at the margin, some states have chipped away at the internal affairs doctrine, and in the example of California applying legal restrictions to out of state firms that have a substantial number of California shareholders, it may also prove useful to preempt state actions that impede on the internal affairs of other states.

¹⁴³ Id.
¹⁴⁴ See id., (noting that one mechanism by which the federal government has obtained leverage over the states to advance cooperative federalism is block grants through which the federal government funds state run programs.) That dynamic as had has not been seen in corporate governance specifically or in financial regulation more generally, but if things change interest groups may use this means to try to evade codification of the internal affairs doctrine.
Section C: Federal Preemption By Statute, Discretionary Agency Power, and The National Exchanges

Kobayashi Ribstein note that one of the requirements for the Tiebout sorting model to work effectively is that “jurisdictions are free to select any set of laws they desire.” Mark Roe’s extensive analysis into the extent to which federal law preempts state corporate law demonstrates the constraints on a full Tiebout model in the corporate federalism context. Roe’s conclusion is that “Because Delaware 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.” 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. Roe generally points to sources of federal preemption as the SEC, the Congress, federal courts interpreting

145 Ribstein & Kobayashi, supra note 117, at 3.
146 “Federal authorities can, and do, confine state competition. They have made rule-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 adjusted to the federal presence, Washington is a player in American corporate governance.” While Roe overstates the case by describing Delaware as thus a “monopoly” he nevertheless accurately sketches Delaware’s relationship to the federal government. Mark J. Roe, Delaware’s Politics, 118 Harv. L. Rev. 2491(2005). 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.

148 Roe acknowledges that Delaware likely obtains benefits from the specter of federal preemption over other states. Pre-emption by way of Sarbanes-Oxley, and exchange rules which were adopted in the wake of Sarbanes-Oxley, including director independence requirements for the Board generally, for particular committees like the audit, nominating, and compensation committees, meetings of non-executive directors, selection of a lead independent director, and the adoption of various policies regarding director qualifications and obligations. Chandler, supra note 113, at 963-66. They also include both procedural and substantive reform of compensation for directors and officers. Id. at 974.
securities law cases (the existing internal affairs doctrine notwithstanding) and the national exchanges. 150 Romano notes that the SEC typically strongly pressures the national exchanges to adopt uniform corporate governance provisions. 151

Roe notes that “Presidents Roosevelt, Taft and Wilson each sought mandatory federal incorporation.” 152 Each of those attempts failed however, suggesting that full-scale nationalization of corporate law is constrained by interest group dynamics. 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.

A historical episode which demonstrates the SEC’s ability to pressure the exchange into adopting listing rules which it wants was in 1990, when an SEC rule restricting the agency’s ability to prohibit dual-class share recapitalizations was struck down by the DC Circuit as violating the internal affairs doctrine and thus outside the SEC’s charter. 153 The SEC simply pressured the exchanges to adopt those prohibitions as listing requirements on their own (private exchange decisions aren’t subject to the internal affairs doctrine.) 154

Romano identifies the federal footprint into traditionally state areas of corporation law as including its provisions for independent audit committees, the requirement for an independent audit committee, the prohibition on loans to officers, and the requirement that executives certify financial statements. 155 Romano reviews the empirical literature for these reforms, and makes the case that the limited empirical support for them argues that their either be repealed, or at a

150 Id. at 598-99.
152 Roe, supra note 151, at 602.
153 Id. at 619.
154 Id.
minimum should be converted to optional provisions that public firms could opt-into.\textsuperscript{156} Given the increasing tendency of the SEC and other agencies to include corporate governance provisions in settlement agreements, the decision for if and how firms can opt-into federal governance options should however be left to the states to ensure states can function as a bulwark against agency pressure which would otherwise be felt on an individual basis.

Romano describes one of corporate federalism’s virtues is that legislative errors are more easily corrected once made clear in a competitive state system than in a federal system.\textsuperscript{157} She posits that, based on Niskanen’s theory of how regulators tend to seek to maximize the number of firms they regulate, a market based discipline will limit bad decisions by state corporate lawmakers in their capacity as regulators in a way from which a single federal regulator is immune.\textsuperscript{158}

Romano also describes how state based competition results in more innovation because it allows for experimentation in corporate governance, something a risk averse federal regulator has no incentive to promote.\textsuperscript{159} This sort of experimentation and innovation is inhibited by Sarbanes Oxley. When SOX requires particular committees of a board of directors and a particular definition for independence requirements, for example, it inhibits not only innovation in audit committee process, but it also inhibits development of new and better definitions of independence, and it inhibits innovation in non-board means of firm governance.

One of the arguments favoring state competition in corporate law is the basic federalism argument that states serve as laboratories of innovation.\textsuperscript{160} And yet, if the federal overlay for public companies risks suddenly, and unexpectedly, obviating an innovation, the incentives to

\textsuperscript{156} Id. at 1595.
\textsuperscript{157} Romano, supra note 122, at 3.
\textsuperscript{158} Id. at 9.
\textsuperscript{159} Id. at 10.
\textsuperscript{160} Ribstein & Kobayashi, supra note 117, at 5 (citing Oates).
innovate in corporate law are reduced. Even if you obtain intellectual property for corporate governance innovation, the risk of sudden shift in federal policy can take away the benefit of new innovations. And, current federal overlay already limits the range in which states can innovate.\textsuperscript{161}

Roe notes that a sudden move by a state to garner reincorporation from Delaware to attract firms would also attract the interest of the federal government, which would create federal policy to stifle competition.\textsuperscript{162} But the risk, and the costs, of potential pre-emption are more wide reaching. Even if a state’s innovation did not cause such a dramatic shift in reincorporation, and merely attracted a few sizeable new IPOs, so wide is the footprint of the federal government that gains to the new innovation could simply be destroyed by random and unintentional preemption.

Section D: Other Federal Agencies Get Into the Internal Affairs Preemption Game

Greve and Parrish point out an increasing level of agency delegation by Congress, and cite the Dodd-Frank Act as an example.\textsuperscript{163} 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 state certification of issues covered by the internal affairs doctrine 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.

\textsuperscript{161} Roe notes that one of the earliest form of preemption in the 34 Act was preemption of shareholder voting disclosure and voting processes as he describes: “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.” \textit{Id.} at 611.

\textsuperscript{162} Mark J. Roe, \textit{Is Delaware’s Corporate Law Too Big To Fail?}, 74 BROOK. L. REV. 75, 93 (2008).

\textsuperscript{163} Greve & Parrish, \textit{ supra} note 145, at 505.
A Federal Reserve Governor recently purposed 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.”

It wasn’t clear whether Governor Tarullo was suggesting a change to state law, or instead was suggesting a federal preemption of state fiduciary duties. 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. The state law doctrine of “Caremark duties” would present a ready means to adapt to Tarullo’s suggestion. suggesting that Tarullo’s proposal could be adapted to a state law Caremark claim.

The Federal Reserve has however explicitly preemption state corporate governance rules as it has recently exercised its regulatory authority over non-banks designated as systemically significant financial institutions under Section 165 of the Dodd-Frank Act to require that GE Capital’s independent directors may not include independent directors serving on the Board of Directors of GE.

---

165 Id. at 5.
166 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 which federal regulators might regulate. Id. at 7.
Some prior cases have limited the ability of federal agencies to interpret statutes as preemptioning state law, particularly in the corporate context. However, agencies can accomplish the same goal through informal guidance and through provisions in enforcement settlements.

Supporters of Tarullo’s argument may believe his proposals are necessary to fulfill the federal government’s role as regulatory of bank safety and soundness, but other tools exercised by the federal regulators are more closely linked to bank safety than corporate governance. For example, Macey has suggested that enhancing the market for bank control could serve to enhance bank oversight by shareholders, but there again the federal overlay limits that mechanism.

Supporters of federalizing corporate governance might argue that some particular industry is special, and thus its governance must be subject to federal constraints. If stock price is not a valid disciplining force on management, as for instance based on a perception that shareholders are incentivized to take risks that capitalize on a federal safety net as in banking, then tinkering with corporate governance relationships between shareholders and boards are not likely to matter nearly as much as regulation of the underlying activities of banks.

Though this subsection has focused on the threat of pre-emption by the Federal Reserve, the threat of non-SEC federal pre-emption is not necessarily limited to federally regulated banks. The EPA could similarly adopt corporate governance rules as part of settlements or as an implicit condition for permit approvals. The FCC has already ventured into some aspects of corporate law, as with veil piercing doctrine in its competition analysis.

---

169 Id.
Section E: Prior Federal Statutes Encroaching on State Internal Affairs Should Either Be Abolished or Become Optional

Bebchuk suggests that federal default rules should be structured to favor corporate governance structures which empirical evidence suggests is value enhancing, and then permit opt-out for firm specific needs.\(^{170}\) This argument doesn’t take into account the fact that federal regulators, and litigants in 34 Act cases, can pressure firms to stay in the federal regime. Thus this article suggests that even to the extent federal corporate governance laws remain on the books as optional arrangements, they should be purely opt-in arrangements.

Though Bebchuk is an ardent proponent of eliminating state corporate code provisions that inhibit the market for corporate control, he recognizes that “several of the proxy rules introduced in the 1950s with respect to consent solicitations have long made mounting proxy challenges more difficult and costly.”\(^{171}\) The answer then is to eliminate those provisions to make the state system more competitive, not introduce more federal preemption.

Bebchuk suggests when considering optional regulatory regimes, it is more efficient to have a default of the empirically tested option and permit firms to opt-out, with shareholder approval.\(^{172}\) Part of his argument rests on the assumption that if boards want to opt-out, they can, but the threat of exercise of federal enforcement authority to favor specific governance regimes weighs against his argument.

Bebchuk argues in favor of a federal rule in instances where empirical literature suggests the state chartering race results in proliferation of governance provisions that reduce shareholder value, like provisions which insulate directors from removal.\(^{173}\) First, his argument doesn’t account for the fact that many firms have recently eliminated some entrenchment protections, for

\(^{170}\) Bebchuk, supra note 130, at 1797.
\(^{172}\) Id. at 338.
\(^{173}\) See Bebchuk & Hirst, supra note 177.
example many firms have eliminated staggered boards in the last decade. Second, his argument also misses the fact that, even if individual and tailored pre-emptions may in an of themselves benefit shareholders, the general practice of federal pre-emption of state corporate innovation makes future pre-emptions more likely, and hence decreases the gains to innovation at the state level, which reduces the level of interstate competition.

One of Bebchuk’s arguments against opt-in is to suggest governance regimes he favors, and then note that few firms have opted into the regime, such as a proxy access regime to make shareholder nomination of alternative board candidates easier. But this begs the question of whether a lack of opt-in simply indicates that the option was not value enhancing (as subsequent empirical work by Stratmann and Verret demonstrated).

Johnsen and Yaha address, in the antitrust context, the argument that lawmaking is subject to scale efficiencies such that federal law is superior by noting that states can simply adopt federal law. Should that be the case in some corporate governance arrangements, one would expect that some individual state would opt-into the federal corporate governance regime if they had the option to do so. It would be advisable to maintain this opt-in on a purely state by state basis, however, and provide individual states with the ability to set the terms, and the voting procedures, by which firms formed in their jurisdiction may opt in to the federal regime, in order to limit a federal agency’s ability to exert its leverage over individual firms to force acceptance of corporate governance provisions which are not optimal for their circumstances.

174 Id. at 343. Bebchuk notes that as of 2010, half of public companies had staggered boards, and he cites that as indicating that opt-in doesn’t work. Id. at 345. And yet his statistic could just as easily be indicia that corporate governance competition is working, and that the difference is a function of heterogeneous firm needs, and the need of some firms to manage investor conflicts, consistent with the Baysinger/Butler theory of chartering competition.


Iacobucci also suggests that Delaware’s relatively high franchise fees can act as a signaling mechanism that firms opting into Delaware’s cod expect to grow such that the size of the fee will be relatively less important in the future.\textsuperscript{177} Iacobucci describes a signaling benefit to chartering competition, in that chartering into high-litigation jurisdictions indicates a firm’s confidence in its ability to avoid lawsuits (and avoid the stock drops that typically precede most lawsuits.)\textsuperscript{178} In that way, if opting-in to the federal regime indicates a reliable signal of quality, one would expect at least one state to offer a menu that allows opt-in to the full federal overlay. This only works however if it’s truly opt-in, and not something in which the regulators can use informal pressure to encourage firm opt-in.

Therefore it will be key that states set the terms of opt-in to a federal regime by managers, including how the opt in takes place (via board bylaw, shareholder bylaw, or charter amendment requiring approval of both, and any attendant supermajority requirements).\textsuperscript{179} But there are reasons to suspect that the federal corporate governance menu is deeply flawed. In addition to empirical analysis of Sarbanes Oxley compiled by Romano and listed in the preceding Part, the federal government’s hostile approach to the market for corporate control (a concept which even critics of Delaware tend to support) indicates the federal approach to corporate governance is deeply flawed. Indicating the federal government’s lack of appreciation for the market for corporate control are the Williams Act on the legislative side, and even when the SEC gets an opportunity to support the market for corporate control through regulation it

\textsuperscript{178} Id. at 331.
\textsuperscript{179} Some states might also be expected to simply offer full opt-in to federal overlay as a default menu item. States may also decide that governance reforms submitted by shareholders who are willing to undertake the costs of the vote, and/or who are willing to post a bond, may be more likely to represent shareholders who are advancing proposals with a sincere desire to improve share value.
fails to do so, as in the proxy access rule which prohibited firms using it from seeking to acquire control of the company.  

Bebchuk challenges supporters of corporate federalism, who also tend to be supporters of the notion that a market for corporate control can reduce agency costs, with the argument that “it is not possible to maintain, as corporate scholars have commonly done, that 1) state antitakeover statutes largely do not serve shareholders and that 2) state competition provides states with strong incentives to provide rules that are optimal for shareholders.”  

What if resolving that apparent dichotomy does not require a federal solution, but instead is a function of how existing federal pre-emption has hindered state competition?

The Williams Act inhibits what could otherwise be a strong state based mechanism for minimizing agency costs in public companies, namely the notion of a market for corporate control first popularized by Henry Manne.  

Manne argued that a free market for corporate control would optimally require the ability to announce a hostile takeover offer, at any time, without notice, and subject to any conditions the offeror can make, and absent any obligation to hold the offer open for a minimum period of time during which alternative bidders can free ride off the initial information discovery done by the first bidder.  

But as Manne argued many times the Williams Act prohibits this approach to the market for corporate control.

A state code could be developed rivaling Delaware and centered on this principle.  But without removing the inhibiting force of the Williams Act, and without the ability to compete with Delaware using an alternative forum like arbitration, it is unlikely that rival approach to

---

180 Kostel’s historical analysis of the Williams Act observes that when it was passed in 1968 it was intended as a constraint on the market for corporate control and the interest groups urging its adoption were all pro-management groups opposed to the market for corporate control, and that immediately after its passage it did in fact have a deterrent effect on takeovers. Mary E. Kostel, A Public Choice Perspective on the Debate Over Federal Versus State Corporate Law, 79 VA. L. REV. 2129, 2142-43, 47 (1993). The deterrence is a function of free-riding by other offerors during the delays in consummating an offer created by the Act, which thereby discourages efforts investments in discovery by initial bidders. Id. at 2148. Ribstein agrees that the Williams Act has inhibited the market for corporate control by inhibiting hostile tender offers. Ribstein, supra note 75, at 141.

181 Bebchuk & Cohen, supra note 124, at 388.


183 Id. at 1388.
governance can take shape. Indeed, this fact likely contributed to the inability of the new North Dakota corporate code to attract significant new entrants (along with other flaws in that code’s approach explored by Bainbridge).

Section F: Public Choice Analysis of Federal Pre-emption

Niskanen’s empire building hypothesis suggests in part that agency employees will attempt to expand their jurisdiction into new areas that increase compliance costs, as it will tend to give employees more opportunities for post-government careers. At the SEC a study of staff turnover conducted in 2002 nearly half of new attorneys responded to a Government Accountability Office Survey that they intended to work at the agency for five years or less.

Recent turnover in the highest positions has been similarly high, and the SEC’s Divisions Directors almost exclusively go back and forth between law firm positions. Metzger lists the reasons federal regulators may discount the state’s role when considering new rules, including tunnel vision, regulatory capture, and lack of expertise.

Wilson offers a number of constraints on agency empire building to challenge the Niskanen theory and argues that agency’s are risk averse and seek to maximize their autonomy from powerful interest groups or from oversight by Congress. This suggests that, given the Delaware delegation’s interest in limiting federal pre-emption of pieces of Delaware’s code that maximize its value, the SEC may have an interest in limiting incursions into core pieces of the Delaware code.

184 MAXWELL L. STEARNS & TODD J. ZYWICKI, PUBLIC CHOICE CONCEPTS AND APPLICATIONS IN LAW 343 (West Pub., 2009).
186 Jean Eaglesham, SEC Deals With Turnover at the Top, WALL STREET JOURNAL (Aug. 20, 2013), http://www.wsj.com/articles/SB10001424127887323423804579020732101136274. Even the SEC’s current Chairman has recognized that the SEC’s disclosure mission has morphed well beyond looking to the needs of investors and instead serves a number of interest groups objectives. Mary Jo White, SEC Chair, Speech at Nat’l Assoc. Corp. Directors (October 15, 2013).
188 Stearns & Zywicki, supra note 191, at 347.
However, to the extent that federal preemption does not threaten core elements of Delaware’s approach, and indeed perhaps limits other states from entering into more active competition with Delaware, then the agency may have more freedom to exercise discretionary authority to preempt. This observation would explain why the SEC has stifled the development of an arbitration based approach to corporate law that is both not a part of the Delaware approach and which might facilitate a competitive challenge to Delaware.

Stearns and Zywicki describe a number of theories from McNollgast and from Macey describing how Congress designs the administrative process and the jurisdiction of agencies to reduce agency drift into unintended areas, and to afford interest groups an opportunity to coalesce in response to agency action. The internal affairs doctrine codification explored in this article can serve that function.

Greve argues that “the task, then is to salvage pieces of the federalist architecture without mounting a frontal, politically unsustainable attack on the new Deal and its constitutional legacy.” As the SEC was a product of the new deal, it is appropriate that agency’s tendency to override well functioning federalism alternatives to its authority should be considered carefully.

Metzger observes that the Supreme Court has been unwilling to curb the authority of Congress on federalism grounds. This supports the need for codification of the doctrine, so that a future Congress would need to directly contradict the doctrine and thereby face greater interest group pressure against what would otherwise be surgical incursions into internal affairs.

Metzger observes that states tend to obtain preferred status in federal court, and that “treat the state differently from other plaintiffs inn challenging federal administrative action and

189 Id. at 372-73.
189 Michael S. Greve, Federalism’s Frontier, 7 TEX. REV. L. & POL. 93, 109 (2002). Greve notes that large businesses, aware of the specter of federal uniform legislation, may lobby for a federal approach that facilitates their interest over competitors. Michael S. Greve, Business, the States, and Federalism’s Political Economy, 25 HARV. J.L. & PUB. POL’Y 895 (2002). One could anticipate Delaware responding in the same way to legislation opening up competition to innovations for which Delaware does not possess a market advantage.
190 Metzger, supra note 195, at 2048.
to do so because of the states’ status as sovereign entities within the federal union.”\textsuperscript{192} This further suggests the states may serve as powerful enforcers of the codified internal affairs doctrine, supporting analysis in the previous subsection.

Metzger observes that states possesses some limited leverage in the state legislative and regulatory process to preserve their interest, which can vary with political trends.\textsuperscript{193} In this instance however there is reason to suggest that without some sweeping change, the dominant player in state corporate governance may currently have reason to support the current level of federal preemption as helping to facilitate its dominance in the chartering race. The next subsection will elaborate why that is the case.

**Section G: Interest Group Politics in Delaware**

From the perspective of state competition on the basis of court systems, rather than from the perspective of code innovation, development of federal corporate governance mandates may actually work to improve Delaware’s advantage in state competitive. Chandler and Strine note that federal governance mandates tend to become the subject of state corporate litigation.\textsuperscript{194} As such a Delaware firm may feel that Delaware court are more likely to responsibly adjudicate that new class of claims than other state courts.

Macey and Miller’s interest group theory of Delaware’s corporate law posits that the market for chartering competition is generally competitive, but Delaware has obtained first mover advantages in its predictability and substantial body of precedent that permit it to “charge firms more than other states for the privilege of incorporating there” by things like “offering a limited menu of less efficient rules in those specialized areas where such rules are highly desired by managers” such as “rules protecting incumbent managers against the threat of hostile

---

\textsuperscript{192} Id. at 2063.
\textsuperscript{193} Id. at 2076.
\textsuperscript{194} Chandler, supra note 113, at 984.
takeovers.\textsuperscript{195} They note that in the distribution of these rents, “an elite cadre of Wilmington lawyers who practice corporate law in the state” are the most powerful interest groups (though to a secondary degree maximizing chartering revenues is a less powerful interest as well).\textsuperscript{196} They suggest that Delaware’s liberal approach to attorney’s fees is an example of this theory.\textsuperscript{197}

They note that Nevada’s attempt to simply refer to Delaware’s body of jurisprudence in its code, and was ultimately unsuccessful because it was unable to replicate Delaware’s dynamic.\textsuperscript{198} They posit that managers want some element of stability with respect to prior settled questions, but also seek flexibility with respect to a state’s ability to respond to new dynamics like the hostile merger wave of the 1980s.\textsuperscript{199} Delaware Judges’ Chandler and Strine’s observation that federal corporate governance rules tend to result in the prospect of state law liability suggests that the prospect of unpredictable future federal corporate governance rules may also help to cement Delaware’s advantage in that regard. If an alternative means of creating and administering corporate codes can be developed, it could challenge Delaware, but not if it does so on Delaware’s terms.

One might expect the Macey Miller interest group calculus could be different for cities administering corporate codes, particularly with respect to smaller firms and new start ups who may be less interested in protections from the market for corporate control than managers of larger incumbent firms. Thus the analysis provided in Part IV of this article ties into this analysis. Macey and Miller also observe that Delaware’s small size tends to insulate it from the diverse interest group pressures that operate in larger jurisdictions and which would otherwise

\textsuperscript{196} Id. at 472.
\textsuperscript{197} Id. at 497.
\textsuperscript{198} Id. at 488.
\textsuperscript{199} Id.
minimize the influence of corporate focused constituencies. While Delaware Courts may be of high quality, they do not limit the Macey Miller analysis. Macey and Miller describe the Delaware judiciary’s role in terms of the Landes/Posner model of the independent judiciary as enforcement mechanism for interest group bargains developed in the legislature.

Macey/Miller also posit that underwriters have an interest in preferring Delaware incorporation because Delaware’s jurisprudence on mergers favors the use of underwriters as “fairness opinion” advisors in merger litigation. This might explain in part the relative dearth in LLCs on public exchanges, which underwriters may fear could opt-out of any potential liability for subsequent merger review such that their firms may lose fairness opinion revenue.

Ribstein argued that alternative entities like the LLC can alleviate problems inherent to the corporate code. In light of Macey/Miller’s analysis, however, it is unlikely that Delaware alternative entity law would remain as enabling as it may be currently if a large share of public companies switched to an LLC form will a full fiduciary opt-out.

This is because the very same interest groups that Macey/Miller examine as powerful in design of the corporate code are similarly powerful in design of the LLC code, and so any shift from corporate entity form to LLC form for public firms that substantially decreases litigation revenue for Wilmington firms would be met with strong resistance among the bar. Though their theory was developed prior to the popularity of the LLC alternative, Macey Miller offer a warning that “the bar could also benefit from legal rules that increase the amount of expected legal fees per corporation, even if such rules…reduced the absolute number of firms chartered in the state.”

---

200 Id. at 490.
201 Macey, supra note 204, at 500.
202 Id. at 518.
203 Id. at 504.
The residual “duty of good faith and fair dealing” contained in Delaware’s LLC law which judges will not permit firms to opt out of may provide the doctrinal hook for a future expansion of LLC duties to combat what Delaware’s litigation interest groups fear is a reduction in revenue for public firms resulting from corporate governance arrangements that reduce litigation costs. 204

Roe describes the Congress passage of Sarbanes-Oxley, and the SEC’s exploration of a rule pursuant to its discretionary authority to allow shareholders greater freedom to nominate candidates to the board, as strong federal pre-emption of state corporate governance rules prompted by the Enron scandal. 205 Roe posits that Delaware is uniquely equipped to adopt governance changes narrowly tailored to forestall some forms of federal pre-emption by the SEC. 206 He argues therefore that “There’s much evidence here of a Delaware-Washington strategic positioning that’s parallel, one in which state-to-state competition for chartering revenues plays no role.” 207

The distortive effect Roe identifies is not new, but has been a distorting force on state chartering competition for decades. Roe’s thesis therefore undermines the view of Bebchuk and others that any failings in state competition can be remedied through discrete federal intrusion, but instead suggests that the specter of potential federal intrusion is itself the problem. If Delaware has an advantage over other states in responding to Federal pre-emption, it may further inhibit what would otherwise have been governance competition at the state level.

204 Delaware’s response could come by way of an amendment to its LLC code, which could be limited to public companies in the same way California recognizes a distinction in its code between public and non-public companies, and thereby would serve to maintain Delaware’s position in the formation of non-public LLCs. Or Delaware’s response may come through doctrine creep in the “duty of good faith and fair dealing” which remains for LLCs and which itself is fairly vague and indeterminate.


206 Id. at 30.

207 Id. at 36.
Roe describes federal preemption as sporadic and unanticipated, typically in response to major national crises or scandal.208 This sporadic character to preemption is particularly inhibiting to state level innovation…a purely random preemption discounts the value to innovation across the board.

Roe’s description of how Delaware’s legislature, courts, and political institutions are nimbly able to limit the reach of federal preemption into issues of high import to Delaware,209 suggests that Delaware may have less to fear from the threat of federal preemption than other competitors contemplating new governance innovations.210

Kahan and Kamar argue that states other than Delaware do not try to compete for franchise revenue, and no other state attempts to invest in infrastructure to compete with Delaware because of limits on start-up costs, because large states are not sensitive to the marginal benefits of increasing franchise revenue and because of the internal politics of other states inhibit setting up business courts.211 But even if they are correct to suggest a lack of competition, it may be that removing the specter of federal pre-emption, and its attendant evisceration of new innovations, could be just enough to tip the scales in favor of a dramatically new strong incentive for states, cities, and private parties to enter the chartering race.

This article explores a number of ways in which start up costs to states challenging Delaware will not be a problem, and explores ways in which the issues with the internal politics in Delaware can be limited in other states, and demonstrates how empowerment of cities can bring even larger states into chartering competition. It also explores solutions to the prospect that Delaware will immediately copy new innovations by exploring alternatives which are either

208 118 Harv. L. Rev. 2491, supra note 151, at 2529.
210 Roe also posits that the presence of occasional federal preemption of issues, like those targeted in Sarbanes Oxley or Dodd-Frank, do not directly threaten Delaware’s status as dominant in the state race, and indeed may limit interest group interest in a more macro level preemption of state corporate law. 34 Del. J. CORP. L. 1, supra note 151, at 6.
211 See D1 at 130-131, describing Kahan and Kamar’s work.
not easily replicated or which are likely to face stiff resistance from Delaware’s powerful interest
groups.

**Section H: Preemption of the Martin Act to Forestall Abuse**

Riker noted that the federal government can have an important role to play in facilitating
federalism, in that it can limit the ability of states to refuse to cooperate in a federalist system. 212
During a time of financial scandal, Eliot Spitzer as Attorney General of New York utilized the
New York’s Martin Act, which criminalizes conduct encompassed by the internal affairs
doctrine, to file actions against a number of public companies. 213 Other states responded with
statutes mirroring the powers granted under New York’s Martin Act. Indeed, as a function of the
Martin Act’s broad terms, referring to “any business practice” deemed “deceptive” or
“fraudulent,” it could be read to capture just about anything covered by the internal affairs
doctrine. 214 Greve also notes that state attorney generals can abuse their Authority in a related
form of horizontal federalism as for example in Eliot Spitzer's abuse of the Martin act to Target
out of state firms. 215

Though Spitzer did not intentionally use the Martin Act to obtain an advantage for New
York in the market for chartering competition, he could have done so, and attorney generals in
other states could be expected to consider this tool if the market for chartering becomes
increasingly competitive. 216

---

212 Ribstein & Kobayashi, supra note 117, at 8 (citing Riker).
214 Id. at 960.
215 Greve, supra note 198, at 102.
216 Greve describes a dynamic in which multiple states can export their laws to other states in an exploitative dynamic but Ribstein by contrast determines that in the context of corporate law the internal affairs doctrine has evolved on its own to avoid such a dynamic and operates as an effective bargain between states to respect each other’s laws. Id. There are however frays at the edges of the internal affairs doctrine with respect to the states’ interaction with each other, such as recent cases in California, suggested that federal recognition of the binding nature of forum selection bylaws on foreign courts may be a useful support for corporate federalism. In order to make federal recognition of the internal affairs doctrine truly binding, this subsection demonstrates that federal preemption of the Martin Act may prove a necessary component.
Section I: When The Federal Overlay Is Rolled Back, Innovation Sprouts: The Case of Publicly Traded Master Limited Partnerships

Though the overwhelming majority of publicly traded firms utilize the corporate form, with its mandatory fiduciary duty regime, a small minority of public firms operate as either LLCs or LLPs.217 Most of those are operated as some variation of a type of public firm which was provided some limited relief from exchange listing requirements by the NYSE and NASDAQ.218

There is a substantial amount of heterogeneity in the organization choices made by the firms. All of those LLCs opted out of appraisal rights entirely.219 Some of them held annual meetings, some did not, and some members (shareholders) held voting rights without making financial contributions.220 Some opted out of fiduciary duties completely, some did not, and most had some hybrid formulation of obligations owed by members of the LLC to each other.221

The governance of Publicly traded master limited partnerships provide a small-scale case study in the adaptability and heterogeneity of business organizational form. Master Limited Partnerships 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. Under exchange listing rules, MLPs are not required to have a majority of independent directors, a nominating committee, or a compensation committee.

217 Looking more broadly to the master limited partnerships that continue to operate using a limited partnership form, Goodgame notes that as of 2012 there were 87 energy related MLPs traded on public markets. John Goodgame, New Developments in Master Limited Partnership Governance, 68 BUS. LAW. 81, 83 (2012). While they have traditionally been organized as limited partnerships, more recently some of them have organized as LLCs. Id. at 84. These energy firm MLPs make up the vast majority of publicly traded alternative entities on US exchanges.
218 Gomstian notes that there were 20 publicly traded LLCs, all of which were formed in Delaware, as of September 2013.219 Most of those were energy companies that had previously been Energy Master Limited Partnerships, and a handful of others were private equity funds and hedge funds that obtained most of their capital through private offerings under Regulation D but which created entities to supplement their capital by raising money in the public markets. Id. at 9. The number of members in these 20 LLCs ranged from 2,000 to 98,000. Id.
219 Id. at 12.
220 Id. at 13.
221 Id. at 14.
MLPs and other public companies are otherwise subject to the same set of federal securities laws. Thus with this relatively minor exception from the federal overlay, a wide diversity of governance arrangement has evolved.

Goodgame describes one of the dominant organizational features of the master limited partnership being that contractual provisions providing for the regular allocation of distribution payments to Equity holders acts as an effective substitute for Equity participation in governance. Goodgame notes that some MLPs have Equity holder participation in governance as features, but those MLPs generally do not provide for the same regular distribution mechanisms as MLPs which do not provide for direct participation in the selection of directors.

Goodgame generally describes a great deal of heterogeneity in organizational form, as some MLPs provide for annual elections, some have staggered boards. Some MLPs have poison pills, others do not. Some choose default fiduciary duties, so 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.

Structural heterogeneity in governance tends to adapt to the particular needs of individual firms, as those with more dependable and steady streams of cash flow tend to substitute earnings distribution, and regular fundraising from capital markets, as agency monitoring measures for traditional governance arrangements. One can readily think of other governance arrangements

---

222 Id. at 98.
223 Id.
224 Id. at 88.
225 Id.
226 They further have a governance innovation similar in many ways to the organization board member proposal advanced by Bainbridge and Henderson and referenced above. Bainbridge & Henderson, supra note 111. MLPs are typically controlled by a sponsoring General Partnership, which reserves contractual control of the board of directors for the sponsoring General Partnership by reserving a majority of board seats for individuals selected by the General Partnership.
which could be useful, such as a different appraisal process tailored uniquely to handle the needs of biotech firms which 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. As these public firms were all formed in Delaware, note that even in the publicly traded alternative entity context, there is one clear item that you cannot contract out of, namely the “implied covenant of good faith and fair dealing.”

One then further wonders that if that binding constraint in the Delaware alternative entity code had not been present, and if another state were operating an alternative arbitration based mode of corporate law, what additional adaptive governance modes would have been developed for the Master Limited Partnership and MLP LLC space.

**Part III: Arbitration of Disputes Between Shareholders and Boards, and A Code Adapted For That Purpose to Compete With Delaware**

**Section A: Arbitration is Key to Challenging Delaware**

Bainbridge notes that North Dakota’s recent attempt to compete with Delaware was doomed to fail because it was not actually innovative, but instead merely adopted provisions already allowed by the Delaware code that shareholders and managers had declined to choose for their organizational structures. North Dakota also failed because it sought to compete with Delaware through a litigation-driven code despite Delaware’s clear advantage in providing consistent, predictable business litigation.

Roe notes that one reason states have difficulty competing with Delaware is, in attempting to create the specialty business courts necessary to compete with the Delaware

---

228 Id. at 488.
litigation model, states find that a coalition of local trial lawyers and interest groups push back for fear of lacking competitive advantage in a pro-business forum for local cases.\textsuperscript{230} This may be a challenge unique to replication of the Delaware model, as replicating a new court of equity to compete with Delaware would entail creating a forum that not only adjudicated state corporate code cases, but that also obtained jurisdiction over contract disputes. An arbitration alternative may not bring the same baggage with it from a local interest group perspective and so may be more likely to succeed.

Kahan and Klausner argue that a lack of heterogeneity in firm organizational contracts can be traced to a combination of learning and network externalities.\textsuperscript{231} Even despite the presence of these network effects however, they do not account for how the economics of innovation in corporate law would change if the presence of potential federal pre-emption of new innovations were reduced or if the dominance of Delaware’s state-based forum were sidestepped with an arbitration alternative. Perhaps those paradigm shifts would be enough to promote more innovation in contractual terms. Indeed, the case of Master Limited Partnerships is instructive for the possibilities in innovation when the federal overhang is lifted.

Furthermore, the speed and ease with which investors can obtain information and third party assessments about governance arrangements should shift when crowdfunded shares are traded through app-based platforms, making things like attorney familiarity with corporate codes less important. Kahan and Klausner note that switching costs may prevent firms from changing their governance choices after going public.\textsuperscript{232} Nevertheless innovation at the crowdfunded firm level may support innovation in large public firms, as it could mean that innovative governance

\textsuperscript{230}Lloyd C. Roe, supra note 168, at 78.
\textsuperscript{231}Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting or (“The Economics of Boilerplate”), 83 Va. L. Rev. 713 (1997).
\textsuperscript{232}Id. at 728.
modes developed at a smaller scale, may stick with firms as firms grow and become a part of the large publicly traded landscape.\textsuperscript{233}

Kahan and Klausner argue that underwriters can serve to coordinate innovations in governance and resolve the challenges posed by network effects, as for instance they can commit to subsequently recommend new innovations in future offerings to create network benefits for early adopters.\textsuperscript{234} Exchanges and crowdfunding platforms can provide a similar form of commitment if they participate in advising new issuers, and if they can operate free from pressure by the SEC.

Kobayashi and Ribstein show that the existence of network effects doesn’t necessarily preclude innovation in corporate law.\textsuperscript{235} They challenge Kahan and Klausner’s network externality hypothesis. They define the network hypothesis in this context as that “an example might be large corporations’ long-term use of Delaware law in order to take advantage of judicial and legal expertise and other benefits they expect the Delaware legal “network” to continue to produce.”\textsuperscript{236}

They show that once the federal tax law overlay changed to permit entity competition for firms, then network effects did little to impede the move to LLCs.\textsuperscript{237} In much the same way, removal of the federal overlay will be key to overcoming the Delaware effect in the public company context. Perhaps what’s going on is that network effects for large public companies only matter because the federal overlay is the source of the “lock in.” Without the federal overlay, network externalities don’t matter any more, as they didn’t with the switch to LLCs for

\textsuperscript{233} As a critical mass of smaller firms develops with more innovative governance models, and as they grow to become larger public firms, governance innovations that begin on smaller crowdfunded exchanges could develop some of the network effects of their own that lower switching costs for existing firms and for new entrants to larger exchanges.

\textsuperscript{234} Id. at 739.

\textsuperscript{235} Kobayashi & Ribstein, supra note 83.

\textsuperscript{236} Id. at 84 n.7. Kobayashi and Ribstein not that one recent and unanticipated innovation in organization structure was the series LLC, which allowed great subdivision of assets and liabilities within an umbrella holding structure. Bruce H. Kobayashi & Larry E. Ribstein, Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies, 2011 U. Ill. L. Rev. 91, 105 (2011). This is the type of unanticipated innovation in organizational structure this paper seeks to encourage through elimination of the federal overlay in corporate governance.

\textsuperscript{237} Id. at 84 n.6.
smaller or non-public businesses once tax code constraints were lifted. Kobayashi and Ribstein describe a number of solutions to network externality limitations, including bundling the law of the new entity form with aspects of the old from during the transition. The use of bundling to aid the transition may be more difficult in this context as the old and new products are much more distinct, it is difficult to say how much of the law of Delaware corps will apply in the arbitrated LLC context, for example. They describe a number of other sources of lock-in, including conflicts of interest from interest lawyers who prefer standardization. The large public company context may exhibit this conflict as underwriters who prefer Delaware because they get advisory opinion business later on.

Kobayashi and Ribstein find that competition for out of state LLC formation is chiefly a function of court quality, and that any competition through innovation of organizational arrangements is not a reliable predictor of firm choices of where to organize. This provides powerful evidence that the Delaware effect, or the high preference firms place on Delaware as a choice of forum, out measures all other variables in chartering competition for alternative entities.

This observation supports the argument of this paper that in order to enhance chartering competition, a clear route must be established for alternative dispute resolution mechanisms other than court adjudication based on the Delaware model. While the Delaware effect does not make innovation completely impossible, as for instance in the series LLC innovation which began outside of Delaware, it does suggest that if other states were able to compete on

238 Id. at 89 n.37.
239 But in some limited senses it could work, as for instance class arbitration methods might draw on some, but not all, procedures present in common law class actions to facilitate the new litigation approaches. But generally the basic obligations and duties of directors and officers and the corporate governance structures of new crowdfunding firms may morph so distinctly that bundling would not be particularly useful.
240 Id.
241 Id. at 135.
adjudication forum as well as code flexibility the level of innovation in corporate codes might be substantially increased.

Section B: Delaware’s Mode of Corporate Governance Creation Maximizes Lock-In

Through Indeterminate Code Matched With Predictable Courts

Ehud Kamar argues that the indeterminate character of Delaware’s law helps to maintain its dominant position in the race for corporate chartering, as it makes Delaware’s law incompatible with rivals and therefore limits their ability to tap into Delaware’s established body of precedent as rival states attempt to set up corporate business courts. It further places a much higher premium on the general reputation of the Delaware judiciary as sophisticated in matters of business, as well as on the tradition of the Delaware legislature quickly responding to judicial decisions seen as threatening Delaware’s dominant position in the chartering race. This shows why a corporate code utilizing a non-judicial means of interpretation will be key to invigorate state competition. Kamar describes it as “Indeterminate law enhances Delaware’s competitive advantages-network externalities, judicial advantage, and credible commitment-and thus reinforces its market power.”

Kamar describes the indeterminate character of Delaware’s law as both serving its competitive interest in competing with other states, and as simultaneously serving the interests of its most powerful interest group, the Delaware litigation bar. This suggests that a competing corporate code with a less indeterminate character, such as a clearer code interpreted by

---

242 Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908, 1910 n.4 (1998). Carney and Shepherd describe this indeterminate character to Delaware law as: “relies extensively on broad legal standards that grant courts wide discretion in deciding corporate disputes. Delaware courts are reluctant to provide corporate actors with bright-line rules distinguishing legitimate from illegitimate actions. Instead, their decisions involve loosely defined legal tests whose precise meaning depends on the particular facts of each case. Their meaning is revealed only when they are applied by the court to specific scenarios.” Id. at 1914 n.16. Carney and Shepherd describe the indeterminate character of Delaware’s law as embodied in the inability of a survey of Delaware lawyers to agree on how many independent fiduciary duties directors owe to shareholders, which Delaware lawyers count as anywhere between two and five. William J. Carney & George B. Shepherd, The Mystery of Delaware Law’s Continuing Success, 2009 U. Ill. L. Rev. 1, 14 (2009). Carney and Shepherd also point to the Delaware Court of Chancery’s high reversal rate of 25% as further indicating indeterminacy. Id. at 15.

243 Id. at 1927 n.75.

244 Kamar, supra note 252, at 1940 n.120.
arbitration and supplemented by an advisory guidance procedure, will less likely be replicated by Delaware.

Fisch observes that merely copying Delaware’s code is insufficient to effectively compete with Delaware for out-of-state formations. A state is still unable to bond to future interpretations consistent with Delaware precedent without a specialty business court with Delaware’s long history of precedent and its institutional dynamics supporting a legislature attuned to the needs of shareholders and managers in Delaware’s corporate code.

Fisch observes that one reason Delaware’s predictability is so important is that, unique to the adjudication of business transactions like those considered under internal affairs questions, predictability can often be more important to potential litigants than optimal rules. And yet many argue its not Delaware’s code which is predictable, but instead Delaware’s courts that are predictable. The former is easy for competitors to replicate, the latter is not, and thereby allows Delaware to protect its innovations in corporate law from other states. Fisch observes that most of Delaware’s important legal innovations are a product of judge-made law.

The Delaware Chancery’s Court’s equity jurisdiction can facilitate quick adjudication in certain types of claims. This is not necessarily a net positive however, as with that flexibility comes attendant limits to freedom on contractual drafting, as one can never be certain a Delaware judge will not use equitable authority to override a contractual agreement.

---

246 Id. at 1070.
247 Id. at 1071.
248 Id. at 1074.
249 Id. at 1077.
Fisch observes that Delaware judge’s preview legal changes through dicta. Other work also explores the unique role of Delaware judges in providing guidance both within opinions, and extraneously, to the business community to meet demand for comfort from company general counsels. If that mode of lawmaking is valued, a competing jurisdiction could develop a more explicit method of providing guidance about the future shape of corporate law, such as through some explicit means of providing advisory opinions or guidance.

Relative to an arbitration alternative, Delaware’s method of adjudication is more expensive and lengthy. Fisch also argues that Delaware’s mode of indeterminate code and judicial let development of codes and standards also makes it more responsive to changes in the business landscape. This flexibility may also make Delaware more responsive to changes in the federal corporate governance overlay than competing states, thereby affording Delaware a federally supported advantage over competing states. Chandler and Strine note how Delaware’s interaction with the federal government works in precisely this way.

Romano responds to Kahan and Kamar by noting that other states can compete with Delaware using alternative technologies to Delaware’s mode that relies heavily on a specialized court. This article explores the federal constraints on that alternative means of competition. Thus Delaware may have an interest in ensuring that state competition for public firm charters continues to be primarily a function of court quality, rather than a function of code innovation, and as such Delaware as a player at the federal level may lobby against the reforms suggested in this article.

---

250 Id. at 1079.
252 One way such an innovation could take shape would be through no-action opinions provide by the court that new innovations do not violate the corporate code. The arbitration entity could vote on annual releases synthesizing opinions of the year and providing guidance about the state of the law which could obtain some precedential value.
253 Fisch, supra note 258, at 1083.
254 Id. at 1085.
255 Romano, supra note 122, at 24.
Section C: Does Ribstein’s Uncorporation Thesis Fill the Gap in Demand?

Ribstein describes how “uncorporations” or LLCs, LLPs and other alternative entity forms allow for more flexible private contracting to develop contractual devices that can substitute for what firms might see as flaws in Delaware’s code and adjudication model for the standard corporation.\(^{256}\) Ribstein ascribes some general features to uncorporate firms and others to corporate firms, including a different approach to lock-in of capital and to the free transferability of shares, and argues that different approaches to corporate governance needs in the more adaptive alternative entity space can achieve some of the ends of corporation law without the indeterminate code that Carney and Shepherd ascribe to Delaware corporation law.\(^{257}\)

Ribstein notes however a number of dubious cases in which Delaware courts struggle to implement the legislature’s intent to promote freedom of contract in alternative entity law.\(^{258}\) Ribstein notes that Delaware has recognized the right of LLC’s to force arbitration,\(^{259}\) but any doctrine creep of the duty of good faith and fair dealing or legislative change could risk that right, and in any event it isn’t likely to do much good for public companies until a right to arbitrate federal securities act claims is recognized.

The Delaware Court of Chancery has interpreted the covenant of good faith and fair dealing as requiring the court to examine the “spirit of the agreement” and apply to doctrine on that basis, indicating room for expansion of the doctrine in the future to substantially limit freedom of contract.

Thus though Ribstein may well have been right that problems inherent to the corporation form will be resolved by migration away to alternative entities like LLCs, it is unlikely that will

\(^{256}\) Ribstein, supra note 187, at 133.
\(^{257}\) Id. at 140-45.
\(^{258}\) Id. at 153-65.
\(^{259}\) Id. at 161.
occur within the Delaware LLC form. This structural limit on contractual freedom within the Delaware LLC code will match with the interest group politics within Delaware explored by Macey and Miller to significantly limit innovation within the Delaware LLC code. As we have further seen, the federal overlay doesn’t support a fully adaptive model for publicly traded firms. Much like model codes, federal corporate governance provisions tend to be uniform and do not facilitate adaptive selective by organizers.

Kobayashi and Ribstein argue, for example, that fiduciary duty opt-outs are efficient for many firms because of the specter of Type I errors, in which judges inaccurately deem management decisions to violate fiduciary duties, may exceed any benefits that shareholders obtain through the possibility of fiduciary duty litigation.\textsuperscript{260} Kobayashi and Ribstein argue that as Delaware and Nevada compete for LLC formation, Nevada’s competitive advantage is that it can bond to maintain a bright line, low liability rule, while Delaware’s competitive advantage is its ability to administer a regime with less clear rules but more predictable courts, and therefore Nevada can compete in a space which Delaware may not wish to enter, as doing so would devalue the institutional investments it has made with its current system.\textsuperscript{261}

Kobayashi and Ribstein note that one advantage which allows Nevada to uniquely compete with Delaware is its small population, which generates greater assurance that Nevada will not arbitrarily change its corporate code because it is more dependent on chartering revenues than states with larger populations.\textsuperscript{262} This argument also supports the notion of providing cities with the power to form business entities explored in Part IV of this article. Kobayashi and Ribstein also note that Nevada’s reputation as a gaming center reduces its sensitivity to any

\textsuperscript{261} \textit{Id.} at 1177.
\textsuperscript{262} \textit{Id.} at 1178.
reputational effects that derive from being a lax jurisdiction state. The dynamic between Delaware and Nevada which Kobayashi Ribstein describe could play out even stronger in an arbitration regime, and it could occur over a greater number of participants in the race to charter firms.

Ribstein and Kobayashi remind that a lack of diversity in corporate governance items may not necessarily reflect lack of competition, but instead may suggest demand for uniformity in rules for which uniformity is efficient, such as rules regarding the relationship with the organization and third parties such as the law of veil piercing. Thus it would be a mistake to suggest that any instance of uniformity in corporate governance is necessarily value reducing. But given the first part of this article’s consideration of likely demanded heterogeneity, and the second part of this article’s exploration of federal constraints on adaptability, there is reason to be believe that a substantial amount of uniformity for publicly traded firm governance is artificial, and crowdfunding offers an initial opportunity to test that hypothesis.

The new era of chartering competition may elevate the public LLC to eclipse the corporate form for public firms according to the Ribstein Uncorporation thesis. Alternatively, it may substantially hybridize our existing understanding of the boundaries between corporations, LLCs, and other entity forms. In any event, no matter where the innovation happens, whether in some new type of business entity or by way of modifications of the LLC code, it is not likely to happen in Delaware and therefore won’t happen until network effects inherent in the Delaware

---

263 Id.
264 Kobayashi and Ribstein note that legal system quality is a key factor in choice of entity formation for LLCs favoring Delaware. Kobayashi & Ribstein, supra note 250, at 94. Kobayashi and Ribstein note there may be reasons why smaller firms will be less interested in tailoring unique organizational forms because they are less likely to be involved in litigation. Id. at 97. However the decrease in search costs for organizational tailoring associated with app-based governance may result in renewed tailoring of organizational form for smaller firms. Furthermore intermediaries and gatekeepers to small firm exchanges may have an interest in facilitating organizational tailoring for smaller firms particularly if they have a role in designing that organization form and or in managing the arbitration forum. They note that local lawyers may use their participating in drafting organizational statutes to develop reputations that can help them obtain clients as the compete with other lawyers in-state. Id. at 98. If the mode of innovation in corporate law assumes an open-source character, in which local attorneys can take credit for particular adaptations of the corporate code, then they can even establish national reputations as organizational lawyers in competition for clients on a much larger scale.
265 Id. at 100.
code, and magnified by the federal overlay, are alleviated through an arbitration-based business entity code framework is possible.

Section D: The Federal Government and Delaware Both Discourage Arbitration For Public Company Shareholders

Note that, although Delaware has innovated in arbitration provisions for contracts, conducted by Delaware judges, the current Delaware statute prohibits use for corporations, and effectively does so for publicly traded LLCs as it requires all parties bound by arbitration to actually sign the LLC agreement. This section will explore how Delaware discourages arbitration, but first it should be noted that until the SEC permits arbitration for federal securities claims by shareholders, arbitration of state corporate law claims will likely be useless. This is because of the ever increasing overlap between securities actions under the federal laws and state law corporate governance claims. Even if Delaware’s code explicitly permitted arbitration of state corporate governance claims, we should expect that nearly all those claims would find a new home as they morph into 34 Act claims.

Thompson and Sale describe private rights of action under the 34 act as being interpreted by federal courts in such a way that they could “annex” corporate governance; this observation is not withstanding the internal affairs doctrine itself. Thompson and Sale describe state corporate governance as essentially relegated to the contacts of corporate acquisitions and self-dealing transactions and observe that otherwise the fundamental regulation of company behavior

---


has been preempted by the federal government by way of private shareholder litigation under Rule 10b-5.268

Thompson and sales describe most private litigation under the 34 Act is brought upon a price earnings misstated by a public company and combine elements of a loyalty claim and a care claims and might have been made pursuant to state law.269 Thompson and Sale note that securities fraud claims often charge that misstatements are made for the purposes of benefiting insiders which clearly overlap with state duty of care claims.270

The mechanisms of state and federal shareholder claims are also quite similar, with typical use of a class action mechanisms largely driven by attorneys.271 This analysis suggests that any attempt to arbitrate shareholder claims at the state level will be largely ineffectual without a concomitant recognition of the shareholder’s right to arbitrate federal securities claims as well, as any arbitration of the former may simply result in the migration of shareholder claims to the latter. If, on the other hand, firms and shareholders choose to maintain shareholder litigation in a judicial forum, but select arbitration of federal securities claims, the extent of federal pre-emption of state internal affairs through private litigation under the 34 Act may be reduced.

Kobayshi and Ribstein note that “mass production and sale of litigation or arbitration kits, perhaps supplemented by low-cost assistance as to how to use the kits, might allay these concerns by better enabling consumers to arbitrate individual claims. This would provide a compromise between the duplication of effort involved in thousands of individual claims and the

268 Id. at 861. Thompson and Sale argue that SEC rulemakings under Item 303 of regulation SK functionally displace the state law duty of care, and that a requirement in Sarbanes-Oxley that CEOs must certify financial statements pre-empt part of the state law duty of care, and they list a number of further functional items which preempt state corporation law in the Sarbanes-Oxley act Id. at 873. Thomson and sale no federal restrictions under Sarbanes-Oxley limiting the ability of firms to provide loans executives effectively replace a piece of the duty of loyalty Id. at 877.
269 Id. at 889.
270 Id. at 901.
271 Thompson & Sale, supra note 281, at 904.
agency costs inherent in class actions. This idea becomes even more helpful, and cheaper, in the context of app-based governance. It is unlikely however that Delaware will ever permit shareholders in public companies to fully arbitrate all claims against companies and their directors outside of the Delaware Court system. The Macey/Miller interest group analysis described elsewhere in this article presents a powerful argument for why the interest groups represented in the Delaware bar would quickly press a solution in the legislature to any effort to diminish the rents they obtain in the system.

Recent events provide a concrete example of the Macey/Miller Delaware interest group theory. In response to a Delaware Supreme Court opinion finding that companies had the right to adopt bylaws imposing the English fee-shifting rule on plaintiff shareholders who failed to win on any claims, the Delaware legislature quickly responded with an amendment to the Delaware General Corporation Law prohibiting fee shifting bylaws for any “internal corporate claim,” which is to say any claim brought pursuant to Delaware corporate law. This result was clearly motivated by a fear that plaintiff’s would migrate out of Delaware and bring claims in other jurisdictions less likely to enforce the fee shifting bylaw, or otherwise bring fewer claims. In recent work Bainbridge, who has often defended the Delaware courts and code, cites this incident as Delaware’s “self-inflicted wound.”

Allen argues that from a purely doctrinal standpoint, there is no reason Delaware law shouldn’t be willing to accommodate mandatory arbitration for corporate claims. She cites American Express Co. v. Italian Colors Restaurant, finding that the Federal Arbitration Act authorizes mandatory arbitration provisions in commercial contracts that prevent class actions,

---

and Boilermakers Local 154 Retirement Fund v. Chevron Corp., in which the Delaware Court of Chancery upheld a board bylaw requiring that Delaware corporate claims be litigated exclusively in Delaware courts, as demonstrating sufficient doctrinal basis for Delaware courts of uphold mandatory arbitration provisions for corporate claims arising under Delaware law. After that litigation, the Delaware Supreme Court upheld the validity of a board bylaw imposing the English fee shifting, loser pays rule on shareholder plaintiffs bringing corporate litigation.

As previously mentioned, the Delaware legislature quickly responded by invalidating board action imposing fee shifting, but accepting the validity of forum selection bylaws. The Delaware legislature’s rapid overturning of a holding which threatened the litigation bar’s rents suggests one should not rely on Delaware doctrine alone in this analysis, but instead should keep a keen eye on the interest group calculus of the Delaware bar.

Even if Delaware law were to expressly recognize a company’s right to adopt arbitration, Delaware courts may still review the decision to adopt an arbitration provision or the decision to exercise it. The unique equity jurisdiction of the Delaware courts has in common with the Hotel California that one can “check out any time you like, but you can never leave.” For instance, in Schnell v. Chris Craft Industries the Delaware Court of Chancery held that “inequitable action does not become permissible simply because it is legally possible.”

---

276 Id. at 753.
277 Id. at 765.
278 Allen argues that if Delaware law found that firms were not permitted under Delaware law to adopt mandatory arbitration, the Federal Arbitration Act would preempt Delaware law. Id. at 771. That presumes, however, that a court wouldn’t find that the internal affairs doctrine requires a reading of the FAA that, since Congress did not directly express an intent to preempt state law, the matter should be left to the states. And in any event, this article argues in another part that arbitration is not likely to take off until roadblocks to mandatory arbitration at the SEC are lifted, and until the legislative recommendations described in this article are passed into law (which includes a strong codification of the internal affairs doctrine.)
279 Schnell v. Chris-Craft Indus., Inc., 285 A.2d 437, 438-40 (Del. 1971). While Delaware’s alternative entity statutes permit arbitration, Delaware law still maintains the contractual duty of good faith and fair dealing requirement that presents a risk you cannot fully contract away. Allen, supra note 291, at 772. And in any event, it is unlikely the interest groups in Delaware would ever permit a full arbitration regime to replace fiduciary litigation for large public companies in Delaware courts.
Allen notes the general assumption that arbitration must of necessity obviate class action procedures.\textsuperscript{280} This would represent a substantial change to the process of corporate adjudication, as a significant percentage of both direct and derivative claims are brought as class actions. If that is what shareholders and firms value, it may be utilized. If however many, particularly large institutional shareholders, were reluctant to give up a class based approach, then some hybrid form of class arbitration could be developed. But a new hybrid class arbitration procedure could be designed to accommodate some of the procedures used to certify and prosecute class actions, but in a much faster, more predictable way than that seen in the Delaware courts in a less indeterminate manner. The first bylaw proposed for a company listed with the SEC which sought arbitration in 1992, which was denied, provided for a form of class arbitration.\textsuperscript{281} Allen notes how Delaware courts attempted to provide for arbitration by Delaware judges in that spirit for private contracts (an arbitration procedure that would expressly not apply to disputes in corporations or for publicly held alternative entities).\textsuperscript{282}

Though that innovation was subsequently challenged as violating open government rules, it may be the case that Delaware would respond to a renewed federalism race in which it was losing substantial market share with some kind of arbitration forum, likely composed of Delaware judges. While such an innovation may present useful choices for new firms, it would likely always be constrained by the gravitational forces of Delaware’s interest group politics and would therefore likely lose a renewed entity formation race.

The SEC staff strongly disfavors arbitration for private claims under the securities laws, despite the fact that they should be perfectly legal.\textsuperscript{283} When previous large corporate IPOs have

\begin{footnotes}
\item[280] Id. at 754.
\item[281] Id. at 803.
\item[282] Id. at 772.
\item[283] This is a rather incredible position, since private rights of action were never actually intended by the drafters of the 34 Act, but were instead created by courts decades later. Chief Justice Rehnquist described the private right of action under the 34 Act as a "judicial oak" grown from a
\end{footnotes}
included in their organizational documents a provision requiring mandatory arbitration of all shareholder claims, the SEC staff have refused to accelerate the registration statements of those companies on the grounds that a provision in the Securities Exchange Act of 1934, which forbids waivers of provisions contained in the 34 Act, forbids mandatory arbitration. SEC Staff has similarly disallowed shareholder proposals for mandatory arbitration on the same basis.

Therefore we see that in order for arbitration to work, it must be expressly permitted, and roadblocks to it abolished, at both the state and federal level simultaneously. Therefore we see that at least in this sense federal pre-emption actually supports Delaware’s dominance of the state entity formation race and inhibits state challengers who might develop an entirely new mode of corporate governance with a host of possible governance innovations.

Section E: Arbitration Will Require A Novel Code Design, and (Initially) An Advisory Opinion Mechanism

Kobayashi/Ribstein note a tradeoff in that lawmaking by arbitration reduces incentives to produce law, and thereby inhibits positive externalities to non-litigants. If the arbitration body and the producer of the corporate code are the same entity, then it may internalize that effect and

“legislative acorn.” Thus one reason why arbitration will be vital to reinvigorating charter competition is that private 34 Act litigation will continue to creep into issue covered by the internal affairs doctrine, and indeed if state law claims become subject to an arbitration process, and are coupled with codes that reduce the range of litigation permitted, migration of otherwise state law claims to federal 34 Act claims would rapidly increase. Note that for crowdfunded firms on a federal platform, an express right to sue is defined in statute and linked to 12(a)(2) damages for securities offerings. See Securities Act of 1933 §12(a)(2). Thus a crowdfund issuer could still opt-out of 34 Act liability, and state crowdfunding platforms should be able to opt-out of 34 Act liability if the SEC were properly applying the law, and possibly also completely opt-out of securities liability.

Another way in which a more streamlined arbitration process is likely to be helpful is in the process whereby the value of minority shareholders’ interest is appraised. This could take place when an entity is dissolved or when a freezeout merger is accomplished and a controlling shareholder with a minimum percentage of ownership “freezes out” by statutory right the remaining holdout shareholders. Delaware’s own Chief Justice Strine bemoans the state of Delaware’s appraisal process: “The concept of fair value under Delaware law is not equivalent to the economic concept of fair market value…[include rest of quote from Delaware case]” Carney & Shepherd, supra note 255, at 28. Carney and Shepherd identify four Delaware merger fairness and appraisal actions that took on average took 8.7 years to resolve. Id. at 45. Carney and Shepherd note that what could otherwise be a simple process of appraising company value has been made unnecessarily difficult by Delaware’s indeterminate approach to company evaluation, which utilizes, rather than a market based measure, a judicial fairness opinion when is guided by nebulous concept of a fair pro-rata apportionment of the pre-merger value for the shareholders. Id. at 25.
thereby have incentives itself to create law through opinions that deal with unanticipated situations…as for example in the form of advisory opinions.\textsuperscript{287}

Innovations in the use of concrete advisory opinions will likely also form a part of a new code. Delaware judge’s dance with this approach through use of dicta and extensive speeches and articles to telegraph expected changes in the law. And indeed they permit other federal courts and the SEC to request what is effectively an advisory opinion from the Delaware Supreme Court. A more direct means of advisory opinion mechanism could offer a clearer picture for business entity formers by way of advisory opinions…as perhaps the arbitrators collectively vote on annual interpretations of the corporate code that have precedential value or otherwise respond to requests for clarification.

In order to compete with Delaware’s initial advantage in its extensive precedential authority, providing determinate corporate codes might require an advisory based means of interpretation to supplement case law precedent, particular in the early years of a new competitor jurisdiction with a new non-judicial forum just getting off the ground. Indeed, Kamar contrasts no-action letters by the SEC, issued in response to requests for guidance from private parties, at the federal level that minimize indeterminacy in the securities laws.\textsuperscript{288}

Allen notes that arbitration provisions can include substantial flexibility in design by contract, incorporating modified versions of nearly any concept seen in common law litigation, including a process for the creation of case law.\textsuperscript{289} Black notes that among the benefits of arbitration over litigation are “faster and less expensive proceedings” “decreased risk of

\textsuperscript{287} One other way in which a different corporate code could be uniquely different from Delaware would be a different means to sift through derivative cases (assuming derivative actions are a concept used in the new code) such that some outside panel of experts in the field, like VC or techies, determine whether a funded business was a good faith venture or in fact a fraudulent sham enterprise, in much the same med mal cases in many states use a panel of MDs to sift through cases before they go to trial.

\textsuperscript{288} Kamar, \textit{supra} note 252, at 1922 n.56.

\textsuperscript{289} Allen, \textit{supra} note 291, at 796, 98, 800.
aberrational jury verdicts” “more accurate outcomes because of arbitrator expertise or the application of trade rules, and “better protection of confidential information.”

She also notes that one typically referenced drawback is limitations on appeals, though FINRA’s process for arbitration appeals to an appeals board is a notable exception.

Section F: Blending the Economics of Crowdfunding Firms with A New Corporate Law System Free of the Federal Overlay

Some crowdfunded firms currently operating on kickstarter mix profit motives with non-profit social objectives. Many states, including the Delaware corporate code, recognize some form of public benefit corporation that merges for profit and non-profit goals. The federal overlay becomes quite awkward if one of these chose to issue public shares in these types of entities.

This article further explores how crowdfunded firms are likely to require a level of flexibility that has thus far been impossible in state charter competition under the federal overlay, particularly the overlay of private litigation pursuant to the 34 Act. Until crowdfunding goes online, the prospect of non-profit business entities being "publicly traded" and the unique issues posed by publicly traded firms of this nature has not been faced. The federal overlay represented by SEC rules promulgated under the auspices of the 34 Act, with its investor profit focus, will significantly limit freedom of innovation in corporate governance for these types of entity forms,
and thereby upend the typical interest group politics of federal pre-emption in corporate governance in the area of what this article will explore as “publicly traded non-profits” or “publicly traded charities.”

Agrawal notes that philanthropic entities are increasingly asking for defined benchmarks of success from grantees.294 It could be that review of activity by a board or by an external reviewing entity such as an arbitration body or the crowdfunding platform itself could simply involve verification that the entity has achieved its benchmark. It may be the case that shareholders could commit themselves to subsequent rounds of funding in advance, premised on the entity’s meeting a series of benchmarks.

For some types of crowdfunded firms, the market for corporate control could prove useful, but for others in which the leadership of the entity has some firm specific attribute the market for corporate control could be unworkable. Shareholder preferences may significantly discount high residual agency losses resulting from these organizational forms. For example, an investor preference may reflect high utility in the ability to say one is a shareholder in their favorite band. A potential investor could exhibit a strong investor preference in the ability to share in any profits through the development of a drug targeting a very small population of patients but nevertheless be willing to see the investment as a donation if development costs dissipate all profits.

Part III has demonstrated that arbitration will be an essential component of a reinvigorated corporate federalism. Even if many firms do not necessarily select an arbitration-based alternative, successfully challenging Delaware’s dominance may require development of at least one successful arbitration based alternative regime. That will require federal recognition of arbitration rights for firms and their shareholders.

294 Agrawal, supra note 13, at 6.
Part I of this article demonstrated that crowdfunding opens up an event window for recharging corporate federalism and entity formation competition, and also demonstrated how crowdfunded firms will have unique and heterogeneous needs outside the range of what is presently available. Part II demonstrated that how and why the federal overlay restricts that available range of innovation. Part III demonstrated that an arbitration-based means of adjudication and a corporate code designed to be arbitrated will be a key component to challenging Delaware’s network effects. The final part of this article with develop some predictive analysis for the various means by which these new innovations might evolve…first over the crowdfunding platform, and then possibly spilling over into renewed innovation for larger public firms.

Part IV: Interstate Crowd funding Compacts and City-Based Incorporation

Parts I-III of this article provides suggestions for opening the door to renewed corporate federalism. Once that door has been opened, Part IV of this article provides analysis to predict exactly how that competitive world might look as one walks through the imaginary door into a bold new world of reinvigorated corporate federalism. First, regional interstate compacts to establish state based crowdfunding platforms are likely to be exempted by the SEC from most SEC crowdfunding rules, which opens up an opportunity for renewed federalism if designed the right way and heeding warnings about interstate compacts gone awry developed by Greve. This article further notes that such interstate compacts could be used to partially protect IP rights in corporate governance innovation by means of enforcing agreement within the compact, which could thereby promote the participation of private firms in corporate governance innovation and
limit a challenge to private law development in this context recognized by Kobayashi and Ribstein.

Second, Part IV argues there is no reason why cities couldn’t serve a useful role in the creation of corporate governance innovations, if they are empowered by their states to do so and if they use an arbitration forum. Third, Part IV explores how states could also provide a sort of visa to international firms seeking to raise capital in the US using their own corporate law, in a more expanded version of the ADR share hybrids that currently trade in the United States.

Section A: Crowdfunding Compacts

It is likely that when the SEC adopts its final crowdfunding rule, it will recognize that multi-state, regional crowdfunding platforms created by interstate compacts between states are covered by an intrastate offering exemption from the federal securities laws. It is as yet unclear what that exemption will look like.

This opens up an opportunity for state based federalism, but only if carefully done. There is precedent for interstate compacts in financial services. The origins of interstate banking took place by way of interstate compacts in which states recognized each other’s regulation of banks and allowed banks from states within the compact to operate within their borders.295

There are roughly 200 interstate compacts currently in effect.296 Interstate compacts can in some cases be treated as binding obligations on states entering into the compact, and limit the ability of future legislatures to unwind those obligations.297 Interstate compacts codified by Congress obtain the highest deference, and the Supreme Court has determined that Congress may

295 Christine E. Blair & Rose M. Kushmeider, Challenges to the Dual Banking System: The Funding of Bank Supervision, 18 FDIC BANKING REV. 1, 3 (2006).
consent through legislation to an interstate compact in advance of its being ratified by the states.298

This suggests an interstate compact could be included in corporate federalism legislation. One feature of the legislation could be that the terms under which states could exclude firms incorporated in states not a part of the compact from exchanges created pursuant to the compact could be clearly defined to ensure that the exclusion is of the property rights variety explored by Mahoney and not the cartelization form feared by Greve.

Interstate compacts also typically involve the create of separate entities to manage items in the compact for which the states share costs,299 which could easily be utilized to create a joint arbitration forum for the various states corporate codes and which could also provide a means for which states within the compact to agree to protect each other’s intellectual property in the creation of corporate governance innovations. For example, the Great Lakes compact provides for alternative dispute resolution of items contained within the compact.300

Hadfield and Talley argue that involvement by private parties in the creation of business entities would result in more heterogeneous corporate codes better able to fit the particular needs of entities.301 One of the greatest constraints to efficient private production of law could be partially resolved through interstate compacts. Kobayashi Ribstein describe the basic logic of intellectual property protection as “rights provide incentives for producing and disclosing information by enabling the inventor or author to appropriate returns for her creation or

298 Id. at 13.
299 Id. at 23.
300 Jessica A. Bielecki, Managing Resources With Interstate Compacts: A Perspective from the Great Lakes, 14 BUFF. ENVTAL. L.J. 173, 209 (2007).
information”302 and “granting creators intellectual property rights in this material can both encourage its creation and limit its usefulness by restricting dissemination.”303

Kobayashi/Ribstein argue that corporate governance innovations, like the poison pill antitakeover device, might be considered patentable.304 But they argue that it is nevertheless unlikely to actually happen. They offer that restrictive licenses to some parties can “balance the use-creation tradeoff” in that “jurisdictions that adopt privately produced and copyrighted model codes could alleviate due process concerns by authorizing use by citizens bound by the law while preventing reproduction for other purposes.”305 But that does not, however, indicate that IP protection for corporate governance arrangements is nevertheless a net cost to social welfare, and must be balanced against the inducements it provides to innovation.306

Kobayashi and Ribstein note two methods to minimize transition costs to an IP protection regime for corporate governance innovation could include application to competing suppliers of corporate law while providing a broad fair use license to the public and preventing IP protection for corporate governance methods currently in use.307 Interstate compacts could include provisions implementing their suggestions and apply by contract to the states entering into the compact. An interstate company agency, with authority to resolve corporate governance IP disputes between states, and perhaps with authority to provide advisory opinions to individual firms incorporated by states in the compact, might be able to resolve impediments to private property rights in corporate law innovation.

302 Kobayashi & Ribstein, supra note 288, at 1175.
303 Id. at 1176.
304 Id. at 1181. The bundle of corporate governance provisions could also be so firm specific as to become excludable, in so far as at that point you’re really selling the talent of the incorporator (such as an exchange.)
305 Id. at 1179. They note that “the existence of some innovation does not prove that patents are unnecessary. Even if inventors and authors can capture some return on their investments through contracts, technology, and secrecy even without statutory intellectual property rights protection, providing this protection may still increase valuable inventions and, therefore, social welfare.”
307 Id. at 1190.
If production by private sources is considered, as in exchanges or crowd fund platforms assisting firms in designing their corporate governance, Kobayashi and Ribstein note that one constraint could be the unauthorized practice of law rules from the local bar.\textsuperscript{308} Whether that problem is prohibitive will depend on the underlying dynamics of the local bar, and whether the state in question has an active corporate law bar that sees the private entity provider as competitive. The arrangement could alternatively involve each exchange or platform partnering with a specific law firm or group of firms. One method Kobayashi/Ribstein suggest to facilitate private entity creation of governance structures, but still involve the state apparatus in creation of the corporate entity, is to allow the private entity to license innovations to the state, and have the state franchise fee pass the licensing fee through to the incorporating firm.\textsuperscript{309}

They suggest that if a method for intellectual property protection could be instituted, private entities might be expected to produce vastly more innovation that state actors are incentivized to provide.\textsuperscript{310} It is hard to say whether interstate compacts, in which some states band together to respect each other’s intellectual property in corporate governance through contract, and in which they prevent firms incorporated in states not bound by the same IP protections from trading on exchanges formed in states in the compact, will be sufficient to reach an optimum level of innovation in corporate governance. But at a minimum it should be expected to significantly increase incentives to innovate.

Section B: Challenges With Interstate Compacts: Passing the Greve Test

Greve warns about four pathologies in interstate compacts that can pose institutional risks that compromise values of efficiency and federalism. He notes that if poorly constructed they

\[\textsuperscript{308} \text{Ribstein, supra note 288, at 1192.}\]
\[\textsuperscript{310} \text{Kobayashi & Ribstein, supra note 288, at 1205.}\]
can infringe on the federal government’s interest in minimizing interstate aggression, impose third party externalities on other states, create cartels that restrict competition between the states, and transfer state authority to unaccountable and opaque agencies created by the compact.311

To the first point, elimination of the federal government’s role in corporate governance is an explicit goal of this approach, and is supported by extensive economic theory and empirical evidence (and to the extent there is contrary evidence about lack of competitiveness at the state level, this article suggests that federal regulation is the root cause).

To the second and third warnings, this article suggests that federal legislation should define the general contours of the compact such that the compact is not designed to inhibit competition in state chartering. Instead the compact should limit any restrictive provisions in the compact to those designed solely to protect the intellectual property in corporate governance innovations of states included in the compact as well as any private parties licensed by states in the compact to create business entities. I also suggest a general clause in the legislation that demonstrates the intent to give maximum support to the internal affairs doctrine and the promotion of interstate competition in business entity formation.

To Greve’s fourth warning, it may be that certain disputes adjudicated by the arbitration body created pursuant to the interstate compact would be confidential, and therefore may seem to implicate Greve’s accountability and transparency concerns about interstate compact agencies. But the accountability and transparency problems is not as cogent where the body created through the compact arbitrates disputes between states that are members of the compact, entities licensed by those states to create companies, and shareholders and officers and directors of those companies. All of those parties would have freely agreed to be bound by decisions of the compact agency by way of private contract. Greve also notes that congressional approval of

interstate compacts may alleviate some of his concerns about those entities, and this article recommends that in this context.\textsuperscript{312}

Crowdfund exchanges, particularly those developed at the state law and exempt from SEC regulation, may more readily develop rules according to the private incentives explored by Mahoney instead of as public choice agents of the SEC. Mahoney’s thesis is that exchange rules that might resemble cartelization are actually merely restrictive rules protecting the information property rights of the exchange.\textsuperscript{313} In the context of state crowdfunding exchanges created through interstate compact, Mahoney’s argument suggests caution in evaluating Greve’s warning that interstate compacts can become tools to perpetuate cartelization. In other words, what may appear as a cartelization device may simply be a restrictive rule substituting for a lack of property rights in intellectual capital created by the exchange to encourage investment by the exchange in a common good.

One way to design this could be recognition in a state cartel that states may limit the participation of member firms to those incorporated in jurisdictions that join a contractual arrangement protecting the intellectual property in corporate governance innovations created by states, cities, or exchanges facilitating the formation of business entities within the compact.

\textbf{Section C: City-Based Incorporation Could Offer Agglomeration Benefits and Minimize Interest Group Problems}

While this article explores the possibility of private firms as incorporators, including crowdfunding platform operators, it may be the case that the only class of participants which can survive in the market for chartering of firms are governments, because only governments can

\textsuperscript{312} Id. at 331.
\textsuperscript{313} Mahoney, supra note 86, at 1485.
provide the level of permanence which firm contractual counterparties need to fulfill their objectives.\textsuperscript{314}

While cities would face high start up costs, those are not necessarily insurmountable. Cities can establish reputation bonds the same way Delaware did. They can create an arbitration forum, with perhaps long term contracts with high profile arbitrators or industry professionals. A state implementing legislation can establish that if a city subsequently adopts retroactive changes to its code that destroy value for entities it has created, that would constitute a taking and the city would be liable for any damages to each corporation it has created.

The Tiebout model that underlies the theory of corporate federalism includes an assumption that the number of jurisdictions competing is large.\textsuperscript{315} The more entities are added to the entity formation race the better. But increasing the number of competitors can’t, by itself, justify a significant deployment of resources toward city-based business entity formation. It helps, but this article suggests that specialization benefits unique to cities, large state interest group politics to which cities in large states are immune, and smaller city responsiveness to changes in franchise tax revenue all combine to suggest that generally speaking cities could serve as far more effective “laboratories of corporate governance” than states.\textsuperscript{316} Traditional

\textsuperscript{314} Hadfield & Talley, supra note 320, at 439. A business entity could see its separate existence end if it became insolvent, but even a city going through bankruptcy still has indefinite life (or, essentially, the same lifespan as the state which created it). But if your formation entity goes bankrupt, does that mean the firm itself loses its separate existence? Even to the extent that private firms participate in the business entity formation business, it will likely in some way or another involve government participation. Hadfield and Talley note that one of the unique features about competition in chartering is that legislators will not merely seek to maximize franchise taxes, because they will only be interested in maximizing franchise revenues to the extent that they are able to translate increases in franchise revenues into private benefits. \textit{Id.} at 418. Hadfield and Talley note that the state must be involved in the creation of corporations in a practical sense because some aspects of corporate law, like corporate personhood and limited liability, affect third parties outside of the contract between shareholders and boards in a way that cannot be achieve through fully private contract. \textit{Id.} But even if that is the case, one wonders whether cities could also compete in the entity formation space. Particularly in a state that does not yet have a well-developed code and active corporate bar (See Macey/Miller interest group analysis), cities may be able to serve this function as well.

\textsuperscript{315} Ribstein & Kobayashi, supra note 117, at 3.

\textsuperscript{316} Aspects of the corporate federalism debate suggest that the smaller a jurisdiction creates corporations, the better. This suggests a potential role for cities in the incorporation game. Numerous commenters, including Romano, identify part of the reason for Delaware’s success in the corporate chartering market as its relatively small size, which makes it more responsive to chartering fees (and thereby “bonded” to future performance) and which limits the presence of a larger set of non-corporate interest groups (meaning not boards, not shareholders, not corporate lawyers) which could otherwise press for changes in the corporate code that limit the benefits of the code to potential firms. Hadfield and Talley note that even to the extent a government entity is interested in maximizing chartering revenues, the larger the jurisdiction’s size the more costly it will be for the government legislators to disseminate information to the voters about their success. Hadfield & Talley, supra note 320, at 425.
federalism arguments also suggest that cities might have a comparative advantage over some states in creating corporate law. Hayek argued that the closer a government is to its constituents, the more it will have particular knowledge about the needs of the locality. 317

Schleicher318 compares the traditional Tiebout sorting model of government competition with the alternative agglomeration economics model to suggest an inherent give and take between city competition designed to sort preferences and the ability of cities to generate positive spillovers or externalities through agglomeration. The agglomeration model suggests that personal contact is one element of agglomeration that helps produce information externalities.

Schleicher’s model of city economics is one in which the Tiebout principle of municipalities competing for residents and being disciplined by the threat of exit by current residents is inversely related to the ability of residents to obtain “nearness” benefits of agglomeration by being near each other and thereby producing positive externalities the make the sum value of the city greater than its parts. 319 Schleicher notes that “the existence of agglomeration gains reduces the degree to which people sort between local governments on the basis of their policy preferences.” 320

Schleicher’s model of city governance describes the extent of state delegation to cities as designed to provide optimal balance between sorting and agglomeration. If that view is correct, there is no reason to suggest states would be constrained from delegating business entity

This suggests another advantage to city-based incorporation in that it increases the responsiveness of city leaders to maximization of chartering revenues.

317 Id. at 5 (citing Hayek).
319 Id. at 1511
320 Id. at 1535. The unique nature of corporate chartering competition, if centered at the city level, suggests a possible exception to Schleicher’s theory. The technical knowledge necessary to create a corporate code unique to the needs of firms in a particular city is an information spillover of the variety Schleicher identifies, and yet chartering competition can make use of Tiebout exit competition to offer a sorting benefit to this particular city legal product without inhibiting the agglomeration spillover that is disciplined by the Tiebout sorting. If cities could compete for charters, particularly if the form of competition is of local lawyers competing to keep local firms chartered in the city, and individuals don’t have to exit a city in order for city charters to exit a city, they you can have your cake and eat it too with respect to sorting and agglomeration under the Schleicher analysis.
formation to cities. The interest politics supporting that drafting project would likely be more helpful than the interest group politics of a CA, MA, or VA state-wide drafting project. Those unique needs could also include an arbitration process in which biotech entrepreneurs with reputations for integrity in the startup community could serve as arbitrators in determining the good faith decisions of firms, rather than judges without industry expertise. Or it could include some other mechanism that this author cannot as yet conceive, and that would only be invented a result of the information spillovers taking place in local jurisdictions, particularly those that have a high level of industry specialization. Or it could be the case that city-specific agglomerative benefits in producing corporate codes and corporate dispute adjudication mechanisms have nothing to do with industry specialization, but instead are a function of diversity within the city.

Schleicher cites evidence for both specialization benefits and diversity benefits in city agglomeration when he notes that “new patents cite other patents developed in the same metropolitan area at a far higher rate than other patents, both inside an industry and across industries.”

Schelicher describes that the Tiebout model breaks down as cities obtain power to impose costs on external parties. In this area, the internal affairs doctrine serves as a constraint on city abuse, and the state statute providing city authority to incorporate entities could include a provision setting clear boundaries for city competition with other jurisdictions that recognizes the continued import of the internal affairs doctrine.

States and cities could also collaborate to help a city compete, if that city had sufficient ability to persuade the legislature or if other groups were not sufficiently interested in the city’s

---

321 Imagine, for example, lawyers at mid sized, regional law firms in Palo Alto, CA, Cambridge, MA, or Fairfax, VA working to draft a corporate entity code unique to the needs of biotech or tech startups not readily catered to by existing corporate codes or LLC enabling codes. Those particular needs could include an appraisal process for corporate firms that did not rely on a DCF methodology for appraising share value (biotechs can go without positive cash flow for the first ten years of intensive R&D).

322 Schleicher, supra 338, at 1527.

323 Id. at 1528.

324 Id. at 1548.
participation. State bar laws could be amended to make it easier for non-lawyers to participate in entity formation and advise potential entities, or make it easier for attorney formers to obtain an equity interest in the firms they advise (or otherwise alleviate some other professional constraint that could assist the local bar in obtaining an advantage in entity formation.)

States could facilitate bonding to a commitment to maintain the permanence of city corporate codes, which new entity formers could fear would be later upended by rapid shifts in city politics, by way of recognition in state law or state constitutions of a statutory takings claim for any firm that loses value because some enabling provision in their incorporation documents is later withdrawn by a city (say if the politics of the city shifts).

This article does not suggest city-based corporate codes as an alternative to the state-based model, but instead as a potential source of additional participants in the chartering race, particular for cities in states that are already not actively competing in the race for chartering.

For firms at the smallest scale, they may have incentives to want to have one lawyer handle both their business entity formation work and other contracts. The creation of a business friendly corporate code could be an investment a city could make to signal it’s commitment to being responsive to encourage firms to come to the jurisdiction.

This article does not suggest that all cities will have an incentive to enter the race for chartering competition, or that many cities will do so. But the entry of one or two cities, with sufficiently sophisticated bar associations to write serious corporate codes and otherwise able to create, and provide assurance through some bond for the performance of, an alternative firm/shareholder dispute resolution mechanism to compete in a space that Delaware’s interest
group politics will otherwise seek to avoid, could provide a dramatic shift on the supply side of business entity formation.

Also note that interstate compacts, once created, are fairly difficult to undo, and so any new adjudication regime created pursuant to interstate compact would be fairly concrete. So should city empowerment also be accomplished as part of an interstate compact mechanism it could serve to bond the permanence of the city’s corporate code to potential incorporators. Also a state providing a city with the power to form corporations, which contemplated an arbitration based method of adjudication, could modify its state rules of civil procedure to provide some certainty in ensuring that arbitration awards are promptly enforced by the state’s courts.325

**Section D: A Foreign Firm “Visa” to obtain US investors subject to foreign law and foreign forum**

States could also consider an entity creation system that gives automatic business entity status to entities created in select foreign countries, effectively a visa to raise capital on exchanges in the US but subject to your home countries laws with respect to your relationship with local shareholders. While the OTC exchanges allow foreign firms to trade directly on the exchanges, though those are only ADRs (derivative instruments so not really entity ownership, its share ownership without governance rights.)

To the extent that foreign firms become more active under such a regime in soliciting investments from US investors for foreign firms governed by foreign law, could that help to support a Weingast equilibrating federalism, such that foreign pressure would add to that of individual states and firms in resisting federal preemption.

325 See Delaware’s arbitration act, which takes such an approach to contractual arbitration, 10 Del.C. § 5701.
This would be an important innovation to help foreign firms raise money on US exchanges. To the extent states are imposing limits on foreign non-US formed firms operating within their jurisdictions, a federal codification of the internal affairs doctrine could help states to grant foreign firms the benefit of mutual recognition through the internal affairs doctrine.

Conclusion

Even if not all of the innovations that evolve in the new world I am suggesting, some of them might, and create things like a functioning arbitration system that could fundamentally alter the network externality/Delaware effect calculus. And even if only some of them crossover into the large public company space, it could substantially alter state chartering competition in that sphere as well. Particularly as smaller sized firms grow and transition from being crowd funded to being large public firms. This article suggests an initial incursion into the federal overlay in corporate governance that could, initially, enhance the incredible benefits of crowdfunding, and ultimately may completely reshape corporation law itself.

---