THE DELAWARE CONTROVERSY—THE LEGAL DEBATE

BY ALLEN HYMAN *

THE CORPORATE form has been in existence in this country for over 200 years.[1] With few exceptions, corporate formation is exclusively provided by state law.[2] During the first half of the nineteenth century, when the corporate organization was first introduced into this country, corporations were created only by special acts of the state legislature.[3] The individual state charters often granted exclusive franchises in a variety of business activities.[4] The undesirable consequences which resulted from the charter system are well documented.[5] The growing negative political reaction to the state creation of these exclusive charters, along with pressures generated by the growth in the number of corporate applications, brought about a de-

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1. *See generally* Williston, *History of the Law of Business Corporations Before 1800*, 2 HARV. L. REV. 105 (1888).

2. CAL. CORP. CODE § 200 (West 1977); DEL. CODE ANN. tit. 8, § 101 (1974). Some exceptions are the federal chartering of: National Banks, *see* 12 U.S.C. § 21 (1976); Federal Credit Unions, *see* 12 U.S.C. § 1753 (1976); Federal Land Banks, *see* 12 U.S.C. §§ 2001, 2002 (1976); Federal Intermediate Credit Banks, *see* 12 U.S.C. §§ 2071, 2072 (1976); and Investment Companies (mutual funds), *see* 15 U.S.C. § 80a (1976).

3. *See* J. DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS (1917).

4. *See id.* 2 at 332-45.

5. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 663-64 (1974) (footnotes omitted), where Cary states:

> [T]here was a revulsion against them as anti-egalitarian, monopolistic, and scandalous. For this reason, in revising its constitution of 1846, New York provided that corporations might not be created by special act 'except . . . in cases where, in the judgment of the legislature, the objects of the corporation cannot be attained under general laws.'

See also Berle, *Historical Inheritance of American Corporations*, Social Meaning of Legal Concepts, 3 The Powers and Duties of Corporate Management (N.Y.U. School of Law, 1950):

> On the legislative side, a wholesale disgust at the manoeuvering [sic] and corruption attending the granting, revision, and renewal of special charters led to revolution. The movement took the form of a doctrine that special charters were inherently bad; that the privilege of doing business as a corporation ought to be available to any one and, by consequence, that states should have a general incorporation law permitting any business group which fulfilled its formalities to obtain a charter from the state.

cline in the use of these separate franchises and generated the birth of the general corporation laws.[6]

The first "general" corporation laws of 1809 and 1811 have undergone a considerable evolution, and state corporation codes of today only slightly resemble those first laws which were enacted over 165 years ago.[7] Initially, the laws governing incorporation were very restrictive as to duration of existence, capital formation, and types of corporate activity allowed. These early codes extensively regulated the internal affairs of the corporation and provided for active minority shareholder participation in the determination of corporate activities.[8] Corporations were not able to incorporate for "any lawful purpose" until late in the nineteenth century.[9]

During the evolution of corporate law over the past eighty-five years, state control over both the formation and the internal affairs of the corporation became less restrictive.[10] As a result of this continu-

6. N. LATTIN, THE LAW OF CORPORATIONS 175 (1971): Special charter enactments by state legislatures were subject to the same political pressures that were associated with any proposed legislation. Incorporation by this method frequently resulted in special commercial favoritism, obtained through the state political process.

7. N. LATTIN, *supra* note 6, at 175:

> In 1811 New York adopted a general corporation act under which any five or more persons might become incorporated to engage in definitely specified types of manufacturing, by signing, acknowledging and filing with the secretary of state a certificate of incorporation setting forth the corporate name, its location, objects, capitalization and number of shares, and the names and addresses of its first board of directors. The Act of 1811 limited the capital to $100,000, the life of the corporation to 20 years, and imposed additional liability upon shareholders for the benefit of creditors upon dissolution if the corporate assets could not pay them.

8. For example, early corporation codes followed the common law concept of one share, one vote, ensuring that the minority voting interest would not be diluted. *See* Comment, *Delaware Resurrects the Common Law: Affirmation of Contractual Voting Restrictions Within a Class of Stock*, 4 DEL. J. CORP. L. 154, 164-65 (1978). Corporate capitalization in Alabama was limited to $200,000 until 1876, when it was raised to $1,000,000. *See* J. DAVIS, *supra* note 3, 2 at 16-18. Until 1881, the maximum capitalization for a New York corporation was $2,000,000 when it was increased to $5,000,000. *See* Code of 1896 (Civil, c. 28, § 12, 59, p. 429); *see also* Liggett Co. v. Lee, 288 U.S. 517, 550-56 (1933) for extensive discussion of this matter.

9. 288 U.S. at 555. Because the corporation was an instrument and an act of the state, it was regarded in its infancy with a kind of fear almost precisely opposite to the fear which exists today. Now questions are asked whether enterprise corporate affairs should not be substantially regulated by state control. The early concern was directed toward giving the state too much power to regulate. Berle, *supra* note 5, at 190. *See also* Liggett v. Lee, 288 U.S. at 548-67. Still others feared growth of corporate law as an

> encroachment upon the liberties and opportunities of the individual . . . . The changes thereby wrought in the lives of the workers, of the owners and of the general public, are so fundamental and far-reaching as to lead these scholars to compare the evolving 'corporate system' with the feudal system; and to lead other men of insight and experience to assert that this 'master institution of civilised life' is committing it to the rule of plutocracy . . . . Such is the Frankenstein Monster which states have created by their corporation law.

10. Basically two types of general corporation statutes are in existence today: the "enabling" act and the "restrictive" act. H. BALLANTINE, BALLANTINE ON CORPORATIONS 41 (Rev. ed. 1946): The enabling acts authorize business men to or-

ous and what has been characterized as competitive liberalization, many state corporation codes now no longer require extensive minority shareholder participation in the determination of corporate decisions.[11] Some corporate law scholars view this "liberal" development in the modern corporate law with alarm, claiming that the competition among the states for corporate residents,[12] results in a set of regulations that are far too permissive.[13]

Over the past seventy-five years the most successful state in this competition for corporate residents has been Delaware which is currently the legal domicile for over forty percent of the firms listed on the New York Stock Exchange.[14] Because of its success in attracting corporations and as a result of its leadership in corporate law "liberalization," Delaware has for many years been the favorite target of those hostile to this modern trend.[15]

In 1931 Professor Ballantine, the principal draftsman for the California State Bar Committee on Corporations, stated in remarks introducing the then new California Code:

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ganize and operate their business, large or small, with the advantages of the corporate mechanism. (A distinct advantage is granted to the management of the corporation, as there are few restrictions to hamper their operation. On the other hand, restrictive acts are designed to protect stockholders and creditors. The term "liberal" is usually synonymous with the enabling acts and is best evidenced by the corporate laws of Delaware. Although New Jersey is generally credited with the first modern "liberal" general corporation statutes, Delaware, which patterned its laws largely after New Jersey's, has become the uncontested leader in liberalized laws today.)

11. E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 278 (1972).

12. *See generally* E. FOLK, *supra* note 11 and Cary, *supra* note 5. *See also* Liggett v. Lee, 288 U.S. at 562 n.43.

13. Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 BUS. LAW. 1031, 1078 (1975).

14. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 992-93 (1976) (footnotes omitted):

> 40 percent of the companies listed on the New York Stock Exchange are Delaware corporations. And it is estimated that over 200 of the Fortune 500 largest industrial corporations are also incorporated in Delaware. Many of these are multinational or multistate corporations with a home base in a financial or industrial center located outside of Delaware; some do no business in Delaware. Others may be "pseudo-foreign corporations" formed by incorporating a purely intrastate business in Delaware solely for the purpose of becoming liberated from effective regulation in the home state.

15. Kaplan, *Foreign Corporations and Local Corporate Policy*, 21 VAND. L. REV. 433, 436-37 (1968). Mr. Kaplan suggests why Delaware is so popular:

> In addition to lower capital stock of franchise taxes in Delaware, other advantages which induce corporate managements to seek incorporation in Delaware include: greater freedom to pay dividends and make distributions; greater ease of charter amendment and less restrictions upon selling assets, mortgaging, leasing, and merging, due to the lower percentage of shareholder approval required and also by virtue of lesser rights of appraisal for dissenting minority shareholders; freedom from mandatory cumulative voting; permission to have staggered boards of directors; lesser pre-emptive rights for shareholders; clearer rights of indemnification for directors and officers; greater freedom of action in many crucial respects for management; and a climate of opinion, thought to be prevalent in the legislature and courts, generally favorable to management and generally unreceptive to the dissident minority shareholder.

> [That though the corporation laws of California] . . . are as liberal and as favorable . . . as the corporation laws of Delaware, . . . [w]e have not attempted to out-Delaware Delaware. The law of Delaware is in some respects unconscionably lax, particularly in such matters as the purchase of shares and the payment of dividends out of paid in surplus.[16]

In 1974, thirty-three years after Ballantine, Professor Cary of Yale voiced similar concerns: "Delaware is both the sponsor and the victim of a system contributing to the deterioration of corporation standards . . . they have watered the rights of shareholders vis-a-vis management down to a thin gruel." [17]

Ralph Nader based his support of federal corporation chartering upon Delaware's alleged inadequacies: "Why federal chartering, such an old idea in 1976? . . . because . . . state chartering laws, downgraded by the Delaware Syndrome have failed to restrain corporate abuses." [18]

Professor Jacoby of U.C.L.A., not necessarily an adversary of the modern corporation, also finds this competition for corporations undesirable: "Federal chartering could however establish a uniform national pattern of corporate governance. It could put a stop to the progressive permissiveness—"charter mongering"— that has marked state chartering for many years." [19]

Professor Schwartz of Georgetown University Law Center also argues: "States having early abdicated their responsibility to govern in an attempt to attract corporate business, are now overpowered by their creations . . . and [i]ncorporation laws have become mere licenses to operate within the privilege of limited liability and a due process shield against government interference and internal operations." [20]

This pervasive criticism of Delaware corporate law refers to the state codes, the court decisions, and the corporate jurisprudence which regulate the corporate internal affairs, most specifically the relationship between the controlling shareholders, the managers of the cor-

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16. Ballantine, *Major Changes in California Corporate Law*, 6 CAL. ST. B.J. 159, 161 (1931).

17. Cary, *supra* note 5, at 663, 666.

18. R. NADER, M. GREEN & J. SELIGMAN, TAMING THE GIANT CORPORATION 252 (1976).

19. Wall Street Journal, Jan. 10, 1977, at 14, col. 6.

20. Schwartz, *Federal Chartering of Corporations*, 61 GEORGETOWN L.J. 71, 95-96 (1976). Jennings, *supra* note 14, at 992. Cary has also stated that Delaware had clearly won the "race for the bottom." Cary, *supra* note 5, at 666.

poration, and the minority shareholders.[21] Professor Folk, for example, finds that the set of regulations which generates his concern are laws and court decisions which allegedly favor management at the expense of the minority shareholders.[22] He argues that the Corporate Laws of Delaware as compared to the laws of less permissive jurisdictions are disadvantageous to minority shareholders because they permit a wider variety of pro-management activities. Of particular concern to Professor Folk are the Delaware code provisions which allow: fundamental corporate changes without supermajority approval,[23] curtailment of appraisal rights in mergers,[24] and indemnification of directors.[25]

There are not only critics of Delaware Corporate law but supporters as well. The debates between friends and foes of Delaware law relate to many provisions of the corporate code.

THE PARTICULAR CONTROVERSIES

Cumulative versus straight voting[26]

Unlike many other states, Delaware *permits,* but *does not require,* cumulative voting[27] for the election of the board of directors. Addi-

21. *See generally* Cary, *supra* note 5, E. FOLK, *supra* note 11, Schwartz, *supra* note 20, and Folk, *supra* note 12.

22. *See generally* Folk, *supra* note 12, at 1033-37.

23. For example, DEL. CODE ANN. tit. 8, § 251(c) (1974) provides for a merger or consolidation of a corporation "[i]f a majority of the outstanding stock of the corporation entitled to vote thereon shall be voted for the adoption of the agreement." DEL. CODE ANN. tit. 8, § 271(a) (1974) provides for sale, lease or exchange of assets when a resolution is "adopted by a majority of the outstanding stock of the corporation entitled to vote." DEL. CODE ANN. tit. 8, § 275(b) (1974) provides for dissolution if a majority agrees.

24. DEL. CODE ANN. tit. 8, § 262(k) (1974) provides, *inter alia,* that no appraisal rights are available if the shares were either listed on a national securities exchange or held by more than 2,000 stockholders.

25. DEL. CODE ANN. tit. 8, § 145 (1974) which provides for indemnification of officers and directors for either civil, criminal, administrative or investigative proceedings.

26. Williams, *Cumulative Voting,* 33 HARV. BUS. REV. 108, 108-09 (1955); The two major methods of electing corporate directors are by "straight voting" and by "cumulative voting." Under the first and more common method, a stockholder group with a majority of the votes at the annual election can elect its full slate of directors; an opposition group with 49% of the votes cast could elect none of the directors. Under cumulative voting, by contrast, each shareholder is entitled to votes equal to the number of his shares multiplied by the number of directors to be elected; he may cast all his votes for a single director or distribute them among the candidates as he sees fit. To illustrate: Take the hypothetical case of a company with 100,000 shares represented at the election and 9 directors to be elected. If cumulative voting were permitted, a group with 49,000 shares is entitled to 441,000 votes (9 × 49,000). By distributing its 441,000 votes among only 4 candidates, the minority group could give each man 110,250 votes and insure his election. No matter how the majority distributes its 451,000 votes, it can elect no more than 5 directors, since it cannot give its sixth candidate as many as 110,250 votes. In essence, cumulative voting is designed to permit stockholder groups to elect directors in rough proportion to their shares of stock.

27. *Compare* DEL. CODE ANN. tit. 8, § 214 (1974) *with* ILL. ANN. STAT. ch. 32, § 157.28 (Smith-Hurd 1954) which requires cumulative voting and was passed in accordance with the Illinois Constitution. CONST. 1870, art. 11, § 3.

tionally, Delaware allows directors' terms of office to be staggered.[28] A staggered term reduces the voting strength of minority shareholders, even if the articles of incorporation provide for cumulative voting.[29]

Professor Cary looks upon this freedom from mandatory cumulative voting and permission to have staggered boards of directors as undesirable signs of liberality.[30] Mr. Arsht[31] replies:

> Cumulative voting is fine for any corporation that is small enough to use it and has one or more stockholders who own enough of its stock to elect themselves or their representatives to the board should they want to. . . . However, cumulative voting has little or no utility beyond such relatively small corporations and could even be a source of mischief.[32] Professor Cary's promotion of cumulative voting . . . raises some pungent questions about corporate democracy as an end in itself. Does Professor Cary know of any case where a corporation has prospered under a sharply divided board or with two antagonistic control factions?[33]

Shareholder voting approval requirements for fundamental changes

For many years the majority of the states required the approval of two-thirds of the shares outstanding for fundamental changes.[34] Professor Folk is critical of the Delaware reduced voting rule which requires a majority of outstanding votes for fundamental changes.[35]

> [T]he real effect is to take away from management an important incentive to tailor the plan to attract the favorable votes of a larger majority. It is much easier to pick up 50%

28. *Compare* DEL. CODE ANN. tit. 8, § 141 (1974) *with* ILL. ANN. STAT. ch. 32, § 157.35 (Smith-Hurd 1954) (which allowed election of directors for "staggered" terms, but was subsequently repealed because it was found to be repugnant to the section of the Illinois Constitution which guaranteed every stockholder the right to cumulate his votes in the election of directors). CONST. 1870, art. 11, § 3.

29. Williams, *supra* note 26, at 109-10: The most important means of restricting the impact of cumulative voting is through the use of classified or "staggered" boards. In many of the states requiring cumulative voting, there is express authority for terms of office for directors of more than one year. Consequently, many corporations have provided by chapter or bylaw for division of the directors into classes. For example: A board may consist of 9 members with 3 directors elected each year for 3 year terms. If all 9 directors were elected at one annual election, a stockholder group with slightly more than 10% of the voting shares could elect one director. If, however, only 3 directors are to be elected, a minority group would require more than 25% of the shares in order to gain representation.

30. Cary, *supra* note 5, at 669.

31. S. Samuel Arsht, Member of the Delaware Bar. Partner, Morris, Nichols, Arsht & Tunnell.

32. Arsht, *Reply to Professor Cary*, 31 BUS. LAW. 1113, 1119-20 (1976).

33. *Id.* at 1120 n.3.

34. For a selection of states requiring approval of two-thirds of the outstanding shares, *see, e.g.*, VA. CODE §§ 13.1-70, 13.1-77 (1950); ILL. ANN. STAT. ch. 32, §§ 157.64, 157.72 (Smith-Hurd 1954).

35. DEL. CODE ANN. tit. 8, § 251 (1974) (mergers), § 271 (1974) (sale of assets).

> of the votes on the given plan than to garner two-thirds: the incremental benefits to the shareholders are often just what is necessary to gain those additional votes. Thus, "flexibility" means in this instance, less need and assistance to deal fairly with the minority shareholders.[36]

Mr. Arsht, in responding to similar arguments by Professor Cary, replies:

> The next generalization of a supposedly unwise feature of the Delaware law is "less restrictions upon selling assets, mortgaging, leasing and merging." Under Delaware law, the sale, lease or exchange of all or substantially all of a corporation's assets, as well as a merger of a corporation, require the approval of both the directors and a majority of the stock entitled to vote . . . . The sections in their present form hardly deserve to be cited as destructive of shareholders' rights vis-a-vis management. Requiring a ⅔ or a ¾ vote of stockholders for a sale or merger, rather than a majority vote, is arguably more protective of stockholders, but it is not as democratic. The vote of a majority in favor of a proposal should not be nullified by the negative votes or failures to vote of a minority. One man's supermajority is another man's veto.[37]

Appraisal rights of a shareholder

In merger actions, Delaware eliminates appraisal rights of dissident shareholders if, for example, the class of shares affected is listed on the National Securities Exchange or is held by a minimum of 2,000 shareholders.[38]

Professor Folk finds unconvincing the argument that appraisal rights are not necessary if an independent market for those shares are available.

> The theory . . . is that a class of shares which is exchange-listed or wisely [sic] held has a market in which dissenters can get rid of their stock if they do not want to go along with the transaction . . . . The reasoning is, of course, fallacious. The very unfairness of a merger which prompts many shareholders to dissent is likely to depress the securities market; heavy selling only increases the supply at a time of weak demands; and so the dissenters can get out, if at all, only at a price which does not reflect "fair value" (the standard for the appraisal remedy) but rather the value of a bad deal further discounted by an oversupply of the stock.[39]

36. Folk, *supra* note 12, at 1039-40.
37. Arsht, *supra* note 32, at 1119.
38. DEL. CODE ANN. tit. 8, § 262(k) (Supp. 1977).
39. Folk, *supra* note 12, at 1041.

Mandatory pre-emptive rights

While Professor Cary is critical of the Delaware law which does not require mandatory pre-emptive rights,[40] Mr. Arsht finds that the absence of this rule gives management more freedom and: "If a stockholder of General Motors wants to assure that his percentage ownership of that corporation is not diminished by a proposed issuance of its stock, he can call his broker and within minutes double or treble his percentage ownership of that corporation's stock." [41]

Standard of care on part of directors

While Professors Cary and Folk say that the standard of care required of management in Delaware is too low,[42] Arsht argues that the standard is sufficiently high as required by court interpretation of those standards.[43] There are many additional provisions of the Delaware Corporation Code that are also held to be either desirable or "too permissive," depending on the particular analyst's perspective.

(A) Delaware authorizes a corporation to lend money to directors and officers whenever the directors reasonably believe it would benefit the corporation. The board is free to decide whether or not to require security or interest; and shareholder approval is unnecessary.[44]

(B) The directors may determine their own salaries, bonuses and pensions.[45]

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40. DEL. CODE ANN. tit. 8, § 102(b)(2) (1974).

41. Arsht, *supra* note 32, at 1119.

42. Cary, *supra* note 5, at 683. Professor Cary bases his opinion on the decision of the Supreme Court of Delaware in Graham v. Allis Chalmers, 40 Del. Ch. 335, 182 A.2d 328 (Ch. 1962), *aff'd*, 41 Del. Ch. 78, 188 A.2d 125 (Sup. Ct. 1963).

43. *See* Guth v. Loft, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (Sup. Ct. 1939) which defined the standards for directors and officers of a Delaware corporation.

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of corporate officers, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.

44. Folk, *supra* note 12, at 1046. *See* DEL. CODE ANN. tit. 8, § 143 (1974).

45. DEL. CODE ANN. tit. 8, § 141(h) (1974).

(C) In most cases, decisions of the board of directors are protected by the "business judgment" rule.[46]

(D) Directorial good faith is a legal presumption in Delaware.[47]

(E) Delaware law allows the corporation to indemnify directors, officers and employees for actual and reasonably incurred expenses, as well as judgments, fines and other amounts paid in settlement. This applies to administrative or investigative proceedings and criminal or civil suits other than derivative actions which grow out of the person's official capacity. As long as the officer acted in good faith, the corporation can indemnify for expenses arising out of civil liability and the corporation can also indemnify expenses arising out of criminal liability if the officer had no reasonable belief his or her conduct was criminal.[48]

Professor Folk is particularly critical about indemnification of corporate officers. He finds:

> Perhaps the most striking evidence of state impotence to prescribe management standards adheres in recent legislative developments on indemnification of directors and officers. . . . When Delaware adopted its revised statute in 1967, it enacted section 145 which drew most of the New York distinctions but, typically, allowed corporations extra leeway in awarding indemnity.[49]

However, Delaware law is not considered wholly onerous even to its critics. Even those hostile to the Delaware law argue that there are some provisions which are laudable in that they provide a relative *advantage* for the minority shareholder.[50]

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46. Under most circumstances, a board of directors enjoys the benefits of the "business judgment" rule in Delaware. Its actions are presumed reasonable and a plaintiff must bear a heavy burden of showing lack of any business purpose, amounting to actual or constructive fraud, before a court will interfere with decisions reached by the board.

Nathan & Shapiro, *Legal Standard of Fairness of Merger Terms Under Delaware Law*, 2 DEL. J. CORP. L. 44-45 (1977). *See, e.g.*, Sinclair Oil Corps v. Levien, 280 A.2d 717, 722 (Del. 1971); Getty Oil Co. v. Skelly Oil Co., 267 A.2d 883 (Del. 1970); Meyerson v. El Paso Natural Gas Co., 246 A.2d 789 (Del. Ch. 1967).

47. Isaacs v. Forer, 39 Del. Ch. 105, 159 A.2d 295, 297 (Ch. 1960).

48. DEL. CODE ANN. tit. 8, § 145 (1974).

49. Folk, *supra* note 12, at 1046-47.

50. Cary, *supra* note 5, at 686-88.

Security for Expenses in Derivative Ltigation

Unlike the majority of states, Delaware does not require shareholders to post a bond for security for expenses in a derivative law suit against corporate directors.[51]

Demand on Shareholders Prior to Derivative Litigation

Delaware does not require in all cases that the plaintiff stockholder make a demand upon shareholders or the board of directors prior to initiating a derivative class action suit.[52]

Inspection of Corporate Records

Delaware again is one of the most liberal states in allowing minority shareholders the right of inspection of corporate records. Unlike most other states, in Delaware one may inspect the records for any proper purpose upon written demand.[53]

51. *Compare* DEL. CODE ANN. tit. 8, § 327 (1974) *with* CAL. CORP. CODE § 800(d) (West Supp. 1977); FLA. STAT. ANN. § 607.147(3) (Supp. 1977); MD. R.P. RULE 328(b) (1963); N.J. STAT. ANN. § 14A:3-6(3) (Supp. 1969); N.Y. BUS. CORP. LAW § 627 (McKinney 1963); PA. STAT. ANN. tit. 15, § 1516(B) (Supp. 1973); N.D. CENT. CODE § 10-19-48 (1960); WIS. STAT. ANN. § 180.405(4) (1957).

52. DEL. CODE ANN. tit. 8, § 327 (1974). Sohland v. Baker, 15 Del. Ch. 431, 141 A. 277 (Sup. Ct. 1927) (stockholder must first make a demand upon the corporation that it bring suit unless such demand would be futile). Several other states have similar provisions. *See, e.g.*, CAL. CORP. CODE § 800(b)(2) (West 1977); Reed v. Norman, 152 Cal. App. 2d 892, 314 P.2d 204 (1957) (if facts show demand would be futile, its absence not fatal to the action, but plaintiff must allege with particularity in the complaint his efforts in this regard); deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968), *aff'd*, 435 F.2d 1223 (10th Cir. 1968) (whether demand is required is within sound discretion of court, where such demand would probably come to naught, it may be excused); Conlee Const. Co. v. Cay Const. Co., 221 So. 2d 792 (Fla. App. 1969) (demand a condition precedent to bringing suit, but may be excused where demand would obviously be unavailing); Nussbacher v. Continental Illinois Bank & Trust Co. of Chicago, 61 F.R.D. 399 (D.C. Ill. 1973) (plaintiff shareholder must either diligently exhaust his internal corporate remedies or allege specifically why such exhaustion would be meaningless); Escoett v. Aldecress Country Club, 16 N.J. 438, 109 A.2d 277 (1954) (not necessary to make demand if it obviously would be in vain); Rice v. Wheeling Dollar & Trust Co., 130 N.E.2d 442 (Ohio Com. Pl. 1956) (demand that corporation bring action, and refusal, is condition precedent to bringing suit, unless it is plain that a demand would be a futility); Browning v. C & C Plywood Corp., 248 Or. 574, 434 P.2d 339 (1967) (plaintiff's failure to make demand does not preclude suit if it is obvious that any protest would be unavailing); Weiss v. Sunasco, Inc., 316 F. Supp. 1197 (E.D. Pa. 1970) (although demand usually required, it is not necessary where defendant-directors were in virtually complete control of the corporation. *But see* Orlando v. Nix, 171 La. 176, 129 So. 810 (1930) (demand must be made on corporation to institute suit).

53. DEL. CODE ANN. tit. 8, § 220 (1974) gives a stockholder the right to inspect corporate books and records for a purpose reasonably related to the stockholder's interest as a stockholder. Once the plaintiff has complied with the form and manner of making demand, then the burden of proof is on the defendant to establish that the inspection is for an improper purpose. Mite Corp. v. Heli-Coil Corp., 256 A.2d 855 (Del. Ch. 1969).

Pennsylvania (PA. STAT. ANN. tit. 15, § 1308(B) (Purdon 1967)), Goldman v. Trans-United Indus., Inc., 404 Pa. 288, 171 A.2d 788 (1961) and Ohio (OHIO REV. CODE ANN. § 1701.37(c) (Page 1978)), Lake v. Buckeye Steel Castings Co., 20 O.S.2d 101, 31 Ohio U.2d 147, 206 N.E.2d 566 (1965) have identical provisions.

Several states, *see, e.g.*, COLO. REV. STAT. § 7-5-117(2) (1977), Dines v. Harris, 88 Colo. 22, 291 P. 1024 (1930); ILL. ANN. STAT. ch. 32, § 157.45 (Smith-Hurd

Jurisdiction Over Out of State Directors

Unlike most other states, Delaware offers a method of bringing suit by attachment against nonresident directors. The courts of Delaware can compel the appearance of a nonresident defendant director through the seizure of his property[54] and the Delaware General Corporation Law makes Delaware "the situs of ownership of the capital stock of all corporations existing under the laws of" Delaware.[55]

The United States Supreme Court has questioned the validity of this means of obtaining jurisdiction and has held that Delaware must have sufficient contacts with the nonresident directors in order to exercise jurisdiction by attachment.[56] Because of this requirement of "minimum contacts" for the attachment of stock, Delaware has enacted a statute for service of process on nonresident directors.[57] The new statute provides a means of acquiring in personam jurisdiction over directors of Delaware corporations.[58]

COMPETITION FOR CORPORATIONS

Government jurisdictions compete for high tax paying low public service consuming residents. In the case of attracting incorporations, the states are providing legal status, registration services and a given set of laws in exchange for an initial filing fee, an additional yearly filing fee and for some states a yearly franchise tax fee. The expressed concern relating to the Delaware Debate is that states are competing for corporate residents by increasingly providing these "lax," "permissive" laws. One would suppose, however, that this competition for

1954), Kaufman v. Goldman, 8 Ill. App. 2d 409, 132 N.E.2d 52 (1956); KY. REV. STAT. ANN. §§ 271A.260(2) & (4) (Baldwin 1978), N.J. STAT. ANN. § 14A:5-28(3) (West 1969), Pilat v. Broach Systems, Inc., 108 N.J. Super. 88, 260 A.2d 13 (1969); OR. REV. STAT. § 57.246(2) (1977), TEX. BUS. CORP. ACT art. 2.44(B) (Vernon 1956), Moore v. Rock Creek Oil Corp., 59 S.W.2d 815 (Tex. Com. App. 1933), require that shareholders must hold five percent of the outstanding stock or have been a shareholder for at least six months prior to his demand.

54. DEL. CODE ANN. tit. 10, § 366 (1974), Delaware's sequestration statute, which provides that "[t]he Court may compel the appearance of the [nonresident] defendant by the seizure of all or any part of his property, which property may be sold under the order of the Court to pay the demand of the plaintiff, if the defendant does not appear or otherwise defaults."

55. DEL. CODE ANN. tit. 8, § 169 (1974).

56. Shaffer v. Heitner, 433 U.S. 186 (1977), holding that the application of Delaware's attachment procedure under title 10, § 366, of the Delaware Code Annotated where the property seized was stock in a Delaware corporation was unconstitutional because Delaware lacked the minimum contacts mandated by International Shoe Co. v. Washington, 326 U.S. 310 (1945). *International Shoe* required such "minimum contacts . . . that the maintenance of the suit does not offend 'traditional notions of fair play and substantial justice.'" *Id.* at 316.

57. DEL. CODE ANN. tit. 10, § 3114 (Supp. 1977) which mandates consent to service of process upon an agent in Delaware. Such service has the same effect as personal service upon the director in the state of Delaware.

58. *Id.*

corporate residents is no less desirable in a social welfare sense than competition for corporate business based on differential state corporate income taxes or differentials in state property tax exemptions. The opportunity for corporations as well as individuals to vote with their feet, to leave one political jurisdiction for another, arguably operates as a desirable discipline upon state and local governments, to prevent them from imposing too great a regulatory or tax burden upon their respective residents.

State competition can only be considered undesirable if there are free riders, that is if one state obtains benefits from its own law, but that the costs and burdens of its "most competitive" law are imposed upon unwilling residents of other states. Assuming Delaware law harms minority shareholders of other states, to what extent then can other states set up barriers to this legal pollution? Do states set up such barriers? [59]

Since Delaware receives filing fees and franchise taxes as a result of corporations locating in Delaware, one could presume that for the state of Delaware, taken as a whole, the benefits (franchise taxes and fees) are greater than the costs (alleged loss to Delaware residents who own minority shares). The argument of the critics must be that Delaware is exporting the burden of its "liberal" laws upon innocent nonresidents.

IRRELEVANCE OF THE EXISTING DEBATE

Yet is this alleged claim of legal pollution (implicitly found in the arguments of Professors Cary and Folk) consistent with modern developments, in the fields of finance, portfolio theory, capital markets and economics?

One cannot argue that minority shareholders are harmed because of their purchase of shares of corporations domiciled in Delaware, given the set of laws in existence *at the time* of their purchase. The

59. *See* CAL. CORP. CODE § 2115 (West Supp. 1978) which specifies sections of the California Corporate Code that must be followed by any foreign corporation which meets the statutory test. The statutory test requires that if any corporation has an average of the property factor, payroll factor, and sales factor which is greater than 50%, and if more than 50% of the securities are held by persons having addresses in California, then the foreign corporation must comply with the statute.

California is apparently trying to protect California residents by regulating foreign corporations which in reality (disregarding the formality of incorporation) can be regarded as domestic corporations. Thus, California is attempting to set up a barrier to this legal pollution.

But see Louart Corp. v. Arden Mayfair, Inc., No. C192091 (Cal. Super. August 5, 1977). A declaratory judgment which held that although Arden Mayfair, Inc., was within the literal requirements of § 2115, the sections on cumulative voting and annual election of directors were invalid as applied to such a corporation.

price of shares already reflects a given set of corporate laws in existence at the time of purchase.

The theory of securities markets holds that all past information has been considered by investors and thus is reflected in current prices of any security. To the extent that one purchases a share of ownership in a stock whose legal domicile is in Delaware, whose internal affairs are thereby controlled by the Delaware law, the effect of that law is already reflected in the value of those securities. The market price of all assets, commodities, government bonds, stocks of companies incorporated in other states or countries, reflect in part the legal structure under which the equity is governed.

Considerable evidence suggests that information is very rapidly disseminated in the organized stock market and the effect on the prices of Delaware shares of any modification in the Delaware law is reflected very rapidly. If current owners' purchase prices reflect existing legal arrangements and if those who criticize the Delaware law were able to force Delaware to modify its laws to benefit the minority shareholder (assuming the minority shareholder had been harmed in the past), then this change in the law would provide a windfall for the existing owners of minority shares of Delaware corporations.

A more sophisticated argument, one not advanced by Professor Cary or any of the critics of Delaware, should have been that Delaware had been imposing losses on minority shareholders of Delaware corporations through unanticipated changes in Delaware law which modified the legal agreements within those corporations domiciled in Delaware to the disadvantage of minority shareholders. A claim of disadvantage or harm to minority shareholders implies that shareholders of Delaware corporations have been harmed by the unanticipated modification of the contractual arrangement which minority shareholders had with the controlling-managerial interest of the corporation of whose shares they own. The prices of Delaware securities in general would reflect these legal changes and prices of Delaware minority shares after the change in Delaware law, would sell for less than shares of comparable corporations domiciled in other states.

Consistent with this criticism of Delaware law, therefore, is the claim that minority shares of Delaware corporations should have a lower market value than shares of comparable corporations domiciled in more restrictive states. Though no two corporations are comparable so that their shares can be compared, there is a method consistent with the theory of the effect of information on stock prices in which the Delaware codes can be tested for their effect upon owners of minority interests and that is by analyzing *the effect of an announcement of a*

change in domicile of a corporation from some other state to Delaware on the prices of that corporation's shares of stock.

What effect does the announcement of a change in the place of incorporation have on the prices of publicly traded shares? When a corporation changes legal domicile, the old state's corporation laws no longer apply to regulate the organizational structure and the internal affairs of the corporation. The corporation is *still* governed by the laws of commercial practice in those states in which it does business. State laws regulating environmental matters and labor practices, for example, still govern the corporation's business activity in those states in which it operates. The only modification resulting from a change of place of incorporation is that the corporation's internal affairs are now regulated by the new state, not the old.

There are several possible financial outcomes affecting controlling and minority shareholder interests resulting from a change of domicile from a given state, to the state of Delaware. Thes possibilities are presented in *Figure 1*.[60]

Figure 1 represents a hypothetical corporation before and after it moves to Delaware. Assume initially before the move that the market value of the shares of the corporation is in total $100, which is made up of the controlling block of shares worth $40, and the sum of the minority shareholders' interest which is worth $60.

When the corporation moves to Delaware, one of three possibilities may occur. These are represented by boxes B, C, and D. The total value of the corporation may fall (for example to $90), or the total value of the corporation may remain the same, or the total value of the corporation may rise (for example to $110). Within these three possibilities, the ratio of the value of the controlling block to the minority block may also change. The ratio of the value of the controlling block to the minority block may stay the same, that is the same ratio of 40/60, or it may increase (for example to 50/50), or it could decrease (fall to 30/70), even though the number of shares of the ownership block may not change.

Several possible outcomes may, therefore, result from this change of corporate domicile. For example, the total value of the corporation could remain the same, that is possibility C, yet if the theory of those who criticize Delaware law is correct, the controlling block because it is now governed by a more liberal set of rules, will become worth more relative to the minority block without the controlling shareholders acquiring more share and the ratio of value of the controlling to minority might become 50/50.

60. *See* Appendix A *infra*.

The total corporation could be worth more as a result of the change of domicile and both the controlling as well as the minority interests could both become more valuable. The total value of the company may go up, down or stay constant, and the relationship between the controlling and minority blocks may also go up, down or stay constant. There are nine possible combinations depending on the change in value of the different shareholder interests. And there is no way, a priori, despite the intense debate concerning this issue, that one could predict or determine what outcome would result. One could well assume that the controlling interests of the corporation would permit the move only if their positions were improved. The controlling interest would not allow the change of domicile under conditions which saw a reduction in the value of its interest.

As there are two types of ownership interests, controlling and minority, there are two markets which serve to broker these interests. There is the market for minority shareholders and the market for controlling blocks. While the public exchanges normally provide the market for the sales of minority interests, sales of controlling blocks are normally placed privately.[61]

In attempting to analyze the effects of a change in the place of incorporation upon minority shareholder interests, an analysis was conducted of the change in stock prices of shares traded on the New York Stock Exchange around *the date that the first public announcement was made that the particular corporation was intending to reorganize in Delaware.*[62]

The New York Stock Exchange listings of place of incorporation were searched from 1968 to 1976 and a list was compiled of all corporations which had changed their place of incorporation to Delaware during the eight year period. The list was purged of all corporations which had not only changed their place of incorporation but had at the same time merged with another corporation or had undergone a basic corporate reorganization. What remained was a list of twenty-six corporations, several of which are among the top 500 industrials, which have changed their domicile from some state to Delaware during the past nine years.

61. FRIEND, HOFFMAN, WINN, THE OVER-THE-COUNTER SECURITIES MARKET 435-36 (1958):

> A third method of long standing is the practice of members or member firms of arranging and executing a transaction of substantial size in a listed issue off the floor of the exchange. Since this is clearly contrary to the general policy of the exchange, special permission by the proper officials is necessary in each case. . . . In general, permission will be granted if the current market for the issue is inadequate to handle the trade.

62. The determination of the announcement day is not that obvious or automatic and the correct determination of that day greatly affects the results of the study.

STOCK PRICE DATA

The closing stock prices for each corporation was collected for thirty trading days prior to and for ten trading days *after the announcement day.* P_1 for stock #1 would be the closing price of stock #1 thirty days prior to the announcement day, and P_{70} for stock #1 would be the closing price forty trading days after announcement day.

For each corporation, a series of seventy ratios were calculated which would provide a standard percentage change of price movement. That is, for stock #1 the following ratios were calculated: P_1/P_1, P_2/P_1, P_3/P_1, P_4/P_1 . . . P_{70}/P_1 so that a series of seventy standardized price ratios were generated for each stock for each of the seventy trading days.

STANDARD AND POORS DATA [63]

This procedure was repeated for Standard and Poors closing index data for each stock of each of the twenty-six corporations for each day its closing price was observed for thirty days prior to and for forty days after the corporation announced it was going to relocate in Delaware. That is, a series of seventy Standard and Poors closing averages were collected for the same days that stock #1's closing averages were collected, and the same procedure was followed for stocks number two through twenty-six.

For the same seventy days trading period for each stock a similar ratio was compiled for the Standard and Poors closings. That is for stock #1, a series of Standard and Poors ratios was compiled: $S\&P_1/S\&P_1$, $S\&P_2/S\&P_1$, . . . $S\&P_{70}/S\&P_1$, which provided a running average of changes in the S&P paralleling stock price the first corporation.

The two series of data compiled contained seventy ratios for twenty-six stocks and seventy ratios of Standard and Poors closing

63. LORIE & HAMILTON, THE STOCK MARKET, THEORIES AND EVIDENCE 62 (1973): The Standard & Poors Composite Index of 500 stocks includes 425 industrials, 25 railroads, and 50 utilities. In contrast to the Dow Jones Averages, the relative importance of the prices of the component stocks is determined by the value of shares outstanding. The index is officially described as a "base-weighted aggregative," but in fact, the weights are adjusted for stock dividends, new issues, etc. The aggregate market value of the stocks in the index is expressed as a percentage of the average market value in the period 1941-1943. This percentage is divided by ten which was selected as the value of the index in the base period. This was done in order to make the index in line with the actual average of stock prices. (When the present index was first published in 1957, its value was 47; the average price of all shares on the New York Stock Exchange was $45.23). The present index of daily prices was first published in 1957, although other less comprehensive indexes were published before that. It has been extended back to 1928 on a daily basis. In coverage, it is considerably broader than the DJI. In 1965, the aggregate market value of the 500 stocks was about 80% of all stocks on the New York Stock Exchange. Interestingly, the market value of Dow Jones Industrial stocks on that date—all of which are

averages for the same days that the closing prices were collected for the twenty-six stocks.[64]

An average of all of the twenty-six stock ratios and the twenty-six Standard and Poors ratios was computed for each trading day. By comparing these moving averages of changes of stock prices and changes in the average of twenty-six Standard and Poors ratios, one can analyze the *announcement effect* of the move to Delaware upon the prices of publicly traded shares. If one observes a significant difference between the stock price average of the companies that are changing their place of incorporation and that of the Standard and Poors average around the announcement day, then one could reasonably attribute that difference to the effect of the announcement of the intended change of place of incorporation. This approach follows the techniques developed by Fisher, Fama, Jensen and Roll.[65]

There is normally a skeptical reaction to the claim that one can isolate the effect of the announcement of some particular information upon share prices. So many factors affect stock prices. However by compiling the stock price and the Standard and Poors data in this manner, one is able to generate comparable data which would most probably isolate the effect of the announcement of the change in place of incorporation.

INDUSTRY MOVEMENT

The sample includes, depending upon one's calculation, anywhere from ten to twenty different industries so the stock price movements are not industry specific.[66] If this analysis included only steel industry stocks and if one measured the changes in stock prices between the steel industry and the Standard & Poors index, one could argue that other factors were affecting the steel industry around the announcement day. That is not likely in this case.

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included in the 500—was about 40% of the "500" market value. The importance of individual stocks in the indexes can be very different. For example, the implicit weight of AT&T in the Dow Jones Industrial was 2.8% in 1965. In the Standard & Poor's "500" its market value weight was 7.5%. If the Dow Jones Industrial used market value weights, that of AT&T would have been 18.6%.

A composite index such as Standard & Poor's has several advantages. The coverage is broad, and the weighting is explicit. Moreover, no adjustments for splits is necessary. Critics have argued that the index is dominated by large companies and that value weights can create an upward bias. These criticisms are much less universal than those aimed at the Dow Jones Industrials.

64. *See* Appendix B *infra.*

65. Fisher, Fama, Jenson & Roll, *Reaction of Stock Prices to New Information,* 10 INTERNATIONAL ECONOMIC REVIEW, 1-21 (February 1969).

66. *See* Appendices C & D *infra.*

BUSINESS FLUCTUATIONS

One might well argue that the changes in stock prices reflected changes in business fluctuations or business cycles. This is unlikely for two reasons.

In the first place, the stock price data of firms which changed their place of domicile to Delaware were accumulated from fifteen different quarters over seven different years.[67] And in the second place, the movement of the Standard and Poors index is a reflection of changes in general economic conditions. By subtracting the changes in the Standard and Poors index average from the changes in the movement in the index average of stock prices, any significant differences in the two indexes is most likely a reflection of some factor other than basic economic trends.

The test, therefore, is to determine if there is a significant difference between the two index averages around the announcement date. The general conclusion is that there is a significant difference around that period of time.

DISCUSSION OF TABLE I [68]

Table I indicated that the difference between the stock price index and the Standard and Poors index is significant for four of the five trading days prior to the announcement date. During these four days the stock price index of companies moving to Delaware *out-performed* the Standard and Poors index. Graph #1 indicates that during the seventeen day bracket around the announcement date, the four days prior to the announcement day were the only trading days in which the difference between the Standard and Poors index and the stock price index were statistically different.

One could argue that this movement of stock prices is indicative of a positive effect of the announcement on stock prices. The prior to announcement effect on stock prices is possible evidence of insider trading.

ANALYSIS OF TABLE II [69]

A major concern in compiling and analyzing this data involves obtaining the correct precise announcement date. An announcement that the corporation intends to move to Delaware is not traditionally the type of information which is tightly controlled by corporations in

67. *See* Appendix E *infra.*

68. *See* Appendix F *infra.*

69. *See* Appendix G *infra.*

order to avoid rule 10b-5 liability. For example, if prior to public disclosure, corporate insiders purchased shares relying upon information concerning the findings of a new mineral deposit, these corporate insiders could be held accountable for inside trading and for improper disclosure of information under Securities and Exchange Commission rule 10b-5.[70]

Information such as the corporation announces it is going to move to Delaware is not treated with as much significance as to warrant tight control over its disclosure.

Initially when the sample of twenty-six stocks was finally compiled, a meeting date where the move to Delaware was voted upon was verified by records in New York Stock Exchange publications. To obtain the announcement date, one counted back thirty trading days from the meeting date. That is, a corporation will normally make an announcement concerning the agenda of a meeting thirty trading days, five or six weeks, prior to the meeting date. That announcement normally is included in a prospectus mailed approximately thirty trading days prior to the meeting.

The initial sample collected data around announcement dates which were approximated by counting back thirty days prior to the meeting date. In order to obtain more reliable announcement date information, fifty corporations were contacted by a mail survey. Thirty-five of the fifty responded to the inquiry and provided specific announcement days, dates in which the prospectus was mailed, or days in which it was stated that the information was made public. Out of the sample of twenty-five or twenty-six stocks, nineteen announcement days have been verified.

Of the nineteen verified replies concerning the announcement date, several stated that the proxy information concerning the change of place of incorporation was mailed on a given day. Other corporations stated that they began to distribute proxy information on a given day. And several corporations replied that they provided a new release on a given day. Several replies indicated that there was no specific day of

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70. *See* 17 C.F.R. § 240.10b-5 (1976) which provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in light of circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

announcement but that public disclosure was made during the week when the proxy information was mailed.

In order to more accurately reflect a study of the effects of the disclosure of information it was useful to study a change in weekly averages.

Table II compares the difference in the means of weekly averages.

The announcement week was defined as week number six. Both week number five, the week prior to the announcement week, and week number six, the announcement week, are both significant in that the average stock prices outperform the Standard and Poor's during those two weeks. There is also out-performance of the Standard and Poors during week 9, 10, and 11. Week 11, is the stockholders meeting week.

ANALYSIS OF TABLE III [71]

Table III attempts to determine the effect of earnings and dividends upon the changes in stock prices. One could argue that the positive movement in stock prices around the announcement date results from the declaration of extraordinary or unusual dividends or earnings. While the movement to Delaware may adversely affect minority shareholders, the controlling shareholders might declare an unusual dividend to buy off the minority. While the net effect of an increase in dividends would be a rise in stock prices, this increase may result from two factors, the negative effect of the movement to Delaware and the increase in dividends.

A casual inspection revealed no unusual dividend declaration between the year prior to the movement to Delaware, and the year of the movement to Delaware and the year after the movement to Delaware. Table III reflects the result that dividends of future, present, and past years does not explain the difference in stock prices around the day of first announcement of a move to Delaware.

SUMMARY OF STATISTICAL RESULTS

It does appear unambiguous that the prices of shares traded publicly on the New York Stock Exchange, outperformed the Standard & Poor's index around the announcement date, when it was first made public that the corporation intended to change its place from some given state to the State of Delaware. These results would tend to support the thesis that the movement to Delaware, not only does not harm minority shareholders, but in fact, works to their advantage.

71. *See* Appendix H *infra.*

Now, it is entirely possible, and in fact this analysis suggests, that the movement to Delaware benefits both the controlling interests and the minority interests and in fact the movement to Delaware, may benefit the controlling interest to a greater degree than it does the minority interest. Yet, it does not appear that a change in the place of incorporation to Delaware prejudices the interests of any of the owners of shares of the corporation.

CONCLUSIONS

When corporations were first formed in the early 19th century, and shares of stock were first issued, the cost of the transfer of ownership by selling stock in one corporation and purchasing shares in another corporation must have been considerably higher in comparison to the cost of transfer of stock today. The cost to a potential investor in the early nineteenth century corporation of acquiring information about a particular corporation, its earnings and dividend history must have been considerably higher in comparison to obtaining that same information today.

One who owns shares in a corporation both then as well as now has two methods of enhancing and protecting, and improving his investment. He could gather information about a variety of corporations and develop a portfolio which would be adjusted by buying and selling shares in a variety of corporations depending upon risk preference, and upon available information concerning the value of different companies. Or he could engage in corporate political shareholder activity where he could modify his portfolio through influencing the activities and actions of the corporate managers. These two methods of protecting and enhancing his financial interest were available 160 years ago and as well as today to any shareholder, any equity owner in a corporation. The two avenues of activity are not mutually exclusive.

But, it can be convincingly argued and demonstrated that as the relative return and/or cost to one type of activity (be it market or corporate political) increased relative to the other, one would see individuals substituting away from the lower yield activity to the one which offered more return for their time and trouble.

Also one can argue that over the past 150 years, the cost of engaging in *market transactions* with one's shares of stock, has fallen drastically in comparison to the cost of engaging in *shareholder corporate political activities as a minority shareholder*. The cost of obtaining information about shares of stock has fallen. Stock markets have become more efficient and individuals can acquire information about

a variety of investments much more cheaply than they could in the past. One could easily postulate that the average cost of trading a share in the stock market has dropped over the last hundred years.

So, it would seem that individuals would more and more desire to affect their wealth interests through a modification of their portfolio, by market adjustments than by affecting their wealth by investing in corporate political activity as a minority shareholder. Certainly, there is no evidence to suggest that the cost of corporate political activity has fallen. It has in all probability remained constant if not increased.

One would predict as the stock markets have become more efficient, and as investor information has become cheaper to obtain, that shareholders would find corporate political activity less important and desirable and would rely on market activity in order to adjust their wealth portfolio. Portfolio experts in fact suggest that the maximum return on stock investment results from a large portfolio of diverse ownership of many corporations.

It seems surprising that this decline in shareholder corporate democratic activity and resultant increase in shareholder trading activity, as evidenced by the increase in the percentage of individuals who own shares of stock in this country over the last hundred and fifty years, would trouble corporate law commentators.

Essentially what Delaware has pioneered and what other states are now following and attempting to accomplish is to provide a set of rules and regulations consistent with a minimum level of corporate political activity on the part of the minority stockholder.

A review of those particular regulations which were outlined in the first portion of this study reveals that these rules for the most part reduce the role that the minority shareholder will play in corporate decision-making. This is consistent with a declining interest on the part of the minority shareholder to engage in corporate political activities. These rules allow the managers and the controlling shareholders to respond more quickly to a changing business climate, to more readily take risks and these rules recognize that minority shareholders more easily can modify their interests through purchasing and selling shares rather than by engaging in corporate political activity.

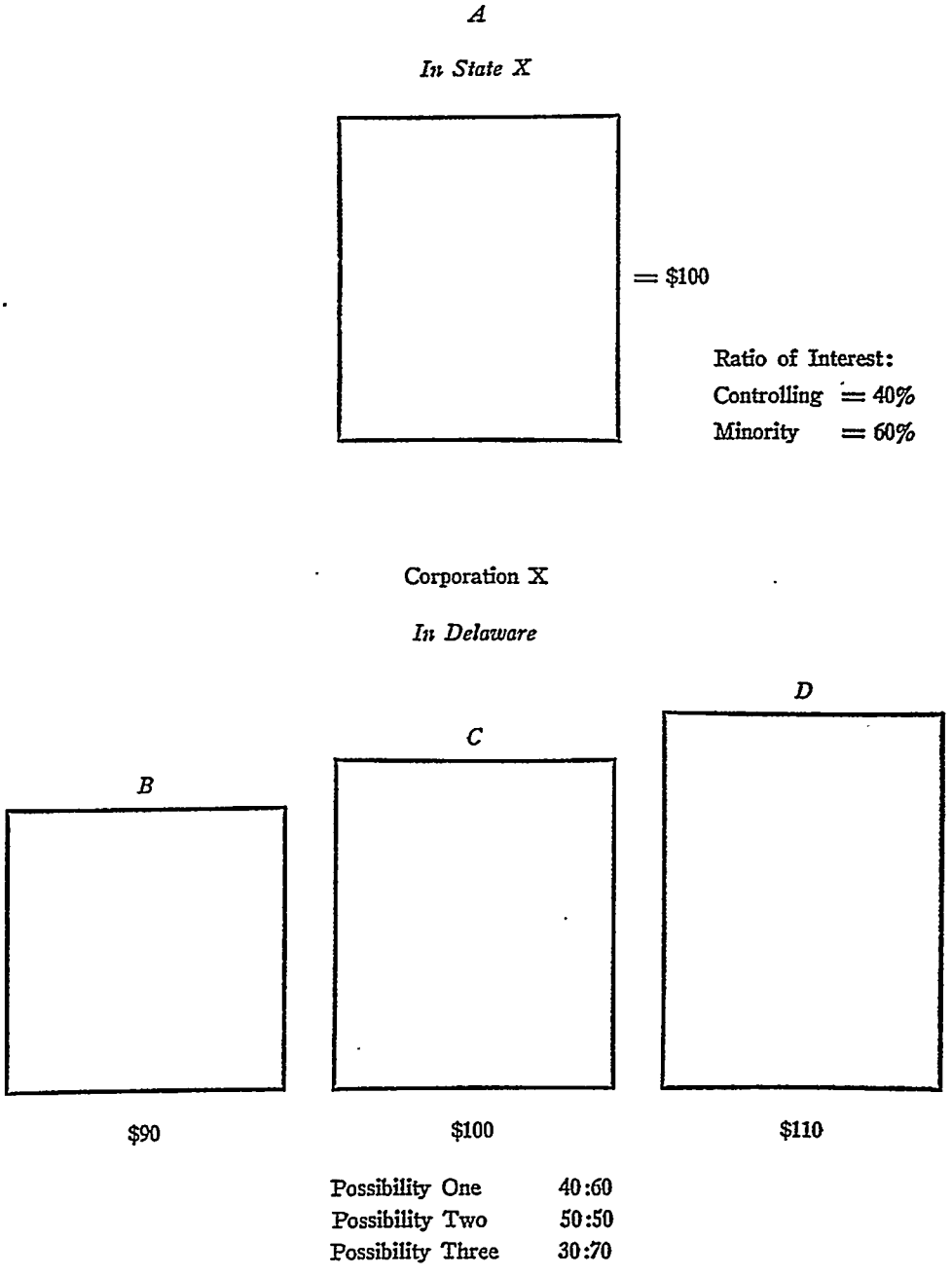
One final note is in order. Earlier in this paper some discussion concerning the problem of legal pollution, which considered the difficulties that might arise if the laws of Delaware applied to minority shareholders residing in states other than Delaware was presented. In response to this concern, some states have attempted to enact laws which hold that if a significant number of shareholders of a foreign corporation reside in that state and if the corporation does a consider-

able amount of its business in that state, then independent of the fact that the corporation is incorporated in a foreign state, the home state's laws will apply to the internal affairs of the foreign corporation. There is some movement by the states to protect themselves from this foreign Delaware type corporation law.

Considering the results developed by this paper, one wonders if the states are acting in the best interest of their residents by attempting to insulate and protect them from the evils of the Delaware Corporations Law.

APPENDIX A

Figure 1



APPENDIX B

SUMMARY OF DATA COLLECTED

Stock Price Data

26 stocks, 70 closing prices—70 ratios

$$\frac{P_1^1}{P_1^1}, \frac{P_2^1}{P_1^1}, \frac{P_3^1}{P_1^1} \ldots\ldots\ldots \frac{P_{70}^1}{P_1^1}$$

$$\vdots$$

$$\frac{P_1^{26}}{P_1^{26}} \ldots\ldots\ldots\ldots \frac{P_{70}^{26}}{P_1^{26}}$$

$$S_1, S_2 \ldots\ldots\ldots\ldots S_{70}$$ Daily averages of 26 stock ratios.

Standard and Poors Data

70 closing averages—70 ratios, paralleling 26 closing Standard and Poor's Prices

$$\frac{S\&P_1^1}{S\&P_1^1} \ldots\ldots\ldots\ldots \frac{S\&P_{70}^1}{S\&P_1^1}$$

$$\vdots$$

$$\frac{S\&P_1^{26}}{S\&P_1^{26}} \ldots\ldots\ldots\ldots \frac{S\&P_{70}^{26}}{S\&P_1^{26}}$$

$$A_1, A_2 \ldots\ldots\ldots\ldots A_{70}$$ Daily averages of 26 S&P ratios.

APPENDIX C

Summary	Announcement Date	Meeting Date	Incorporation in Delaware
1. Carpenter Technology		November 4, 1968	November 1968
2. Carter Wallace		July 16, 1968	November 1968
3. Clarke Equipment Co.	May 24, 1968	June 26, 1968	June 1968
4. Colt Industries		May 3, 1968	October 1968
5. Conagra, Inc.	September 26, 1975	October 28, 1975	January 1976
6. Dentsply International	March 25, 1969	April 23, 1969	March 1969
7. Esmark, Inc.	January 27, 1969	February 27, 1969	December 1968
8. Gannet Co.	April 10, 1972	May 2, 1972	May 1972
9. Green Giant Co.	June 15, 1973	July 20, 1973	July 1973
10. Hall Printing Co.	May 21, 1971	June 28, 1971	July 1972
11. Hays Albion Corp.	October 26, 1968	November 21, 1968	November 1968
12. Interlake, Inc.	March 23, 1970	April 23, 1970	May 1970
13. Iowa Beef Processors		February 25, 1969	June 1969
14. Kidde and Company	June 6, 1968	July 1, 1968	July 1968
15. Liggett Group, Inc.(1)	March 29, 1968	April 30, 1968	March 1968
16. Loew's Corp.		May 27, 1969	November 1969
17. Lone Star Industries		May 16, 1969	May 1969
18. Marquett Company	January 31, 1973	February 28, 1973	March 1973
19. Reliance Electric		February 18, 1969	March 1969
20. Rohr Industries	May 15, 1969	June 27, 1969	August 1969
21. Scott Foresman	July 15, 1969	August 14, 1969	September 1969
22. Sunbeam Corp.	May 21, 1969	June 20, 1969	July 1969
23. UARCO Inc.	December 23, 1969	January 27, 1970	September 1969
24. Warner Communications	January 19, 1972	February 10, 1972	February 1972
25. Western Union	September 19, 1969	November 5, 1969	July 1969
26. Wickes Corp.(2)	April 27, 1971	May 27, 1971	March 1971

(1) Used in some samples
(2) Excluded from some samples

APPENDIX D

INDUSTRIES SURVEYED

1. Specialty metals
2. Consumer products, personal care, pet products, drugs
3. Axles and transmissions, material handling equipment, construction equipment
4. Materials, industrial and power equipment, fluid control systems, firearms
5. Food processor
6. Dentists' supplies
7. Meats, chemicals, insurance, petroleum and energy
8. Newspaper publisher
9. Canned vegetables and meats
10. Printing & binding
11. Metals processing, casting
12. Steel producer
13. Beef
14. Security, commercial and consumer products, industrial equipment
15. Tobacco, alcoholic beverages
16. Cigarettes, hotels, movies, real estate, insurance
17. Cement, construction sales
18. Cement
19. Communications equipment
20. Automation systems, power transmission systems, scales
21. Aerospace, marine equipment, transit buses
22. Publishing
23. Small electrical appliances
24. Business forms and associated equipment

APPENDIX E

QUARTERLY PERIODS WHEN ACTIVITY OCCURRED

Meeting Dates:

	Quarter:	# in Sample:		Quarter:	# in Sample:
1968	1		1973	1	
	2	3		2	2
	3	2		3	1
	4	2		4	
1969	1	3	1974	1	
	2	5		2	
	3	1		3	
	4	1		4	
1970	1	1	1975	1	
	2	1		2	
	3			3	
	4			4	1
1971	1		1976	1	
	2	2		2	
	3			3	
	4				
1972	1	1			
	2	1			
	3				
	4				

APPENDIX F

TABLE I

DAILY DIFFERENCE BETWEEN STOCK PRICE INDEX AND S & P INDEX NEAR ANNOUNCEMENT DATE

	Day	*Difference in Means*	*T-Value of difference*	*2-Tail Probability of difference*
	25	.0218	1.59	.124
	26	.0253	1.74**	.094
	27	.0257	1.86**	.076
	28	.0291	2.10*	.046
	29	.0243	1.69**	.103
Announcement Date	30	.0192	1.25	.224
	31	.0206	1.34	.193
	32	.0186	1.26	.219
	33	.0213	1.43	.167
	34	.0179	1.17	.254
	35	.0178	1.22	.234

Source: *ISL Daily Stock Price Index,* Standard & Poors Corp., NY, NY 1968-1976.

NOTE: Verified Announcement Date — N = 25. 19 verified, 6 used meeting date minus 30 trading days.

* Indicates statistical significance at .05 level of significance.

** Indicates statistical significance at .10 level.

APPENDIX G

DIFFERENCES IN WEEKLY AVERAGES BETWEEN STOCK PRICE INDEX AND S & P INDEX

	Week	*Difference in Means*	*T-Value of difference*	*2-Tail Probability of difference*
	1	.0000	.00	1.000
	2	.0086	1.06	.302
	3	.0187	1.88**	.072
	4	.0162	1.29	.208
	5	.0241	1.76**	.091
Announcement Week	6	.0273	2.01*	.056
	7	.0216	1.54	.138
	8	.0252	1.63	.117
	9	.0352	1.80**	.084
	10	.0411	2.27*	.032
	11	.0487	2.18*	.039
	12	.0425	1.56	.113
	13	.0736	1.51	.145
	14	.0624	1.32	.199

Source: ISL Daily Stock Price Index, Standard & Poors Corp., NY, NY, 1968-1976.

Verified announcement date N = 25. 19 verified, 6 used meeting date minus 30 trading days.

* Indicates statistical significance at .05 level of significance.

** Indicates statistical significance at .10 level.

APPENDIX H

EFFECT OF PAST AND FUTURE EARNINGS AND DIVIDENDS ON STOCK PRICE CHANGES

Mean of Sample — Mean Standard/Poor's = f (Earnings y_2 — Earnings y_1)

DAY:	*R Square*	*T-Value*
29	.00132	.028
30	.00318	.067

DAY: = f (Dividend y_2 — Dividend y_1)

	R Square	*T-Value*
29	.0573	.7
30	.0307	.43

DAY: = f (Earnings y_3 — Earnings y_2)

	R Square	*T-Value*
29	.1125	1.2
30	.1136	1.1

DAY: = f (Dividend y_2 — Dividend y_1)

	R Square	*T-Value*
29	.02109	.453
30	.0355	.773