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The Mandatory Disclosure of State Corporate Law

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The Mandatory Disclosure of State Corporate Law

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I. INTRODUCTION

In the United States, the relationship between investors and the managers of public companies is governed by a combination of state and federal law. Traditionally, state corporate law¹ has provided the substantive rules that govern the relationship between management and investors. Federal law, on the other hand, has provided rules requiring public companies to provide investors with information. Although one may argue that the federal government has become more involved in providing substantive rules for the governance of public companies in recent years,² the distinction between how state law and federal law affect the governance of public companies remains true in most respects.³

Despite the central role state corporate law plays in the governance of public firms and despite the intense focus legal academia places on state corporate law (evidenced by the in-depth treatment of the subject in casebooks, legal hornbooks, and law review articles), public companies are not required to disclose information about the

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1. This Article defines state corporate law as a state's statutory provisions and case law regarding the organization and governance of a corporation and the ability of investors to make use of the civil process to police management misfeasance and malfeasance.
 2. "The federal regime had until [the Sarbanes-Oxley Act of 2002] consisted primarily of disclosure requirements rather than substantive corporate governance mandates, which were traditionally left to state corporate law." Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1523 (2005). For example, the Sarbanes-Oxley Act requires certain board member to be independent directors (by requiring members of the audit committee to be independent directors) and prohibits the corporation from making loans to directors. See 15 U.S.C. §§ 78j-l(m)(3), 78m.
 3. See Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisuredly Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 553 (2002) ("In the United States, most corporate law issues are left for the state, and corporations are free to choose where to incorporate and thus which state's corporate law system will govern their affairs.").

corporate law of their respective states of incorporation in their regular disclosures to the market (i.e., the disclosures companies first make when they first go public and the annual and quarterly disclosures they must make thereafter). The message to the investor is clear: If you want to know how state corporate law affects the public company, you must gather this information yourself.

Of course, gathering this information would be relatively simple if all public companies were subject to one corporate law. However, they are not. Although the State of Delaware may dominate the market for incorporation of public firms, roughly forty percent of public firms in the U.S. incorporate in states other than Delaware,⁴ and nearly every jurisdiction in the United States is the state of incorporation for at least one public company.⁵

The implicit assumption of our current disclosure regime is that there is insufficient justification for requiring disclosure of state corporate law. In this Article, I challenge that assumption and question why we do not require public companies to disclose specific information on state corporate law. Indeed, because arguments against mandatory disclosure of state corporate law are not particularly strong, and because the market would receive significant benefits from such disclosures, I conclude that we should require public companies to disclose certain aspects of state corporate law as part of the regular disclosures they make to the market.

Requiring public companies to disclose any information is controversial. There has been strong opposition from some legal scholars to any kind of mandatory disclosure for public companies.⁶ The scholars who call for the elimination of mandatory disclosure subscribe to the idea that regulators are in a relatively poor position to determine the scope and content of a socially optimal disclosure regime. They argue that if public companies desired to exploit the market for capital, they would provide the market with the information the market de-

4. See Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 389 (2003) (stating that, based on data through the end of 1999, fifty-eight percent of public corporations are incorporated in Delaware).

5. See *id.* at 395 (Table 5) (based on statistics through the end of 1999, North Dakota was the only state that was not a state of incorporation for at least one public company).

6. The scholars most closely associated with this position are George Stigler and George Benston. For good summaries and critiques of the works of Stigler and Benston, see Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1369-95 (1999); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2372-81 (1998); Joel Seligman, *The Historical Need for a Mandatory Corporate Disclosure System*, 9 J. CORP. L. 1 (1983).

manded.⁷ For this group of scholars, a voluntary disclosure system would be the best way to achieve socially optimal disclosure.

Another group of scholars stops short of calling for the elimination of mandatory disclosure but argues the current system is in need of reform.⁸ These scholars concede the need for mandatory disclosure rules but argue the federal government should not hold a monopoly on the authority to make these rules.⁹ They propose that each of the various states should be allowed to regulate the disclosures of public companies.¹⁰ A public company would choose the state it feels provides optimal disclosure rules by incorporating in that state and subjecting itself to that state's securities laws.¹¹ The proponents of this system, borrowing from the literature on the competition for corporate charters,¹² argue that competition between the states for incorporation revenues would result in a disclosure regime that at least fairly approximates a socially optimal one.¹³

Finally, there are scholars who support our current federal mandatory disclosure regime.¹⁴ These scholars argue that eliminating mandatory disclosure rules altogether and relying on market forces ignores the real possibility of market failure.¹⁵ They further argue that those who call for a competitive system of state disclosure regimes fail to recognize that the states may have little incentive to participate in such a competition and that the resulting disclosure regimes would have a bias towards underdisclosure.¹⁶

7. See Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 683-85 (1984).

8. See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998); Romano, *supra* note 6; Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453 (1997).

9. See Romano, *supra* note 6, at 2362 ("As a competitive legal market supplants a monopolist federal agency in the fashioning of regulation, it would produce rules more aligned with the preferences of investors, whose decisions drive the capital market.").

10. *Id.* at 2365 (suggesting competition should be allowed among "the fifty states, the District of Columbia, and the federal government").

11. *Id.* at 2366 ("[P]romoters of firms will find they can obtain a lower cost of capital by choosing the regime that investors prefer.").

12. See *id.* at 2383-88 (discussing the literature on competition for corporate charters among the states and its implications to securities regulation).

13. See *id.* at 2365-66 ("Competing regulators would make fewer policy mistakes than a monopolistic regulator . . .").

14. See Seligman, *supra* note 6; Fox, *supra* note 6.

15. See John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984).

16. See Fox, *supra* note 6, at 1417 ("There are a number of market failures associated with [a competitive system of state disclosure regimes] that are likely to result in most issuers underdisclosing.").

In this Article, I do not take a position on the more general issue of the propriety of a federal mandatory disclosure regime for public companies. A federal mandatory disclosure regime is a fact of life in America, and, for now at least, public companies and scholars need to work within that rubric.¹⁷ However, one clear lesson to be learned from the debate on mandatory disclosure is the importance of engaging in critical review of the content and scope of the information we require companies to disclose. Indeed, when regulators substitute their judgment for that of a competitive market, there needs to be frequent and robust debate on their decisions. The only hope for such a system to even come close to achieving socially optimal disclosure is through continual discussion and review of the scope and content of mandatory disclosure.¹⁸ In this Article, I attempt to lay the groundwork for further discussion and debate on requiring public companies to disclose information about the corporate law of their respective states of incorporation.

The content of a public company's disclosures should provide investors with information that will aid them in determining whether to invest in the securities of a public company and, if they do invest, how much to pay for these securities. Using this information, investors can protect themselves from investment risks by either refusing to invest in a company or by adjusting the price they are willing to pay for the securities in order to accommodate for the risk.¹⁹ When investors price securities based on certain information, they are not only protecting themselves—they are also helping to incorporate that information into the market price of the securities. When the market prices of securities reflect all relevant information, the economy as a whole benefits from a more efficient allocation of investment capital.²⁰

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17. See Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 417 (2003) (recognizing that "the debate has been settled for decades, with mandatory disclosure winning the day"); Fox, *supra* note 6, at 1339 (stating that despite the debate, there was now a "rough consensus . . . with . . . most economics-oriented legal academics . . . concluding that, on balance, mandatory disclosure should be retained").
 18. Disclosure is socially optimal when the benefits of disclosure meets or exceeds the costs of the disclosure. See Fox, *supra* note 6, at 1339. Of course, this definition provides us with no answer; rather, it just provides an invitation to a deeper cost-benefit analysis.
 19. As an example, Professor Roberto Romano stated: "[A]s long as investors are informed of the governing legal regime, if promoters choose a regime that exculpates them from fraud, investors will either not invest in the firm at all or will require a higher return on the investment (that is, pay less for the security) . . ." Romano, *supra* note 6, at 2366.
 20. See Merritt B. Fox, Randall Morck, Bernard Yeung & Artyom Durnev, *Law, Share Price Accuracy, and Economic Performance: The New Evidence*, 102 MICH. L. REV. 331, 334 (2003) (stating that studies "strongly suggest that greater share price accuracy does lead to enhanced efficiency in the real economy").

Mandatory disclosure plays an important role in this process by providing the market with the relevant information it needs.²¹

The information investors use to evaluate a company may be related to the future prospects of the company's main line of business, or it may be related to the possibility that the managers of the company will use their control over the company to expropriate benefits for themselves at the expense of the company and the shareholders. This Article argues that information on state corporate law is an integral piece of the overall mix of information investors need to evaluate the risk of management expropriation in public companies. It further argues that mandatory disclosure of state corporate law is the most efficient way of disseminating this important information to the market.

The remainder of the Article proceeds as follows: Part II presents how our current mandatory disclosure regulations generally ignore information on state corporate law; Part III makes the case that information on state corporate law is an important part of the information that investors in public companies need to evaluate investment risk; Part IV argues that mandatory disclosure of state corporate law would reduce information costs in the market; Part V presents and discusses some of the costs of a rule requiring disclosure of state corporate law and suggests how we could draft the rule to minimize some of these costs; and Part VI concludes.

II. THE DISCLOSURE OF STATE CORPORATE LAW UNDER OUR CURRENT SYSTEM

Although federal disclosure regulations require public companies to disclose a vast amount of information to the investing public, they require disclosure of almost no information about state corporate law. Regulation S-K, which provides the specifics of the disclosures a public company must make,²² has only one item that explicitly calls for disclosure of a provision of state corporate law. Item 202 requires companies to disclose "[l]iability to further calls or to assessment by the

21. *See id.* (stating that their study suggests "mandatory disclosure does in fact increase the amount of meaningful information reflected in share prices").

22. When a company sells securities through a public offering, the Securities Act of 1933 ("1933 Act") requires it to make certain disclosures to investors. Once a company becomes a public company, the Securities Exchange Act of 1934 ("1934 Act") requires it to make regular disclosures of certain information to the investing public. These regular disclosures generally consist of quarterly reports and annual reports. Although disclosure of information for a public offering is governed by the 1933 Act and the continuing disclosure of information by public companies is governed by the 1934 Act, Regulation S-K specifies the nature of the information that must be disclosed for both disclosure circumstances. For a more detailed discussion of the scope and disclosure requirements of the 1933 Act, the 1934 Act and the role of Regulation S-K, see THOMAS LEE HAZEN, *THE LAW OF SECURITIES REGULATION* §§ 1.0, 1.2[3], 3.4, 9.1, 9.4 (5th ed. 2006).

registrant and for liabilities of the registrant imposed on its stockholders under *state statutes* . . . ”²³ Item 202 also requires disclosure of the terms of the capital stock (where capital stock is being registered), including certain rights that might be granted under state law, such as voting rights and preemption rights, although state law is never expressly mentioned.²⁴

There are other items in Regulation S-K that may require the disclosure of state corporate law, but may also refer to exchange rules, provisions in the company’s organizational documents, or a private agreement between the company and members of management or some other third party. For example, Item 308 requires the company to make “[a] statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant”²⁵ Item 702 requires a statement of the “general effect of any *statute*, charter provision, bylaws, contract or other arrangements under which any controlling persons, director or officer of the registrant is insured or indemnified in any manner against liability which he may incur in his capacity as such.”²⁶ Item 201 requires disclosure of any “restrictions . . . that currently materially limit the registrant’s ability to pay such dividends or that the registrant reasonably believes are likely to limit materially the future payment of dividends on the common equity”²⁷ Item 201 may refer to state corporate law restrictions on the ability of companies to make distributions to shareholders unless the company’s financial situation meets certain conditions, but it may also refer to charter or bylaw restrictions or even to restrictions in debt instruments or other loan agreements.

It seems as though the federal disclosure requirements have actually marginalized the importance of state law to the investors of public companies by the glaring lack of any reference to state law. Indeed, there are several places where Regulation S-K addresses issues that may implicate state corporate law, but fails to require any disclosure of state corporate law. For example, Item 101 requires disclosure of “the year in which the registrant was organized and its form of organization,”²⁸ but it does not require the issuer to disclose why it organ-

23. 17 C.F.R. § 229.202(a)(ix) (2007) (emphasis added).

24. 17 C.F.R. § 229.202(a) (2007). Item 501 specifically mentions state law in when it requires “[a]ny legend or statement required by the law of any state in which the securities are to be offered.” 17 C.F.R. § 229.501(b)(6) (2007). However, this item addresses state Blue Sky Laws, not what we would traditionally consider to be state *corporate* law. In addition, this provision does not necessarily refer to or even include the issuer’s state of incorporation.

25. 17 C.F.R. § 229.308(a)(1) (2007).

26. 17 C.F.R. § 229.702 (2007) (emphasis added).

27. 17 C.F.R. § 229.201(c)(1) (2007).

28. 17 C.F.R. § 229.101(a)(1) (2007).

ized in a particular state. Item 404 requires disclosure of the "registrant's policies and procedures for the review, approval, or ratification of [related party transactions],"²⁹ but the regulation makes no mention of how those procedures are influenced or supplemented by state corporate law.

Item 202 of Regulation S-K provides one of the most glaring examples of the marginalization of state corporate law in the federal regulation of public company disclosures. It requires the company to discuss and describe any provision in its charter or bylaws that would hinder a change of control of the company.³⁰ However, this item specifically excludes a charter or bylaw provision that may be mandatory under state law.³¹

Regulation S-K is concerned with the corporate governance of public companies. In fact, there are many provisions in S-K that deal with corporate governance issues. Items 307 and 308 address the company's internal controls over disclosure and financial reporting.³² Items 402 and 403 require detailed disclosure of the compensation of the company's principal executives and their ownership of the company's securities.³³ Item 406 requires disclosure of any code of ethics regarding corporate governance that the company has adopted for its principal executive officers.³⁴ However, these items do not explicitly require the disclosure of state corporate law rules or standards. In fact, there is an entire provision in Regulation S-K that deals exclusively with "corporate governance," but it makes no mention of state corporate law rules or standards.³⁵

Although Regulation S-K requires a public company to make disclosures relevant to corporate governance, it does not require any disclosure about many aspects of state corporate law that would provide a better overall picture of the corporate governance of the company. For example, state law governs shareholder derivative lawsuits. Information about the state corporate law's approach to a demand that may have to be made by a plaintiff before initiating a lawsuit, the adequacy of board review of such a demand, and a board's refusal of a demand would provide the investor with a more complete picture of the company's corporate governance environment. Our current disclosure regime does not require a public company to disclose any information about state law regulation of derivative lawsuits.

29. 17 C.F.R. § 229.404(a)(instructions) (2007).

30. 17 C.F.R. § 229.202(a)(5) (2007).

31. *Id.*

32. 17 C.F.R. §§ 229.307, 229.308 (2007).

33. 17 C.F.R. §§ 229.402, 229.403 (2007).

34. 17 C.F.R. § 229.406 (2007).

35. 17 C.F.R. § 229.407 (2007).

State law also defines the fiduciary duties of directors, officers, and controlling shareholders. An understanding of how the courts of the state of incorporation define and shape fiduciary duties would provide investors with a more complete picture of the corporate governance of the company. Our current disclosure regime does not require a public company to disclose any information about state law fiduciary duty standards in any one of the many contexts that it might arise. In fact, our current disclosure requirements do not mandate disclosure of state laws governing shareholder rights to inspect corporate books and records, dissenters' rights, protection of non-shareholder constituencies, and other corporate governance issues as part of a public company's regular disclosures.

In addition, although investors may be able glean certain aspects of state corporate law from the disclosure of the company's articles of incorporation, bylaws, and other corporate documents, our disclosure regime puts the onus on the investor to pour through the disclosure documents rather than on the company to disclose this information in an organized, easy-to-read manner.

Thus, our current disclosure regime considers corporate governance information to be important for investors, but it treats state corporate law as largely irrelevant to the governance of public firms or insufficiently important to merit the costs of disclosure.

III. THE IMPORTANCE OF STATE CORPORATE LAW TO INVESTORS IN PUBLIC COMPANIES

If state corporate law were unimportant or irrelevant to investors in public companies, it would be foolish to require public companies to disclose any information about the corporate law of its state of incorporation. A group of prominent economists have explained, however, that corporate law is indeed important to investors:

When their rights are better protected by the law, outside investors are willing to pay more for financial assets such as equity and debt. They pay more because they recognize that, with better legal protection, more of the firm's profits would come back to them as interest or dividends as opposed to being expropriated by the entrepreneur who controls the firm. By limiting expropriation, the law raises the price that securities fetch in the marketplace.³⁶

Thus, if the corporate law of a particular state efficiently limits expropriation by those in control of the firm, investors will be willing to pay relatively more for the securities of a company that is organized under the laws of that state. Conversely, if the corporate law of a particular state fails to efficiently limit expropriation by those in control of the firm, investors will pay relatively less for the securities of a company incorporated in that state. In either case, investors will place

36. Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer & Robert Vishny, *Investor Protection and Corporate Valuation*, 57 J. FIN. 1147, 1147 (2002).

importance on information about how the law of a company's state of incorporation protects their rights.

This section discusses some possible challenges to the proposition that state corporate law is important to the investors of public companies and also presents the evidence in support of that proposition.

A. The "triviality" or irrelevance of state corporate law

Professor Bernard Black has argued that state corporate law is trivial.³⁷ Professor Black's "triviality hypothesis" is a provocative claim that, at first glance, may seem to advise against mandatory disclosure of state corporate law—after all, state corporate law is "trivial." However, upon closer analysis, the triviality hypothesis, even if true, does not lend support to an argument against mandatory disclosure. In fact, the triviality hypothesis may support an argument in favor of requiring public companies to disclose certain aspects of state corporate law.

Professor Black's thesis is that much of state corporate law is trivial because corporate law rules fall into one of the following four categories:

- "*market mimicking*" rules—rules that managers and investors would have agreed upon if they had considered drafting for the particular contingency;³⁸
- "*avoidable*" rules—default rules that managers and investors can vary through the charter or bylaw provisions, or rules they can avoid through reincorporation in another state;³⁹
- "*changeable*" rules—rules managers and/or investors could change over time through lobbying efforts;⁴⁰ or
- "*unimportant*" rules—rules the company could comply with "at [a] nominal cost, or involv[ing] situations that almost never occur."⁴¹

Even assuming Professor Black's triviality hypothesis is correct, it does not justify an argument against mandatory disclosure of state corporate law. With respect to market-mimicking rules, it is difficult,

37. Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. REV. 542, 544 (1990) ("[T]he 'triviality hypothesis' [is] that, appearances notwithstanding, state corporate law is trivial: it does not prevent companies—managers and investors together—from establishing any set of corporate governance rules they want."); *id.* at 562 ("The positive claim . . . is that all state corporate law rules arguably fit within one or more of the four categories of trivial rules.").

38. *Id.* at 552–55.

39. *Id.* at 555–59.

40. *Id.* at 559–60.

41. *Id.* at 560.

if not impossible, to say for certain whether a rule is market-mimicking.⁴² Of course, scholars often make arguments that corporate law provides the rules to which the parties would have agreed in the majority of transactions. But what if a particular rule is not market-mimicking? In such a case, disclosure of that rule allows the market to fully incorporate its cost. Clearly, then, if we justify non-disclosure of state corporate law because it is market-mimicking, we run the risk of exacerbating the costs of our mistakes. Not only do we run the risk that the law creates transaction costs because it is not market-mimicking, we also run the risk that these costs will not be fully incorporated into the price of the securities because we have not required disclosure.⁴³

With respect to the remaining categories of trivial corporate law—avoidable and changeable rules—Professor Black essentially argues that corporate law is trivial as long as its rules are not mandatory or, if they are mandatory, they can be changed through political pressure or avoided by reincorporating in another state.⁴⁴ In other words, given enough time (for political forces to work) and space (for changing the jurisdiction of incorporation), corporate law is trivial.

This argument, however, necessarily recognizes the importance and relevance of state corporate law. The argument that corporate law in the U.S. is trivial because parties can avoid the less preferred rules of one state by reincorporating in another state necessarily recognizes the non-triviality of corporate law in any one particular state. In addition, the argument that corporate law is trivial because it will change over time necessarily recognizes that it is non-trivial at any particular point in time—especially if change is not easy because of bureaucracy or political opposition or because managers and investors may disagree whether the law needs to be changed.

In a similar vein, Professors Robert Thompson and Hillary Sale have made the case that federal law has made state corporate law irrelevant to a certain extent.⁴⁵ They claim that federal securities law now serves as a substitute for many state corporate law claims.⁴⁶ They argue that “federal securities law and enforcement via securities fraud class actions today have become the most visible means of regulating corporate governance.”⁴⁷ They further argue that federal law

42. Professor Black would at least concede that we could rarely say for certain whether a rule is market-mimicking. *Id.* at 552.

43. See *infra* Part IV.G (discussing the costs of unincorporated corporate law information).

44. See *supra* notes 37–41 and accompanying text.

45. See Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections Upon Federalism*, 56 VAND. L. REV. 859 (2003).

46. *Id.* at 861 (arguing that “corporate governance outside of [acquisition and self-dealing transactions] has passed to federal law”).

47. See *id.* at 860.

addresses the conduct of executive officers more directly than state corporate law⁴⁸ and that federal law makes a significant contribution to defining the directors' duty of care⁴⁹ and to policing the directors' duty-of-loyalty obligations.⁵⁰

Professors Thompson and Sale, however, stop short of arguing that state corporate law has been supplanted completely by federal law. In fact, they recognize that state law still plays a role in the corporate governance of public companies.⁵¹ Thus, even if federal law is now playing a greater role in defining and policing substantive areas of corporate governance that were formerly within the exclusive realm of state corporate law, state corporate law is still relevant to public companies. Eventually, state corporate law may be directly supplanted by federal corporate law. Until then, the mere existence of a proactive federal regime does not lend much support to an argument against the mandatory disclosure of state corporate law.

Professor J. Robert Brown has also argued that state corporate law is irrelevant.⁵² The essence of Professor Brown's thesis is that state corporate law is irrelevant to public companies because "most states . . . do not impose meaningful duties on managers of public companies."⁵³ This claim raises an interesting question: If the corporate law of all states is simply "bad," does that fact support an argument against requiring a public company to disclose certain aspects of the law of its state of incorporation? This Article contends that the answer to this question is unequivocally no. In fact, Professor Brown's claim, if true, would only speak against mandatory disclosure when the corporate laws of *all* states provide *equally* bad (or good) protection for investors and there is no possibility for the development of differences between the states. In other words, only formal uniformity of corpo-

48. See *id.* at 877 ("And, in recognition of where the locus of today's governance is, federal law imposes obligations directly on officers, bypassing the intermediaries of the board.").

49. See *id.* at 873-77; *id.* at 904 ("In theory, state law duty of care litigation continues to afford relief to these shareholders, but as disclosure and securities fraud litigation have expanded, and as Delaware has raised the bar for care claims, the balance has shifted to a larger federal role."); see also J. Robert Brown, Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. RICH. L. REV. 317, 375 (2004) ("Sarbanes-Oxley forces the board to be more informed, largely supplanting Delaware law concerning the duty to monitor.").

50. See Thompson & Sale, *supra* note 45, at 877 (noting "the section of [federal law] that regulates the fiduciary duty of loyalty by banning corporate loans to executive officers and directors").

51. See *id.* at 909-10 ("Corporate governance, once almost the exclusive domain of state law, is now very much a function shared by the federal and state governments.").

52. See Brown, *supra* note 49.

53. See *id.* at 348.

rate law would obviate the need for mandatory disclosure of state corporate law.⁵⁴

B. Relying on voluntary disclosure as a proxy for relevance

One might argue that the market should decide on the importance of state corporate law. If disclosure of state corporate law were socially optimal—*i.e.*, if the issuer's costs of disclosure did not exceed the benefits to the investors—then issuers would voluntarily disclose the information because the market would demand it.⁵⁵ However, this argument necessarily assumes that the interests of the management and the investors are aligned when disclosure is socially optimal, which is not necessarily true. Professor Merritt Fox has argued that the voluntary disclosure of information by a public company does not depend on whether the disclosure is socially optimal.⁵⁶ Instead, voluntary disclosure depends on the private costs of disclosure—namely, the marginal costs of disclosure to the *managers* versus the marginal benefit of the disclosure to the *managers*.⁵⁷

In other words, the managers of a public company will not always disclose the information that the investors want. The disclosure of some information by the company, although socially optimal, might reduce the private interests of the management. Management is essentially presented with a choice. If, on one hand, the managers disclosed the information, they would lose whatever private benefits they received from non-disclosure. If, on the other hand, the managers did not disclose this information, the market would penalize them. The investors would assume the worst and discount the price they were willing to pay for the issuer's securities, increasing the costs of capital for the company.⁵⁸ The increased costs of capital would adversely affect the company's bottom line and, thereby, penalize the managers by reducing their incentive-based compensation and placing their jobs in

54. See *infra* Part IV.F (discussing the uniformity of state corporate law).

55. See Fox, *supra* note 6, at 1339 (stating that opponents to mandatory disclosure "argued that market forces alone could provide sufficient incentives for issuers to disclose at their socially optimal levels").

56. See *id.* at 1344. More specifically, Professor Fox was discussing what type of disclosure regime issuers would choose if they had several options, as opposed to our current system of one federal securities law. *Id.* The basic analysis, however, is equally valid for a voluntary disclosure regime.

57. *Id.*

58. See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 288 (1991) (stating that investors would reason "if the firm had anything good to say for itself it would do so"); Paredes, *supra* note 17, at 421 (stating that opponents of mandatory disclosure argue "a company will voluntarily disclose information that investors demand in order to reduce its cost of capital and avoid any discount that the market might apply to the company's stock price").

jeopardy.⁵⁹ When the value of the private benefits they would lose because of disclosure exceeds the penalty they suffer for non-disclosure,⁶⁰ the managers would choose not to disclose—even if disclosure would be better for the investors.⁶¹

These dynamics create a challenging quandary for policymakers. Although we might not want a system that relied completely on voluntary disclosure,⁶² we also do not want to mandate disclosure of information that investors do not consider important enough to justify the costs.⁶³ Ideally, we would only interfere in a market decision on the disclosure of certain information when management's private benefit of non-disclosure exceeded the market penalty for non-disclosure. Unfortunately, it is impossible for us to determine with any certainty when this occurs. We can merely try to recognize the conditions that increase the likelihood management will not make socially optimal disclosure of certain information. Disclosure of state corporate law is arguably one of those instances where there is a significant likelihood management will not make socially optimal disclosure.

Management may be unwilling to make socially optimal disclosure of state corporate law for two main reasons. The first reason is that the corporate law of the state of incorporation might unduly favor management. If the corporate law of the state of incorporation favored management, investors would tend to prefer full disclosure of such information, depending, of course, on the costs to the issuer, because it helps them to better evaluate the risk of expropriation.⁶⁴ In contrast, managers would tend to prefer not disclosing this information because making investors aware of the pro-management nature of the law may prompt them to demand changes, which would then reduce managers' private benefits. Of course, information about state corporate law is available to investors without disclosure from the company,⁶⁵ but whether the market actually researches and acquires

59. See EASTERBROOK & FISCHEL, *supra* note 58, at 290 (stating that the "self-interest" of managers leads them to make voluntary disclosure).

60. Competent managers can reduce the affects of the increased capital costs for the firm by increasing the firm's competitiveness in other markets, such as the product market or the labor market.

61. See Fox, *supra* note 6, at 1344 ("[M]anagers will choose the regime that requires the issuer to disclose closest to the level at which the marginal increase in cost to the managers . . . equals the marginal increase in benefit to them . . .").

62. Professor Fox claims that the level of disclosure under a voluntary disclosure system will inevitably fall below the socially optimal level of disclosure. *Id.* at 1344.

63. See Geoffrey A. Manne, *The Hydraulic Theory of Disclosure Regulation and Other Costs of Disclosure*, 58 ALA. L. REV. 473, 481 (2007) ("[A]dditional disclosure also imposes increasing costs on firms, and even if we accept the argument that firms voluntarily under-produce information, an optimal information disclosure regime would surely not require disclosure of *all* private information.").

64. See *supra* note 36 and accompanying text.

65. See *infra* Part IV.C.

this information depends on the costs of acquiring the information.⁶⁶ Managers trying to hide the advantages that state corporate law provides them rely on these information costs to keep the market ignorant.⁶⁷

We might expect that managers would be more than willing to voluntarily disclose information about state corporate law if the law favored investors' interests. In fact, we might expect them to advertise it.⁶⁸ As a practical matter, however, this is unlikely. No state has a corporate law that does not have at least some provisions that favor the interests of management. Of course management would want to disclose the aspects of state corporate law that benefit investors without disclosing those that favor management. However, this type of selective disclosure is unlikely because it would be misleading.⁶⁹

The second reason why management might be unwilling to make socially optimal disclosure of state corporate law is that liability for inaccurate disclosures under current securities laws creates a general preference for less disclosure, rather than more. "[S]ecurities laws themselves reduce the amount of information that is provided by issuers because they impose significant liability for the production of misinformation."⁷⁰ Thus, because the voluntary disclosure of any information, including, but not limited to, information on state corporate law, is less likely under our current legal and regulatory environment, it may be an unwise policy decision to rely on voluntary disclosure.

C. A substitute for disclosure of state corporate law— disclosure of firm-level rules

One argument against the mandatory disclosure of state corporate law is that firm-level rules are more important to investors than state corporate law and that companies are currently required to disclose their firm-level rules.⁷¹ It is possible that the corporate law of a particular state may provide little protection for shareholders, but the firm may choose to provide better protection through its charter, by-

66. See *infra* Part IV.D.

67. See *infra* Part IV.G for a discussion of whether the information costs discourage the market from acquiring this information.

68. See EASTERBROOK & FISCHER, *supra* note 58, at 288 (noting that "[a] firm with a good project . . . would disclose more and more").

69. Managers might also choose not to disclose simply because they are "overconfident in their own abilities" and "feel that disclosure [is] simply unnecessary and bothersome." Frank B. Cross & Robert A. Prentice, *The Economic Value of Securities Regulation*, 28 CARDOZO L. REV. 333, 341 (2006).

70. Edmund W. Kitch, *The Theory and Practice of Securities Disclosure*, 61 BROOK. L. REV. 763, 770 (1995).

71. See 17 C.F.R. § 229.601 (2007) (Exhibit table) (requiring the disclosure of articles of incorporation, bylaws, and codes of ethics as exhibits).

laws, internal guidelines/policies, or other firm-level rules. Similarly, the law may provide very protective default rules, but the firm may choose to opt out of these rules. Under these circumstances, the investor is more concerned with the disclosure of firm-level rules than with state corporate law.

In fact, a public company will disclose any deviation from the corporate law default rules through the disclosure of its charter and bylaws under Regulation S-K.⁷² However, since charter and bylaw provisions do not always reflect mandatory provisions of state corporate law or even default rules from which the company has not opted out, there are many aspects of state corporate law that affect the corporate governance of public firms that are not revealed through disclosure of firm-level rules.

For example, imagine that the corporate law of State X allows a company to adopt a charter provision that exculpates directors for violations of the duty of care.⁷³ Although the exculpatory provision in the charter might provide investors with important information about the corporate governance of the firm, it does not make state corporate law standards on the duty of care irrelevant. State corporate law might still allow shareholder derivative suits to enjoin actions by the directors that violate their duty of care. In addition, state corporate law standards for the duty of care are still very relevant for the company that has not adopted the exculpatory charter provision.

Similarly, imagine that a public company incorporated in the State of X has adopted a "poison pill" in the form of a rights plan.⁷⁴ This rights plan will be disclosed in the articles of incorporation and thus available for investors through current mandatory disclosure rules.⁷⁵ However, the charter will not disclose the standards that a judge in State X will use to review a decision by the board of directors on whether to redeem the rights plan.⁷⁶ It is not the rights plan alone, but the rights plan along with state corporate law standards that provides the investors with a more accurate picture of their level of protection against management misconduct.⁷⁷

72. *Id.*

73. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(b)(7) (1947).

74. *See* JESSE H. CHOPER, JOHN C. COFFEE, JR. & RONALD J. GILSON, CASES AND MATERIALS ON CORPORATIONS 979 (6th ed. 2004) (stating that the "most popular contemporary version" of the poison pill is known as the "Share Purchase Rights Plan").

75. *See supra* note 71.

76. The literature discussing judicial review of poison pills and other defensive tactics is extensive. For a good introduction, see WILLIAM A. KLEIN & JOHN C. COFFEE, JR., BUSINESS ORGANIZATION AND FINANCE LEGAL AND ECONOMIC PRINCIPLES 202-07 (10th ed. 2007); ARTHUR R. PINTO & DOUGLAS M. BRANSON, UNDERSTANDING CORPORATE LAW 347-59 (2d ed. 2004).

77. In this case, the misconduct would be management entrenchment.

Thus, information on firm-level rules provides an integral piece of the puzzle of the corporate governance picture of a firm, but it is not a substitute for information on state corporate law.

D. Evidence of the importance of state corporate law—the debate on the competition for corporate charters

The scholarship on the competition for corporate charters provides strong evidence of the importance of state corporate law. It has been suggested that states compete with one another to attract incorporations.⁷⁸ Some scholars posit that this competition has resulted in a race to the bottom—the “bottom” being corporate law that provides suboptimal protection for shareholders.⁷⁹ The scholars in the race-to-the-bottom camp argue that the states have adjusted their corporate laws to serve the interests of corporate managers in order to attract incorporations and that the interests of the managers often conflict with those of the shareholders.⁸⁰ Some scholars argue that this race to the bottom justifies a federal corporate law, or at least justifies expansion of federal law into areas that were once considered the exclusive domain of state corporate law.⁸¹

On the other side of the debate, there are scholars that have argued that the competition for charters between states has led to a race to the top—the “top” being a corporate law that provides optimal protection for shareholders.⁸² They argue that in order to reduce the costs of capital, companies will incorporate in a jurisdiction with a corporate law that provides the greatest value.⁸³ The scholars in this camp would generally oppose a federal corporate law or the expansion of federal law into what they view as traditionally state corporate law

78. For a more detailed summary of the state competition for corporate charters, see Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the “Race” Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1797–1800, 1804–13 (2002); Bebchuk & Hamdani, *supra* note 3, at 561–63.

79. See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992).

80. See Subramanian, *supra* note 78, at 1798 (stating that Cary, Bebchuk, Cohen, and Ferrell “have argued that states cater to managers . . . resulting in a race to the bottom”).

81. Bebchuk & Hamdani, *supra* note 3, at 608 (“[C]ritics of state competition argue[] that mandatory federal rules might be desirable with respect to corporate issues for which competition might pressure states in undesirable directions.”).

82. See, e.g., Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 256 (1977).

83. See Subramanian, *supra* note 78, at 1797–98 (stating that Winter, Easterbrook, Fischel and Romano “have argued that states compete against each other to offer laws that maximize shareholder value, resulting in a race to the top”).

issues. They argue that a federal corporate law would put an end to the state competition for corporate charters, resulting in a suboptimal corporate law.⁸⁴

There seems to be no clear consensus regarding whether interstate competition results in optimal or suboptimal corporate law. However, the underlying premise of the debate, which is that state corporate law affects the value of a company to investors,⁸⁵ provides sufficient support for my argument that state corporate law is relevant to investors of public companies.

More recent scholarship now challenges the proposition that an active interstate competition for charters actually exists.⁸⁶ However, the absence of this competition does not undermine the claim that state corporate law is important to investors—it merely undermines the notion that corporate law in the U.S. is presumptively efficient because it results from a competitive process.⁸⁷

In fact, the possibility that an interstate competition for incorporations does not exist provides greater weight to an argument in favor of mandatory disclosure of corporate law. Once the idea that corporate law is a product of a competitive market is rejected, that law's efficiency then becomes doubtful. However, mandatory disclosure of the law to the market will allow the market to pass judgment on the efficacy and efficiency of a particular law or rule through the incorporation of that law into the price of a security.⁸⁸

In addition to facilitating accurate share pricing, a mandatory disclosure rule might also benefit the quality of corporate law in states that do not compete for corporate charters. It has been argued that states not competing for incorporations may “tend to have corporate

84. See Romano, *supra* note 6, at 2392.

85. See Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. Rev. 1559, 1565–66 (2002) (stating that “each side [of the debate] agrees that legal rules affect the creation or distribution of the firm's value and that firms therefore search the array of fifty potential legal regimes and select the regime with the most favorable legal rules”).

86. Professors Marcel Kahan and Ehud Kamar have argued that this interstate competition for charters no longer exists, although it may have taken place in the past. See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684 (2002). Professor Lucian Bebchuck and Assaf Hamdani also challenge the idea that there is any real competition. See Bebchuk & Hamdani, *supra* note 3, at 555 (“The alleged vigorous race among states vying for incorporations, we argue, simply does not exist.”).

87. Bebchuck and Hamdani explain the significance of their findings: “The absence of strong competition undermines the basis for the view that Delaware's dominance is the product of its winning a vigorous competition. Thus, the analysis implies that the case for preferring state competition to mandatory federal rules is much weaker than supporters of state competition have assumed.” See Bebchuk & Hamdani, *supra* note 3, at 558.

88. See *supra* notes 19–21 and accompanying text (providing a summary explanation of accurate share pricing).

laws that lack predictability, [that are] slow to copy innovations, and . . . invest little in developing innovations on their own.”⁸⁹ If this is the case, then to the extent mandatory disclosure of state corporate law brings attention to, or raises awareness of these shortcomings, it may put pressure on managers to reincorporate in another state, to lobby for corporate law changes, or where possible, to remedy the shortcomings through amendment of the company’s organizational documents.

E. Evidence of the importance of state corporate law—empirical studies

In their influential article, *Investor Protection and Corporate Valuation*, Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert Vishny (“LLSV”) examined the effect of legal protection of investors on the valuation of firms.⁹⁰ They studied 539 firms in 27 different countries⁹¹ and assessed the quality of legal protection of investors in these countries based on the origin of law (*i.e.*, common law, civil law, or other) and “antidirector rights.”⁹² They concluded that “poor shareholder protection is penalized with lower valuations.”⁹³ In other words, the quality of a jurisdiction’s legal protection of investors—its corporate law—affects the price investors are willing to pay for a company’s securities. This correlation between poor corporate law and lower valuations of corporate assets clearly demonstrates the importance of corporate law to investors.

Although the LLSV study compared the corporate laws of different countries, not of the different U.S. states, the same principle should apply to the corporate laws of the states.⁹⁴ If differences exist between the corporate laws of the states, then the LLSV study tells us they should be as important to investors as the divergences between the corporate laws of different nations.⁹⁵

89. See Kahan & Kamar, *supra* note 86, at 738.

90. La Porta et al., *supra* note 36.

91. *Id.* at 1154.

92. See *id.* at 1155–58.

93. See *id.* at 1168.

94. Although the various states are part of one larger nation, they have as much sovereign power to determine the scope of their corporate laws as Italy, Japan, and Germany, for example. There may be certain forces that discourage the various states from diverging too far from each other. For example, a national securities market and close communications and interactions among the citizenry, the commercial actors, and the lawmakers of the various states. However, these forces do not necessarily ensure that significant divergences do not occur.

95. See Kahan & Kamar, *supra* note 86, at 682 (“Empirical evidence suggests that [U.S. domestic] domicile choices affect the value of companies by several percentage points.”).

Professor Robert Daines conducted a study that focused specifically on the value of Delaware corporate law in comparison to the corporate law of other states.⁹⁶ He concluded that Delaware firms were worth more relative to firms incorporated in other states and attributed the difference in value to the quality of Delaware law.⁹⁷ Professor Daines' conclusions, if correct, provide direct support for the argument that the corporate laws of the states are important to investors.

Some scholars have criticized Professor Daines' conclusions.⁹⁸ For example, Professors Lucian Bebchuk and Allen Ferrell have argued that the increased value of Delaware firms might be attributable to variables other than Delaware corporate law.⁹⁹ Professor Guhan Subramanian found that the effect of Delaware corporate law on the value of firms did not exist after 1996 and concluded that "Delaware law does not improve market value in an economically meaningful way."¹⁰⁰

Empirical studies that show Delaware law increases, decreases, or has no effect on the value of firms compared to the corporate laws of other states are not dispositive of the issue of the relevance of corporate law to investors. The proposition that corporate law can affect the value of firms, and is thus important to investors, is still largely uncontroversial.¹⁰¹ In addition, there are several possible reasons why empirical studies might not show that the corporate law of a particular state creates a difference in value. One reason may be that there are no substantial differences between the corporate laws of the various states. However, such a reason would only support an argument against mandatory disclosure of state corporate law if the uniformity of these laws were formal and permanent, which is not the case in the United States.¹⁰² A second reason why empirical studies

96. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

97. *See id.* at 532-35.

98. For a summary of these criticisms, see Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 34-36 (2004); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law*, 90 CAL. L. REV. 1775, 1784-87 (2002).

99. *See* Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 137 (2001) ("It might be that Delaware firms are different from other firms in some respects and the difference in Tobin's Q might reflect these differences rather than increased value attributable to Delaware law.").

100. *See* Subramanian, *supra* note 98, at 57.

101. *See* John C. Coffee, Jr., *The Rise of Dispersed Ownership: The Roles of Law and the State in the Separation of Ownership and Control*, 111 YALE L.J. 1, 66 (2001) (stating that a strong legal framework is necessary for a securities market to function optimally).

102. *See infra* Part IV.F (discussing the uniformity of state corporate law).

may not show that the corporate law of a particular state has created a difference in value might be that the market has not fully impounded corporate law into the price of securities.¹⁰³ This reason would support a proposal for a the mandatory disclosure of state corporate law—better dissemination of information about state corporate law would increase the likelihood that it is fully incorporated into securities prices.¹⁰⁴

There is also empirical evidence that state law is important to incorporation choices.¹⁰⁵ While these studies do not necessarily measure the value of a particular state's corporate law, they do demonstrate the importance of state corporate law to investors. For example, Professor Marcel Kahan states:

We find substantial evidence that firms are more likely to incorporate in states with a corporate law that offers firms flexibility in areas unrelated to takeovers and significant though less robust evidence that firms are more likely to incorporate in states with a higher quality judicial system . . . Firms value flexibility and a high-quality judicial system in setting up their governance arrangements and are more likely to incorporate in their head-quarter state if it has a legal regime that offers these features.¹⁰⁶

In other words, state corporate law is important to the governance of public firms and is important to investors in those firms. Indeed, information about state corporate law is important to investors no matter whether a firm chooses to incorporate in a state because its corporate law favors managers or because it increases value for shareholders.¹⁰⁷

F. Preliminary conclusion

This section has demonstrated that information on state corporate law is an integral piece of the overall mix of information investors need to evaluate the risk of management expropriation in public companies. Any argument against the mandatory disclosure of corporate law solely because it is irrelevant to the investors of public companies is untenable.

Arguments that directly attack state corporate law as trivial or irrelevant are not directed at the relevance of state corporate law for disclosure purposes. However valid these arguments may be for their intended purposes, they fail as arguments against mandatory disclo-

103. See *infra* Part IV.G (discussing market incorporation of state corporate law into the price of securities).

104. See *id.*

105. See, e.g., Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality or Takeover Protection?*, 22 J.L. ECON. & ORG. 340 (2006); Bebchuk & Cohen, *supra* note 4; Daines, *supra* note 85.

106. Kahan, *supra* note 105, at 363.

107. See *id.* at 340 (discussing the debate on whether firms incorporate in a state because the law favors managers or increases firm value).

sure of state corporate law because they implicitly concede that investors are interested in information on state corporate law.

This section has also demonstrated the weakness of any argument against the mandatory disclosure of state corporate law on the grounds that public companies would disclose it voluntarily if it were truly relevant to investors. In fact, mandatory disclosure is necessary because it is unlikely that public companies would otherwise disclose this information even when investors preferred such disclosures.

This section has also demonstrated that any argument against the mandatory disclosure of state corporate law because it is already indirectly disclosed through the mandatory disclosure of firm-level rules also ultimately fails. Many important aspects of state corporate law will not be reflected in firm-level rules.

Finally, this section has demonstrated that empirical evidence generally supports the proposition that corporate law affects the value of firms, even though there is no consensus on the more specific question of whether Delaware corporate law adds value to public companies.

IV. THE BENEFITS OF MANDATORY DISCLOSURE OF STATE CORPORATE LAW

If it is assumed, for the sake of argument, that the preceding section successfully argued that information about state corporate law was important to investors in public companies, there still may be objections to a rule requiring public companies to disclose such information. One might argue that requiring issuers to disclose information on state corporate law forces the issuer to incur unnecessary costs since the information is already publicly available. The remainder of this section discusses this argument.

A. The efficient capital market hypothesis ("ECMH")

The efficient capital market hypothesis ("ECMH") is a fascinating theory on how capital markets incorporate public and non-public information into the price of securities.¹⁰⁸ It has been a popular topic in economic, financial, and legal scholarship.¹⁰⁹

108. "What makes the ECMH non-trivial, of course, is its prediction that, even though information is *not* immediately and costlessly available to all participants, the market will act *as if* it were." Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 552 (1984). For a well-presented and relatively detailed summary of the ECMH, see KLEIN & COFFEE, *supra* note 76, at 417-25.

109. See Lynn A. Stout, *The Mechanisms of Market Inefficiency: An Introduction to the New Finance*, 28 J. CORP. L. 635, 636 (2003) (stating the efficient market hypothesis had "captured the imagination of a generation of economists and finance theorists" and "[s]oon after it captured the imaginations of legal scholars and lawmakers as well").

The earliest scholarship on the ECMH focused on how the availability of information—from publicly-available information to private information—affected arbitrage opportunities for those who had access to the information.¹¹⁰ In other words, if one has access to certain information that is relevant to the price of the securities of a certain publicly-traded company, can one use that information to make a profit from buying or selling the company's securities?¹¹¹ If the market processed the information and impounded it into the price of the securities before an investor had a chance to trade on the information, the investor could not profit from the information. Whether the market quickly and efficiently incorporates the information in question may depend on how available the information is to other traders.

If the only information an investor had was the historical performance of the price of the security, would the investor be able to engage in lucrative arbitrage opportunities? The *weak form* of the ECMH posits that investors cannot beat the market simply by examining how the price of the security has fluctuated in the past.¹¹² There is no advantage over the other traders in the market because the information is readily available and is relatively easy to process. Furthermore, it is also unlikely that the information is material to the future performance of the security. Empirical studies have provided support for the weak form of the ECMH.¹¹³

The *semi-strong form* of the ECMH addresses whether an investor has an advantage over other traders in the market when he has publicly-available information (other than information on the historical performance of the security).¹¹⁴ One might think that if anyone had actually read and processed this information, that person could take advantage of other traders in the market who did not know of the information or who had not actually processed the information. However, the semi-strong form of the ECMH posits that an investor could not gain such an advantage.¹¹⁵ In fact, the main point of the ECMH is that if the information were widely available, the market price would reflect the information.¹¹⁶ Because the price any trader is willing to pay or accept is based on the market price, if the market has already

110. See Gilson & Kraakman, *supra* note 108, at 554–56 (describing Eugene Fama's "landmark 1970 review article").

111. See *id.*

112. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 389–96 (1970).

113. See Gilson & Kraakman, *supra* note 108, at 555 n.25 (describing the empirical literature).

114. See Fama, *supra* note 112, at 383, 404–09.

115. See KLEIN & COFFEE, *supra* note 76, at 417 ("[P]ursuit of undervalued stocks in a deep, liquid securities market is likely to be fruitless, because securities prices reflect all publicly available information . . .").

116. See Stout, *supra* note 109, at 640 ("One of the most salient implications of this view of market efficiency . . . is that in an efficient market, traders cannot profit

impounded the information into the price of the security, even the trader who has no knowledge of the public information in question will receive a price (or pay a price) that reflects the information.

Finally, the *strong form* of the ECMH addresses whether an investor can gain an advantage over the market when he is one of only a few traders who have access to the information.¹¹⁷ If the market efficiently incorporates this kind of private information into the price of the stock, then the investor would not profit by trading on it.

B. The ECMH and the disclosure of state corporate law

The ECMH has normative implications for the information public companies are required to disclose.¹¹⁸ The semi-strong form of the ECMH—which states that publicly available information is already incorporated into the price of securities—might suggest that companies need not be required to disclose material aspects of state corporate law since it is already publicly available through a variety of sources.¹¹⁹

Indeed, the statutory corporate law of any U.S. jurisdiction is readily available on the internet. State court decisions creating common law corporate governance rules and interpreting the statutory corporate law are widely available either on the internet or in the law libraries of public institutions. Furthermore, the organizational documents (*e.g.*, the articles of incorporation, the bylaws, etc.) of public companies are widely available through a combination of state filings, federal disclosure rules, and state laws providing shareholders with access to certain corporate records.

If state law is indeed publicly available, then information about state corporate law should already be incorporated into the price of securities. One could argue, based on this logic, that requiring companies to assemble and disclose such information would impose unnecessary costs on public companies.

I am not convinced, however, that the semi-strong form of the ECMH instructs us that there is no need to require public companies to disclose state corporate law. First, even assuming the ECMH is true, it does not work by magic. Information is not incorporated into

from trading on publicly available information in a way that allows them to 'beat the market.'").

117. See Fama, *supra* note 112, at 409–13.

118. See Gilson & Kraakman, *supra* note 108, at 549–50 (stating that the ECMH has influenced the SEC's revision of the disclosure system).

119. See Romano, *supra* note 6, at 2366 ("It is plausible to assume that investors are informed about [state corporate law] liability rules given the sophistication of the institutional investors who comprise a majority of stock market investors and whose actions determine market prices on which uninformed investors can rely.").

the price of securities without costs.¹²⁰ In fact, the three different types of information discussed under the weak, semi-strong, and strong forms of the ECMH are merely proxies for information costs—namely the costs of gathering, processing, and validating information.¹²¹

The information costs for the historical performance of a company's securities, as discussed under the weak-form ECMH, are relatively low. In contrast, the costs for other publicly available information, as discussed under the semi-strong form ECMH, may be higher depending on where the information is available (as well as the cost of gathering the information and verifying it) and how much processing of the information is required. Finally, private information, as discussed under the strong-form ECMH, by its nature is costly to acquire.

Thus, as a general matter, the ECMH, if true, simply tells us that the lower the costs of the information, the more likely that the information will be incorporated into the price of the securities.¹²² Professors Gilson and Kraakman, in their influential article, *The Mechanisms of Market Efficiency*, suggest that the more efficient the market for information is, the more efficient the capital market will be.¹²³ If such is the case, then rather than instructing that a particular kind of information ought not be required to be disclosed, the ECMH instructs that there should be careful consideration of whether utilizing disclosure rules would reduce the costs of information and thus improve the efficiency of the market for information.¹²⁴ This pragmatic approach to the understanding of efficient markets is especially valid if market mechanisms may not incorporate information as well as some interpretations of ECMH suggest.¹²⁵

C. The information costs of state corporate law

Does ECMH and the general availability of information on state corporate law make it unnecessary to use the mandatory disclosure

120. See Stout, *supra* note 109, at 652–55 (discussing the theory that “market prices behave as if all investors know the information” because of the trading activity of arbitrageurs, but noting that “arbitrage is not a costless process”).

121. See Gilson & Kraakman, *supra* note 108, at 597, 611.

122. See KLEIN & COFFEE, *supra* note 76, at 421 (presenting the argument that “the cheaper the information is to acquire, the more efficient will be the market”).

123. See Gilson & Kraakman, *supra* note 108, at 597, 611.

124. See KLEIN & COFFEE, *supra* note 76, at 421 (presenting the “perspective” that securities laws are a “strategy for the collectivization and broad dissemination of securities information, in order thereby both to reduce the cost of information acquisition and to increase the speed of its dissemination”).

125. “[T]he market mechanism described by Gilson and Kraakman is anything but a clean, elegant, well-designed machine. Rather, it is a Rube Goldberg apparatus: a jury-rigged contraption full of frail components, weak links, and moving parts, rife with potential for failure.” Stout, *supra* note 109, at 638.

system to reduce information costs? To answer this question, it must be recognized that although information on state corporate law is available to the general public, it is not costless. First, there is the cost of acquiring the information.¹²⁶ Although statutory law is readily available on the internet and in law libraries, finding court decisions interpreting statutes and establishing common law rules requires a more significant investment,¹²⁷ and it is in court decisions where many important substantive rules of corporate law are found.¹²⁸

Furthermore, once the investor has found the law and sorted out the most important of its rules and standards, she will bear the costs of processing the information.¹²⁹ The most substantial of these processing costs is the investment in knowledge that allows the investor to understand the significance of the information.

Finally, the investor bears the cost of validating the information.¹³⁰ When one is receiving state corporate law information from primary legal sources, then validating the information is part of the cost of gathering the information—accuracy and timeliness are part of the legal research process. When one is acquiring the information through secondary legal sources, the costs of validating the accuracy and timeliness of the information are separate and distinct from the costs of gathering the information.

D. Reducing information costs for investors through mandatory disclosure

When we do not require the issuer to bear the costs of compiling information and providing it to the market, individual traders will be required to bear these costs. In a hypothetical market of 10,000 traders, for example, the market will bear the costs of acquiring the information 10,000 separate times.¹³¹

If, on the other hand, the burden is placed on the issuer to acquire the information, overall costs are reduced because only the issuer will

126. See Gilson & Kraakman, *supra* note 108, at 597, 611.

127. The time to actually do the research; the time and money spent in learning how to do legal research; and the time and money invested in an education in corporate governance that will allow one to sift through statutes and court opinions to glean the rules that are important should all be considered.

128. See Kahan & Kamar, *supra* note 86, at 707 ("It is judge-made law, rather than statutory law, that governs such fundamental issues as the fiduciary duties of directors, officers, and controlling shareholders in self-dealing transactions, the scope of corporate opportunities, the obligations of directors in dealing with control challenges, the prerequisites for a derivative suit, directors' disclosure obligations, and the scope of impermissible corporate waste.").

129. See Gilson & Kraakman, *supra* note 108, at 597, 611.

130. See *id.*

131. Of course, they can reduce these costs by collectivizing their efforts. See *infra* Part IV.I.

make the investment in acquiring the information. Thus, by requiring public companies to disclose information about state corporate law, "the repetitive cost of individual acquisition of information by each analyst"¹³² is eliminated, and information costs for the market are reduced.

A mandatory disclosure regime will also reduce the costs of verifying the accuracy of the information. Civil and criminal laws penalizing those who provide inaccurate information reduce the risk that companies will disclose intentionally inaccurate information.¹³³ In addition, because other companies incorporated in the same jurisdiction should disclose the same information, companies will have an incentive to be careful and diligent about the accuracy of their own disclosures. The market can easily verify information disclosed by one company by reading the disclosures of other companies incorporated in the same jurisdiction. Of course, companies will always have an incentive to produce the minimum amount of information or present it in the most favorable light,¹³⁴ but absent collusion, they will be wary of being embarrassed by another issuer's more accurate and careful disclosure of the law. In addition, inaccurate information will generate law review articles, blogging by corporate law professors, and reports in the financial press, further facilitating the market's validation of the information.

Admittedly, mandatory disclosure of state corporate law will have less of a beneficial effect on reducing the costs of processing the information. Even with a rule requiring companies to disclose information on state corporate law, investors will still need to invest in the knowledge and time required to make qualitative judgments about the information. That is not to say that mandatory disclosure could have no effect on the costs of processing the information. A well-crafted disclosure rule would require the company to organize the information on state corporate law and present it in context—*i.e.*, in the context of its current practices and firm-level rules as well as any exchange rules that may apply. In some sense, it would require the company to partially digest some of the information for the market in a way similar to

132. See Gilson & Kraakman, *supra* note 108, at 601 (commenting generally on how "legislation such as the Securities Exchange Act of 1934, which requires continual disclosure of extensive current information by public companies" contributes to the reduction of information costs).

133. See *id.* at 605 (stating that civil and criminal penalties are a "potentially less expensive" solution to the problem of verification costs). Of course, the threat of penalty will likely encourage issuers to disclose as little information as possible.

134. See *id.* at 602 ("[T]he information's producer will often stand to benefit by leading the recipient to overvalue the product . . .").

what is already required in the management's discussion and analysis¹³⁵ and the compensation discussion and analysis.¹³⁶

E. Information costs for the company

As stated above, the mandatory disclosure of state corporate law would not eliminate information costs, but would merely shift them from the investors to the public company. This approach is only an efficient solution when the company has a comparative advantage in the information.¹³⁷ In other words, investors would only prefer a rule requiring public companies to disclose information on state corporate law when the issuer can address the information costs more efficiently than the investors (comparatively). After all, it is the investors who will eventually bear any information costs imposed on the company.¹³⁸

It seems likely that public companies have a comparative advantage in information about state corporate law. First, the information costs to the company are almost certainly lower than the costs to investor population as a whole. As explained above, if the information costs are placed on investors, then numerous investors, not just one, will each bear the same costs of investing in the same information.¹³⁹

Placing the burden on the company instead of the investors, then, reduces duplicative efforts in the market, but it does not completely eliminate them. Public companies will also engage in duplicative efforts in producing information on state corporate law. An issuer incorporated in State A, for example, should be producing the same information on state corporate law as the other issuers incorporated in State A. Thus, whether issuers or investors should bear the information costs seems to boil down to which group's duplicative efforts are less costly.

It seems that the duplicative efforts of issuers are less costly for two reasons. First, there are fewer issuers than investors in the market. The duplicative costs of (fewer) issuers would be lower than the duplicative costs of (more) investors. Second, even without a mandatory disclosure rule, most issuers would invest in gathering, processing, and validating a substantial amount of information about state corporate law for internal uses. After all, corporate governance is necessarily a major part of the "business" of any public company.

135. 17 C.F.R. § 229.303 (2007) (Management's discussion and analysis of financial condition and results of operations).

136. 17 C.F.R. § 229.402(b) (2007).

137. See Kitch, *supra* note 70, at 775. Professor Kitch has suggested that this should be limited to "value-relevant information about the issuers own business." *Id.*

138. See Easterbrook & Fischel, *supra* note 7, at 696 (stating that the costs of disclosure are "borne in large part by investors").

139. See *supra* Part IV.D.

Thus, it is to be expected that most, if not all, public companies would invest in informing its directors and executive officers about (1) their duties, rights, and protections under state corporate law and (2) whether and how those duties, rights and protections were modified by firm-level rules.¹⁴⁰ Therefore, a mandatory disclosure rule would only create additional costs for companies if the rule required disclosure of information that deviated significantly from the information the company already collected.

F. The implications of substantial uniformity of state corporate laws on information costs

Of course, one of the assumptions justifying the argument that the costs of state corporate law information are relatively high for investors is that investors need to research fifty-one different corporate laws.¹⁴¹ If the corporate laws of all the states were uniform, however, there would be little or no justification for mandatory disclosure of state corporate law. The information costs for investors under a uniform law would be reduced significantly because investors would only need to gather, process, and validate information on one uniform corporate law that would apply to all U.S. public companies.

There is not formal uniformity of state corporate law in the U.S. However, there is strong support for the proposition that there is substantial uniformity.¹⁴² For example, both Professor Bernard Black and Professor Roberta Romano predicted substantial uniformity in state corporate law in separate articles written nearly two decades ago.¹⁴³ In an empirical study published in 1998, Professor William Carney found that "American corporate law reveal[ed] a pattern of substantial uniformity."¹⁴⁴ In a more recent article, Professor J. Robert Brown argued that although the corporate laws of the various U.S. states do diverge in certain aspects, they are largely consistent with Delaware's approach.¹⁴⁵ Further support for the idea that there is substantial uniformity in state corporate law comes from the literature on comparative corporate governance. When scholars compare

140. Even if not all of the companies are engaging in this type of activity, we would still expect that a significant majority of public companies would.

141. See *supra* notes 4–5 and accompanying text (stating that nearly all U.S. states are the state of incorporation for at least one public company).

142. See John C. Coffee, Jr., *The Future As History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 702 (1999) (stating that empirical literature shows a "high degree of uniformity" in U.S. corporate laws).

143. See Black, *supra* note 37, at 586; Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 718 (1987).

144. William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 755 (1998).

145. See Brown, *supra* note 49, at 334.

the corporate governance of various nations, they consider the U.S. as a single jurisdiction, and do not make distinctions between the laws of the various U.S. states.¹⁴⁶

I do not necessarily disagree with the claims of substantial uniformity in state corporate laws, but I do caution against using substantial uniformity as an argument against mandatory disclosure of state corporate law. Professor Romano recognized that even with substantial uniformity, there would be periods of divergence as innovations disperse from state to state.¹⁴⁷ Similarly, Professor Carney tempered his observation of substantial uniformity by noting that the "pattern [of uniformity] is less than complete because of a *constant* process of innovation driven by interest groups."¹⁴⁸

In fact, in addition to the spread of successful innovations that both Professors Romano and Carney expressly acknowledged, we can imagine there will also be unsuccessful innovations, the dispersion of which will be eventually halted by market rejection, but not before some states had already adopted the innovation. Thus, even when there is substantial uniformity there will be periods of time where there are major differences in state corporate laws because either "good" innovations have not spread to all states or because "bad" innovations have not yet been repealed in the states that have adopted them.¹⁴⁹ Mandatory disclosure would reduce information costs that arise because of these constant and inevitable divergences.

As one example of these divergences, in 1998, when Professor Carney published his paper, one would find that thirty-one of the fifty states, or sixty-two percent, had a statute that provided for dissenters rights as an exclusive remedy.¹⁵⁰ This number provides sufficient support for an argument of substantial uniformity, but only because the relevant time line is so long. The first state to adopt a statute did so in 1959,¹⁵¹ and the last one to adopt it did so in 1994.¹⁵² A further breakdown reveals that of the thirty-one states with this statutory provision in their corporate codes, two states adopted it prior to

146. See La Porta et al, *supra* note 36. See also James A. Fanto, *The Absence of Cross-Cultural Communication: SEC Mandatory Disclosure and Foreign Corporate Governance*, 17 Nw. J. INT'L. L. & BUS. 119 (1996) (examining whether foreign issuers should be required to disclose more information about the corporate governance systems of their home countries because of the possible differences between their corporate governance systems and the U.S. corporate governance system).

147. See Romano, *supra* note 143, at 718.

148. See Carney, *supra* note 144, at 755 (emphasis added).

149. See *id.* at 740 (noting "a strong tendency toward uniformity over time") (emphasis added).

150. See *id.* at 743-44 (Table 2).

151. The first state was Connecticut. See *id.* at 743 (Table 2).

152. Arizona was the last state. See *id.* at 743 (Table 2).

1966,¹⁵³ two states adopted it between 1966 and 1975,¹⁵⁴ ten states adopted it between 1976 and 1985,¹⁵⁵ and seventeen states adopted it between 1986 and 1994.¹⁵⁶ This breakdown demonstrates substantial divergence in corporate law in numerous shorter time periods within the longer time line of 1959 to 1995. This pattern does not contradict Professor Carney's conclusion that there is substantial uniformity in state corporate law today, but it supports my argument that even with substantial uniformity, mandatory disclosure of corporate law can reduce information costs of inevitable and substantial divergences.

Of course, one could argue that although states have not achieved actual uniformity, the capital market has achieved functional uniformity. Approximately fifty-eight percent of public firms incorporate in Delaware, and the percentage seems to be increasing.¹⁵⁷ Once again, however, I would caution against using functional uniformity as a justification for not requiring issuers to make disclosures about the corporate law of their respective states of incorporation. One of the reasons Delaware has captured such a large percentage of the market for incorporations may be due to lower information costs about Delaware corporate law because of the vast attention it receives in scholarship and the financial media.¹⁵⁸ Thus, although Delaware's large market share of incorporations arguably creates a functional uniformity of state corporate law, this functional uniformity may be caused, at least in part, by the current absence of a rule mandating public companies disclose state corporate law. Mandatory disclosure of state corporate law for all public companies will reduce costs of information for the corporate laws of every state and possibly remove one of Delaware's advantages.

153. Connecticut adopted its law in 1959, and New York did so in 1961. *See id.* at 743–44 (Table 2).

154. California adopted its statute in 1975. Texas adopted its statute in 1967. *See id.* at 743 (Table 2).

155. These states include: Colorado, Hawaii, Idaho, Illinois, Minnesota, Nebraska, New Hampshire, New Mexico, North Dakota, and Virginia. *See id.* at 743–44 (Table 2).

156. These states include: Arizona, Arkansas, Florida, Georgia, Iowa, Kentucky, Michigan, Mississippi, Missouri, Montana, Nevada, North Carolina, Oregon, Tennessee, Washington, Wisconsin, and Wyoming. *See id.* at 743–44 (Table 2).

157. *See* Bebchuk & Cohen, *supra* note 4, at 389 (“Delaware has by far the largest stake of incorporations: 58 percent of all firms, 59 percent of Fortune 500 firms, and an even higher percentage—68 percent—of all firms that went public in the period 1996–2000.”).

158. As I argue in Part IV.I, *infra*:

With a wide variety of public companies incorporated in Delaware, traders can use their information on Delaware corporate law for more than one company without jeopardizing diversification. In addition, intermediaries who collect information for investors can do so at a lower cost because the attention academics and the media pay to Delaware law makes information available at a lower cost.

G. Reducing the costs of unincorporated information

To this point, this Article has suggested that mandatory disclosure of state corporate law would promote a more efficient capital market because it would help ensure information on state corporate law would be incorporated into the prices of securities at a lower cost. Mandatory disclosure of state corporate law also would promote a more efficient capital market by ensuring that information on state corporate law is incorporated into the price of securities when there is a likelihood that some important aspects of it would not be incorporated at all without mandatory disclosure.

When information is costly, there is a possibility that the market will not invest in that information at all, which results in market prices of securities that do not reflect the information.¹⁵⁹ Without a rule mandating disclosure of such information, the market would bear the costs of inaccurate prices.¹⁶⁰

It is a fairly uncontroversial proposition that the better the dissemination of the information, the more efficiently it will be incorporated into the market price.¹⁶¹ For prices to fully reflect a certain piece of information, there must be a certain volume of informed trading, which requires a certain number of informed investors.¹⁶² Because it is uncertain when this critical mass of informed trading has been reached, conditions must be created that are conducive to it. To that end, it would be reasonable to posit that the greater disincentives traders have to invest in and trade on certain information, the greater the chance that the information will *not* be incorporated into the market. With respect to information on certain aspects of state corporate law, there is a strong argument that there are substantial disincentives for traders to invest in such information because it is costly and because they may not recoup those costs by trading on the information.¹⁶³

State corporate law information is arguably quite costly—not in absolute terms, but in relative terms. There are numerous factors and

159. See Stout, *supra* note 109, at 656 (stating that even if information is public it may never be incorporated in securities prices).

160. See *supra* notes 19–21 and accompanying text (providing a summary of the importance of accurate share pricing).

161. See Gilson & Kraakman, *supra* note 108, at 593 (“The lower the cost of particular information, the wider will be its distribution, the more effective will be the capital market mechanism operating to reflect it in prices, and the more efficient will be the market with respect to it.”).

162. See *id.* at 568 (“rapid price equilibration does not require widespread dissemination of information, but only a minority of knowledgeable traders who control a critical volume of trading activity”).

163. See *id.* at 571 (“Since informed trading is costly, market professionals must enjoy some informational advantage that permits them to earn a commensurate return.”).

variables that influence the value of a company's securities, and a rational trader with limited resources will have to make decisions about where to invest her resources.¹⁶⁴ She will invest her resources in information that will provide her the greatest potential return. For every dollar she invests, she expects at least one dollar in return. Since her rationality is bounded, she will most likely focus her efforts on the "big ticket" issues—such as product markets, labor markets, and economic indicators. If she did focus on state corporate law, she would limit her focus on the few issues that have the most pronounced affect on the price of securities—such as anti-takeover statutes.¹⁶⁵ This strategy gives her the best chance to receive a positive return on her investment in information.

If this is the investor's strategy—and I believe it is the most plausible strategy—she will not pay much attention, if any, to the influence of most of state corporate law on corporate governance unless it is provided to her. Indeed there is a possibility that for every dollar she invests in gathering this knowledge, she will receive less than a dollar return, or at least this might be her perception when she is allocating resources to do research. Even if her one-dollar investment in state corporate law information resulted in a positive return, the trader would be better off investing that dollar gathering information that would provide a greater return. Thus, traders have a disincentive to invest in gathering and validating information on state corporate law because it is relatively too costly.

There is also an argument that an efficient capital market itself further exacerbates the relatively high cost of state corporate law information by creating free-rider costs that reduce the potential for return on the investment in information. The ECMH implicitly tells us uninformed investors free-ride on the efforts of informed investors, at least to a certain extent.¹⁶⁶ Informed investors acquire, gather, and process the information. They then trade on that information. Their trading activity causes the information to be incorporated into the price of the stock. Uninformed traders benefit by the trading activity of informed investors because they trade based on the market price of

164. See Stout, *supra* note 109, at 655 ("[A]rbitrageurs, like the rest of us, enjoy access to only finite amounts of money . . .").

165. See Daines, *supra* note 85, at 1560 ("These findings are consistent with the theory that . . . Delaware [corporate law] better facilitates takeovers, thereby improving shareholder value."); Lucian Bebchuck, Alma Cohen, and Allen Ferrell, What Matters in Corporate Governance (2005) (working paper available at http://papers.ssrn.com/abstract_id=593423) (finding a negative correlation between firm value and certain anti-takeover, or "entrenching" provisions in organizational documents).

166. See Easterbrook & Fischel, *supra* note 7, at 694 (stating that "uninformed traders can take a free ride").

the security, which already reflects the information gathered, processed, and verified by informed investors.

This type of "spillover" (or "positive externality") is only problematic if it creates a disincentive for the informed traders to invest in informing themselves. If the informed investors cannot use their information to gain an advantage in the market, then they have a disincentive to invest in that information.¹⁶⁷ Thus, the more efficient the capital market is in incorporating information into the price of securities, the less incentive traders have to bear the information costs.¹⁶⁸

There is an argument that, as a general proposition, there is just enough inefficiency in the market to encourage traders to invest in information.¹⁶⁹ In addition, there might be sufficient opportunity for a trader to engage in arbitrage with respect to the influence of information on the fundamental value of the security. The idea is that even assuming the market is so efficient that it immediately incorporates any information into securities prices ("informational efficiency"),¹⁷⁰ it still may not be as efficient in incorporating the *correct* value of that information into the price ("fundamental value efficiency").¹⁷¹ Put another way, the market may incorporate the information immediately, but it may not incorporate it correctly.¹⁷² Thus, even though the trader may not have an incentive to bear the information costs of state corporate law because she will not be able to beat

167. See Kitch, *supra* note 70, at 774-75 ("[T]here will tend to be both underinvestment and overinvestment in the activity of predicting the accurate price. There will be underinvestment because no actor is able to capture the full benefits of being accurate."); Stout, *supra* note 109, at 640 n.24 (stating that it cannot be true that traders can never beat the market or "no one would have incentive to trade on information in a way that leads to the incorporation of that information into prices").

168. See KLEIN & COFFEE, *supra* note 76, at 420 (explaining the paradox as, "if the return on investment in information is low, one cannot reasonably expect the search activities to continue that keep the market efficient").

169. See generally Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980).

170. See Stout, *supra* note 109, at 640 ("The concept of informational efficiency accordingly can be understood as a prediction or implication about the *speed* with which prices respond to information."). Other scholars have referred to informational efficiency as "speculative efficiency." See KLEIN & COFFEE, *supra* note 76, at 421.

171. See Stout, *supra* note 109, at 640 ("Markets are efficient in the fundamental value sense if stock prices respond to available information not only quickly but *accurately*, so that market prices mirror the best possible estimates, in light of all available information, of the actual economic values of securities in terms of their expected risks and returns."). Other scholars have referred to fundamental value efficiency as "allocative efficiency." See KLEIN & COFFEE, *supra* note 76, at 421.

172. See Stout, *supra* note 109, at 651 (arguing that when "finance economists define market efficiency in terms of the difficulty of making arbitrage profits" they have implicitly accepted the idea that "a market can be informationally efficient without also being fundamental value efficient").

the market in time, she may have an incentive to invest in the information in order to beat the market in valuing the information.

Of course, if a trader understands the correct value of the information better than the market, she has only won half the battle. She must now also convince the market that her interpretation of the information is correct—otherwise, the price will never reflect her view.¹⁷³ Thus, a trader who wants to beat the market on fundamental value must not only invest a great amount of resources in processing, gathering, and verifying the information, she might also need to invest money in convincing the market that her assessment of the fundamental value is correct.¹⁷⁴ She might be willing to bear these costs, but she will do so only when the chance for a return is greater, providing her a better chance for her to recoup these costs. Thus, she has a greater incentive to invest in the type of material information that will create the biggest movement in the stock price—such as product markets, takeover markets, economic indicators, etc. She has little or no incentive to invest in information, like certain aspects of state corporate law, that alone cause little or no movement in stock prices.

Thus, there is a strong argument that if public companies are not required to bear the costs of disclosure of state corporate law, then the market has little or no incentive to invest in acquiring, verifying, and processing the aspects of state corporate law which create less obvious movements in stock prices. In which case, it will be unlikely for these aspects of state corporate law to be impounded into the price of the securities.

H. “Piecemeal incorporation” of state corporate law information

One of the problems with discussing how the market incorporates state corporate law into the price of securities is that most of our understanding of efficient markets seems to assume that information occurs in “events.” In other words, most previous scholarship has either expressly focused on, or implicitly assumed, the sudden occurrence of some important event when examining how the market incorporates information into the price of securities.¹⁷⁵

Unfortunately, state corporate law does not fit neatly into that mold. State corporate law itself is not an “event.” It has been around

173. See Coffee, *supra* note 15, at 725–26 (quoting the Wall Street Trader’s credo, “A bargain that remains a bargain is no bargain”).

174. See Stout, *supra* note 109, at 655 (stating that arbitrageurs “face the risk that uninformed investors will stay uninformed”).

175. See *id.* at 652 (describing “the great enthusiasm legal scholars and economists have shown in recent years for ‘event studies’ that attempt to assess investors’ views of the merits of changes in corporate law or policy by gauging whether, when the event is announced, share prices rise or fall”).

since the existence of modern capital markets. Of course, there have been revisions, amendments, modifications, and interpretations of state corporate laws over the years that can properly be considered "events."¹⁷⁶ The question, then, is whether state corporate law is impounded piecemeal into market price as a series of events or whether it is something more organic that sits there and evolves, but remains largely unnoticed in the market price of a security.

The argument that the market has slowly incorporated the price of state corporate law into securities is plausible,¹⁷⁷ but not necessarily true. Essentially, the argument for piecemeal incorporation of state corporate law assumes that state corporate law information is "'old' information imbedded in securities prices,"¹⁷⁸ which is later updated and incorporated into the price of securities by well-publicized events. However, it is debatable whether state corporate law was ever incorporated into the price of securities in the past. Incorporation of state corporate law in the past would suffer from the same problems already discussed—namely, that investors have a disincentive to bear the information costs of state corporate law.¹⁷⁹ It may be that time and media attention to major changes in state corporate law have somewhat mitigated the effects of the disincentives, but by no means have time and media attention ensured that the market has fully impounded state corporate law into securities prices.

In addition, even assuming for the sake of argument, that state corporate law was incorporated into the prices of securities sometime in the past (at the initial public offering stage, for example), for the current prices to reflect that information, we would have to believe that the market never forgets. However, it is quite plausible that this information gets lost in the market over the years as the prices of the securities fluctuate in response to other information. Mandatory, regular disclosure of this information would ensure that the market price continuously reflects information on state corporate law.

176. For an example of an event study trying to measure investors' reactions to a change in state corporate law, see Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989) (trying to measure the market response to a Delaware Supreme Court decision on the duty of care and a change to Delaware General Corporation Law allowing a charter provision exculpating directors for violations of the duty of care).

177. See Gilson & Kraakman, *supra* note 108, at 562 (describing how the trader's acquisition of new information "increases his total store of information, but it may also alter some or all of the information he already holds").

178. See *id.* at 568 (discussing how "'old' information imbedded in securities is the closest approximation to universal dissemination of information").

179. See *supra* Part IV.G.

I. Market solutions

Besides state corporate law, there is likely a whole variety of material information that is never incorporated into the price of the securities because the information costs are too high. The key to getting this information into the market price, if we consider it important enough, is to reduce the costs of the information. Although mandatory disclosure can reduce these information costs, we must remember that there are also market solutions to reducing the information costs.¹⁸⁰

Investors could collectivize their efforts in order to reduce information costs. For example, let us say that the cost of a certain piece of information is one dollar, but it will only result in a \$0.10 difference in value for the investor who invests in 10,000 shares of Company A. If more than ten investors equally share the one-dollar cost of the information, then their investment in the information will be worthwhile. The market would see the emergence of market intermediaries that gather, process, and verify state corporate law information at a price if it were worthwhile for these third parties to do so.¹⁸¹

Alternatively, an individual investor could reduce the relative cost of the information if she invested in Company A and ten other public companies to which the information was relevant. When the information is the corporate law of a particular state, the investor can reduce her costs when she can invest in several companies that are incorporated in the same state.

In a similar fashion, public companies can engage in conduct that reduces state corporate law information costs for the investors. Company A, for example, could incorporate in a jurisdiction that is the state of incorporation for many other public companies and, thus, allow investors to invest in many companies for which the information would be relevant.¹⁸² This analysis suggests that one of the reasons Delaware is the state of incorporation for the majority of U.S. public companies¹⁸³ may be the lower information costs with respect to Delaware corporate law.¹⁸⁴ With a wide variety of public companies incor-

180. See KLEIN & COFFEE, *supra* note 76, at 420 ("Many familiar market institutions, such as the investment banking firm, can be understood as market mechanisms for reducing information costs.").

181. See Gilson & Kraakman, *supra* note 108, at 600 ("We then see market efforts to economize on acquisition costs through collectivization at both private and public levels Indeed, the very existence of information intermediaries . . . reflects, in part, the potential for economies of scale and scope in efforts to economize on information costs.") (citations omitted).

182. They may prefer to do this rather than voluntarily disclose information about state corporate law for the reasons discussed above. See *supra* Part III.B.

183. See *supra* note 4.

184. See Bebchuk & Cohen, *supra* note 4, at 385 (discussing how incorporating in might have positive effects that are due to "network benefits" and are unrelated to the quality of Delaware corporate law).

porated in Delaware, traders can use their information on Delaware corporate law for more than one company without jeopardizing diversification. In addition, intermediaries who collect information for investors can do so at a lower cost because the attention academics and the media pay to Delaware law makes information available at a lower cost.¹⁸⁵

However, the existence of potential market solutions to reduce information costs does not necessarily negate the need for, or the benefit of, mandatory disclosure of state corporate law. The emergence of a market intermediary, for example, is not guaranteed. A market intermediary will only emerge when market conditions are favorable. Because a market intermediary will bear the costs of gathering, processing, and verifying the information, it will only emerge when these costs are exceeded by the price that subscribers are willing to pay for the information. One cannot know where the tipping point is, but one does know that the emergence of the intermediary (and investor subscription to intermediary services) is more likely by reducing costs of information through mandatory disclosure.

There are currently various companies that provide information of the corporate governance of public companies. RiskMetrics Group, for example, creates a "Corporate Governance Quotient" that purports to include some information on state corporate law, although that information is limited to the "anti-takeover" provisions of the various states of incorporation.¹⁸⁶ Mandating public companies to disclose state corporate law would reduce information costs for these intermediaries and promote incorporation of the information into the price of securities at a lower cost.¹⁸⁷ In addition, mandatory disclosure would provide investors with low-cost access to information on state corporate law when they are unsatisfied with the manner in which the market intermediaries select, collect, present, or process the information on state corporate law.

J. Preliminary conclusion

This section has argued that the ECMH suggests public companies should be required to disclose certain aspects of state corporate law to reduce investors' information costs, even though information on state corporate law is already available through various sources. This policy would not only aid in reducing the costs of incorporating informa-

185. See *supra* Part IV.F (discussing the how the dominance of Delaware creates a functional uniformity of state corporate law).

186. RiskMetrics Group, U.S. Corporate Governance Quotient Criteria, <http://www.issproxy.com/issgovernance/esg/uscgqcriteria.html> (last visited Nov. 9, 2007).

187. A mandatory disclosure system would not displace these intermediaries in the market because many traders would still rely on the expertise of an intermediary to process information on state corporate law.

tion on state corporate law into the price of securities, it would also help ensure that the information would indeed be incorporated into securities prices when there is a real possibility the market would have otherwise ignored some of its important aspects.

V. THE COSTS OF MANDATORY DISCLOSURE OF STATE CORPORATE LAW

The immediately preceding sections have presented the argument that (1) state corporate law is important to investors of public companies and (2) the mandatory disclosure of state corporate law would reduce information costs in the market. However, although the market may benefit from reduced information costs, it will bear other costs of a mandatory disclosure rule. This section discusses some of the other costs of mandatory disclosure of state corporate law.

A. Administrative costs

There are administrative costs of creating a mandatory disclosure rule and enforcing it.¹⁸⁸ The market bears these costs directly through SEC filing fees, for example. It bears these costs indirectly through taxes, some of which eventually find their way into the SEC's budget.

As stated above, there may be some self-policing in the market that would somewhat reduce the costs of monitoring by the SEC.¹⁸⁹

B. Liability costs

There are the costs of the risk of liability for inaccurate disclosures. As discussed above, one of the reasons managers would prefer not to disclose state corporate law is because of the risk of liability for inaccurate disclosures.¹⁹⁰ If they are required to disclose this information, they may be subjected to fines, criminal penalties, or civil lawsuits for inaccurate disclosures.

If the issuer's directors or executive officers are subject to fines or lawsuits, the issuer will still bear most of these costs through director and officer insurance premiums, indemnification agreements, and the increased difficulty of attracting talented people to fill positions in the company. Managers would also protect themselves by causing the company to hire expensive attorneys to prepare the disclosure statements and to provide legal opinions stating that the disclosures accu-

188. See Michael D. Guttentag, *An Argument for Imposing Disclosure Requirements on Public Companies*, 32 FLA. ST. U. L. REV. 123, 163 (2004) ("Administration costs are the costs of constructing, monitoring, and enforcing disclosure requirements.").

189. See Part IV.D, *supra*.

190. See *supra* note 70 and accompanying text.

rately portray the corporate law of the state of incorporation. Once again, it is the investors who ultimately bear these costs.

The risk of inaccurate disclosure may indeed be quite palpable under a rule requiring disclosure of state corporate law, especially if something more than a mechanical regurgitation of state corporate law statutes is required. As a mandatory disclosure rule is drafted, consideration must be given to how companies are expected to disclose relatively indeterminate corporate law standards¹⁹¹ and inaccurate depictions will be sanctioned. In the early years of the rule, a more light-handed regulatory approach would allow the market to develop standard statements of certain aspects of corporate law that are less determinate. Self-policing mechanisms in the market may be sufficient to protect investors from at least the most deliberate and egregious misstatements.¹⁹²

C. Avoidance costs

Managers will often attempt to avoid mandatory disclosure by, for example, avoiding the behavior that is subject to disclosure. This response to mandatory disclosure may be costly to the company because the avoidance activity may be less efficient than the activity that was subject to disclosure.¹⁹³

A regulation requiring public companies to disclose information on state corporate law is less susceptible to these types of costs. For example, mandatory disclosure of state corporate law might result in the managers deciding to reincorporate in State B to avoid disclosing a certain aspect of State A's corporate law. Alternatively, the company may modify the effects of State A's corporate law through amendment of the company's organizational documents. In either case, however, the company arguably would not suffer any avoidance costs¹⁹⁴ because this type of behavior would not occur unless there was a market preference for the reincorporation or the amendments to the organizational documents. In other words, these types of changes, if they actually occurred, would be a benefit of mandatory disclosure rule and not an avoidance cost.

191. For a discussion of whether Delaware law is overly indeterminate, see Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998); William T. Allen, *Ambiguity in Corporation Law*, 22 DEL J. CORP. L. 894 (1997); Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990).

192. See *supra* note 189.

193. See Guttentag, *supra* note 188, at 163 ("Avoidance costs refer to the distortionary effects that disclosure can have on a company's business practices."). For a detailed analysis of avoidance costs and mandatory disclosure, see Manne, *supra* note 63.

194. Of course, it would suffer the costs of reincorporation or the internal administrative costs of amending its charter or bylaws.

D. "Information overload" costs

"Information overload" is another potential cost of mandatory disclosure.¹⁹⁵ More information for investors will not necessarily result in better investment decisions, even if the information is relevant. It is initially appealing to err on the side of providing more information because investors can sort through the information and choose to process only the information they find most helpful.¹⁹⁶ However, Professor Troy Paredes has presented the argument that providing too much information may actually be more detrimental than providing too little information.¹⁹⁷ In fact, this principle may even apply to expert investors as well as non-expert investors.¹⁹⁸

The question then becomes how the concept of information overload applies to help the decision about whether to require disclosure of state corporate law. Because the details of information overload is sketchy at best, it alone cannot justify excluding any specific information from the mandatory disclosure regime.¹⁹⁹ Too many questions about information overload remain unanswered;²⁰⁰ namely, at what point is there too much information? Even if the point of information overload could be identified, how does one determine what information should be deleted and what information should be maintained?

At this point, recognition of the possibility of information overload merely serves as a caution to require disclosure of important information in a manner that makes it easier for investors to process.²⁰¹ To that extent, a rule requiring public companies to describe a particular state corporate law rule or standard with an explanation of how firm-level rules (as well as exchange rules) modify or supplement it may be appropriate.

195. See Paredes, *supra* note 17.

196. See *id.* at 435 (presenting the possibly mistaken view that "more information is always better than less").

197. See *id.* at 441 ("Studies have shown that . . . once the information level reaches a certain point, . . . the decision maker's decision quality decreases if she is given additional information.").

198. See *id.* at 454 ("Several studies and experiments show that experts can become overloaded, even if they can effectively use more information than non-experts.").

199. See *id.* at 451 ("[I]t is likely that we would add certain disclosures, even if the disclosure system were scaled back . . .").

200. See *id.* at 473 (stating that "before revamping our securities laws to avoid information overload, we need more data about how people process information and make investing decisions" and that "it would be unwise to make any significant regulatory changes [because] [t]he risk of doing more harm than good might be too great").

201. See *id.* at 474 ("Another option [to mitigate the risk of overload] is to make the information overload, whatever it is, easier to evaluate.").

E. Preliminary conclusion

This section has presented the potential costs of a rule requiring public companies to disclose information about the corporate law of their respective states of incorporation. I have refrained from making any arguments with respect to whether the benefits of a mandatory disclosure rule (namely, a reduction of information costs) outweigh these costs. Because these costs are difficult to quantify, any argument on their weight relative to the benefits would be speculation. Instead, this section merely suggests that if it is agreed that information on state corporate law is an important part of the information that investors in public companies need to evaluate investment risk and that mandatory disclosure would reduce information costs for the market, then a rule should be carefully drafted to reduce the potential costs of administration, liability, avoidance, and information overload.

VI. CONCLUSION

This Article has made a case for requiring public companies to disclose information about state corporate law as part of their regular disclosures. State corporate law is an important part of the information investors need to evaluate corporate governance risk. Furthermore, mandatory disclosure of state corporate law would reduce the costs of disseminating information in a market where there are fifty-one possible jurisdictions for which investors need to research and process information on state corporate law. Finally, mandatory disclosure of state corporate law better ensures that this information is incorporated into the price of securities when there is a possibility the market largely ignores some important aspects of state corporate law.

I leave the details of the specific form and content of the disclosure rule to further scholarship, but I do have some preliminary suggestions. With respect to content, companies should be required to provide more than corporate law statutes. Corporate lawyers and scholars would generally agree that case law provides many rules and standards that are important to the governance of public firms.²⁰² Moreover, the argument for mandatory disclosure of these judge-made rules and standards is even stronger because the cost of acquiring this type of information is greater than the cost of acquiring rules directly from a state corporate law statute.²⁰³

Requiring disclosure of information about the institutional infrastructure of the state of incorporation should also be considered be-

202. See Kahan & Kamar, *supra* note 86, at 707 (stating that "judge-made law" governs many "fundamental issues" of corporate governance).

203. See *supra* Part IV.C.

cause of its effect on the quality of a state's corporate law.²⁰⁴ However, it should be recognized that this type of mandatory disclosure may put an additional burden on firms because it is not necessarily something they are already gathering for internal use.

Finally, a rule should be fashioned to focus on more than state corporate law regarding takeovers. There is empirical support for the proposition that aspects of corporate law besides takeover statutes affect firms' decisions where to incorporate.²⁰⁵

With respect to the form of the disclosures, the structure of any disclosure should mitigate the potential costs of information overload and somewhat reduce the costs of processing the information. To that end, the company's disclosures of state corporate law should be organized together with other corporate governance information that is currently part of its required disclosures. For example, the disclosure would (1) present the state's corporate law on an issue, (2) explain whether and how the company's firm-level rules have adopted or modified the rule, and (3) explain who has the power to change the firm-level rule—the board of directors, the shareholders, or some combination of the two.

As I stated in the Introduction, because the United States has chosen a federal mandatory disclosure system, there must be continuous debate with respect to the content of mandatory disclosure. Although the additional burdens placed on public companies by the Sarbanes-Oxley Act of 2002 may make the thought of yet more disclosure requirements unpalatable for some scholars and policymakers, the possibility should still be evaluated, and the disclosure of information on state corporate law should be high on the agenda of the ongoing mandatory disclosure debate.

204. See Bebchuk & Hamdani, *supra* note 3, at 580–81 (“The presence of this institutional infrastructure is an important component of the quality of the system offered by Delaware.”).

205. Kahan, *supra* note 105.