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Toward an Interest-Group Theory of Delaware Corporate Law

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I. Introduction

This Article applies a model based on the interest-group theory of regulation to explain and predict the legal rules that affect the affairs of corporations chartered in Delaware. Two existing theories purport to explain and predict these legal rules. The traditional, "reformist" theory depicts Delaware as the winner of a deplorable "race to the bottom"[1] in which competition among the states for franchise taxes has led Delaware to produce a system of corporate law rules that permits corporate man-

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1. The phrase "race for the bottom" was coined by Professor William Cary. *See* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 666 (1974). It is derived from the famous dissenting opinion of Justice Brandeis in Louis K. Liggett Co. v. Lee, 288 U.S. 517, 559 (1933), describing competition among states for corporate chartering revenues as a race "not of diligence but of laxity." Many others have become adherents of the traditional race-to-the-bottom school. *See* R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION (1976); Folk, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875; Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991 (1976); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883 (1976); Young, *Federal Corporate Law, Federalism and the Federal Courts*, 41 LAW & CONTEMP. PROBS., Summer 1977, at 146 (1977).

In modern parlance, the phrase is "race *to* the bottom." *See, e.g.*, Young, *supra*, at 151 (misquoting Professor Cary). Whether termed a "race to the bottom," *id.*, a "race of leniency," Kaplan, *supra*, at 883, or a "race for the bottom," Cary, *supra*, at 666, the concept is well recognized. This Article adopts the phrase "race to the bottom."

agers to exploit shareholders for their own ends. More recently, the law and economics movement has produced a competing theory, the corporate federalist theory, which posits that the desire to obtain income from corporate charters has led Delaware and other states to develop efficient corporate law rules. Far from exploiting shareholders, this theory holds that these rules actually benefit shareholders by increasing the wealth of corporations chartered in states with these rules.[2]

Although both of the existing theories start with the observation that Delaware's policy is to craft rules that maximize revenues from corporate chartering, the theories diverge in almost every other respect. They differ dramatically from one another, not only in their positive predictions about the likely configuration of Delaware decision rules, but also in their normative conclusions about the overall desirability of the current system of state competition for corporate charters. Adherents of the traditional theory advocate scrapping the current system of state-law competition and replacing it with some form of federal regulation to end the race to the bottom and provide shareholders with adequate protection from exploitation by managers. The lawyer-economists advocating the corporate federalist theory generally believe that the current system of state competition promotes the development of optimal state laws and therefore should not be displaced by federal regulation.[3]

The existing theories can credibly explain portions of the Delaware system of corporate law, but neither theory is as robust as the interest-group theory applied here. In applying the interest-group model to Delaware law, this Article draws heavily on important premises from both of the existing schools and on insights developed by Roberta Romano in her recent seminal work.[4] From the race-to-the-bottom school we draw the proposition that states, in competing for charters, may sometimes provide special benefits to managers who decide where to incorporate, even when these benefits are not in the shareholders' best interest. This proposition is entirely consistent with an economic approach to corporate law, although it is somewhat inexplicably missing from the corporate fed-

2. R. POSNER, ECONOMIC ANALYSIS OF LAW 306-07 (2d ed. 1977); R. WINTER, GOVERNMENT AND THE CORPORATION 28-42 (1978); Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 181-82 (1985); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 919-20 (1982); Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 265-73 (1985).

3. *See* Fischel, *supra* note 2, at 920; Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 290 (1977); *see also Corporate Governance Proposals Debated by Lawyers, Economists*, 15 Sec. Reg. & L. Rep. (BNA) 1823 (Sept. 30, 1983) (remarks of Judge Ralph K. Winter).

4. Romano, *supra* note 2.

eralist theory. From the corporate federalist school, we draw the proposition that competition among states for charters will tend to generate efficient legal rules. Thus, we do not share the proregulation bias of the reformist school.

A complete theory of Delaware corporate law requires analysis of the ways in which the state's legal system responds to two broad constituent groups: (1) the "consumers" of Delaware corporate law (principally out-of-state shareholders and managers); and (2) the interests within the state that stand to benefit in various ways from the state's chartering system. For convenience, we will refer to the influence of the former group as the "demand side" for Delaware corporate law, and to the influence of the latter group as the "supply side."

Our theory offers a fuller explanation of the demand side than either of the existing alternatives. Any demand side theory of Delaware law must first offer a model of the dynamics of the market for corporate charters generally, and second explain why Delaware seems to occupy such a unique niche within that market. Our model of the chartering market combines important insights of both existing schools into a more general theoretical framework. By combining these propositions we derive a theory in which the consumers of corporate law generally demand efficient rules over inefficient ones, but in which a state can be expected to capitalize on agency costs by offering a limited menu of less efficient rules in those special areas where such rules are highly desired by managers. The principal area in which these inefficiencies can be expected to occur is that of rules protecting incumbent managers against the threat of hostile takeovers.

Within this general model of the demand side, the particular problem of Delaware law is to explain why that state has been able to obtain and preserve such a dominant position in the market for corporate charters. If the chartering market is competitive, we might expect to see other states undercutting Delaware's position through emulation and price competition. But efforts by states such as Nevada to compete with Delaware in the chartering business have not been very successful. We offer several suggestions to explain this apparent anomaly. Drawing on insights developed by Roberta Romano we observe that Delaware, over time, has developed an important capital asset in the form of a legal environment that is highly desired by consumers of its corporate law both for the present structure of its rules, and—perhaps more importantly—for the reliable promise it makes that rules adopted in the future will also be highly desired. These "first mover" advantages[5] cannot be fully emulated by other states. As a consequence, Delaware is so desirable a site for incorporation that it is able effectively to "charge" firms more than other states for the privilege of incorporating there.

The fact that Delaware can charge apparently supercompetitive prices for charters becomes highly significant when we turn to the second important determinant of Delaware corporate law—the differing interests of various in-state groups that we have referred to as the supply side. Delaware's dominant position in the chartering market results in the creation of substantial quasi-rents that are then distributed among the interested in-state groups through the political process. At the same time, the process is a reciprocal one in that political competition might partially dissipate these rents to the extent that the winners in the in-state political struggle have an interest in the state's adopting rules that undercut its comparative advantage vis-à-vis other states in the chartering market.

Neither of the existing theories of Delaware corporate law focuses on the supply side question. The implicit assumption of these theories is that chartering revenues are evenly distributed among the state's taxpayers.[6] We reject this assumption, positing instead the existence of two groups within the state whose interests are differentially affected depending on the nature of the legal rules supplied to firms incorporated there: (1) the taxpayers and groups allied with them; and (2) the Delaware bar. We envisage the supply side as a political equilibrium in which each group obtains desired legal rules depending on its political influence. A principal hypothesis emerging from this model is that the bar is the most important interest group within this equilibrium. Thus, the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state.

Part II of this Article describes and analyzes the existing theories of Delaware corporate law. In the following Part, this Article sets forth an interest-group theory and compares it to the existing theories. Part IV goes on to examine the application of this new theory to a number of Delaware statutes and judicial decisions.

Our interest-group model leads us to several useful observations

5. "First mover advantages" refers to the fact that relocating and reincorporating a corporation can be costly. Therefore, firms will choose to move to a state that has mechanisms in place that guarantee favorable behavior to corporations. One of the major mechanisms is having a large number of corporations in that state, thereby ensuring favorable behavior to avoid losing state revenues by having unhappy corporations depart, which in turn would slow future incorporations. Romano, *supra* note 2, at 280.

6. *See infra* subpart III(B).

about the nature of Delaware corporate law. First, the higher fees that Delaware is able to charge to corporations because of its advantage in the jurisdictional competition for corporate charters are not spread evenly or randomly throughout the state. Rather, these gains are apportioned to those special interest groups that compete most effectively within the political process.

Second, the nature of the fee structure by which Delaware charges for the privilege of incorporating within the state reflects this interest-group dynamic. The fee structure includes not only direct taxes to incorporating firms, but also indirect charges which come in the form of expected fees to Delaware lawyers.

This last point is of particular interest because it affords Delaware lawyers an opportunity to exploit the comparative advantage that they enjoy over other interest groups within the state. Because of their preexisting knowledge of the legal system and their low cost access to the law reform process, Delaware lawyers are able to craft the set of legal rules that maximizes the total demand for their services.

Finally, based on these observations, we conclude that Delaware law reflects a political equilibrium among the various interest groups within the state in which the lawyers enjoy a dominant position. We predict that as the legal system evolves, it will continue to reflect this equilibrium.

II. The Current Theories: Jurisdictional Competition

Judges Frank Easterbrook and Ralph Winter, and Professors Daniel Fischel, Roberta Romano, and other market-oriented legal scholars posit that Delaware corporate law rules are efficient, that is, they systematically advance shareholder welfare.[7] In contrast, those who follow in the tradition of Adolph Berle and Gardiner Means,[8] such as Professors William Cary, Donald Schwartz, and Melvin Eisenberg, argue that Delaware's quest for revenue has led it to enact laws favorable to management at the expense of shareholders, and that corporate managers choose to locate in Delaware to facilitate the exploitation of the corporation's shareholders.[9] Thus, an important distinction between the existing theo-

7. R. WINTER, *supra* note 2, at 5-46, 69-73; Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 33-35 (1983); Fischel, *supra* note 2, at 917-23; Romano, *supra* note 2, at 265-73.

8. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

9. Cary, *supra* note 1, at 665-86, 688-92; Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187, 188-91, 196-98, 202-09 (1983); Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 552-55 (1984).

ries is their conception of how well market forces constrain managerial opportunism.

A. The Race-to-the-Bottom Theory

The theory that Delaware corporate law is the product of a race to the bottom from the perspective of the shareholders may be traced to the pioneering work of Adolph Berle and Gardiner Means. In their 1932 book, *The Modern Corporation and Private Property*, Berle and Means made the now-famous observation that the large modern business corporation is characterized by a "separation of ownership and control."[10] Because shareholders are highly dispersed, they are unable to exercise effective control over corporate affairs. The real power, therefore, lies in the hands of corporate managers who may hold only a small percentage of the firm's shares. The Berle-Means thesis lends itself to the inference that government intervention is necessary to prevent corporate managers from exploiting powerless shareholders.

The race-to-the-bottom theory was presented most forcefully in Professor William Cary's famous article that gave rise to that phrase.[11] The Cary theory is in the Berle-Means tradition because it views Delaware as bidding for chartering business from corporate managers who, unconstrained by shareholder interests, will tend to choose states where the benefits to managers are greatest even if shareholders suffer in the process.

Starting with the hypothesis that "there is no public policy left in Delaware law except the objective of raising revenue,"[12] Cary examined a series of substantive corporate law issues—fiduciary duty, proxy contests, takeovers, accrned dividends on preferred stock, reclassifications of preferred stock, de facto mergers, fairness between parent and subsidiary, directors' duty of care, and director indemnification—and concluded that in each case the statutes and decisions uniformly advanced the interests of incumbent management, often at the expense of the shareholders.[13] Cary went on to observe that Delaware courts "have contributed to shrinking the concept of fiduciary responsibility and fairness, and indeed have followed the lead of the Delaware legislature in watering down shareholders' rights."[14]

Certain assumptions about the behavior of state lawmakers are la-

10. A. BERLE & G. MEANS, *supra* note 8, at 4.
11. *See* Cary, *supra* note 1, at 666 (referring to the race as a "race for the bottom").
12. *Id.* at 684.
13. *Id.* at 672-86, 688-90.
14. *Id.* at 696.

tent in Cary's theory. He implicitly posits that Delaware legislators have an incentive to enact statutes that are harmful to shareholder welfare when doing so will attract additional revenue from franchise taxes to the state.[15] Although the costs of such a scheme are distributed over shareholders located throughout the country, the group that enjoys the benefits from these increased charter revenues—presumably lower state taxes and increased state services—consists exclusively of the Delaware legislators' constituents.

It is somewhat more difficult to see how the Delaware judiciary is interested in the state's revenue raising scheme. Cary provides an interest-group explanation for how a "state policy based on revenue production and pride in remaining the foremost state for incorporation" translates into a judicial policy consistent with that goal.[16] Observing that virtually all the judges who have sat on the Delaware Supreme Court "have been directly involved in major political positions in the state,"[17] he concluded that in Delaware:

> [W]e have in microcosm the ultimate example of the relationship between politics, the bar, and the judiciary. There is certainly nothing "wrong" or surprising about these relationships. Yet it is clear that Delaware may be characterized as a tight little club in which the corporate bar cites unreported decisions before the courts in which they practice. Thus major participation in state politics and in the leading firms inevitably would align the Delaware judiciary solidly with Delaware legislative policy. Indeed, as outstanding members of the bar they may have contributed to its formulation before they became judges and at any rate might be disloyal to their state to pursue any other course.[18]

Cary contrasted the *laissez faire* attitude of the Delaware courts with contemporaneous federal court decisions in which managers and directors were held to increasingly rigorous fiduciary standards.[19]

Cary recognized that the "Delaware syndrome" of judicial and legislative hostility to shareholders may not be unique to that state. After all, other states have shown a strong interest in entering the lucrative race for corporate charters, so the problem perceived by Cary would not disappear even if Delaware law were refashioned.[20] Thus, Cary's ultimate conclusion was that the destructive race to the bottom among the

15. Professor Cary notes that "[t]he state of Delaware derives a substantial portion, roughly one-quarter, of its income from corporation fees and franchise taxes." *Id.* at 697-98.

16. *See id.* at 688.

17. *Id.* at 692.

18. *Id.*

19. *Id.* at 692-96.

20. Nevada and South Dakota have also attempted to attract corporation chartering. *Id.* at 665.

states could only be halted by instituting a national system of corporate law.[21] Cary proposed a federal corporate uniformity act to "remove much of the incentive to organize in Delaware or its rival states."[22]

B. The Corporate Federalist Theory

In contrast to the reformist position described above, the corporate federalists believe that Delaware "has achieved its prominent position because its permissive corporation law maximizes, rather than minimizes, shareholders' welfare."[23] Like the race-to-the-bottom theorists, the corporate federalists are mindful that ownership and control are separated in the large modern corporation. The normative conclusions they draw from this observation, however, are radically different from the views of the Berle and Means and Cary school.

Drawing on principles of financial economics, the federalists find it perfectly understandable that shareholders, who supply the firm with its capital, should not need or desire to exercise direct control over corporate managers' decision making. The federalists assume that rational investors hold diversified portfolios representing a fractional equity position in a large number of firms. Thus, it would be ludicrous to suggest that the individual security holders can acquire the information or expertise to manage these firms.[24] Accordingly, as Professor Fischel observes, "efficient allocation of risk bearing implies a large degree of separation of security ownership from control of a firm."[25]

Corporate federalists do not contend that managers always act in the best interests of shareholders. Rather, in this context, efficiency means only that this form of corporate finance is superior to alternative institutional arrangements and that the overall benefits exceed the costs. Managers' interests will often diverge from shareholders' interests in significant ways.[26] On any given day, a firm's managers might prefer to

21. *Id.* at 701.

22. *Id.* at 702.

23. Fischel, *supra* note 2, at 919-20.

24. *Id.* at 918.

25. *Id.*; *see also* Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980) (arguing that the "separation of security ownership and control can be explained as an efficient form of economic organization within the 'set of contracts' perspective"); Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301, 321-23 (1983) (arguing that separation of risk bearing from decision management leads to decision systems that separate decision management from decision control and thereby minimize agency costs); Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 327-28 & n.28 (1976) (stating that although separation of ownership and control incurs positive costs (agency costs) and is thus nonoptional, this corporate form of organization has yet to be replaced by a more efficient form). Separation of ownership and control is allocatively efficient even for large investors. *See* R. WINTER, *supra* note 2, at 17.

26. Shareholders probably will not agree, however, to bear the costs of an alternative institu-

play golf, although its shareholders might prefer that they remain in the office, maximizing profits. Similarly, a management team faced with a hostile tender offer that may deprive them of their jobs if it succeeds may prefer that the offer be defeated, even though it is clearly in the best interests of the firm's shareholders that the offer succeed.

According to the corporate federalists, market forces[27] limit managers' ability to pursue their own wishes at the expense of their shareholders. In many important respects, the difference between the proponents of the race-to-the-bottom theory and the corporate federalists lies in their different views of the efficacy of these market forces. For the corporate federalists, decisions about where to incorporate generally will be made in the best interests of the shareholders because market forces provide "compelling incentives" for managers to maximize shareholder welfare.[28]

The corporate federalists believe that Delaware retains its position as the leading state for incorporations because it provides the forum that is most conducive to maximizing shareholder wealth. Specifically, the corporate federalists assert that efficient legal rules emerge in Delaware through a remarkable manifestation of Adam Smith's invisible hand in which the self-interest of the Delaware legislature and judiciary produces legal rules that benefit the shareholders of large, publicly held firms.[29]

A "pure" corporate federalist approach presumably would hold that market competition eventually will force all corporations to incorporate in the state providing the most efficient menu of legal rules. If reincorporating in Delaware produced gains for all firms, those that did not relocate to Delaware would be expected to disappear as investors transferred resources to Delaware firms. But this withering away of Delaware firms

tional arrangement unless they are smaller in magnitude than the benefits such shareholders enjoy from the efficient risk bearing inherent in the separation of ownership and management. Jensen & Meckling, *supra* note 25, at 328.

27. These include, for example, performance of the firm, compensation packages, and the market for corporate control of inefficient management teams. Fischel, *supra* note 2, at 919.

28. *Id.*

29. This point has been made most forcefully by Judge, then Professor, Ralph Winter:

> It is not in the interest of Delaware corporate management or the Delaware treasury for corporations chartered there to be at a disadvantage in raising debt or equity capital in relation to corporations chartered in other states. Management must induce investors freely to choose their firm's stock instead of, among other things, stock in companies incorporated in other states or other countries . . . .
>
> . . . [A] corporation's ability to compete effectively in product markets is related to its ability to raise capital, and management's tenure in office is related to the price of stock. If management is to secure initial capital and have access to capital in the future, it must attract investors away from the almost infinite variety of competing opportunities. Furthermore, to retain its position, management has a powerful incentive to keep the price of stock high enough to prevent takeovers, a result obtained by making the corporation an attractive investment.

R. WINTER, *supra* note 2, at 10-11.

is not observed. Either Delaware reincorporation does not produce gains for all firms or firms refusing to relocate do not disappear, for though Delaware is successful in attracting and retaining corporate charters, many corporations continue to thrive under charters granted by other states—evidence that at least some firms may incorporate outside Delaware without incurring serious competitive disadvantage.

In response to the inadequacy of this pure theory, Judge Posner and Professor Scott modify the standard corporate federalist argument by suggesting that Delaware specializes in corporate law that is particularly attractive to large, publicly held corporations.[30] Empirical evidence provides some support for this position: Delaware's greatest area of dominance over other states lies in the percentage of New York Stock Exchange firms incorporated there. Forty-three percent of such firms are located in Delaware, but New York, the state with the next highest percentage, has fewer than eight percent.[31] In addition, ninety percent of the sample firms reincorporating between 1927 and 1977 chose Delaware as their new home.[32] But again, although firms incorporating in Delaware tend to be large, nearly as many large manufacturing firms are chartered outside of Delaware as are chartered in the state.[33] Thus, even if Delaware provides an especially conducive climate for large firms, market forces have not caused all or even a substantial majority of the nation's largest firms to reincorporate there.

Similarly, Professors Baysinger and Butler reject the notion that Delaware law is superior to that of other jurisdictions in some absolute sense.[34] Their hypothesis is that investors choose to invest in particular firms on the basis of how well shareholders are able to monitor the managers of those firms. They posit that investors who are superior monitors will choose to invest in Delaware firms and investors who are poor monitors will choose to invest in firms that are incorporated in states that impose stricter fiduciary duties on managers.[35] They draw support for their hypothesis from the fact that Delaware firms have more institu-

30. R. POSNER & J. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 111 (1980).

31. *See* N.Y.S.E. Guide (CCH) ¶¶ 701.3-799 (Jan. 31, 1986) (reflecting the percentages of New York Stock Exchange listed firms chartered in Delaware as of January 31, 1986).

32. Dodd & Leftwich, *The Market for Corporate Charters: 'Unhealthy Competition' Versus Federal Regulation*, 53 J. BUS. 59, 263 (1980). This figure compares favorably with the general figure of 81% for all surveyed firms reincorporating in the period 1961 through 1983. Romano, *supra* note 2, at 244-45.

33. Romano, *supra* note 2, at 261-62. "Large manufacturing firms" were defined as those in the top 100 industrial corporations as ranked by *Fortune* magazine. FORTUNE, May 3, 1982, at 260-78.

34. *See* Baysinger & Butler, *supra* note 2, at 183.

35. *See id.* at 181-83.

tional investors (who presumably are better monitors) and fewer individual investors than other firms.[36]

Professor Romano offers a different explanation of why the pure corporate federalist theory fails to fully account for choice of corporate charter state. She hypothesizes that firms reincorporate in Delaware because they anticipate engaging in a transaction that could be cheaper to carry out in that state. Romano finds that most reincorporations preceded or coincided with certain distinct and identifiable transactions, particularly public offerings of securities, new merger and acquisition programs, and antitakeover defensive maneuvers.[37] According to Romano, firms relocate to Delaware on the eve of such transactions to avail themselves of the state's well-developed body of law in such areas.

C. *Evaluation of the Competing Theories*

In our view, although both the race-to-the-bottom theorists and the corporate federalists capture important elements of the dynamic forces at work in the market for corporate charters, neither analysis is complete. The race-to-the-bottom theorists correctly observe that states have a powerful incentive to adopt legal rules that serve the interests of the managers who decide where to incorporate. The corporate federalists' rejection of this thesis is somewhat surprising because one of the major theoretical components of the economic analysis of corporate law has been the recognition that agency costs are pervasive in corporate law. Thus, many of the legal rules and marketplace monitoring arrangements in this area can be understood as attempts to reduce the costs of the inherent conflicts of interest between corporate managers and shareholders.[38]

The concept of agency costs in corporate law refers to the fact that the interests of shareholders (principals) often diverge dramatically from the interests of the managers (agents) of the corporations in which they own shares. Managers, because they are presumed to be rational eco-

36. *See id.* at 189 & n.13.

37. Romano, *supra* note 2, at 265-73.

38. For example, demand by investors for greater internal monitoring has increased the use of special litigation committees in response to derivative suits. *See* Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, 71 CORNELL L. REV. 261, 275 (1986). Public offerings of common stock at a time when a corporation is paying dividends have been explained as a means used by shareholders to insure monitoring of the firm by outside investors and investment bankers. *See* Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 654 (1984). Employing outside auditors whose reputational capital is of greater value than fees generated from any particular client is seen as an additional means of monitoring managerial performance. *See* Watts & Zimmerman, *Agency Problems, Auditors, and the Theory of the Firm: Some Evidence*, 26 J.L. & ECON. 613 (1983).

nomic actors, inevitably will be concerned with maximizing their own utility, rather than the utility of their shareholders. Shareholders have incentives to limit the extent of these agency costs through contracting *ex ante* and monitoring *ex post*. In addition, because anticipation of future agency costs will result in shareholders placing a lower expected value on managers' services, the managers also have incentives to make credible (bonded) promises that they will refrain from such opportunistic behavior *ex post*.

Such monitoring, bonding, and contracting on the part of managers and shareholders is costly and will only take place until, at the margin, the costs equal the benefits in terms of reduced agency costs. These costs will be particularly high in the large publicly held corporation because of free-rider problems among the shareholders. Specifically, in publicly held firms, the benefits of monitoring, bonding, and contracting will be spread among the shareholding population *pro rata*, but the costs will be concentrated upon whichever shareholder takes it upon herself to attempt to control the managers. Thus, although a plethora of mechanisms to control agency costs have emerged,[39] it is undisputed that some residual loss remains.[40] The debate centers solely around the size of the potential divergence of shareholder and management interests and the various forms that the divergence may take.

Thus, the race-to-the-bottom theorists have correctly identified agency costs as an important element in the competition for corporate charters.[41] But the corporate federalists also are undoubtedly correct in asserting that, over a wide range of issues, Delaware has a strong interest in adopting legal rules that enhance the welfare of corporate shareholders. Over the long run, corporations will prosper in states that provide

39. Easterbrook, *Manager's Discretion and Investor's Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543 (1984) (discussing "market mechanisms that . . . induce managers to act in the interest of investors"). Chief among the market mechanisms that reduce agency costs is the market for corporate control. *See* Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965); *see also* Easterbrook & Fischel, *Auctions and Sunk Costs in Tender Offers*, 35 STAN. L. REV. 1, 9-17 (1982) (suggesting that imposing rules to promote auctions for tender offers would not be in the shareholder's best interest); Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169 (1981) (stating that "[t]he tender bidding process polices managers . . . and disciplines or replaces them if they stray too far from the services of shareholders"); Macey & McChesney, *A Theoretical Analysis of Corporate Greenmail*, 95 YALE L.J. 13, 16 & nn.16 & 17 (1985) (maintaining that "[r]egulatory or judicial changes that would restrict greenmail across the board deprive shareholders in at least some firms of a legitimate means of protecting or advancing their interests in certain situations").

40. Jensen & Meckling, *supra* note 25, at 305.

41. *Cf.* Maloney, McCormick & Tollison, *Economic Regulation, Competitive Governments, and Specialized Resources*, 27 J.L. & ECON. 329, 331 (1984) (noting that states are likely to impose economic regulation on markets when the cost of such regulation is borne primarily by out-of-state consumers).

wealth-enhancing legal rules. The capital markets will adjust for this expected wealth effect by pricing a corporation's shares accordingly. Moreover, the corporate federalist approach does not necessarily reject as inefficient the agency costs that inevitably accompany the exercise of broad discretion by corporate managers. We do not live in an ideal world. The question is not whether agency costs exist, but whether those costs are greater than the costs that would be imposed by limiting the discretion of managers. Accordingly, the corporate federalists convincingly refute the implicit assumption of the reformist theory that legal rules which enhance the discretion of managers inevitably harm the welfare of shareholders.[42]

A few empirical studies have addressed the question of whether incorporating in Delaware is beneficial to shareholders. A recent study by Professor Romano concludes that reincorporating in Delaware is associated with positive, abnormal returns and is "at worst . . . a zero net present value transaction" from the shareholders' perspective.[43] As Romano points out, the data indicate that firms relocate to Delaware when they are about to engage in transactions that increase the likelihood of litigation:

> Mergers and acquisitions and projected antitakeover defenses are fraught with the potential for litigation, involving disputes over the

42. Romano, *supra* note 2, at 272-73; *see also* Fischel, *The Business Judgment Rule and the* Trans Union *Case*, 40 BUS. L. 1437, 1454 (1985) ("Cary's position has been discredited; indeed, in recent years it has been discussed only as an illustration of how it is possible to reach the wrong conclusions if one lacks a basic understanding of the economic structure of the corporation and of corporate law." (footnote omitted)). In sheer numbers of supporters, however, the race-to-the-bottom theorists appear to have won the day. At the height of the debate over federal chartering, a statement endorsing federal intervention was signed by eighty law professors representing sixty-two different law schools. *Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce*, 94th Cong., 2d Sess. 343, 343-46 (1976); *see also* R. NADER, M. GREEN & J. SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS 84 (1976) ("Today the case for federal chartering [is] compelling . . . [because] to control national and multi-national corporations requires national authority . . . [and] our current economic crisis and corporate crime wave underscore the failure of the old corporate law system."); Cary, *supra* note 1, at 705 ("[T]here should be a federal interest in the proper conduct of the corporation itself as much as in the market for securities."); Conard, *An Overview of the Laws of Corporations*, 71 MICH. L. REV. 623, 687 (1973) (maintaining that federal legislation "is a necessary step in any fundamental simplification of the corporate regime"); Folk, *supra* note 1, at 958 (asserting that the "negative development [of lax state statutes] is partially offset by . . . the rapid growth of 'federal corporation law' "); Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DE PAUL L. REV. 915, 918, 925 (1972) (noting Germany's "dramatic economic development" after reforming its corporate law and that a "federal business corporation act might be the appropriate vehicle for this new institutional approach to the problem of corporate power" in the United States); Jennings, *supra* note 1, at 997 (insisting that "[s]ome form of federal resolution of the problem is crucial if the federal interest is not also to be thwarted by the charter-mongering activity of a single state"); Schwartz, *Towards New Corporate Goals: Co-existence with Society*, 60 GEO. L. J. 57, 104 (1971) (advocating exploration of federal incorporation to aid in "harmoniz[ing] our economic activity with society's idea of general welfare").

43. Romano, *supra* note 2, at 273.

> fairness of offer terms or the appropriateness of management's actions. The legal system also becomes important after a public offering. . . . [F]irms going public, by the change in their capital structure, subject themselves to a greater likelihood of legal conflict under fiduciary rules.[44]

But the fact that firms relocating to Delaware often are subject to suit does not provide support for either of the existing hypotheses about Delaware decision rules. The data simply take us back to the initial question of whether managers or shareholders are benefitting from these reincorporations and the associated increase in litigation. For a firm that does not anticipate being involved in intrafirm litigation, the contours of the law of the state in which it is incorporated are largely irrelevant. Thus, data that indicate that firms tend to relocate to Delaware when they anticipate litigation is the empirical equivalent of saying that firms relocate to Delaware only when relocating there matters. The question of why it matters still remains. If the litigation that ensues upon reincorporation to Delaware is harmful to shareholders, the Romano data support the race-to-the-bottom theory.[45] If such litigation benefits shareholders, then her data support the corporate federalists.

Peter Dodd and Richard Leftwich found that firms relocating to Delaware earned positive, abnormal returns of thirty percent over the twenty-five month period preceding and including the month of the change.[46] Professor Fischel, a leading corporate federalist, has observed that this study is "a powerful empirical refutation of the 'race to the bottom' thesis and, more generally, of the attack on the separation of ownership and control in the large publicly held corporation."[47] But the Dodd and Leftwich study is subject to a number of different interpretations. If, as Romano observes, firms that relocate in Delaware usually do so in anticipation of some important corporate change, then the decision to relocate in Delaware signals the market that other fundamental changes are about to occur. If the expected returns of these events are significantly positive, then the increase in share value observed by Dodd and Leftwich could be the result of the market's assessment of these underlying changes rather than the market's reaction to the applicability of Delaware corporate law. Moreover, even if this signaling hypothesis is rejected, the Dodd and Leftwich data do not in themselves establish that

44. *Id.* at 250.

45. For example, a large number of firms reincorporate in Delaware to engage in some form of antitakeover defensive maneuvering. Those who view reincorporations in Delaware as a race to the bottom would point to such maneuvering as harmful to shareholders and supportive of their thesis.

46. Dodd & Leftwich, *supra* note 32, at 275.

47. Fischel, *supra* note 2, at 920.

Delaware corporate law provides an optimal set of rules from the point of view of economic efficiency. It could be, as argued below, that the market for corporate charters is not perfectly competitive. If Delaware has achieved a position of dominance in the market, it may have the power to adopt rules that are not optimal for shareholders if the overall package that Delaware provides to shareholders is better than the package of corporate law rules and institutions that other states can offer.

III. A Theory of Delaware Corporate Law

Having described the advantages and disadvantages of the two dominant theories, we will now set forth our theory.[48] First, drawing on Romano's earlier work, subpart (A) explains the sources of Delaware's market power in the competition for corporate charters. The next subpart considers the direct and indirect charges that Delaware can impose for the privilege of incorporating in the state. Finally, in subpart (C), we propose an interest-group analysis to predict the particular mix of charges Delaware exacts from firms wishing to incorporate there.

A. Delaware's Dominance of the Corporate Charter Market

Delaware is easily winning the competition for corporate charters. Over forty percent of all New York Stock Exchange listed companies are incorporated there,[49] and eighty-two percent of all firms that reincorporate move to Delaware.[50] As the dominant state in this market, Delaware offers a product that is highly desired by those deciding where to incorporate. Delaware is attractive to these decision makers for two reasons.[51] First, it offers an attractive mix of existing corporate law rules. Second, it provides believable assurances that it will continue to supply such a desirable mix of rules in the future.

48. Although our theory does not purport to explain how Delaware came to dominate the corporate chartering market, Delaware's dominance is significant for our theory because it explains why the state is able to charge a premium for its corporate charters. It is the size of this premium that determines the size of the spoils to be divided among the various interest groups in the state. As Delaware's dominance increases, the potential payoff to interest groups within the state increases as well.

49. *See* N.Y.S.E. Guide (CCH) ¶¶ 725-799 (Jan. 31, 1986).

50. Romano, *supra* note 2, at 244. Romano discusses "why Delaware is so successful at the incorporation game" by examining "literature on state competition, in order to specify the more important assumptions . . . concerning the impact of a system of state corporation laws" and describing "the supply and demand sides of the corporate charter market." *Id.* at 227.

51. The discussion in this subpart draws on the existing literature, combining the corporate federalists' observation that Delaware law is efficient with Romano's insight that Delaware offers corporations credible promises that its rules will continue to benefit shareholders.

1. Advantages of Existing Delaware Law.—Probably the greatest benefit that Delaware offers corporations is a highly developed case law that provides not only a useful set of precedents, but also a substantial degree of certainty about legal outcomes.[52] As one corporation pointed out to its shareholders in a proxy statement proposing relocation in Delaware, "The Delaware courts have developed considerable expertise in dealing with corporate issues . . . thereby providing greater predictability with respect to corporate legal affairs."[53] Predictability is desirable because it facilitates long-term corporate planning and reduces the riskiness of a firm's activities.

Predictability would not be highly valued, however, if the rules of law applied by the state were not attractive to prospective chartering firms. Accordingly, we believe that Delaware's dominance in the chartering market is partially due to the attractive nature of its substantive corporate law rules. Delaware corporate law provides incentives to charter in Delaware to all the major parties involved in corporate decision making—shareholders, managers, attorneys, and investment bankers.

Delaware is in the forefront of states authorizing and supporting private arrangements that permit firms to "contract around" the statutory scheme by amending their bylaws or corporate charters. As the corporate federalists observe, most sections of the Delaware Corporation Code are "default" provisions: they apply in default of any rule to the contrary in the corporate charter or bylaws.[54] The flexibility inherent in the statute is augmented by an unusual Delaware rule of statutory interpretation under which an action that would be prohibited under one section of the Corporation Code is nevertheless permitted if the same action is authorized under some other section of the Code.[55] The Corporation Code operates as a set of "off the rack" rules that corporations can adopt simply by failing to provide otherwise. Such rules reduce error costs and transactions costs by eliminating the necessity for those forming corporations to anticipate and stipulate for all future contingencies when organizing the firm.[56] Thus, the structure of the Delaware Corporation

52. *See* Romano, *supra* note 2, at 280.

53. 1985 Proxy Statement of Atlantic Richfield Co., *reprinted in* R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 150 (3d ed. 1986).

54. *See* Easterbrook, *supra* note 39, at 549 ("Delaware . . . statutory law allows almost unlimited alteration of rules in the articles and bylaws.").

55. *See, e.g.*, Orzeck v. Englehart, 41 Del. Ch. 361, 365-67, 195 A.2d 375, 377-78 (1963) (stating that an action permitted by one section of the Corporation Code is still valid even though the same action would be prohibited by another unrelated section of the Corporation Code).

56. Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 266 (1985).

Code encourages arrangements that enhance the value of the firm and, therefore, increase shareholder wealth. Other things being equal, corporate managers would prefer to charter in states where firm value is maximized because much of their compensation is directly or indirectly tied to the performance of the firm's stock in the capital markets.[57]

But corporate managers do not necessarily decide where to incorporate solely on the basis of shareholder welfare. The decision about where to charter effectively is made by managers who have interests that potentially conflict with the overall welfare of the firm.[58] Managers are likely to value things like perquisites, power, and influence. Above all, managers may value their job security, without which the ability to consume these other pleasurable goods would be impossible. Because managers make the decision about where to incorporate, it is in Delaware's interest to cater to them to lure corporations into the state.

Many provisions of Delaware law appear calculated to give corporate managers flexibility in obtaining desired personal benefits. Delaware is among the least restrictive of the states in second-guessing the amount of managers' compensation,[59] rejecting insider contracts on grounds of self-dealing,[60] or permitting corporations to indemnify officers and directors for liability incurred in connection with their services to the corporation.[61] Moreover, recent decisions of the Delaware Supreme Court, although not wholly free of ambiguity, suggest a desire to protect managers from the threat of losing their jobs in a hostile tender offer.[62] Whether "promanagement" provisions help or hurt shareholders[63] is irrelevant in this context, because in either case they seem calculated to appeal to those who make the decisions about where a firm incorporates. Accordingly, they help explain Delaware's dominance in the corporate charter market.

57. One study showed that chief executives of large corporations own an average of $1,566,009 worth of stock in the firms for which they work. *See* R. NADER, M. GREEN & J. SELIGMAN, *supra* note 1, at 116; *see also* W. LLEWELLEN, THE OWNERSHIP INCOME OF MANAGEMENT (1971) (showing that for top managers of manufacturing and retail firms, the after-tax value of stock-based compensation was three to five times the after-tax value of other compensation); Demsetz, *The Structure of Ownership and the Theory of the Firm*, 26 J. L. & ECON. 375, 388 (1983) (showing that managers of the ten largest Fortune 500 firms owned an average of $151,621 of stock in their firms, managers of middle Fortune 500 firms owned an average of $124,560 of stock in their firms, and managers of the bottom ten Fortune 500 firms owned $27,134 of their firms' stock).

58. Easterbrook, *supra* note 39, at 545.

59. *See* DEL. CODE ANN. tit. 8. § 141(h) (1983).

60. *See id.* § 144.

61. *See id.* § 145.

62. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (finding that, in implementing a plan to thwart a hostile takeover, "[t]he directors may not have acted solely or primarily out of a desire to perpetuate themselves in office").

63. *See supra* subparts II(A) & (B).

Corporate attorneys may also be "seduced" by Delaware's substantive corporate law. The most influential advisors to corporate management are generally the firm's lawyers. The incorporation decision is heavily dependent on the different legal environments within which the firm could operate, which is dependent on the particular expertise of the firm's legal counsel. Moreover, the actual logistics of reincorporation are handled by lawyers. Professor Romano's survey strongly supports the hypothesis that lawyers exercise a great deal of influence over the incorporation decision.[64] Of firms that had changed their domicile, the overwhelming majority stated that the move had been suggested by legal counsel.[65]

Thus, Delaware's edge in the chartering market can be partially explained if its legal system is particularly appealing to corporate counsel. Romano has proposed that the Delaware legal system appeals to attorneys because "for lawyers, the cost of doing business is substantially reduced and the value of their human capital less rapidly depreciates, when their expertise can be centered on one jurisdiction, and in particular, a jurisdiction in which legal outcomes are more certain, such as Delaware."[66] Romano's analysis, however, is somewhat ambiguous. Lawyers working on an hourly fee basis will not necessarily benefit by having their clients move to a legal environment in which legal outcomes are more certain, because the number of billing hours per client can be expected to be less in such an environment. Moreover, hourly fee lawyers may not object to having their human capital depreciate as a result of changes in corporate law codes because they can sustain their human capital by researching problems as they arise and charging the clients for the time. In such an environment, lawyers who adapt quickly to change will thrive. Presumably Romano's point is that competition in the legal market will encourage lawyers to recommend a Delaware charter for fear of being undersold by competitors who offer to perform the client's legal work at lower cost if the corporation moves to Delaware.[67] Under this view, Delaware is not catering to the interests of lawyers as much as providing a jurisdiction in which the lawyer must recommend incorporation as a matter of competitive necessity. The legal market, however, may not be as competitive as this theory suggests. The market for legal services is subject to serious information problems because the client is often at a disadvantage in assessing the quality of the lawyer's work. Evaluating a

64. Romano, *supra* note 2, at 273.

65. *Id.*

66. *Id.* at 275.

67. *See id.* at 275 n.71.

lawyer's suggestion to relocate a firm to Delaware is particularly costly for shareholders to evaluate. Moreover, the cost involved in changing legal counsel presents a substantial barrier to competition. Of course, the legal market is competitive to some extent, and Delaware law, therefore, may provide a set of incentives that encourages lawyers from other states to recommend that clients choose Delaware as their chartering state.

Delaware corporate law also may encourage investment bankers to advise clients to incorporate in Delaware.[68] In addition to legal opinions, corporations often rely on the recommendations of investment bankers in deciding where to incorporate. Professor Romano reports, on the basis of conversations with legal and banking professionals, that "investment bankers frequently advise clients to switch to Delaware for antitakeover reasons."[69]

As discussed below, considerable evidence suggests that the Delaware Supreme Court has created an environment in which investment banks and other securities professionals may earn hefty profits as a result of Delaware incorporation.[70] In recent years, the Delaware courts have provided powerful incentives for incumbent managers, as well as potential acquiring firms, to solicit costly opinions from investment banks regarding the fairness of the compensation package offered in a corporate control transaction. These rulings reward a profession that can be influential in encouraging Delaware incorporation. Accordingly, the favorable opinion of Delaware incorporation expressed by many investment bankers may well be another ingredient of Delaware's recipe for success in the corporate chartering game.

In sum, Delaware's dominance in the corporate chartering market stems from the fact that its substantive law rules benefit those ultimately responsible for the incorporation decision. Over a wide range of decisions the relevant decision maker will be the shareholders. But because of free-rider problems and high information costs, it will often be difficult for shareholders to determine whether a decision about where to incorporate is in their best interests or not, particularly because such a decision involves a comparison of legal rules across fifty jurisdictions. Again, the benefits of such a comparison will be shared equally among all shareholders, but the costs will be borne exclusively by the person who conducts the analysis.

68. Reliance on an investment banker is particularly likely in the case of reincorporations accomplished for the purpose of facilitating a securities offering.

69. *See* Romano, *supra* note 2, at 275 n.72. Professor Romano's survey responses failed to uncover such activity, but this is presumably because the questionnaire she used did not list investment banks as potential parties to suggest reincorporation. *See id.*

70. *See infra* subpart IV(C)(2).

2. *Delaware's Regulation as a Guarantee of Future Performance.*— The preceding subsection explained why decision makers find Delaware's corporate law rules attractive. This subsection explains how Delaware is able to maintain its dominant position in the competition for corporate charters. The fact of Delaware's domination seems particularly perplexing given the ease with which other states can duplicate the substantive provisions of the Delaware Corporate Code. And, even if judicial opinions are a significant part of the package that attracts firms to Delaware, a state legislature can simply instruct its courts to follow the decisions of the Delaware courts on issues of corporate law. In fact, Nevada essentially has followed this course, adopting both the Delaware statutory and common law as it applies to corporations.[71] Yet Nevada has not made substantial inroads into the monolith of Delaware's chartering business.

The best argument for how Delaware has been able to retain its dominance is that it offers a reliable promise—one that cannot be matched by its competitors—that its corporation law will remain highly attractive to managers in the future.[72] This promise is important to firms deciding where to incorporate because changing a corporate domicile is a relatively costly process, involving search costs for more desirable corporation codes as well as substantial transactions costs. Thus, managers want to know in advance that they will not have to change their firms' domicile in the future.

This promise of future performance has both a static and a dynamic element. Corporations want assurances that Delaware's law will remain relatively stable, in the sense that existing rules will not be set aside for less desirable ones. But corporations also want state law to be flexible enough to respond rapidly to changing circumstances in the marketplace. For example, if a wave of hostile takeovers develops, corporate managers may desire their corporation's chartering state to respond quickly with changes in the law that protect the jobs of incumbents against corporate "raiders."

Delaware's promise that its corporation law will remain attractive is bonded in several different ways. First, Delaware judges, corporate attorneys, and legislators are more knowledgeable about and have a greater interest in corporate law than do people with similar positions in other states. For example, the Delaware legislature's drafting committees his-

71. *See, e.g.*, Cary, *supra* note 1, at 665 ("Indeed, Nevada has attempted to become the western Delaware . . . .").

72. This argument is based on Oliver Williamson's theory of contractual precommitment (hostage-taking). *See* Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983). Roberta Romano first applied this theory to Delaware corporate laws. Romano, *supra* note 2, at 235 & n.13.

torically have been staffed with attorneys experienced in corporate law.[73] This expertise means that Delaware is likely to adopt desirable rules to handle complex and technical problems as they arise. Delaware judges, attorneys, and legislators have both the expertise to guide the development of corporate law in a way that is consistent with its overall philosophy—thus ensuring stability—and the knowledge of the structure of the law to make needed changes in response to unforeseen circumstances.

Second, a number of political factors in Delaware tend to guarantee the continued production of statutes that serve the needs of corporate managers. For instance, the Delaware Constitution requires a two-thirds vote to change corporate laws.[74] Thus, corporations need not fear that Delaware will change its perspective on corporate law whenever there are small changes in the political complexion of the state legislature. At the same time, a blocking minority is unlikely to develop to stop needed changes in response to unforeseen conditions. The supermajority rnles have not obstructed Delaware's ability to alter its law in response to changing circumstances. Professor Romano has examined four novel corporate law provisions enacted in various states.[75] These provisions, which related to indemnification, merger vote exemption, appraisal rights exceptions, and antitakeover rules, were all enacted by one jurisdiction or another between 1961 and 1968. Delaware was the first state to adopt one of these provisions, and it adopted the other three much more quickly than any other state. Thus, as Romano points out, Delaware's responsiveness to other states' innovations helps explain how it has been able to maintain its dominant position.[76]

73. *See* Cary, *supra* note 1, at 690.

74. DEL. CONST. art. IX, § 1. Although at first blush the Delaware constitutional provision making it difficult to amend the Corporation Code may seem easy for rival states to duplicate, the whole point of having such a provision in a constitution instead of a statute is to make it costly to alter the provision. By parity of reasoning, this rule also makes it difficult for other states to change their constitutions to mimic Delaware's. After all, if it were simple for a state to amend its constitution in this respect, it also would be simple for the state to amend it again to remove the protections provided by the first change. *See* J. BUCHANAN & G. TULLOCK, THE CALCULUS OF CONSENT 211 (1962).

A somewhat analogous rule limits the extent to which the Delaware Supreme Court can break with existing precedent. The Delaware Supreme Court comprises five judges who ordinarily sit in panels of three. A decision by a panel is final only if it is unanimous. A dissenting opinion automatically sets the case for reargument before the court en banc. The substantial costs that a dissenting panel opinion imposes both on the court—by increasing its caseload—and on the litigants deters dissent. Because dissent is costly, the common law process in the Delaware Supreme Court becomes both more certain and less subject to rapid doctrinal change than it would in other states. *Cf.* Easterbrook, *Ways of Criticizing the Court*, 95 HARV. L. REV. 802, 825-29 (1982) (stating that the more choices judges have open to them in deciding a case, the less likely it is that they will decide on a single analysis and render decisions consistent with prior decisions).

75. Romano, *supra* note 2, at 233-42.

76. A recent example is a statute passed by the Delaware legislature in June, 1986, that permits shareholders to eliminate director's liability except in cases of actual disloyalty, bad faith, or inten-

Another political factor tending to guarantee future reliability is Delaware's status as a small state without many political pressures that could disrupt the orderly development of its corporate law. Because the physical assets of most large Delaware corporations are located in other states, Delaware lawmakers ordinarily are not subject to pressures from unions, environmental groups, local communities, or other special interests associated with the corporation's physical plant or assets. Accordingly, corporate managers know that their legislative influence, relative to that of other interests, is likely to be greater in Delaware than in many other states.[77] The influence enjoyed by chartering firms in Delaware also tends to give reliability to the state's promise that its statutes will continue to serve the interests of corporate managers.

Finally, Delaware has more to lose than other states from changing its corporate law in ways undesirable to corporate managers. Delaware could lose a great deal in absolute terms because more corporations are chartered in Delaware than in any other state. A significant "reform" of Delaware law could be followed by a widespread exodus of Delaware corporations to other states. And there is every reason to expect that other states would be glad to serve as the promised land for these emigrants. Indeed, Nevada already is trying to lure corporations away from Delaware.[78] History also provides a useful example. In the early twentieth century, New Jersey, not Delaware, was the preferred state for incorporation. But when New Jersey toughened up its corporation code under reformist Governor Woodrow Wilson, its corporations defected en masse to Delaware, which obligingly had enacted New Jersey's prior corporate code into its own statute books.[79] New Jersey lost its dominance over the chartering business and has never recovered its former market share.

Not only does Delaware have more to lose in absolute terms, but it also has more to lose relative to its other sources of income. Delaware receives almost seventeen percent of its total revenues from its corporate chartering business,[80] more than any other state.[81] As Professor Romano and others have pointed out, because Delaware is much more reliant on corporate chartering than are other states, it is much less likely to

tional misconduct. DEL. CODE. ANN. tit. 8, § 145 (1986). A substantial number of companies reportedly intend to use this law, and companies are moving to Delaware specifically to take advantage of it. Lewin, *Board Liability in Delaware*, N.Y. Times, Jan. 13, 1987, at 26, col. 1.

77. Delaware, of course, is not free of interest-group pressures. *See infra* subpart III(C)(2).

78. *See supra* note 71 and accompanying text.

79. *See* Cary, *supra* note 1, at 664.

80. Romano, *supra* note 2, at 240.

81. Pennsylvania ranks second with 9.8% of its revenues from the franchise tax. *Id.* at 240 n.24.

act in a way that sacrifices its chartering business.[82] Moreover, as discussed below, the explicit franchise tax is only one of the ways in which corporate chartering can inject revenues into the state.[83] Other beneficiaries of chartering include the state's corporation service companies and the corporate bar. The capital and labor these firms have tied up in their businesses cannot easily be moved elsewhere. Thus, a sudden loss of chartering business as a result of changes in the state's corporation law would constitute an economic loss for these politically powerful groups.

B. "Charges" Imposed by Delaware for the Privilege of Incorporating

Delaware does not provide advantages to corporations it charters free of charge. It competes for corporate charters to obtain benefits for the state; these benefits are obtained by imposing costs on firms seeking Delaware charters. Moreover, because Delaware offers advantages no other state can fully match, it maintains preeminence in the corporate marketplace. This market power means that Delaware effectively faces a downward-sloping demand curve for its product—corporate charters—and thus is able to exact higher "charges" from its client corporations than can other states.[84]

82. *See id.* at 231-35.

83. *See infra* subpart III(B).

84. Delaware evidently enjoys a degree of market power, but it does not necessarily earn monopoly profits from the chartering business. As we have noted, Delaware's position of dominance in this market is due largely to the extensive human capital investment by lawyers within the state and around the country in becoming expert on Delaware law. *See supra* text accompanying notes 66-68. The apparently abnormal profits earned by the state could be quasi-rents—profits stemming from higher capital investment than by other states. These profits do not represent an abnormal return on capital. And, as Judge Bork and others have shown, the mere existence of barriers to entry are not themselves objectionable.

> When existing firms are efficient and possess valuable plants, equipment, knowledge, skill, and reputation, potential entrants will find it correspondingly more difficult to enter the industry since they must acquire those things . . . . But these difficulties are natural; they inhere in the nature of the tasks to be performed. There can be no objection to barriers of this sort.

R. BORK, THE ANTITRUST PARADOX 310-11 (1978).

We do not disagree with Bork's observation. We do, however, wish to note that competition among states presents a special case, different from the general model of competition among purely private firms that Bork describes.

If, over a period of time, a firm in the computer industry develops a reputation for dependability in making and servicing computers, that firm will be able to charge higher current prices than a new competitor with no reputation who is selling identical computers. Consumers are willing to pay a premium for the lower risks associated with buying the computers sold by the firm with the better reputation. Although customers may soon discover that the rival computer is reliable, and the new firm can post a bond to assure that it will service the machines it makes, such activities are costly. Bork's point is that there is nothing objectionable about the current ability of the older firm to charge a premium for its products. The premium, which presumably is distributed among the firm's shareholders, is not a supercompetitive profit. The premium is the current payoff for years of costly investment by the old firm's shareholders in developing a reputation for reliability and for servicing its products. The situation in Delaware is largely analogous to the situation described above with

The existing literature, almost without exception, views the "price" that Delaware charges for the incorporation privilege as the franchise fees exacted from state-chartered corporations.[85] Consistent with our theory about Delaware's pricing strategy, these fees are higher in Delaware than in almost any other state.[86] But Delaware's ability to impose a higher explicit charge for its charters and still dominate the market is only one indication of the power that the state enjoys in the corporate chartering field.

The relevant literature fails to recognize that there is a second, very important, component of the charges that Delaware imposes on corporations. These are what might be called "indirect costs" of Delaware incorporation—the fees paid to lawyers, accountants, investment bankers, and corporation service companies as incidents of Delaware incorporation. A manager also must consider these costs in determining whether to charter in Delaware or in some other state.

From the standpoint of shareholders and corporate managers, both franchise fees and the panoply of indirect costs are largely interchangeable. These decision makers are ordinarily indifferent to whether the firm must pay an extra dollar to the state fisc in franchise fees, to a lawyer for defense of a lawsuit arising under Delaware law, or to someone else. As

one notable exception—Delaware is not owned by shareholders and the state has no incentive or obligation to share the gains associated with its enviable market position among the taxpayers of the state. Rather, the high current prices that flow into Delaware are divided among the special interest groups who influence this aspect of the political process. *See infra* subpart III(C).

85. *See* Cary, *supra* note 1, at 668-69, 697-98.

86. Romano, *supra* note 2, at 255-58 & Table 7. When a corporation files its original certificate of incorporation in Delaware, it pays a franchise fee of $15 plus an amount based on the number of authorized shares of capital stock. For a corporation with over 200,000 authorized par value shares, the fee is $1,100 plus 1/5 of a cent for each share over 200,000. For firms with between 20,000 and 200,000 no par value shares, the fee is $100 plus 1/4 of a cent for each share over 200,000. If the company has more than 2,000,000 no par value shares, it pays $5,050 plus 1/5 of a cent for each additional share. DEL. CODE ANN. tit. 8, § 391(a)(1) (1985). Delaware collects an additional tax upon filing a certificate of amendment or restated certificate of incorporation that increases the authorized capital stock. The tax on these filings equals the difference between the tax computed on the original certificate and the tax computed on the new total number of shares authorized. DEL. CODE ANN. tit. 8, § 391(a)(2) (1985). Delaware also collects an annual franchise tax, not to exceed $130,000, based on the authorized number of shares of capital stock or an amount based on the assumed no par capital plus the assumed par value of the capital of the corporation. DEL. CODE ANN. tit. 8, § 503(a) (1985).

A brief survey of other states indicates that the fees charged by Delaware are relatively high. California charges a fee of $70 for filing articles of incorporation or agreements of consolidation providing for shares. CAL. GOV'T. CODE § 12201 (West Supp. 1987). New York charges $100 for filing the original certificate and $60 for a certificate of amendment, certificate of merger, or certificate of consolidation. N.Y. EXEC. LAW § 96(9)(b) (McKinney 1982). New Jersey charges $50 for filing an original certificate, amended certificate, or certificate of merger or consolidation. N.J. STAT. ANN. § 14A:15-2 (West Supp. 1986). Texas charges $200 for filing articles of incorporation, $100 for filing articles of amendment, and $200 for filing articles of merger or consolidation. TEX. BUS. CORP. ACT ANN. art. 10.01A (Vernon 1980).

far as the firm is concerned, the dollar is a cost of Delaware incorporation regardless of the identity of its recipient.

To the recipients, however, the identity of the payee is crucial. It makes a great deal of difference to Delaware taxpayers, lawyers, and corporation service firms whether the dollar is paid in franchise fees, legal fees, or for some other purpose. This observation is crucial for the remainder of this Article, for it suggests that the shape of Delaware corporate law may be affected significantly by interest-group rivalries, as different factions within the state vie to capture the lion's share of the revenues for themselves.

The trade-off between direct and indirect costs, however, is not simply a matter of allocating gains among different groups within Delaware. Although the direct costs of Delaware incorporation are all captured by the state's taxpayers in the form of revenues to the state's fisc, the indirect costs can only partially be captured by state residents. For example, very few investment banking services are provided in Delaware. The major investment banks that serve Delaware corporations are located almost exclusively in New York. To the extent that Delaware law encourages the use of investment banks, the benefits will largely be captured by people outside the state.

Another example of costs that are shared with people out of state is legal fees. Although the Delaware bar is clearly the most significant in-state recipient of indirect chartering revenues, the bar cannot capture all the legal work on corporate law issues arising under Delaware law. In advisory matters, for example, "Delaware lawyers" are scattered among major law firms across the United States. An attorney does not need to be a member of the Delaware bar in order to provide advice on that state's law.[87] In fact, Delaware lawyers probably operate at a competi-

87. *See, e.g.*, N.Y. JUD. LAW, Code of Professional Responsibility, EC 3-9 (McKinney 1975):

> Authority to engage in the practice of law conferred in any jurisdiction is not per se a grant of the right to practice elsewhere, and it is improper for a lawyer to engage in practice where he is not permitted by law or by court order to do so. However, the demands of business and the mobility of our society pose distinct problems in the regulation of the practice of law by the states. In furtherance of the public interest, the legal profession should discourage regulation that unreasonably imposes territorial limitations upon the right of a lawyer to handle the legal affairs of his client or upon the opportunity of a client to obtain the services of a lawyer of his choice in all matters including the presentation of a contested matter in a tribunal before which the lawyer is not permanently admitted to practice.

At least one state court has affirmed the principle that

> legal services to New Jersey residents with respect to New Jersey matters may ordinarily be furnished only by New Jersey counsel; but we pointed out that there may be multistate transactions where strict adherence to this thesis would not be in the public interest and that, under the circumstances, it would have been not only more costly to the client but also 'grossly impractical and inefficient' to have had the settlement negotiations conducted by separate lawyers from different states.

tive disadvantage vis-à-vis lawyers in other states because of the need in advisory work for extensive and sustained client contact. Our theory, however, predicts that Delaware attempts to maximize the amount of advisory work performed by Delaware counsel. For example, firms chartered in Delaware must obtain Delaware counsel to review their documentation each year.[88] Delaware attorneys also can capture a significant share of revenues from litigation because of legal regulations requiring that court appearances and filings be made by a member of the state bar[89] and because actual court appearances necessarily will take place in Delaware. The filing requirement, however, can be partially avoided through retention of local counsel who adds his or her name to briefs and motions as an accommodation to an out-of-state lawyer who prepares the papers. Delaware lawyers reputedly have developed local counsel services into an art, providing their clients with details and gossip about the inner workings of the Delaware court system, as well as excellent assistance in finding lodging and entertainment while in Wilmington—all for a hefty hourly fee. The requirement that court appearances be by a bar member can easily be surmounted by a motion to appear *pro hac vice*, which is granted as a matter of course. Some lawyers, however, believe that the Delaware judiciary is likely to look with more favor on a case argued by a recognized member of the state's bar; thus many important cases are argued by local counsel.[90]

Moreover, a case arising under Delaware corporate law need not be brought in Delaware at all. Such a case can be commenced in or removed to federal court under diversity of citizenship jurisdiction, provided that the citizenship requirements are met,[91] or under pendent

In Re Estate of Waring, 47 N.Y. 367, 376, 221 A.2d 193, 197 (1966); *see also* MODEL CODE OF PROFESSIONAL RESPONSIBILITY EC 3-9 (1981):

> [T]he legal profession should discourage regulation that unreasonably imposes territorial limitations upon the right of a lawyer to handle the legal affairs of his client or upon the opportunity of a client to obtain the services of a lawyer of his choice in all matters including the presentation of a contested matter in a tribunal before which the lawyer is not permanently admitted to practice.

88. Romano, *supra* note 2, at 248 n.39.

89. *See* DEL. SUP. CT. R. 12; DEL. CH. CT. R. 170.

90. *See, e.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1985) (respondent's case argued by Wilmington counsel); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985) (plaintiffs-appellants' case and defendants-appellees' case argued by Wilmington counsel); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (both sides argued by Wilmington counsel); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985) (both sides argued by Wilmington counsel); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (appellant's case argued by Wilmington counsel).

91. *See* 28 U.S.C. § 1332(a) (1982). Corporate citizenship is defined:

> For the purposes of this section and section 1441 of this title, a corporation shall be deemed a citizen of any State by which it has been incorporated and of the State where it has its principal place of business: *Provided further*, That in any direct action against the insurer of a policy or contract of liability insurance, whether incorporated or unincorpo-

jurisdiction as part of a case involving a federal issue.[92] Delaware decision rules ordinarily would apply in such litigation because of the interplay between the *Erie* doctrine[93] and conflict-of-laws principles. Generally, matters involving a corporation's internal affairs are determined under the law of the state of incorporation.[94] Similarly, these cases can often be brought in state courts outside of Delaware if jurisdiction can be obtained over the defendants—a requirement that may not be onerous in light of many state long-arm statutes giving states jurisdiction to the extent permissible under the federal constitution.[95]

Although Delaware in no sense has a monopoly over litigation aris-

> rated, to which action the insured is not joined as a party-defendant, such insurer shall be deemed a citizen of the State of which the insured is a citizen, as well as of any State by which the insurer has been incorporated and of the State where it has its principal place of business.

Id. § 1332(c) (italics in original).

92. The doctrine of pendent jurisdiction enables a federal court to exercise jurisdiction over nonfederal claims for which there is no independent jurisdictional basis when these claims are related to federal claims properly before the court. *E.g.*, Prochish v. American Univ., 727 F.2d 1174, 1182 (D.C. Cir. 1984); *see* Moor v. County of Alameda, 411 U.S. 693, 711-12 (1973). Thus, claims under Delaware law against a Delaware corporation could be brought in federal court even without diversity if the claims are sufficiently related to federal claims also brought against the corporation. *See, e.g.*, Forest Labs., Inc. v. Pillsbury Co., 452 F.2d 621, 629 (7th Cir. 1971) (finding pendent jurisdiction over a state-law claim against a Delaware corporation for misappropriation of trade secrets when that claim was joined with a related federal antitrust claim even though the parties did not meet diversity requirements).

93. The doctrine arose from the seminal Supreme Court decision in Erie R.R. v. Tompkins, 304 U.S. 64 (1938). In simple terms, "the core of the Erie doctrine is that the substantive law to be applied by the federal courts in any case is state law" except when the matter is properly a federal question. 19 C. WRIGHT, A. MILLER & E. COOPER, FEDERAL PRACTICE AND PROCEDURE § 4501, at 2 (1982). The Supreme Court has clearly decided that the *Erie* doctrine requires a federal court to apply the conflict-of-laws rules of the state in which the federal court sits. Klaxon v. Stentor Elec. Mfg. Co., 313 U.S. 487, 496 (1941). In Day & Zimmerman, Inc. v. Challoner, 423 U.S. 3 (1975), the Court reaffirmed the *Klaxon* rule and, in the view of some critics, made it clear that *Klaxon* should be followed in the "most uncompromising and mechanical fashion." 19 C. WRIGHT, A. MILLER & E. COOPER, *supra*, § 4506, at 72. Thus, notwithstanding the view of modern scholars who argue that conflict-of-laws rules applied in federal cases are more properly the province of federal common law, *see* Hart, *The Relations Between State and Federal Law*, 56 COLUM. L. REV. 489, 514 (1954); Horowitz, *Toward a Federal Common Law of Choice of Law*, 14 UCLA L. REV. 1191, 1194 (1967), "it is settled that as to matters governed by state law under *Erie* a federal court must follow the choice of law rules of the state in which it is sitting," 19 C. WRIGHT, A. MILLER & E. COOPER, *supra*, § 4506, at 73 & n.37 (1982).

94. "As a general matter, the law of the state of incorporation normally determines issues relating to the *internal* affairs of a corporation." First Nat'l City Bank v. Banco Para el Comercio Exterior de Cuba, 462 U.S. 611, 621 (1983) (emphasis in original); *see also* Reese & Kaufman, *The Law Governing Corporate Affairs: Choice of Law and the Impact of Full Faith and Credit*, 58 COLUM. L. REV. 1118, 1124-25 & n.37 (1958) (stating general rule and citing cases that have followed general rule).

95. *See, e.g.*, CAL. CIV. CODE § 410.10 (West 1973) (stating that personal jurisdiction may rest on "any basis not inconsistent with the constitution of this state or of the United States"); MINN. STAT. ANN. § 543.19 (West Supp. 1987) (language permitting exercise of personal jurisdiction over nonresidents to the fullest extent consistent with the United States Constitution); *see also* Neadeau v. Foster, 129 Cal. App. 3d 234, 239, 180 Cal. Rptr. 806, 808 (1986) (describing California Civil Code § 410.10 as manifesting the intent to exercise broadest possible jurisdiction); Marquette Nat'l Bank v. Norris, 270 N.W.2d 290, 294 (Minn. 1978) (similarly describing MINN. STAT. § 543.19 (1967)).

ing under its corporate law, an impressionistic glance at important corporate law cases over the past few years suggests that a substantial proportion of such cases—and presumably less important cases as well—are brought in Delaware.[96] Delaware's success as a forum for litigation involving Delaware corporations has several explanations. Under the doctrine of forum non conveniens, courts may dismiss actions involving the internal affairs of a corporation on the ground that the litigation should properly be brought in the state where the firm is incorporated.[97] In litigation involving corporate directors, jurisdiction may be difficult to obtain in other states, but it is a routine matter in Delaware.[98] As discussed below, security-for-costs, which deters the filing of derivative litigation in many states, is not required in Delaware.[99] Although security-for-costs statutes are substantive for *Erie* purposes,[100] they have been held to be remedial for purposes of state conflict-of-laws decisions,[101] and

96. *E.g.*, Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986); Moran v. Household Int'l, Inc., 500 A.2d 1346 (Del. 1985); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985); Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985); Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983).

97. Historically, courts have declined to hear cases involving the internal affairs of corporations incorporated in other states. *E.g.*, Rogers v. Guaranty Trust Co., 288 U.S. 123, 130 (1933); *see also* R. WEINTRAUB, COMMENTARY ON THE CONFLICT OF LAWS 218 (3d ed. 1986) (stating that "courts have traditionally been reluctant to interfere with or control . . . the management of the internal affairs of a corporation organized under the laws of another state"). The current trend, however, especially in federal courts, has been to regard the involvement of the internal affairs of a corporation as merely a factor in the overall forum non conveniens inquiry, not an independent rule of law. *See* Koster v. (American) Lumbermens Mut. Casualty Co., 330 U.S. 518, 527-28 (1947); *see also* R. WEINTRAUB, *supra*, at 219 (citing *Koster* and stating that the "internal affairs rule is not entitled to separate status and should be treated as one facet of the more general forum non conveniens doctrine"); 15 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 93, § 3828, at 171 & n.20 (2d ed. 1986) (stating that the Supreme Court has refused to adopt the internal affairs rule and citing lower federal courts which have followed the Court's approach). For a general discussion of the doctrine of forum non conveniens in federal courts, see 15 *id.* § 3828.

98. The Delaware director consent statute provides that all persons who serve as directors, trustees, or members of the governing body of a corporation organized under Delaware law are deemed to have consented to the appointment of the corporation's registered agents or the Delaware Secretary of State as their agent upon whom service of process may be made in all civil actions brought in the state involving the corporation. DEL. CODE ANN. tit. 10, § 3114(a) (Supp. 1986).

99. *See infra* notes 146-50 and accompanying text.

100. Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 555-57 (1949). In *Cohen*, the Court found that the statute was not "merely a regulation of procedure" because it created a "new liability where none existed before [by making] a stockholder who institutes a derivative action liable for the expense he puts to the corporation . . . if he does not make good his claims." *Id.* at 555. The Court further found that the statute did not conflict with Federal Rule of Civil Procedure 23, now FED. R. CIV. P. 23.1, which does not require security for cost. Consequently, the *Cohen* holding was not affected by the separate bifurcated *Erie* analysis for federal rules of procedure laid down in Hanna v. Plumer, 380 U.S. 460 (1965). *See supra* note 93. In fact, federal courts continue to follow *Cohen* and enforce state security-for-costs statutes in diversity cases. *See* 19 C. WRIGHT, A. MILLER & E. COOPER, *supra* note 93, § 4510, at 170 & n.19.

101. *See* Berkwitz v. Humphrey, 130 F. Supp. 142, 145 (W.D. Ohio 1955). The *Berkwitz* court stated that to characterize the right under such statute as substantive was an "imprecise and incorrect designation." *Id.* at 144. Instead, the court found that such right was properly deemed "reme-

accordingly, a security requirement will be imposed by many states in litigation involving Delaware corporations.[102] Finally, and perhaps most importantly, the plaintiff, who has the initial choice of forum, will often be an entrepreneurial attorney seeking an award of attorneys' fees.[103] Unlike many state judicial systems, the Delaware state court system awards attorneys' fees based on the relief obtained rather than the number of hours reasonably expended.[104] Such fees are widely believed, at least in the Delaware bar, to be much more generous than the fees obtained through an hourly fee "lodestar" approach prevailing elsewhere.[105] Accordingly, although the Delaware bar cannot capture all corporate litigation expenses, there is good reason to suppose that it attempts to maximize its share of these payments and that it can in fact capture a significant part.

Thus, depending on the nature of the indirect costs of incorporation,

dial" and therefore inapplicable because remedial rights are generally "governed by the law of the place where the remedy is sought." *Id.* at 145-46.

102. *See, e.g.,* CAL. CORP. CODE § 800(e) (West Supp. 1987) (stating that if a plaintiff in a shareholder derivative action furnishes a $50,000 bond to secure the reasonable expenses of the parties, no further bond will be required and any motion demanding that the plaintiff furnish bond will be denied); N.Y. CIV. PRAC. L. & R. 8501 (McKinney 1981 & Supp. 1987) (requiring a plaintiff that is not a domestic corporation or a foreign corporation licensed to do business in the state to post "security for costs" upon motion by defendant).

103. *See* Coffee, *Understanding the Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of the Law Through Class and Derivative Actions,* 86 COLUM. L. REV. 669 (1986); Coffee, *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation,* LAW & CONTEMP. PROBS., Summer 1985, at 5, 12 [hereinafter Coffee, *The Unfaithful Champion*].

104. In Delaware, plaintiffs' counsel in shareholder derivative suits are awarded fees on a common fund or quantum meruit theory. Dann v. Chrysler Corp., 42 Del. Ch. 508, 215 A.2d 709 (1965), *aff'd,* 43 Del. Ch. 252, 223 A.2d 384 (Del. 1966). Thus, the suit must confer a benefit on the corporate defendant to justify a fee award, but this benefit need not be monetary or proprietary. 42 Del. Ch. at 515, 215 A.2d at 713.

> [I]n Delaware, in a settled derivative action in which a fund has been created as a result of the efforts and skills of counsel for plaintiff, the first inquiry has traditionally been into the nature and extent of the results obtained . . . although . . . other tests . . . , namely the amount of time and effort applied to a case by counsel . . . as well as any contingency factor and the standing and ability of petitioning counsel are, of course, considered in the award of fees in an appropriate case.

Thomas v. Kempner, 398 A.2d 320, 327 (Del. 1979).

In *Thomas,* the court awarded as attorneys' fees a percentage of tangible benefits to the defendant corporation and additional compensation for intangible benefits based on the time expended and the effort exerted by plaintiffs' counsel. The suit was filed by shareholders of Sugarland Industries, a corporation dominated by the Kempner family, seeking injunctive relief barring the sale of corporate real estate for allegedly inadequate compensation and damages attributable to actions or inaction by the board of directors. Pursuant to a temporary restraining order issued by the trial court, Sugarland sought and obtained higher offers for the land. Plaintiffs' counsel were awarded 20% of the additional profits made as a result of plaintiffs' efforts, less offset for the unethical conduct of one of plaintiffs' attorneys. 398 A.2d at 331. The court also awarded plaintiffs' counsel "$500,000 for the time expended and effort exerted by them during the second phase of the case (damages), which resulted in a settlement which promises to terminate the feud which has split the Kempner family in recent years, thus indirectly benefitting Sugarland Industries and its Stockholders." *Id.* at 332.

105. *Cf.* Hensley v. Eckerhart, 461 U.S. 424, 433-34 (1983) (stating that hours not "reasonably expended" should be excluded when calculating the fee award).

Delaware and its citizens can capture a greater or lesser amount of the expenditures as revenue. The State of Delaware, however, cannot capture all such costs. If the state were acting as a pure profit maximizer, it would attempt to minimize the indirect costs and maximize the direct costs of Delaware incorporation. The indirect costs cannot be eliminated; any system of corporate law will require the use of attorneys, investment banks, and the like. But for Delaware to maximize its profits as a state, it would keep the indirect costs as low as possible consistent with retaining enough of the advantages of Delaware incorporation as not to reduce revenues by driving firms away.

But Delaware does not appear to minimize indirect costs in this fashion. Instead, it imposes indirect costs greater than would be called for in a pure profit-maximizing model. Delaware may favor indirect over direct costs because allowing some business to escape to other states may actually be beneficial because the recipients of the business who have thus gained the indirect benefit of Delaware incorporation may tend to prefer Delaware incorporation as a consequence. If these recipients are influential with those making the incorporation decision, they may return the favor by recommending Delaware as a corporate situs. As discussed below, some of the recent Delaware judicial decisions can be understood partially on these grounds.[106]

The other reason Delaware does not attempt to maximize the direct costs of Delaware incorporation at the expense of indirect costs is that the state is responding to interest-group pressures. Specifically, our thesis is that the Delaware bar, as the major in-state recipient of these indirect revenues, has exerted a powerful influence on Delaware law in order to increase its share of the total revenues from chartering activity. This Article now turns to an examination of this interest-group thesis.

C. An Interest-Group Analysis of Delaware Corporate Law

1. The Economic Theory of Regulation.—Our theory about Delaware decision rules is derived from the economic theory of regulation.[107] This theory assumes that legal rules are demanded and supplied like any other commodity. Regulation is supplied to those groups that success-

106. *See infra* text accompanying notes 164-94.

107. The classic articles are by George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971), and by Sam Peltzman, *Towards a More General Theory of Economic Regulation*, 19 J. LAW & ECON. 211 (1976). *See generally* Macey, *Promoting Public-Regarding Legislation Through Statutory Interpretation: An Interest Group Model*, 86 COLUM. L. REV. 223, 227-30 (1986) (arguing "that the Constitution was designed to serve public rather than private interests and explain[ing] how the traditional method of statutory interpretation is an integral part of this design").

fully "bid" for it with compensation in the form of political support, campaign contributions, lobbying expenditures, and the like. The contours of a given law will therefore reflect a competitive equilibrium among the rival interest groups affected by the law.[108] A further prediction of the economic theory of regulation is that laws will tend to benefit small, cohesive special interest groups at the expense of the general public. Although individual members of the public lack sufficient incentives to promote laws that benefit the public directly, interest groups have strong incentives to lobby for laws that transfer wealth from the public to themselves.[109]

The interest-group theory of regulation was developed to explain the behavior of legislatures, which are seen as highly responsive to pressures from organized political groups. The theory's application to the judicial decision-making process is less well developed. The federal government and almost every state including Delaware have constitutional provisions designed to insulate the judiciary from interest-group pressures.[110] Despite these institutional constraints, Professor Cary argued that the Delaware judiciary was extremely responsive to the interests of the Delaware bar. Specifically, the judiciary was seen as a major contributor to the jurisdictional competition that caused the perceived decline in corporate law standards. Thus, an important aspect of Cary's proposal was to displace the Delaware state courts from their position of primacy in corporate law matters. This coup would be accomplished by giving certiorari jurisdiction over certain matters of internal corporate governance to the federal circuit courts or a "special [federal] corporate court."[111]

108. *See generally* Peltzman, *supra* note 107, at 222-24 (applying economic theory of regulation to represent political equilibrium among politicians).

109. *See* Macey, *supra* note 107, at 230-32.

110. *Cf.* Landes & Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875 (1975) (arguing that an independent judiciary is "an essential component in a system of interest-group politics").

111. Cary, *supra* note 1, at 704-05. In the years since the publication of the Cary article, most commentators have agreed that Delaware provides inadequate protection for shareholders. As Cary predicted, however, no federal regulation of corporations has been enacted, and none is on the horizon. Cary attributed this failure to interest-group pressures. In his view, American big business has sufficient political influence to block any attempt to protect shareholder welfare by such a statute. *See id.* at 700. Prospects may change, however, because the race-to-the-bottom theory recently has been given new vitality in the American Law Institute's controversial proposed PRINCIPLES OF CORPORATE GOVERNANCE AND STRUCTURE: RESTATEMENT AND RECOMMENDATIONS (Tent. Draft No. 1, 1982; Tent. Draft No. 2, 1984; Tent. Draft No. 3, 1984; Tent. Draft No. 4, 1985; Tent. Draft No. 5, 1985). Some of the ALI's major recommendations center on the establishment of higher standards of director liability for corporate decisions. The ALI drafts are not meant as a restatement, but rather as an analysis of the "legal duties incident to corporate management and control." *Id.* (Tent. Draft No. 1) at viii. Although such proposals correspond to the views held by Cary and his followers, they are disputed by a growing cadre of corporate federalists, none of whom are represented among the drafters of the ALI's corporate governance project. *See* Winter, *The Development*

We reject the contention that Delaware judges are subject to the same interest-group pressures as are legislators. Delaware judges are appointed by the Governor with the consent of the state senate[112] and serve for terms of twelve years.[113] During their tenure they can be removed only for cause such as willful misconduct, persistent failure to perform duties, or commission of an offense involving moral turpitude.[114] Removal is by a special judicial court[115] rather than by the legislature, as it is for federal judges.[116] Delaware even goes so far as to impose rules splitting its judicial appointments among political parties.[117] Interest-group theory would predict that these safeguards make the Delaware judiciary less responsive to political pressures than the legislature because it has less to lose or gain by offending or pleasing different groups.

Thus, the Delaware judiciary at most will be only partially responsive to interest-group pressures. Rather, the forum for interest-group activity within the state of Delaware remains within the "political" branches of the government. At first blush it may seem that an independent judiciary can increase the costs of interest-group legislation by refusing to enforce legislation it does not like. Upon closer inspection, the effects of the relationship between the legislature and the courts on the interest-group dynamic are far more subtle. Indeed, as Landes and Posner have pointed out, "the independent judiciary is not only consistent with, but essential to, the interest-group theory of government."[118] Landes and Posner argue that without an independent judiciary, interest groups have no assurance that the legislature will not rescind the deals it has struck with them by repealing the relevant legislation. To facilitate interest-group activity, legislatures thus have an incentive *ex ante* to establish procedural rules that make repeal difficult.[119] In addition, special interest legislation is of little value to interest groups if there is no independent enforcement mechanism. When courts interpret and apply legislation in accordance with the original understanding between the legislature and the interest groups, an independent judiciary "facilitates rather than . . . limits the practice of interest-group politics"[120] by ex-

of the Law of Corporate Governance, 9 DEL. J. CORP. L. 524, 529 (1984). *But see id.* at 529 n.1 (noting that "one Adviser was in fact associated with the modern school of thought").

112. DEL. CONST. art. IV, § 3.

113. *Id.*

114. *Id.* § 37.

115. *Id.*

116. U.S. CONST. art. I, § 3.

117. DEL. CONST. art. IV, § 3.

118. Landes & Posner, *supra* note 110, at 877.

119. *Id.* at 878.

120. *Id.*

tending the expected gains from special-interest legislation beyond the period of the enacting legislature.

A general implication of this analysis is that an independent judiciary can both impede or facilitate interest-group bargains, depending upon whether or not the legislation is interpreted in accord with the original interest-group bargain.[121] An independent judiciary, however, does not have the ability to *nullify* the bargains struck between interest groups and the legislature because the legislature can always trump the court through a subsequent legislative enactment overruling the decision.[122]

The Delaware judiciary, therefore, would be viewed as an exogenous variable in the interest-group dynamic we are describing. According to our analysis, the statutory regime that exists in Delaware represents a particular political equilibrium among the state's various interest groups. If a judicial decision upsets that equilibrium, the legislature can restore the balance by enacting new statutes. Interest-group activity will be greatest in states where the legislature is particularly responsive to such changed conditions. Delaware has the reputation for being extremely responsive to such changes.[123]

The Landes and Posner analysis implies that interest-group activity will be more prevalent where courts have a tradition of upholding and respecting interest-group bargains than where courts have a tradition of striking down the bargains they have reached with the legislature. Even in the latter case, judicial activity will have little effect on interest groups when the legislature acts quickly to restore the terms of the original bargain by nullifying the court's decision through subsequent statutory enactment.[124]

Consistent with our view that courts are an exogenous variable in

121. Macey, *supra* note 107, at 250-56.

122. Our analysis in the text refers only to matters of statutory as distinct from constitutional interpretation. When courts invalidate interest-group bargains as unconstitutional, they can nullify the legislative results of interest-group politics. Indeed, "[t]he Supreme Court's policy toward economic legislation during a period of roughly 50 years ending in the late 1930's [the so-called Lochner era] illustrates the power and proclivity of an independent judiciary to nullify the legislative results of interest group politics." Landes & Posner, *supra* note 110, at 876. Today, however, regulatory statutes are rarely invalidated on constitutional grounds.

123. *See* Romano, *supra* note 2, at 259.

124. To illustrate the point, suppose that the probability of a particular statute being interpreted in a way that is consistent with the relevant interest-group bargain is ninety percent in State *X* and only forty percent in State *Y*. This statute will be worth more *ex ante* to the relevant interest groups in State *X* than to the relevant groups in State *Y* because the expected value of the payoff will be higher in State *X*. Thus, *ceteris paribus*, we would expect more activity among the interest groups affected by this statute in State *X* than in State *Y*. But, if the legislature in State *Y* can be expected to issue clarifying legislation immediately after the statute is "misinterpreted" by the courts, then State *Y* becomes more attractive because those interest groups can now be certain that their deal will be upheld. Thus, the temperament of the judiciary becomes far less significant in states such as Delaware that have a well-deserved reputation for responsiveness to new conditions.

the interest-group equilibrium, it must be the case that courts can further the goals of interest groups through statutory interpretation as easily as they can thwart them. When, for example, state courts, for whatever reason, are favorably disposed to the point of view of a particular group, the costs to that interest group of achieving its goals will be diminished substantially. We believe that this is the case in Delaware with regard to the views of the courts and the local corporate bar. Because of their own backgrounds, the Delaware judiciary is likely to be favorably predisposed to legislation that carves out a broad role for the Delaware bar in the affairs of firms chartered in Delaware.

The members of the Delaware Supreme Court are drawn predominantly from firms that represent corporations registered in Delaware.[125] The bar and the judiciary are tied together through an intricate web of personal and professional contacts. Unlike Professor Cary, we do not suppose that Delaware judges consciously formulate legal rules designed to increase revenues for their former colleagues. We doubt that they have such cynical motives. Yet, it is unsurprising that Delaware judges believe strongly in the efficacy of the Delaware legal system or that such judges often agree with the legislature that firms will be better off if Delaware corporate lawyers play an active role in their affairs. In other words, in Delaware well-intentioned judges can be expected to devise legal rules requiring that Delaware lawyers be consulted when important decisions are to be made. Moreover, if Delaware judges believe that the state judicial system well serves Delaware corporations, they will be more likely to approve rules that stimulate litigation in the Delaware courts. Thus, we agree with Professor Cary's conclusion, although not his reasoning, that the Delaware judiciary is likely to approve rules that serve the interests of the corporate bar. This judicial temperament lowers the costs to the Delaware bar of achieving the legal environment that maximizes demand for its services.

2. *The Relevant Interest Groups.*—Our hypothesis is that corporate decision rules in Delaware are generated in a political process dominated by two distinct types of political forces, each having its own set of separate and often conflicting goals. Thus, the state is similar in some respects to a firm that has two classes of claimants on its income stream. On one side are the numerous interest groups within Delaware that stand to benefit if more money flows into the state treasury. A catalogue of interest groups that might benefit if Delware increases its general reve-

125. Cary, *supra* note 1, at 691.

nues would include local construction companies, which stand to benefit if Delaware spends its additional revenues to build more roads; government workers such as teachers, who stand to benefit if the revenues are spent on pay raises; and the elderly, who stand to benefit if the money is spent to provide increased social or medical services, as well as the various trade and professional associations within the state.[126]

Aligned with these groups for most purposes are the Delaware corporation service companies—firms that assist out-of-state companies to obtain and maintain Delaware charters.[127] Opposed to these groups is the Delaware bar, in particular that segment of the bar which makes its living by providing legal services to out-of-state corporations chartered in Delaware.

The interests of these various groups are not entirely antithetical. All groups prefer, other things being equal, that the state provide a legal regime that is highly desired by corporate managers. Accordingly, the groups will tend to support the kinds of provisions that appeal to corporate managers and those that influence them:[128] rules promoting economic efficiency; safegnards for incumbent managers; and provisions favored by lawyers, investment bankers, or others with influence on the incorporation decision.

Although these concerns are broadly shared, the groups' interests diverge over the ideal proportion of direct to indirect revenues from corporate chartering.[129] Those groups that wish to maximize the revenues to the state's coffers from franchise fees will attempt to minimize the indirect costs of Delaware charters because a disproportionate share of the revenues from these indirect costs are captured by the Delaware bar, and the effect of these costs is to reduce revenues to the competing groups.[130] The competing groups would prefer to price franchise fees so that the state's revenues are maximized after deducting the costs of providing the franchise.

The Delaware bar is interested in maximizing one specific portion of the indirect costs of Delaware incorporation—fees to Delaware lawyers paid for work on behalf of Delaware corporations. These legal fees are functionally related to the number of charters in Delaware in the sense

126. This list, of course, is meant to be suggestive, not inclusive.

127. "For a fee, these companies provide a variety of services, including incoporation, qualification as a foreign corporation, post-corporate filings, provision of a registered office and registered agent, corporate staffing of inactive (usually nameholder) corporations, and conducting of meetings." R. HAMILTON, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 157 (3d ed. 1986).

128. *See supra* subpart III(A)(1).

129. *See supra* subpart III(B).

130. *See supra* text following note 86.

that the expected legal revenues will increase as the number of corporations chartered in the state increases. Accordingly, the bar would tend to favor low franchise fees, because keeping the fees low will tend to increase the number of Delaware corporations. But the bar could also benefit from legal rules that increase the amount of expected legal fees per corporation, even if such rules, by imposing additional costs on Delaware corporations, reduced the absolute number of firms chartered in the state. If the legal fees gained exceed the fees lost by deterring Delaware incorporation, the bar would prefer to adopt rules that did not serve the interests of the other interest groups within the state. In this respect, the bar's interests are opposed to the interests of all other groups.

Analysis of the legal rules that the bar is likely to favor is somewhat complex. As between revenues from advisory work and litigation, the bar would certainly favor litigation, because a higher percentage of advisory work can be performed by lawyers in other states.[131] It is not clear, however, that Delaware law could be structured to enhance one type of legal work at the expense of the other, because the two seem to be highly correlated.[132] Both advisory work and litigation are functions of the level of economic activity, a matter largely outside the influence of the state. They are also functions of the clarity of the applicable legal rules, because an unclear rule is likely to generate both a greater need for legal advice and a greater likelihood of litigation.[133] Thus, it is doubtful that the bar would be able to effect a substantial trade-off between litigation and advisory work.

The bar, however, does benefit from increasing the amount of litigation and accordingly would tend to favor litigation-increasing rules, even if such rules also increase advisory fees largely captured by out-of-state law firms. Delaware could stimulate litigation in two primary ways. First, Delaware could make litigation cheaper by reducing the costs to the parties, especially plaintiffs who make the initial choice of forum. For example, a statutory provision requiring plaintiffs to post security for expenses before bringing a derivative suit is highly related to litigation. As the rule changes to require plaintiffs to post more security for expenses, plaintiffs at the margin will be discouraged from bringing suit against Delaware-based firms. A state could therefore make litigation cheaper by not adopting a security-for-costs rule. Other devices that

131. *See supra* text accompanying notes 87-105.

132. In addition, rules that increase litigation are likely to be correlated with an increase in indirect costs other than legal fees. For example, a rule that stimulates disputes over appraisal rights will create a demand for expert witnesses who can testify about the fair value of the corporate shares. Such experts can be from anywhere in the country, and indeed are unlikely to come from Delaware.

133. *See infra* note 135.

lower the cost of litigation, and thus should be favored by the bar, are low filing fees, easy service of process, and rapid turnaround on cases.[134]

Second, Delaware could stimulate litigation by supplying legal rules that are unclear in application.[135] The bar therefore has some interest in reducing the clarity of Delaware law to enhance the amount of litigation. But the bar risks killing the proverbial goose that laid the golden egg because it is primarily the certainty and stability of Delaware law that creates the opportunities for profits in the first place. The bar as a whole does not have an interest in making the law so unclear that corporations begin to move elsewhere in large numbers. The bar should instead favor an equilibrium point of uncertainty at which the marginal increase in bar revenues from litigation fees equals the marginal loss in revenues due to reduced incentives to incorporate in Delaware.

Under one possible scenario, the bar could favor increased uncertainty even when the ultimate effect would be to reduce legal fees. An increase in uncertainty might generate substantially increased fees for the bar during the short-run period before corporations respond to the change by pulling up stakes. If so, the bar would have an opportunity for short-term profit, even though the long-term impact on its revenues would be deleterious. If the leaders of the bar were senior lawyers who could earn large profits in the short run and then retire, thus avoiding the long-term losses, they might have an incentive to push for uncertainty-increasing changes even when such changes would not benefit the bar as a whole. An unexpected glut of lawyers in Delaware might present an analogous situation; the bar could be motivated to adopt a short-term profit-maximization strategy even though the end result would be

134. Not all rules are litigation related. An example is the rule on cumulative voting for directors. Cumulative voting enables minority shareholders to elect representatives to corporate boards by permitting shareholders to cast one vote per share for each board vacancy, and to allocate all their votes to a single director if they desire. *See* Williams, *Cumulative Voting*, HARV. BUS. REV., May-June 1955, at 108, 111. Delaware allows corporate shareholders to decide for themselves whether to permit cumulative voting. DEL. CODE ANN. tit. 8, § 214 (1983). Altering this rule would not have a large impact on the demand for services of Delaware lawyers. Thus, everyone in Delaware has an interest in seeing that this rule takes the form most likely to maximize the number of firms that select Delaware to incorporate.

135. The standard economic theory of litigation posits that lawsuits are brought and not settled when the parties have differing views on the probable outcome of the case or the probable judgment if the plaintiff prevails. *See, e.g.*, Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1, 13-16 (1984) (characterizing the probabilistic cost-benefit analysis performed by prospective litigants deciding to settle or litigate as one in which the likelihood of litigation increases as the objective extent of defendant's fault approaches the actual standard of decision to be applied by the court); Miller, *Some Agency Problems in Settlement*, 16 J. LEGAL STUD. (forthcoming) (discussing conflicts between plaintiffs and their attorneys that affect settlement); Note, *An Analysis of Settlement*, 22 STAN. L. REV. 67, 70-77 (1969) (suggesting that settlement negotiations are based on "parties' anticipation of the result of a contemplated lawsuit"). These differences of opinion are more likely to occur in cases in which the law is uncertain.

adverse.[136]

3. *The Political Equilibrium.*—The model of interest-group politics that forms the basis for our interest-group theory of Delaware corporate law posits that legislation is supplied to those political coalitions that outbid competing coalitions, because market forces provide strong incentives to politicians who serve such groups. The rules adopted by a given legislature will reflect the underlying equilibrium of pressures from competing political interest groups.[137] If this model provides an accurate description of the Delaware corporate law system, we would expect the rules supplied in the political marketplace to reflect an equilibrium between the objectives of the various interest groups competing to expand the size of the state's treasury on the one hand, and the Delaware bar, on the other.

The power of a political interest group—and therefore the degree to which the equilibrium conditions of legislation will favor its interests—is a function of several different variables. The most important of these variables include the number of members in the group, the amount of their individual stakes in the matter, and the degree to which they are able to cooperate as a single organized unit. The groups that this Article identifies as interested in Delaware corporate law differ widely as measured by these variables. The bar is small, discrete, and highly organized. Its members tend to have a large personal stake in the subject matter of the regulation. They also tend to be more wealthy than other groups and to have good political connections. Indeed, many members of the Delaware legislature are themselves members of the bar. Such legislators tend to be represented disproportionately on legislative committees that draft the provisions of the Delaware Corporation Code.[138] As noted above, the bar can be expected to capture much, although not all, of the gains from increasing the amount of legal fees generated by provisions of the Delaware corporate law.[139] Accordingly, the bar is a powerful political

136. The number of lawyers in Delaware has increased dramatically over the past few decades. In 1970, Delaware had a population-to-lawyer ratio of 745:1, which placed the state 31st out of 50 in terms of its percentage of lawyers. *See* B. CURRAN, K. ROSICH, C. CARLSON & M. PUCCELTI, THE LAWYER STATISTICAL REPORT: A STATISTICAL PROFILE OF THE U.S. LEGAL PROFESSION IN THE 1980'S, at 233 (1985). By 1980, the state's ratio had dropped to 466:1, and it had jumped from 31st to 15th in population-to-lawyer ratio. *Id.* And as of 1985, Wilmington, which is regarded as the headquarters of the Delaware corporate bar, ranked fourth out of 469 principal American cities in terms of population-to-lawyer ratio. *Id.* at 493.

137. *See* Peltzman, *supra* note 107, at 239.

138. *See, e.g.*, Folk, *Reflections of a Corporate Law Draftsman*, 42 CONN. B.J. 409, 411 (1968) (noting that the 1968 Delaware Corporate Law Revision Committee "consisted chiefly of pro-management corporation attorneys").

139. *See supra* notes 87-105 and accompanying text.

force pressing for rules that maximize legal fees but do not necessarily maximize the revenues from corporations chartering in the state.

In contrast to Delaware attorneys, other interest groups within the state are unlikely to be able to galvanize into a coherent force to constitute a potent political threat to the bar. Although large in numbers, the individual stakes of the multitude of competing interests are small, and they are relatively unorganized. The economic theory of regulation predicts that free-rider problems will prevent them from having much success in countering the Delaware bar's drive for increased legal fees, especially because none of these individual interest groups has any assurance that it will be the one to enjoy the fruits of any overall increase to the general corporate treasury.[140] In other words, the competing groups are not organized into an effective political coalition because they lack sufficient incentives to incur the costs of promoting laws that will increase the general revenues of the state. All the costs of pushing for efficient corporate laws must be borne by discrete groups or individual taxpayers. These costs consist of the expenses of making campaign contributions and engaging in other forms of lobbying activities, as well as the search costs of ascertaining what sort of laws are likely to lead to an increase in chartering revenues in the first place. Although the costs of pressing for efficient corporate law in Delaware must be concentrated in specific groups, the benefits of such laws, like the benefits from public interest laws generally, would be spread among all the groups, and perhaps even to the general population. Indeed, should rival interest groups prevail over the Delaware bar in achieving the legislation it wants, these groups would in all likelihood fight a second battle among themselves to determine how the spoils should be divided.[141]

In other words, a rival interest group must win two political battles

140. *See* M. OLSON, THE RISE AND DECLINE OF NATIONS 17-19 (1982); M. OLSON, THE LOGIC OF COLLECTIVE ACTION: PUBLIC GOODS AND THE THEORY OF GROUPS 165-67 (1965). The "free-rider" problem arises from "[t]he economic theory of legislation [which] predicts that laws are likely to benefit the few at the expense of the many, because no one has an incentive to enact laws that benefit the people in general." Macey, *supra* note 107, at 231.

> By definition, the benefits from public spirited legislation fall on the public generally. As such, it is extremely unlikely that any individual will find it advantageous to devote privately the necessary resources to obtain such legislation. . . . Since any gain goes to the group as a whole . . . it pays for each individual to do nothing and to hope that others will make an effort upon which he can "free ride."

Id. at 231 n.44.

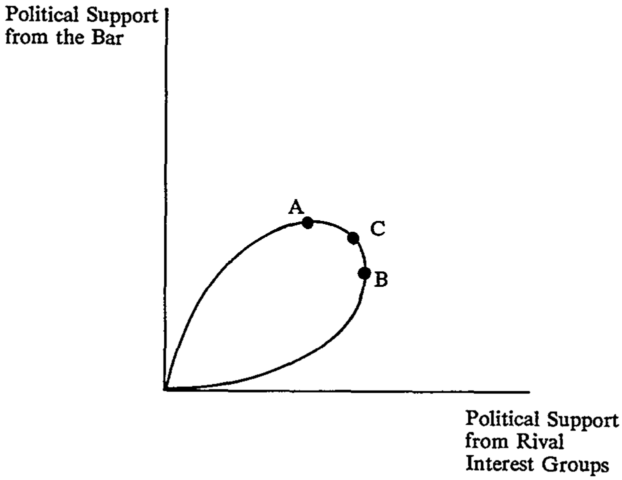
141. Direct opposition to the interests of the bar is likely to come from the state's corporation service companies. *See* Cary, *supra* note 1, at 687 (describing attempts by Delaware corporation service companies to eliminate the Delaware sequestration statute). Such companies are not subject to the severe free-rider problems that hinder efforts to organize citizens into an effective coalition. Like the bar, corporation service companies are discrete and well organized. Corporation service companies, however, cannot compete with the bar in terms of political influence. Their numbers and revenues are dwarfed by those of the bar. These firms, therefore, are likely to have some political

to achieve a favorable wealth transfer from a change in the Delaware Corporate Code. First it must prevail in its contest with the Delaware bar to obtain the initial revenue increase, and then it must prevail over all other interest groups to obtain the specific legislation that will transfer this additional revenue to it.[142] Perhaps the most important reason the

influence, but not enough to prevent the bar from capturing a substantial portion of the gains from the corporate chartering business.

142. *See* R. McCormick & R. Tollison, Politicians, Legislation, and the Economy: An Inquiry into the Interest-Group Theory of Government 17 (1981) (observing that groups that have borne the start-up costs in seeking wealth transfers will have a comparative advantage over other groups in obtaining the benefits of such transfers). The political-support maximization model developed by Stigler, Peltzman, and others, *see supra* notes 107-08 and accompanying text, which we apply to Delaware corporate lawmakers, predicts that Delaware legislators are driven by competition within the political marketplace to adopt the set of corporate law rules that provides them with the greatest overall level of political support. The application of this model to Delaware corporate law is represented by the graph below.

Figure A



The curved line in the graph represents all possible sets of legal rules that Delaware might adopt. To simplify matters (specifically, to keep the graphical presentation within a two-dimensional space), the graph presumes that political support for corporate law rules comes from two sources, the state's lawyers and the state's other interest groups. Political support from the bar is displayed on the vertical axis, and political support for changes in Delaware corporate laws from the other interest groups is displayed on the horizontal axis. Each point on the curve depicts a different possible configuration of corporate law rules for Delaware companies. Movements along the curve to points that correspond to higher locations on the vertical axis represent movements to sets of corporate law rnles that provide increased revenues.to members of the Delaware bar. Similarly, movements along the curve to points corresponding to locations further away from the origin on the horizontal axis represent movements to sets of legal rnles that provide greater revenue to other groups.

Thus, as one moves outward from the origin along the vertical axis, political support from the Delaware bar increases. The bar is willing to provide increasing levels of political support in exchange for increasingly favorable legal rules. For the same reason, as one moves outward from the origin along the horizontal axis, other groups provide increasing levels of political support to Delaware politicians. As the graph indicates, over a wide range of possible legal rules, Delaware legisla-

Delaware bar is able to prevail over rival groups in procuring favorable corporate law rules is that, for reasons unrelated to lobbying, the bar has already internalized the significant start-up costs necessary to lobby effectively for the rules it wants. Rival groups must incur these costs in learning what the relevant corporate law rules are, and how they can be written to benefit the state treasury. The state's corporate lawyers, of course, obtain this costly information as a by-product of their normal activities.[143]

IV. Applications of the Theory

The preceding Parts of this Article set forth an interest-group theory of Delaware corporate law. The theory is more complex than either of the existing models. It draws on both models while providing additional elements—most importantly the notion that Delaware law reflects an internal equilibrium among competing interest groups. This theory provides the best available explanation for the existing structure of Delaware corporate law. In this Part we examine a number of important statutory provisions and common-law decisions to test this theory.

One caveat is in order at this point. With the interest-group theory, as with the race-to-the-bottom and corporate federalist theories, false positive results may surface in the sense that the apparent consistency between observation and theory is potentially due to manipulability of the model. None of the existing theories, including ours, provides a complete account of Delaware law. The theories attempt the less exacting task of identifying the relevant variables and specifying their functional

tors can please both the bar and the other groups by enacting laws that increase the incidence of chartering within the state (thereby pleasing the other groups) without affecting the level of demand for the services of Delaware counsel (thereby maintaining the support of the state's corporate lawyers).

Certain rules, however, redound to the benefit of the bar, but impose costs on the other groups. As such, although the bar is willing to provide political support to Delaware legislators to see that these sorts of rules are enacted, the other groups will oppose these rules and withdraw support from Delaware legislators who support such rules. This set of rules is represented by the section of the curve between point *B* and point *C* on the graph. Along this portion of the graph, political support from the bar is increasing, but political support from the other groups is declining. Similarly, certain rules will benefit other groups but harm the bar. Legislators who support these rules will gain support from the service companies but lose support from the bar, as depicted by the portion of the curve that lies between points *A* and *C*. Over this range of possible legal rules, political support from the rival groups is increasing but political support from the bar is declining.

Clearly the bar would prefer the set of legal rules represented by point *A*, and the other groups would prefer the set of legal rules represented by point *B*. The actual set of legal rules we should expect to observe, however, is located at point *C*. It is this set of legal rules that maximizes the overall level of political support to politicians and therefore represents the equilibrium position between the demands of the major special interest groups concerned with Delaware corporate law.

143. *Cf. id.* at 17 (some groups will be able to produce political lobbying as a by-product of performing some other function, thereby avoiding start-up costs of lobbying).

interactions. They fail to specify the values that the variables are expected to obtain in the context of Delaware's political system. This limitation makes it difficult to falsify the interest-group theory. For example, we postulate that the bar would tend to favor an equilibrium level of vagueness in corporate law rules.[144] Once this preference standard is established, we can then examine the existing rules for vagueness. But without knowing the actual value of the equilibrium predicted by this theory, it is impossible to say with assurance whether the observations comport with the theory.

Our claim, however, is not that our theory is the best possible one, simply that it is preferable to the alternatives. We hope that what follows provides convincing, if somewhat impressionistic, support for our interest-group approach to Delaware corporate law.

A. *Procedural Rules*

Legal scholars differ greatly in their assessments of the efficacy of shareholder derivative litigation. Some commentators see such litigation as beneficial to shareholders because it provides an effective mechanism for monitoring corporate managment. Others doubt the value of such suits. This very lack of agreement over the value of many facets of corporate law has caused disagreement about the nature of Delaware corporate law. But, regardless of one's view on the overall desirability of shareholder derivative suits, there is general agreement that at least some fraction of such suits are "strike" suits, brought only to enrich plaintiffs' attorneys.[145] Thus, both sides of the corporate governance debate agree

144. *See supra* notes 131-35 and accompanying text.

145. Coffee, *The Unfaithful Champion*, *supra* note 103, at 13 (quoting Justice Black in Surowitz v. Hilton Hotels Corp., 383 U.S. 363, 371 (1966), that strike suits are brought "by people who might be interested in getting quick dollars by making charges without regard to their truth so as to coerce corporate managers to settle worthless claims in order to get rid of them"). There is voluminous literature arguing that derivative actions consist at least in part of frivolous suits brought to force unwarranted settlements and earn high fees. Criticism begins with The Wood Report which found that plaintiffs recovered in only 13 out of 573 derivative suits involving publicly held corporations within the survey period. F. WOOD, SURVEY AND REPORT REGARDING STOCKHOLDERS' DERIVATIVE SUITS 32 (1944). Wood concluded that plaintiffs' attorneys in this field made "the ambulance-chaser by comparison a paragon of propriety." *Id.* at 47. The Wood Report led to the adoption of "security for expenses" statutes designed to curb derivative litigation. *See* N.Y. BUS. CORP. LAW 627 (McKinney 1986); *see also* Conard, *Winnowing Derivative Suits Through Attorneys Fees*, 47 LAW & CONTEMP. PROBS. 269, 281-82 (1984) (noting that multimillion dollar derivative suits coupled with customary contingent fees, lead one to "hardly doubt that these awards inspire filing some long-shot lawsuits"); Duesenberg, *The Business Judgement Rule and Shareholder Derivative Suits: A View From the Inside*, 60 WASH. U.L.Q. 311, 331-33 (1982) (arguing against the value of derivative suits in regulating corporate behavior and concluding that "[f]iling lawsuits with little or no merit has become, it seems, a way of life with many lawyers"); Herzel & Hagen, *Plaintiff's Attorneys' Fees in Derivative and Class Actions*, LITIGATION, Winter 1981, at 25-27 (arguing that calculation of fees by hourly rates and adjustments for the risk of losing cases creates too great an incentive to bring and prolong derivative suits). *See generally* Dawson, *Lawyers and Involuntary Clients in Public Interest*

that there are benefits to those devices that reduce frivolous shareholder litigation.

A device particularly well suited to curtail the incidence of strike suits against corporations is a statutory provision requiring plaintiffs to post security for expenses. New York,[146] Pennsylvania,[147] Florida,[148] and even California[149] require plaintiffs to post security for expenses. By contrast, Delaware imposes no such requirement in shareholder derivative actions, a policy inconsistent with the corporate federalist assumption that the Delaware Corporate Code is designed primarily to serve the interests of shareholders. It is also inconsistent with the race-to-the-bottom theorists' model of the Delaware Corporate Code because that theory presumes that the law caters to the interests of incorporated firms' managers. Indeed, the only group that seems to benefit from the lack of a security statute is the bar, because the increased threat of litigation against Delaware firms will increase the demand for legal services.[150]

Other procedural provisions in the Delaware Corporate Code are inconsistent with both of the established theories on what forms the basis for Delaware decision rules. Even Professor Cary recognized that many procedural provisions of the Delaware Corporate Code could not be reconciled with either the corporate federalists' theory or with his own race-to-the-bottom theory:

> Delaware offers a method of bringing suit against non-resident directors by quasi in rem jurisdiction. Though described as archaic, cumbersome and inefficient, the sequestration process authorizes the courts of chancery to "compel the appearance of the [non-resident] defendant by the seizure of . . . his property" and treats the situs of "the capital stock of all Delaware corporations . . . as in this State." . . . [These provisions are] based on the solicitude of the state for the Delaware bar. The Committee that drafted the [1967 amendments to the Delaware Corporate Code] consisted pri-

Litigation, 88 HARV. L. REV. 849, 929 (1975) (concluding that the "court-directed game of roulette" that has emerged from viewing the value of services rendered by lawyers as "a variable, measured by the gains that the litigation produced," has "the same attractions for the adventurous lawyer as those to be found in other games of chance").

146. N.Y. BUS. CORP. LAW § 627 (McKinney 1986). New York is the leading state for incorporations after Delaware. *See* N.Y.S.E. Guide (CCH), *supra* note 31, at ¶¶ 701.3-799.

147. PA. STAT. ANN. tit. 15, § 1516 (Purdon 1967 & Supp. 1985). Pennsylvania is the state with the highest proportion of revenue derived from chartering fees after Delaware. Romano, *supra* note 2, at 240 n.24.

148. FLA. STAT. ANN. § 607.147(3) (West Supp. 1986).

149. CAL. CORP. CODE § 800(e) (West Supp. 1986). California is generally considered to be the state whose law is most sensitive to the concerns voiced by Professor Cary. Baysinger & Butler, *supra* note 2, at 185. California, Illinois, New York, and Texas are states in which "strict laws provide a relatively greater scope for the involvement of shareholders in managing the firm . . . ." *Id.* at 181.

150. *See* Cary, *supra* note 1, at 686-88.

marily of Delaware lawyers who enjoy a lucrative Wall Street practice in a comparatively pastoral setting. . . . They have a direct interest in permitting suits to be brought in Delaware.[151]

The Delaware policy that permitted sequestration was dramatically at odds with the race-to-the-bottom theory because it imposed costs on corporate officers and directors—the very group that the theory predicts will benefit from Delaware law. It is also unlikely that the statute was designed to benefit shareholders by making it easier to sue nonresident directors as the corporate federalists would predict. The existence of a sequestration statute in Delaware, like the lack of a requirement that plaintiffs post security for expenses, can be viewed as a legislative response to the demands of the Delaware bar.

The debates surrounding the proposed elimination of the sequestration statute provides further support for the interest-group theory. In 1966, the members of the Delaware Corporation Law Revision Commission battled over whether the sequestration procedure should be eliminated. Those members of the Commission representing Delaware's corporation service companies, which stood to benefit from an increase in the total number of incorporations but not from increased litigation, favored the complete elimination of sequestration from the Delaware Code.[152] The corporation service companies believed that a large increase in the number of incorporations in Delaware would follow the repeal of the sequestration statute.[153] Members of the Delaware bar who served on the Commission, however, took the opposite view: several of them "freely admitted that they voted for retaining sequestration because it means more business for them."[154] The lawyers prevailed, and the Delaware Corporation Law Revision Commission refused to recommend repeal. When the Delaware sequestration statute finally was held unconstitutional by the United States Supreme Court,[155] the Delaware legislature immediately passed a "consent" statute facilitating the ability of plaintiffs' lawyers to obtain jurisdiction over nonresident corporate fiduciaries.[156]

Delaware corporate law generally may favor shareholders as the corporate federalists suggest. But when it comes to rules that relate to

151. *Id.* at 686-87 (footnotes omitted). The sequestration statute was found unconstitutional in Shaffer v. Heitner, 433 U.S. 186, 213 (1977).

152. *Id.* at 686-88; *see also* Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 889 n.201 (1969) (reporting opinion by committee member that the sequestration statute had reduced incorporations in Delaware).

153. Carey, *supra* note 1, at 687.

154. Comment, *supra* note 152, at 890.

155. Shaffer v. Heitner, 433 U.S. 186 (1977); *see supra* note 151.

156. DEL. CODE ANN. tit. 10, § 3114 (1975 & Supp. 1986); *see* Winter, *supra* note 3, at 274 n.72.

litigation within the borders of the state, Professor Bishop provided a more accurate summary of the state's policy: "Delaware's general approach . . . is to make it easy to sue the executives of Delaware corporations, no matter where they reside or the corporation does business, so long as the suit is in Delaware courts, and conducted by Delaware counsel."[157]

B. Substantive Statutory Provisions

Delaware gives shareholders a broad statutory right to inspect corporate books and records, including lists of stockholders.[158] Unlike other states,[159] Delaware does not require shareholders to have held their stock for any minimum period, or to own a significant amount of stock in order to avail themselves of this right.[160] This liberal inspection rule is consistent with our theory in that it maximizes the potential for litigation based on information obtained from corporate records. In addition, Delaware lawyers are often hired to conduct this inspection on behalf of nonresident shareholders. Both of the established theories predict that Delaware's rule would be otherwise. The race-to-the-bottom theory predicts that Delaware would make it difficult for shareholders to gain access to materials that could facilitate a shareholder derivative suit or launch an acrimonious proxy contest or takeover battle. The corporate federalist theory predicts that market forces would provide sufficient protection for shareholders and that the right to inspect corporate records should be discouraged to minimize the incidence of strike suits.

One of the most controversial aspects of Delaware's substantive corporate law relates to the indemnification of officers and directors. Race-to-the-bottom theorists point to Delaware's liberal indemnification provisions as evidence that the law benefits managers at the expense of share-

157. Bishop, *Sitting Ducks and Decoy Ducks: New Trends in the Indemnification of Corporate Directors and Officers*, 77 YALE L.J. 1078, 1084 (1968).

158. *See* DEL. CODE ANN. tit. 8, § 220 (1983).

159. California law is different from that of Delaware only with regard to the examination of a list of shareholders. To examine the list of shareholders of a California corporation, a person must be a shareholder with 5% of aggregate stock or 1% of the voting stock. CAL. CORP. CODE § 1600 (West Supp. 1986). As in Delaware, any shareholder may examine the corporation's books and records. CAL. CORP. CODE § 1601 (West 1977). In New Jersey, a person must be a shareholder for six months or hold 5% of the corporation's stock to inspect the current records. N.J. REV. STAT. § 14A:5-28(3) (West Supp. 1986). Any shareholder may examine balance sheets and income statements from the preceding fiscal year. N.J. REV. STAT. § 14A:5-28(2) (West Supp. 1986). Requirements of New York law are similar to those of New Jersey. To inspect the records, a shareholder must have held stock or be acting on behalf of himself and others who together hold 5% of the corporation's stock. N.Y. BUS. CORP. LAW § 624 (McKinney 1986). Texas law is identical to that of New Jersey; a shareholder must have held stock for six months or hold 5% of the stock to inspect the corporation's records. TEX. BUS. CORP. ACT ANN. art. 2.44 (Vernon 1980).

160. *See* DEL. CODE ANN. tit. 8, § 220 (1983).

holders. The corporate federalists respond that liberal indemnification ultimately benefits shareholders by enabling corporations to attract qualified officers and directors by guaranteeing them protection against liability. The corporate federalists' arguments are supported by Professor Kraakman's observation that a firm's officers and directors are less efficient risk bearers than a firm's shareholders because they are unable to diversify their human capital investment in the firm.[161] Thus, shareholders may in fact benefit by permitting liberal indemnification of officers and directors.

The indemnification debate has focused on efficient allocation of risk within the corporation. Our theory suggests that the laws are structured in response to special interests outside the corporation in order to facilitate the litigation and settlement process. For example, as Arsht and Stapleton have pointed out,

> With respect to payments in settlement of a derivative action it was the [Delaware Corporation Law Revision Committee's] view that to permit such indemnification would have the ultimate effect of discouraging settlements since, in such a situation, derivative plaintiffs could demonstrate no benefit arising to the corporation from their action and, presumably, could not justify being reimbursed for their litigation expenses.[162]

As Professor Bishop observed, "the implication of this . . . practical consideration seems to be that the statute contemplates amicable settlements of Delaware litigation, with the corporation scattering largesse among the legal dramatis personae."[163] Thus, consistent with our model, both Delaware substantive law and procedural rules tend to subordinate a concern for producing efficient corporate law rules to a policy of maximizing revenues for the local bar.

C. *Delaware Case Law*

In this subpart we examine some recent decisions in the Delaware Supreme Court in light of the interest-group analysis presented above. Once again the interest-group theory proves to be more robust than either the race-to-the-bottom or corporate federalist theories in predicting decisions of Delaware state courts.

As explained above, when Delaware judges articulate common-law fiduciary duties owed by managers to shareholders, they have considera-

161. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 864 (1984).

162. Arsht & Stapleton, *Delaware's New General Corporation Law: Substantive Changes*, 23 BUS. LAW. 75, 80 (1967).

163. Bishop, *supra* note 157, at 1084.

ble freedom to formulate corporate law decision rules independent of the state legislature. But when those decisions upset the prevailing political equilibrium, they can be modified by the legislature. When they maintain the equilibrium, they will be left alone. As we have shown, this equilibrium is likely to be strongly biased in favor of the bar. For exogenous institutional reasons, the courts are likely to support this bias, thus lowering the cost to the Delaware bar of achieving the set of legal rules they most prefer.

1. Zapata Corp. v. Maldonado.—The Delaware Supreme Court in *Zapata Corp. v. Maldonado*[164] examined the authority of a committee appointed by a board of directors to dismiss a derivative suit brought by dissident shareholders. Four years after a group of Zapata shareholders filed a derivative suit in the Delaware Court of Chancery,[165] the corporation's board of directors appointed two outside directors who had been named to the board after commencement of the suit,[166] to a committee with authority to investigate the plaintiffs' claims and determine whether the litigation should continue.[167] After investigation, the committee decided that the suits lacked merit and that proceeding with the litigation against Zapata was contrary to the corporation's best interests. Zapata's counsel moved to dismiss the suit on the basis of this report.[168] Counsel also moved to dismiss a similar suit that had subsequently been filed in federal court in New York.[169]

In the New York case, District Judge Weinfeld held that under Delaware law a committee of disinterested directors could, in its exercise of business judgment,[170] require the termination of a derivative suit brought

164. 430 A.2d 779 (Del. 1981).

165. Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom.* Zapata v. Maldonado, 430 A.2d 779 (Del. 1981).

166. Zapata, 430 A.2d at 780-81.

167. *Id.* at 781.

168. Maldonado v. Flynn, 413 A.2d at 1254-55.

169. Maldonado v. Flynn, 485 F. Supp. 274 (S.D.N.Y. 1980), *rev'd in part*, 671 F.2d 729 (2d Cir. 1982).

170. "The judgment of the directors of corporations enjoys the benefit of a presumption that it was formed in good faith and was designed to promote the best interests of the corporation they serve." Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928). This presumption, referred to as the " 'business judgment' rule, evolved to give recognition and deference to directors' business expertise when exercising their managerial power." Zapata Corp. v. Maldonado, 430 A.2d 779, 782 (Del. 1981). The rule is most often invoked to limit "the scope of judicial review of the merits of managerial decision." Fischel, *supra* note 42, at 1439. Invocation of the business judgment rule typically shifts the focus of judicial inquiry from the merits of an action by a board of directors to an inquiry into whether there has been "such an abuse of discretion as would constitute a fraud or breach of that good faith which . . . [directors] are bound to exercise toward the stockholders." Hunter v. Roberts, Throp & Co., 83 Mich. 63, 71, 47 N.W. 131, 134 (1890). Traditionally, the courts have reviewed the merits of an action by directors only when they have found such fraud or breach of duty.

by shareholders on the firm's behalf.[171] This holding is consistent with the interests of shareholders as those interests are construed by the corporate federalists, who question the value of derivative litigation altogether.[172] By contrast, the Delaware Chancery Court held that the corporation could not use the disinterested committee procedure to frustrate the right of individual shareholders to bring a derivative suit on behalf of the corporation.[173]

On appeal, the Delaware Supreme Court rejected the chancery court's view that shareholders have an absolute right to bring derivative suits against Delaware firms.[174] In an opinion that provides more comfort to Delaware lawyers than to shareholders, the Delaware Supreme Court held that a derivative suit could be dismissed on the basis of a recommendation by an independent committee provided two conditions were met. First, the corporation must file a pretrial motion to dismiss that includes "a thorough written record of the [committee's] investigation and its findings and recommendations."[175] Second, both sides must be given the opportunity to make a record on the motion.[176] When these requirements are satisfied, the court must apply a two-part test to decide if the motion for dismissal should be granted. First, the court must determine whether the corporation has met its burden of establishing that the committee's investigation was made independently and in good faith and that it had a reasonable basis for its conclusions. The second part of the test requires the court to determine, by "applying its own independent business judgment, whether the motion should be granted."[177]

The Delaware Supreme Court's holding in *Zapata* is a disappointment to corporate federalists and adherents of the race-to-the-bottom theory. On the one hand, given their traditional promanagement sympathies, Delaware courts are unlikely to ignore the recommendations of the independent litigation committees. On the other hand, to corporate federalists such as Professor Fischel, the decision is "most significant and most unsettling" because of its "explicit rejection of the business judgment rule as the proper standard for determining whether a derivative suit can be dismissed."[178]

Consistent with the theory of judicial behavior by Delaware judges

171. *See* 430 A.2d at 781.

172. *See* Fischel & Bradley, *supra* note 38, at 271-74.

173. Maldonado v. Flynn, 413 A.2d 1251 (Del. Ch. 1980), *rev'd sub nom.* Zapata v. Maldonado, 430 A.2d 779 (Del. 1981).

174. 430 A.2d at 782.

175. *Id.* at 788.

176. *Id.*

177. *Id.* at 780-89.

178. Fischel, *supra* note 2, at 937.

advanced in this Article, the decision in *Zapata* reaches a result likely to increase the demand for the services of Delaware lawyers. The holding requires corporations "to spend large sums on information gathering [even] if these costs exceed the expected gain from better informed business decisions."[179] Much of the money spent on information gathering inevitably will go to the lawyers who prepare the pretrial motion, conduct the investigation on behalf of the corporate board, and prepare the "thorough written records of the investigation"[180] required of both sides. The beneficiaries of the decision, therefore, will be Delaware attorneys—a conclusion consistent with our hypothesis that the Delaware judiciary for its own reasons tends to adopt rules that reflect the political equilibrium between maximizing state revenues and serving the interests of the state bar.

2. Smith v. Van Gorkom *(the* Trans Union *case).*—In *Smith v. Van Gorkom*[181] the shareholders of the Trans Union Corporation filed a class action against the board of directors, seeking to set aside a merger of the corporation into a wholly-owned subsidiary of Marmon Group, Incorporated. As a result of the merger, Trans Union stockholders received $55.00 per share for their stock, which previously had been trading for approximately $34.00 per share.[182]

The Delaware Chancery Court, relying on discretion afforded board members under the business judgment rule,[183] granted judgment for the defendant directors.[184] The Delaware Supreme Court reversed the court below and found that the directors of Trans Union had breached their duty to make an informed decision about the merits of the merger.[185] The court's opinion focused on the inadequate procedures and lack of information that the board used to evaluate the terms of the merger proposal. The court found that Trans Union's board had agreed too hastily to the merger in an effort to accommodate the acquirer's demand for a rapid decision on the proposal. Specifically, the board failed either to question the chief financial officer or obtain an opinion from a financial expert on the fairness of the $55.00 per share offer.[186] The *Trans Union* opinion suggests that future boards protect themselves against liability by

179. *Id.* at 940.
180. *Zapata*, 430 A.2d at 788.
181. 488 A.2d 858 (Del. 1985).
182. *Id.* at 866 & n.5.
183. *See supra* note 170.
184. The chancery court's decision was issued as an unreported letter opinion dated July 6, 1982. 488 A.2d at 854.
185. *Id.* at 874-78.
186. *Id.* at 876-77.

utilizing all the information "reasonably available to them" before accepting or rejecting merger proposals.[187]

After finding that the directors breached their duty of care by failing to deliberate the proposed merger sufficiently, the court remanded the case to the chancery court and instructed it to award damages "to the extent that the fair value of Trans Union exceeds $55.00 per share."[188] The case subsequently was settled.[189]

Again, the *Trans Union* case was a clear disappointment to the corporate federalists. In his analysis of the case, Professor Fischel concludes that

> shareholders are the biggest losers after *Trans Union*. Firms will have no difficulty finding an "expert" who is willing to state that a price at a significant premium over the market price in an arm's length transaction is "fair" . . . . But the cost of obtaining such an opinion is, in effect, a judicially imposed tax on corporate changes. The inevitable consequence will be that fewer transactions will occur and that when they do occur, returns to investors will be lower.[190]

Fischel predicts that, as a result of *Trans Union*, managers and directors of Delaware firms will not approve any proposed mergers without first consulting outside experts.[191] This opinion is consistent with our view that Delaware judges are likely to reach results that maximize the involvement of Delaware lawyers in the decisions of Delaware corporations and will, therefore, be consistent with the political equilibrium obtained in the legislature. Although investment bankers, the most likely group to act as outside consultants, are generally located outside of Delaware, they are influential in a firm's decision of where to incorporate. Thus, a decision that benefits investment bankers may indirectly benefit the state by encouraging Delaware incorporations.[192]

The real significance of the decision, however, lies in its impact on management's ability to defeat hostile takeover attempts. The opinion seems to be detrimental to incumbent managers because it imposes potentially devastating personal liability for actions that did not seem to be negligent, much less "grossly negligent" as found by the Delaware

187. *Id.* at 877.

188. *Id.* at 893.

189. Wall St. J., Aug. 2, 1985, at 18, col. 3. The settlement was reportedly in the amount of $23.5 million. *Id.* The directors' liability insurance carrier was expected to pay only "about $10 million" of this sum. *Id.*

190. Fischel, *supra* note 42, at 1453.

191. *Id.*

192. *See supra* text accompanying notes 69-70.

Supreme Court.[193] But, a somewhat different picture emerges when the impact of *Trans Union* on corporate takeovers is considered. As a result of the decision, incumbent managers must delay their response to "hot" suitors who come forward with a merger proposal and insist on an immediate answer. Because of the increased duty of care and potential personal liability, managers are required to consult outside investment counsel about the fairness of the offer. This requirement can work to the manager's advantage: they are free to find a cooperative banker willing to supply an opinion that the offer is inadequate. They also have the advantage of a breathing spell in which to marshal antitakeover defenses. *Trans Union* thus provides incumbents with a powerful weapon against rnsh offers by unfriendly acquirers.[194]

Trans Union appears to benefit the Delaware bar because it offers a marginal increase in the demand for advisory legal work. The opinion, therefore, is consistent with our theory that the Delaware Supreme Court will act for its own reasons to maintain the status of Delaware as the nation's premier state of incorporation by providing legal rules—such as protections against unfriendly takeovers—that are highly desired by incumbent managers. This objective appears to have been accomplished in *Smith v. Van Gorkom*.

3. Moran v. Household International, Inc.—A final application of our theory of judicial behavior is *Moran v. Household International Inc.*,[195] the first judicial challenge under Delaware law to a "poison pill" antitakeover defense.[196] We examine this case in some detail because it is at least superficially in tension with the thesis put forth in this Article. Upon close analysis, however, the case is consistent with, and even supportive of, our interest-group theory.

193. 488 A.2d at 884.

194. Like Professor Fischel, we do not condone the decision of the Delaware Supreme Court because it will result in a waste of resources as directors are forced to create a lengthy record to justify their decisions. Unlike Professor Fischel, however, we doubt that the decision raises the probability that managers will be held liable for their decisions. In fact, the *Trans Union* decision may lower this probability because managers and directors may be able to insulate themselves by creating the type of paper record prescribed by the court. Interestingly, Professor Fischel describes the decision as requiring corporate directors to hire the services of outside consultants "as a type of insurance." Fischel, *supra* note 42, at 1453. We believe that this is an accurate characterization of the Delaware court's opinion. Among other things, it tends to explain the cryptic comment made by Mr. Justice Moore of the Delaware Supreme Court to one of us (Miller), during oral argument in *Moran v. Household Int'l, Inc.*, that "there will never be another *Van Gorkom*."

195. 490 A.2d 1059 (Del. Ch. 1985), *aff'd*, 500 A.2d 1346 (Del. 1985).

196. One of us (Miller) briefed and argued the *Moran* case to the Delaware Supreme Court on behalf of dissident shareholders challenging the "poison pill." *See generally* M. Ryngaert & G. Jarrell, The Economics of Poison Pills (Dec. 23, 1985) (unpublished manuscript available from the authors).

A poison pill is a complex device, adopted by a board of directors without shareholder approval, that imposes devastating consequences on hostile acquirers that take over a target company and then merge or consolidate with it.[197] As the trial court in *Moran* acknowledged, a certain type of poison pill ultimately may alter the balance of power between shareholders and the board of directors[198] by making target firms essentially takeover-proof unless the acquisition has the support of the incumbent management. Nevertheless, the chancery court endorsed this transfer of power by upholding a corporate board's adoption of a form of poison pill as a valid exercise of its business judgment.[199] This conclusion was endorsed by the Delaware Supreme Court.[200]

The *Moran* decision will be construed by most corporate federalists as harmful to shareholder interests. Corporate federalists stress the importance of the market as a force in controlling the discretion of managers and in enhancing shareholder wealth. They also rely on an impressive body of empirical work suggesting that corporate takeovers are good for shareholders of acquired firms.[201] The stocks of acquired firms routinely show abnormally high returns in the months surrounding the acquisition. A poison pill, by precluding hostile takeovers, threatens to eliminate these benefits. The takeover market cannot effectively control agency costs when incumbent managers can rest assured that no matter how poorly they run the company, they will not be removed in an unfriendly acquisition. The decline in takeovers that can be expected as a result of poison pills deprives shareholders of the benefits of higher stock prices. Although an economic case can be made in support of the poison

197. The term "poison pill" refers

> to a family of shareholder rights agreements which, upon the occurrence of some triggering event such as the acquisition by a tender offeror of a certain percentage of a target corporation's common stock, entitle the remaining shareholders to receive additional shares of common stock (or other securities) at bargain prices.

Dynamics Corp. of Am. v. CTS Corp., 794 F.2d 250, 254-55 (7th Cir. 1986). The purpose of a poison pill is to discourage hostile takeover attempts. For two differing views of the merits of such devices, compare Gilson, *A Structural Approach to Corporations: The Case Against Defensive Tactics in Tender Offers*, 33 STAN. L. REV. 819 (1981) with Scherer, *Takeovers: Present and Future Dangers*, BROOKINGS REV., Winter-Spring 1986, at 15.

198. 490 A.2d at 1070.

199. *Id.* at 1083.

200. 500 A.2d at 1347.

201. *See, e.g.*, Bradley, *Interfirm Tender Offers and the Market for Corporate Control*, 53 J. BUS. 345, 345-46, 375 (1980) (demonstrating that shareholders of target company gain from takeover whether or not they tender their shares); Dodd & Ruback, *Tender Offers and Stockholder Returns: An Empirical Analysis*, 5 J. FIN. ECON. 351, 372 (1977) (concluding that shareholders of target corporations earn "large and significant abnormal returns" in the month following announcement of a tender offer); Jarrell & Bradley, *The Economic Effects of Federal and State Regulation of Cash Tender Offers*, 23 J.L. & ECON. 371, 381-82 (1980) (refuting "corporate piracy" theory of takeover effects); Kummer & Hoffmeister, *Valuation Consequences of Cash Tender Offers*, 33 J. FIN. 505, 516 (1978) (finding that takeovers maximize use of corporate resources and return to shareholders).

pill,[202] the majority of scholars in the corporate federalist camp disapprove of the device.[203]

The *Moran* decision is more consistent with the race-to-the-bottom theory in that it appears to endorse a management expropriation of shareholder wealth. Certain elements of *Moran*, however, do not fit the Cary thesis. If the Delaware Supreme Court had no concerns other than appealing to managers, it could have issued a stronger opinion creating a heavy presumption in favor of managers' business judgment in the context of takeovers. Instead, it merely upheld the facial validity of poison pills in the abstract setting in which no actual takeover was underway.[204] The court suggested that the discretion given management under the business judgment rule might be rebutted if managers failed to show that the "defensive mechanism was 'reasonable in relation to the threat posed.' "[205] Although the opening the court left potential acquirers is small, the court declined to preclude the possibility that a firm with a poison pill could be acquired in an unfriendly takeover.

It is difficult to determine what interests, if any, were served by the court's decision in *Moran*. Corporate control transactions have been a fruitful source of litigation in the Delaware courts. Poison pills threaten this business by reducing the probability that an unfriendly acquisition will be attempted if the target firm has adopted a poison pill—as many firms have done.

At the time of the *Moran* decision, however, the state was confronted with the possibility that poison pills would become so desirable that managers would be willing to move the firm's domicile to a more friendly location if the device were held illegal under Delaware law.[206] The poison pill was a highly publicized mechanism that already had been adopted by corporations around the country. In this particular context,

202. The poison pill can be justified as a device for giving management the leverage to bargain with potential acquirers to get the best price for the corporation's shares. Shareholders are not well situated to engage in such bargaining because they face a form of prisoner's dilemma: although it may be in the interest of all shareholders to hold out for more than is currently being offered, shareholders will nevertheless rush to tender out of fear of being frozen out for less consideration in a second-stage acquisition. According to this argument, the increased costs that flow from giving managers the power to veto unfriendly acquisitions are exceeded by the benefits to shareholders from allowing management to act as their champion in bargaining with a potential acquiring firm.

203. Empirical work on the "poison pill" defense has suggested that it may have a weak negative effect on shareholder wealth. *See* M. Ryngaert & G. Jarrell, *supra* note 196.

204. *Moran*, 500 A.2d at 1349.

205. *Id.* at 1356-57 (quoting Unocal Corp. v. Mesa Petroleum, 493 A.2d 946, 955 (Del. 1985)).

206. Professor Romano observed that several firms actually left Delaware for Virginia when the latter state offered greater protections to incumbent managers against the threat of hostile takeovers. Romano, *supra* note 2, at 246.

the danger of losing chartering business was probably a major consideration influencing the court.

The interests of the corporate bar would not be served by a rule that drove a substantial number of corporations out of Delaware, even if the rule had the effect of generating more litigation per firm. Thus, the court's decision seems to protect the interests of all groups with an economic stake in Delaware chartering activity. But it is significant that the court did not baldly endorse the poison pill in all its applications. Instead, consistent with our view of the structural bias of the Delaware Supreme Court, it left open the possibility of profitable litigation in cases in which an actual takeover was attempted.

V. Conclusion

This Article develops an interest-group theory to explain the legal rules that govern the behavior of Delaware chartered corporations. The Article begins by examining the "demand side" of Delaware law. It notes that firms are willing to pay a premium for the privilege of incorporating in Delaware. We observe that firms are better off after chartering in Delaware in spite of the necessity of paying this premium. As Romano has observed, firms find Delaware a particularly attractive state of incorporation for two reasons. First, unlike other states, its judges are specialized in resolving corporate law disputes and as a consequence, the state can offer firms access to a system of corporate law rules that is stable, predictable, and sophisticated relative to that of other states. In addition, the state is able to make a credible, bonded promise to firms that its rules will remain attractive in the future.

The stability and predictability of Delaware law is a capital asset owned by the state. The wealth created by this asset is not given to firms that charter in the state free of charge. Instead, consistent with the political-support maximization model developed by Stigler and Peltzman and others, special-interest groups will compete to appropriate the income produced by this asset.

In applying the political support maximization model to Delaware corporate law, we posit that the Delaware bar is likely to be more successful than other groups in transforming Delaware's competitive advantage into profits. This group enjoys significant advantages in organizational structure as well as economies of scale in obtaining information about the effects of changes in Delaware law on the demand for corporate charters and legal services. In addition, the bar is not plagued with the same start-up costs and free-rider problems that confront other groups. The bar is not the only interest group within Delaware that benefits from the state's dominance in the market for corporate charters, but its gains are disproportionately high relative to those of the groups with which it competes.

Despite the costs imposed by these interest groups on chartering firms, Delaware will remain the dominant state in the jurisdictional competition for corporate charters as long as the net costs of Delaware incorporation are lower than the net costs of incorporation elsewhere for a plurality of firms. Furthermore, although the Delaware judiciary does not participate in the political competition we describe, for exogenous reasons the courts have gradually moved towards a procedural approach to corporate law that (in the short run) is likely to increase the revenues of the Delaware bar relative to that of other groups.

In short, our interest-group theory predicts that the corporate law of Delaware reflects an equilibrium among competing interest groups. There are two existing theories that attempt to explain Delaware's corporate law. One posits that Delaware dominates the jurisdictional competition for corporate charters by permitting corporate managers to exploit shareholders for their own selfish ends. The other predicts that competition among the states leads to the "optimal" set of corporate law rules from the shareholders' perspective. Analysis of the relevant provisions of the Delaware Corporate Code as well as the prevailing legal culture as revealed by the corporate law decisions of the Delaware Supreme Court suggests that our theory explains the state's corporate law rules more fully than either of the existing theories.