

# DELAWARE AND THE MARKET FOR CORPORATE CHARTERS: HISTORY AND AGENCY

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### I. INTRODUCTION

There is considerable disagreement as to whether the current system of corporate chartering, in which charters are granted by

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\* Associate, Skadden, Arps, Slate, Meagher & Flom, Wilmington, Delaware. J.D., Yale Law School, 1988. I thank both Skadden, Arps and the *Journal* for their great assistance in this project.

states, serves the interests of shareholders better than either chartering by the federal government or state chartering regulated by national minimum standards.<sup>1</sup> Also debated are two related questions: why

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1. For arguments preferring the current system of state-issued charters, see Carney, *Toward a More Perfect Market for Corporate Control*, 9 DEL. J. CORP. L. 593 (1984) (arguing that if market for corporate control is relatively ineffective at disciplining management, such market failure is due to restrictions of Williams Act); Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. L. 259, 275, 281 (1980) (finding that firms that change their site of incorporation to Delaware earn positive abnormal returns greater than 30% over a 25-month period preceding the reincorporation and arguing that there is no satisfactory explanation for Delaware's extended success in charter market); Drexler, *Federalism and Corporate Law: A Misguided Missile*, 3 SEC. REG. L.J. 374 (1976) (criticizing William Cary's analysis of Delaware statutory and case law described *infra* at notes 15-24 and accompanying text); Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984) (arguing that even if shareholders are defenseless, management's discretion is sufficiently disciplined by markets for capital, products, and corporate control, and by legal rules proscribing fraud and self-dealing and imposing fiduciary obligations); Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 398 (1983) (arguing that state-provided legal rules generally give shareholders the voting arrangements shareholders would find desirable if they could be arranged and enforced at low cost); Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913, 944 (1982) (arguing that proper role of corporate law is limited to providing a framework for private parties to maximize their joint welfare by minimizing transaction costs between such parties and characterizing race to the bottom thesis as fundamentally misunderstanding organizational theory); Herzl & Richman, *Delaware's Preeminence by Design—Foreword* to R. BALOTTI & J. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS lix (Supp. 1989) (arguing that the market for charters provides incentives for states to continually improve their corporation law and that the quality of Delaware's corporation law is established by its predominant market share); Hyman, *The Delaware Controversy—The Legal Debate*, 4 DEL. J. CORP. L. 368, 389 (1979) (study finding that reincorporation in Delaware may benefit controlling shareholders more than minority shareholders, but no shareholder's interests are hurt, and concluding that Delaware provides an optimal statute that is consistent with a minimum level of minority shareholder political activity and a maximum level of minority shareholder market activity); Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 189 (1987) [hereinafter Romano, *Political Economy*] (arguing that in the context of takeover statutes, Delaware may be the state best able to respond to shareholders' preferences); Romano, *The State Competition Debate in Corporate Law*, 8 CARDENZO L. REV. 709 (1987) [hereinafter Romano, *State Competition Debate*] (arguing that Delaware's success in the chartering market results from Delaware's superior ability to minimize transaction costs); Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) [hereinafter Romano, *Law as a Product*] (arguing that national corporate chartering would impose a welfare loss on shareholders because the federal government cannot offer transaction specific assets as hostages to safeguard the investments of firms); Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEO. STUD. 251 (1977) (criticizing Cary's analysis for neglecting to account for the effects

are over forty percent of the New York Stock Exchange-listed companies<sup>2</sup> and over fifty percent of the Fortune 500 companies<sup>3</sup> incorporated in Delaware, the second smallest state in the Union (whose entire population of 595,000 is smaller than the population of San Jose, California), and why do eighty-two percent<sup>4</sup> of the firms that reincorporate move to Delaware?<sup>5</sup>

Under the present system of state chartering of corporations, corporate management has the authority to decide where to incorporate,<sup>6</sup>

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of the markets for capital, products, and corporate control on management's discretion and arguing that if incorporation in Delaware decreased returns to shareholders, Delaware corporations would be at a relative disadvantage in those markets).

*See infra* note 10 (examples of arguments criticizing both the market for charters and Delaware).

2. Letter from Joseph Grundfest, Commissioner, U.S. Securities and Exchange Commission, to David Brown, Secretary, Council of the Corporate Law Section of the Delaware State Bar Association (Dec. 10, 1987), reprinted in C. SMITH & C. FURLOW, *CORPORATE PRACTICE SERIES: GUIDE TO THE TAKEOVER LAW OF DELAWARE* app. E, at 162 (1988) [hereinafter Letter from Joseph Grundfest]. See also 1 N.Y.S.E. Guide (CCH) 725-803 (Aug. 1989) (listing corporations whose stocks are traded on the New York Stock Exchange and their state of incorporation). New York, the state with the second highest percentage of New York Stock Exchange-listed companies, has fewer than eight percent. *See id.*

3. Letter from Joseph Grundfest, *supra* note 2, at 162 n.2. Delaware's measurable influence would be even greater if a capitalization weighted index were used. *Id.*

4. Romano, *Law as a Product*, *supra* note 1, at 244.

5. In 1978, there were approximately 17,000 new corporations formed in Delaware as compared to approximately 31,000 in 1987, and the total number of Delaware corporations has increased from approximately 104,000 in 1978 to approximately 188,000 in October 1988. However, only three-tenths of one percent of all shareholders reside in Delaware. Letter from Joseph Grundfest, *supra* note 2, at 162.

6. "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). 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 & 1128 n.37 (1958).

The location of the corporate domicile is important because state corporation codes vary significantly and the internal affairs of a corporation (such as what powers belong to the board of directors, what limitations can be placed on their compensation, what kinds of self-interested transactions can members of the board of directors enter into, what duties must directors and officers perform, and in what ways can directors and officers be found liable for breaches of those duties) are governed by the general corporation law of the state of incorporation—even if the corporation's principal office, all of its physical assets, and its principal place of business are in other states, and even though none of its officers, directors, or shareholders are residents of the state of incorporation.

and the states compete<sup>7</sup> for the revenues derived from being the site of the corporate domicile.<sup>8</sup> This system of competing political jurisdictions provides a market for corporate charters;<sup>9</sup> and, as noted above, little Delaware dominates this market.<sup>10</sup>

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7. The state's goal in this competition is not necessarily to lure corporations from other jurisdictions; some states seek only to retain the corporations they presently have and to get a share of new incorporations. Romano, *State Competition Debate*, *supra* note 1, at 709-10.

8. As a result of the increasing number of Delaware corporations, there has been a corresponding increase in the revenue generated from corporate franchise taxes and fees. Such revenue has increased from \$55.0 million in 1975 to \$180.8 million in 1988, with projected 1990 revenues of \$224.6 million. As a percentage of Delaware's general fund revenues, corporate franchise taxes and fees have increased from 16.5% in 1975 to 17.8% in 1988, and are projected to represent approximately 20% of general fund revenues in 1990. Report of the Committee on the Court of Chancery, Irving S. Shapiro, Chairman, 3-5 (Dec. 21, 1988) [hereinafter Chancery Report].

9. See, e.g., Dodd & Leftwich, *supra* note 1, at 260.

10. For examples of arguments criticizing Delaware or the current system of state-issued corporate charters or the market for charters, see R. NADER, M. GREEN, & J. SELIGMAN, *CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS* (1976) (a muckraking classic); Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974) (the seminal article postulating that Delaware is leading the race to the bottom); Coffee, *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 CARDozo L. REV. 759 (1987) (arguing that federal government should enact a statute that gives shareholders the right to reincorporate in another state by shareholder plebiscite); Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 Bus. LAW. 1031 (1976) (arguing that state legislation cannot establish credible and forceful standards of managerial duty); Folk, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409 (1968) (arguing that at the state level, corporate law statutes that are enabling rather than regulatory are inevitable and desirable, but freedoms granted to corporations under state law will inevitably and increasingly be taken away by federal laws, such as Rule 10b-5 and the Williams Act); Herman, *The Limits of the Market as a Discipline in Corporate Governance*, 9 DEL. J. CORP. L. 530 (1984) (arguing that management will pursue corporate growth over maximizing present corporate value for the benefit of shareholder welfare, the market for corporate control notwithstanding); Henning, *Federal Corporate Chartering for Big Business: An Idea Whose Time Has Come?*, 21 DE PAUL L. REV. 915 (1972) (arguing that the market for charters compels states to give giant super-corporations all the power they want, and that such power is dangerously subject to severe abuse); Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 Bus. LAW. 991 (1976) (arguing that because of the market for charters, only federal law can adequately regulate managerial misconduct); Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 Bus. LAW. 883 (1976) (arguing that federal law on fiduciary duties of management is preferable to state law, and that Delaware statutory and case law is over-favorable to management); Kirk, *A Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain Corporate Preeminence*, 10 J. CORP. L. 233 (1984) (arguing that

Because of Delaware's market dominance, the General Corporation Law of Delaware controls the internal affairs of thousands of corporations, including more than half of the 500 largest industrial firms in the United States. This makes the General Corporation Law of Delaware the most important corporation law in the United States. In addition, market forces work to make Delaware's importance even greater. The other states must compete with Delaware in the charter market if they are to maintain their current market shares (and the

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Delaware has consciously designed its corporation law to further the state's own interests); Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (hypothesizing that consumers of corporate law generally demand efficient rules over inefficient ones, but states capitalize on agency costs by offering some less efficient rules that are highly desired by management); Murdock, *Delaware: The Race to the Bottom—Is an End in Sight?*, 9 LOYOLA U.L.J. 643 (1978) (arguing that the then newly-decided cases of *Lynch v. Vickers Energy Corp.*, 383 A.2d 278 (Del. 1977); *Singer v. Magnavox*, 380 A.2d 969 (Del. 1977); and *Tanzer v. International Gen. Indus., Inc.*, 379 A.2d 1121 (Del. 1977), represented a small effort by the Delaware Supreme Court to stem the erosion of minority shareholders' rights under Delaware's liberal statutory law); Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545 (1984) [hereinafter Schwartz, *Federalism*] (arguing that there are major defects in the current laws controlling corporate governance, that the market for charters prevents the states from correcting these problems, and that American Law Institute's Corporate Governance project should be adopted as the solution); Schwartz, *A Case for Federal Chartering of Corporations*, 31 BUS. LAW. 1125 (1976) [hereinafter Schwartz, *Federal Chartering*] (arguing that federal chartering is necessary to correct the flaws created by the chartering market and to broaden the goals of corporate law beyond wealth maximization for shareholders); Schwartz, *Towards New Corporate Goals: Coexistence with Society*, 60 GEO. L.J. 57 (1971) [hereinafter Schwartz, *Towards New Corporate Goals*] (arguing that a federal corporation law should be enacted as a way of using corporations for the advantage of all of society); Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249 (1976) (asking, after a review of the evolution of Delaware's corporation law, whether corporate law affecting all Americans should be drafted by a handful of Wilmington attorneys accountable only to their giant corporate clients); Vagts, *The Governance of the Corporation: The Options Available and the Power to Prescribe*, 31 BUS. LAW. 929 (1976) (arguing that only federal action can improve and simplify corporate law); Note, *Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89 (1972) (arguing that the chartering market has caused states to abdicate their responsibilities to govern corporations, and that federal chartering is the solution); Comment, *Vestiges of Rights Under the New Delaware Corporation Law*, 57 GEO. L.J. 599 (1969) (arguing that the 1967 revision to Delaware General Corporation Law severely curtailed the shareholder's voice in corporate affairs); Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861 (1969) [hereinafter Comment, *Law for Sale*] (documenting the political process that produced the major 1967 revision to Delaware General Corporation Law and arguing that that process is convincing proof that Delaware sells its corporate law for the benefit of General Assembly, state bar, and corporation service companies).

revenues attending those shares).<sup>11</sup> If Delaware adopts a provision that makes its corporate legal environment relatively more attractive to corporations, then the other states must adopt the same or similar provisions.<sup>12</sup> Thus, the Delaware General Corporation Law not only governs the affairs of important corporations incorporated in Delaware, it also serves as a nearly irresistible innovator, competitor, and model for the corporate codes governing many of the remaining corporations.

This article, after sketching the debate over Delaware and the market for corporate charters, describes some of the recent political history of the Delaware General Corporation Law and concludes that Delaware's success in the market for corporate charters results from Delaware's superior ability to minimize the costs to corporations of using agents to create some of the rules that control corporate behavior.

## II. THE DEBATE

### A. *Corporate Nationalists*

According to the view held by some corporate nationalists, managers are assumed to be rational maximizers of their own utility. When they are acting as the agents of the shareholders and the interests of the two parties do not coincide, welfare losses are sustained by shareholders, referred to as agency costs.<sup>13</sup> Corporate nationalists argue that the agency costs borne by the shareholders as a result of the separation of ownership and control of corporations can only be minimized by federal action.<sup>14</sup> The most often cited advocate of this position is William Cary, former Chairman of the Securities and Exchange Commission. Cary stridently opposed state chartering.<sup>15</sup> In considering the roles that shareholders, employees, consumers, and the public should play in corporate governance, Cary wrote: "The first step is to escape the present predicament in which a pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage in-

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11. Delaware is not always the innovating state, but when other states create a corporate law provision that is attractive to corporations, Delaware is the most responsive state in terms of adopting such innovations. Romano, *Law as a Product*, *supra* note 1, at 233-40.

12. In the alternative, they could try to innovate a dissimilar but equally attractive provision, but this method would be at a relative cost disadvantage, and if the provision were successful, Delaware would likely adopt it. *See id.*

13. *See infra* notes 157-60 and accompanying text.

14. *See Note, Federal Chartering of Corporations: A Proposal*, 61 GEO. L.J. 89, 125-28 (1972) (listing recent proposals for national chartering of corporations).

15. Cary, *supra* note 10.

corporation within its borders, thereby increasing its revenue."<sup>16</sup> Cary examined the Delaware General Corporation Law and the relevant case law<sup>17</sup> and concluded that Delaware was leading the "race for the bottom."<sup>18</sup> That is, Delaware was the most successful of the states at liberalizing its corporation code to allow management to advance its selfish interests at the expense of the interests of shareholders.<sup>19</sup> Cary argued that federal minimum standards of corporate responsibility were the solution to the Delaware predicament.<sup>20</sup>

Cary's theory of legislative behavior was simple: state legislatures will seek to maximize revenues by adopting measures attractive to the persons who decide the location of the corporate domicile<sup>21</sup>—

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16. Cary, *supra* note 10, at 701. Delaware has aroused even more disparaging criticism.

Meanwhile the little community of truck-farmers and clam-diggers have had their cupidity excited by the spectacle of their northern neighbor, New Jersey, becoming rich and bloated through the granting of franchises to trusts which are to do business everywhere except in New Jersey, and which are to go forth panoplied by the sovereign state of New Jersey to afflict and curse other American communities. ... In other words little Delaware, gangrened with envy at the spectacle of the truck-patchers, sand-duners, clam-diggers and mosquito wasters of New Jersey getting all the money in the country into her coffers,—is determined to get her little tiny, sweet, round, baby hand into the grab bag of sweet things before it is too late.

*Little Delaware Makes a Bid for the Organization of Trusts*, 33 AM. L. REV. 418, 419 (1899).

17. Cary examined the fiduciary duties of officers, directors, and majority stockholders in the following areas: buying stock from the minority or individual stockholders, proxy contests, takeovers, greenmail, accrued dividends on preferred stock, reclassification of preferred stock, *de facto* mergers, gross and palpable overreaching of a subsidiary by a parent company, directors' duty of care, director indemnification, and dividends on common stock. Cary, *supra* note 10, at 672-86, 688-90.

18. *Id.* at 705.

19. *Id.* at 668-70.

20. *Id.* at 701-03. Cary's support for a minimum standards proposal reveals a self-contradiction, for though he would have preferred national chartering of corporations, and he admitted that such was a logical implication of his criticisms, he rejected national chartering as politically unrealistic, *id.* at 700, apparently forgetting that his own critique was founded upon what he perceived as political market failure at the state level. *Id.* at 684 ("perhaps there is no public policy left in Delaware corporate law except the objective of raising revenue"). By admitting political market failure at the national level, Cary gives readers strong reason to believe that corporate management will be no "less skilled at protecting their interests when it comes to a federal corporation code." Romano, *State Competition Debate*, *supra* note 1, at 713 (citing the federal tax code as an example of pork barrel legislation and as analogous to Cary's proposal).

21. According to Romano,

This behavioral assumption is plausible: There is a positive linear relation

managers.<sup>22</sup> Both Cary and his opponents agree that agency costs exist and that it would be in the interests of shareholders and corporations generally to minimize these costs, but the corporate nationalists<sup>23</sup> believe that no mechanism in the status quo exists to effectively minimize these agency costs.<sup>24</sup> As a result, managers use their virtually uncontrolled discretion to locate the corporation in a state in which they can engage in the greatest amount of opportunistic behavior—Delaware. Corporate federalists<sup>25</sup> believe that the markets for capital, products and corporate control effectively align the interests of shareholders and managers and, therefore, control agency costs.<sup>26</sup>

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between the percentage of total revenues that states obtain from franchise taxes and states' responsiveness to firms in their corporation codes. [That is, t]he more dependent a state is on income from franchise tax revenues, the more responsive is its corporation code.

Romano, *State Competition Debate*, *supra* note 1, at 710 (citation omitted).

22. The management, by virtue of its authority to run the affairs of the corporation, has the legal authority to choose the state of incorporation. However, that decision is strongly influenced by the input of the corporate bar, both outside and in-house counsel. Romano, *Law as a Product*, *supra* note 1, at 273-74. Investment bankers have also been identified as having significant input into the jurisdictional decision. Macey & Miller, *supra* note 10, at 487.

23. See also Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. MIAMI L. REV. 187 (1983) (discussing common and conflicting interests of shareholders and managers); Schwartz, *Federalism*, *supra* note 10, at 552-55 (same).

24. But Cary's analysis was seriously flawed in that he failed to consider the existence of the markets for capital, products, and corporate control. Winter, *supra* note 1. It is beyond peradventure that these markets could minimize agency costs. Nevertheless, Cary's conclusion cannot be lightly dismissed because the existence of these markets does not establish that they are sufficiently effective in aligning shareholder and management interests to warrant preferring the current system of state chartering over national proposals. Romano, *State Competition Debate*, *supra* note 1, at 711-12.

25. See Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 33-35 (1983); Fischel, *supra* note 1, at 919-20; Romano, *Law as a Product*, *supra* note 1; Romano, *State Competition Debate*, *supra* note 1; and Romano, *Political Economy*, *supra* note 1; Winter, *supra* note 1.

26. Winter characterized Cary's theory as implausible on its face. He argued that if Delaware corporations allowed management to appropriate resources to unproductive uses, then their earnings must be lower than those of non-Delaware corporations. Lower earnings would place Delaware corporations at a relative disadvantage in the capital markets, which would place them at a relative disadvantage in the products market, which would cause aggregate share price to fall below the inherent value of the underlying assets of the corporation. If this undervaluation became greater than the transaction costs of a corporation takeover, then a takeover would occur, and the new management would remove the corporate domicile to

### B. Corporate Federalists

Corporate federalists do not deny the great permissiveness of the Delaware General Corporation Law; they disagree as to its effect. Instead of opportunistic behavior vis-à-vis shareholders, corporate federalists see flexibility and the power to maximize the wealth of the firm and to succeed in competition with other firms. Because the capital, product, and corporate control markets align the interests of shareholders and managers, corporate federalists argue that no disadvantage exists in allowing managers to act their interests.<sup>27</sup>

The most detailed explanation of Delaware's success in the charter market is Romano's.<sup>28</sup> She concludes that Delaware's success is a result of: (a) comprehensive statutes and a body of case law, which provide greater certainty of legal outcome; (b) an experienced and small judiciary, which also increases certainty; (c) the large number of corporations currently domiciled in Delaware, which increases the rate at which precedents are made and increases the relative economic importance of franchise tax revenue to the state; (d) a two-thirds supermajority vote requirement in the General Assembly for amendments to the Delaware General Corporation Law making it difficult to reverse the presently favorable corporate code; and (e) high levels of investment in transaction specific assets<sup>29</sup> such

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another state, thus realizing the gains to be had from non-Delaware domicile. Winter, *supra* note 1, at 256.

Winter argued that corporation laws were not the only controls on management's discretion. He hypothesized that the forces of the capital, product, and management control markets would align the interests of management and shareholder. *Id.* at 255-58. Thus, competing states could encourage incorporation within their borders only if they offered corporation laws that provided an optimal mix of benefits to management and shareholders. Winter believed that Delaware was the most successful at providing such a legal environment.

27. This ignores the alternative of "hit and run" corporate looters who intend to "manage" the firm only long enough to convert all available corporate assets into negotiable instruments and place tickets to faraway places. A corporate code that eliminated this problem would also paralyze the corporation.

28. Romano, *Law as a Product*, *supra* note 1; Romano, *State Competition Debate*, *supra* note 1.

29. Transaction specific assets have economic value that greatly decreases if they must be redeployed away from their appointed transaction. O. WILLIAMSON, TRANSACTION COST ECONOMICS 16-22 (Economics of Organization Working Paper No. 31, Mar. 1987). For example, a retailing company, *M*, will have disincentives to invest in software that works only with the hardware of company *I* because that software has no value in transactions with any other company.

as a highly developed statutory law and common law and the expertise of its corporate attorneys.<sup>30</sup>

Romano was the first to recognize that: (a) the role of the corporate bar could be more important than that of corporate managers in driving innovations in corporate law;<sup>31</sup> (b) that for the purposes of determining corporate domicile, the agency relationship between a corporation and its legal counsel could be more important than the agency relationship between shareholders and management;<sup>32</sup> (c) that indirect revenues to Delaware (fees to corporate attorneys, for example) are much greater than direct revenues (taxes);<sup>33</sup> and (d) that there is a principal-agent relationship between management and state legislatures.<sup>34</sup> Romano concludes that Delaware has a cost advantage in the charter market and that corporations will relocate to Delaware when this cost advantage is greater than relocation transaction costs, which occur most often when the corporation is planning to undertake transactions that will significantly affect its operations or organization.<sup>35</sup>

Romano comes to two conclusions that this article rejects: (a) the significant involvement of corporate attorneys in the legislative process of creating corporate law has no effect on shareholder welfare;<sup>36</sup> and (b) shareholder welfare would be increased by requiring that all substantive legislative revisions to corporate law be publicly scrutinized and debated.<sup>37</sup>

### C. Macey and Miller's Interest-Group Analysis

Mace and Miller have recently contributed to the chartering debate.<sup>38</sup> They hypothesize that consumers of corporate law generally demand efficient rules over inefficient ones, but states will capitalize on agency costs by offering some less efficient rules that are highly

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30. *Id.*

31. Romano, *Law as a Product*, *supra* note 1, at 276 n.74.

32. *Id.* at 273-76.

33. *Id.* at 240-41.

34. *Id.* at 236.

35. *Id.* at 226, 249-50, 279-80; Romano, *State Competition Debate*, *supra* note 1, at 717-18.

36. Romano, *State Competition Debate*, *supra* note 1, at 724 n.39.

37. *Id.* at 756-57.

38. Macey & Miller, *supra* note 10.

desired by management, particularly antitakeover rules.<sup>39</sup> They construct an interest-group model in which Delaware charges supra-competitive rates and Delaware attorneys use their political power to appropriate the bulk of the resulting "profits" for themselves.<sup>40</sup> They argue that the existing literature implies that the chartering revenues that flow to Delaware are evenly divided among interest groups within the state.<sup>41</sup> They then reject, however, the hypothetical implication in favor of "a political equilibrium in which each group obtains desired legal rules [and thus income] depending on its political influence."<sup>42</sup>

Macey and Miller make some assertions about the nature of the competing interest groups in Delaware: the corporate bar is small, discrete, wealthy, and highly organized.<sup>43</sup> Its members have large personal stakes in the corporate law and have good political connections; indeed, Mace and Miller suppose, many members of the General Assembly are members of the bar<sup>44</sup> and likewise members of the bar are disproportionately represented on the legislative committees that draft the corporate code.<sup>45</sup> On the other hand, the competing interest groups are diffuse, with small personal stakes in corporate chartering, and relatively unorganized.<sup>46</sup> Macey and Miller conclude that the Delaware General Corporation Law is calculated to appeal to those who determine corporate domicile,<sup>47</sup> for the benefit of Delaware attorneys.<sup>48</sup>

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39. *Id.* at 471.

40. *Id.* at 498-509.

41. *Id.* at 472.

42. *Id.*

43. *Id.* at 506.

44. *Id.*

45. *Id.*

46. *Id.* at 507.

47. *Id.* at 485.

48. Macey and Miller predict that management will strongly desire antitakeover statutes and that states will eagerly provide them. Delaware, as the state capitalizing the most on agency costs, should therefore have been one of the first to adopt such a statute, however, such was not the case. Delaware was uncharacteristically slow in adopting a first generation takeover statute, and it was the twenty-eighth state to adopt a second generation statute. See Testimony of A. Gilchrist Sparks, III Before the Delaware Senate and House Judiciary Committees (Jan. 20, 1988), reprinted in C. SMITH & C. FURLOW, *supra* note 2, at 306 [hereinafter Testimony of Sparks]; Romano, *Political Economy*, *supra* note 1, at 144.

### III. DELAWARE

In spite of Delaware's importance to the corporate world, little scholarship exists on the political process that produces the Delaware General Corporation Law.<sup>49</sup> Delaware adopted its first modern general corporation law in 1899.<sup>50</sup> The statute has been amended hundreds of times since then.<sup>51</sup> In 1967 the entire Delaware General Corporation Law was revised, and at least since these 1967 revisions,<sup>52</sup> the procedure and the participants involved in amending the corporation law have been the same. The participants are: (a) the General Assembly; (b) the Governor, his appointed Secretary of State, and the State Division of Corporation Administration and Policy; (c) the Corporate Law Section of the Delaware Bar Association and its leadership—the council of the Corporate Law Section; and (d) the corporation service companies. The statute is, of course, interpreted by a final participant—the state judiciary.

#### A. *The General Assembly*

The 133rd General Assembly of Delaware (1984-1985) consisted of 21 senators (8 Republicans and 13 Democrats) and 41 representatives (22 Republicans and 19 Democrats). It is the third smallest bicameral state legislature in the United States.<sup>53</sup> In the Senate there were three women and one black. Fourteen of the twenty-one were college graduates. Fourteen were born in Delaware. Three were denominated full-time legislators (though the General Assembly is in session only from January to June). There were two teachers,

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49. Romano, *State Competition Debate*, *supra* note 1, at 731 nn. 59, 75. There are only a few articles which discuss the process in some significant way. Arsh, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. L. 1 (1976); Cary, *supra* note 10 (discussing Delaware's lead in the race to the bottom); Kirk, *supra* note 10 (discussing the historical evolution of Delaware's preeminence in corporate law); Comment, *Law for Sale*, *supra* note 10.

50. Act of Mar. 10, 1899, ch. 273, § 1, 21 Del. Laws 445 (1899).

51. See, e.g., Arsh, *supra* note 49, at 8-13; Arsh & Black, *The Delaware General Corporation Law: Recent Amendments*, 30 BUS. L.W. 1021 (1975); Arsh & Stapleton, *Delaware General Corporation Law: 1969*, 25 BUS. L.W. 287 (1969); Arsh & Black, *The 1974 Amendments to the Delaware Corporation Law*, 2 CORP. GUIDE (P-H) ¶ 375 (1974); Arsh & Black, *Analysis of the 1973 Amendments to the Delaware Corporation Law*, 2 CORP. GUIDE (P-H) ¶ 365 (1973); Arsh & Stapleton, 2 CORP. GUIDE (P-H) ¶ 359 (1970).

52. The 1967 revision was exceptional in that the *idea* of a comprehensive revision came from the Governor's office.

53. Alaska, Nebraska (unicameral), and Nevada are smaller. THE COUNCIL OF STATE GOVERNMENTS, THE BOOK OF THE STATES, 1982-1983, at 189 (1982) [hereinafter BOOK OF THE STATES].

three self-employed and three retirees. There was a business consultant, a funeral director, a phone company supervisor, a restaurant manager, and others. There was one employee of the Du Pont Company and no attorneys.<sup>54</sup> Three were single. The average age was fifty-two.<sup>55</sup>

In the House of Representatives there were seven women and two blacks, and thirty-one college graduates. Twenty-two were born in Delaware.<sup>56</sup> There were four full-time legislators, eight teachers or educators, four farmers, five Du Pont employees (all Republicans), and two retirees. There was one banker, one private investigator, one deputy sheriff, one realtor, and others. There were no attorneys. Six were single. The average age was fifty.

The Senate is organized into twenty committees,<sup>57</sup> but there is no committee devoted largely or exclusively to corporate matters.<sup>58</sup> Amendments to the Delaware General Corporation Law are consid-

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54. In fact, since 1966 no member of the General Assembly has been an attorney who practiced corporate law and only nine members have been attorneys at all. Statistics compiled by the Delaware Legislative Council. Traditionally, attorney is the most common occupational background for state legislators (followed by businessmen and farmers). R. MADDOX & R. FUQUAY, *STATE AND LOCAL GOVERNMENT* 142 (1966). The absence of lawyer-legislators may even be more surprising considering that the population-to-attorney ratio in Delaware is 446:1, fifteenth among all states. B. CURRAN, K. ROISCH, C. CARLSON & M. PUCCELTI, *THE LAWYER STATISTICAL REPORT, A STATISTICAL PROFILE OF THE U.S. LEGAL PROFESSION IN THE 1980s*, at 233 (1985). Furthermore, Wilmington ranks fourth out of 469 principal United States cities in population-to-attorney ratio. *Id.* at 583. This consistent absence of members of the Delaware Bar Association in the General Assembly is directly contrary to the assertion made by Macey and Miller in their *Texas Law Review* article: "Indeed, many members of the Delaware legislature are themselves members of the bar." Macey & Miller, *supra* note 10, at 506.

55. Statistics compiled by the Delaware Legislative Council.

56. Statistics compiled by the Delaware Legislative Council.

57. The committees are: Administrative Services and Energy, Agriculture, Banking, Community Affairs, Corrections, Education, Ethics, Executive, Finance, Health, Social Services and Aging, Highways and Transportation, Insurance and Elections, Judiciary, Legislative Council, Labor and Industrial Relations, Natural Resources and Environmental Control, Public Safety, Revenue and Taxation, Small Business, and Sunset.

The House is also organized into committees, but it, too, lacks a committee devoted to corporate matters. As in the Senate, the Judiciary Committee considers amendments to the corporation code.

58. While the absence of a committee dedicated to corporate law is not unusual, it is interesting evidence of the General Assembly's lack of involvement in drafting the corporate code.

ered by the Judiciary Committee.<sup>59</sup> Additionally, the Senate does not use its committees to perform its legislative functions. The committees do not meet as such, nor are they staffed as such.<sup>60</sup> In fact, neither the committees nor individual members, except party leaders, are provided any professional staff at all.<sup>61</sup>

According to a member of the Judiciary Committee neither the members nor leaders of the Senate Judiciary Committee, nor of the House Judiciary Committee, nor any other member of the General Assembly knows enough about corporate law to make any informed decisions about the Delaware General Corporation Law.<sup>62</sup> This committee member does not recall ever seeing a copy of the Senate bill containing the 1987 amendments to the Delaware General Corporation Law, Senate Bill No. 93,<sup>63</sup> before he/she voted on it.<sup>64</sup> The Committee member explained that if a corporate law bill has the support of the Delaware Bar Association and the Secretary of State's office, then it is passed without amendment or debate.<sup>65</sup>

Delaware has two active parties,<sup>66</sup> but party politics play no part in the formation of the Delaware General Corporation Law. Neither party has ever formally supported or opposed any corporation law bill.<sup>67</sup>

#### B. *The Executive Branch*

Within the executive branch of Delaware state government, the Assistant Secretary of State/Director of the Division of Corporation Administration and Policy is the person most involved in amending

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59. Interview with member of Senate Judiciary Committee in Wilmington, Delaware (Aug. 24, 1987) [hereinafter Committee Member Interview]. The Delaware Journal of Corporate Law did not participate in the interviews cited herein and it not responsible for the descriptions provided by the author.

60. Except the financial committees. *Id.*

61. *Id.*

62. *Id.*

63. *Id.*

64. Committee Member Interview, *supra* note 59. This contradicts the assertion by Macey and Miller that Delaware legislators are more knowledgeable about corporate law than legislators in other states. See Macey & Miller, *supra* note 10, at 488.

65. Committee Member Interview, *supra* note 59.

66. S. MOREHOUSE, STATE POLITICS, PARTIES AND POLICY 67, 80 (1981); R. Ross & K. MILLSAP, STATE AND LOCAL GOVERNMENT AND ADMINISTRATION 205 (1966).

67. Interview with Frank DiMondi, chairman of the Republican State Committee, in Wilmington, Delaware (Aug. 27, 1987).

the Delaware General Corporation Law.<sup>68</sup> He attends, upon invitation, meetings of the Corporate Law Section of the Delaware Bar Association and subsequently presents the corporate law bills, originating from the Corporate Law Section, to the leadership of the General Assembly.<sup>69</sup> The executive branch reviews, but does not make any recommendations for change in, proposals approved by the Corporate Law Section.<sup>70</sup>

#### *C. The General Corporation Law Section of the Delaware Bar Association*

The General Corporation Law Section is the largest of twelve sections of the Delaware Bar Association.<sup>71</sup> It has 224 members, and membership is open to any member of the Delaware Bar Association who practices in that area.<sup>72</sup> The Corporate Law Section is governed by a council of fifteen members. Membership to the council is by election. Nomination to stand for election is by a nominating committee composed of sitting council members. Nomination is tantamount to election.<sup>73</sup> With only two exceptions (a proposed second

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68. The Assistant Secretary of State/Director of the Division of Corporation Administration and Policy is not a member of the bar.

69. Interview with Rick Templeton, Assistant Secretary of State/Director of the Division of Corporation Administration and Policy, in Wilmington, Delaware (Aug. 28, 1987) [hereinafter Templeton Interview].

70. *Id.*

71. The other sections are: commercial law, criminal law, estates and trust, family law, general corporation law, labor and employment law, litigation, real and personal property, taxation, torts and insurance practice, and women and the law. 1989 DELAWARE LEGAL DIRECTORY 96. The Bar Association also has 14 standing committees: administration of justice; bar and media; continuing legal education; fee dispute conciliation and mediation; general legislation; judicial appointments; judicial compensation; law and the elderly; lawyer referral service; medical-legal/dental-legal; new lawyers; professional ethics; program; and unauthorized practice of law. *Id.* at 97. It has 13 special committees: administrative law, awards, bar center, bench and bar conference, benefits, judicial criticism response, judicial portraits, needs of children, paralegal, professional guidance, public legal education, solo and small firm practice, and specialization. *Id.* The Delaware Bar Association has approximately 1200 members.

72. Interview with an officer of the Delaware State Bar Association, in Wilmington, Delaware (Aug. 28, 1987) [hereinafter Bar Interview]. Until recently, this was not the case. Membership in the Corporate Law Committee, as it was previously titled, was granted only by appointment from the existing members.

73. Interview with a founding partner of a large Wilmington law firm, in Wilmington, Delaware (Aug. 24, 1987) [hereinafter Attorney 1 Interview]. It is unclear how representative the Council is of the Section, or of the Delaware Bar Association, but members have been known to make a good faith effort to include nonmembers of different persuasions. For example, Bruce Stargatt, who was not

generation takeover statute and any amendments that raise the franchise tax),<sup>74</sup> the Corporate Law Section is the body from which all proposed legislative reform to the Delaware General Corporation Law comes,<sup>75</sup> and no proposals recommended by the Corporate Law Section have ever failed to pass in the General Assembly.<sup>76</sup> In fact, they generally pass by overwhelming vote margins without amendment or debate.<sup>77</sup>

Any amending, redrafting, debating or lobbying that affects proposed legislation occurs within the Corporate Law Section.<sup>78</sup> The

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a member of the Corporate Law Section, the membership of which, at that time (1986), was by appointment from sitting members, when he was opposed to the section's recommendation of a directors' and officers' indemnification statute. Starrant had strong criticism about the way the section and council worked. He has since been made a member of both. *Id.*

74. See, e.g., Testimony of Sparks, *supra* note 48.

75. Arsh, *supra* note 49, at 17. For example, the revised 1967 code was drafted by three members of the Corporate Law Section, Arsh, Canby, and Corroon, three senior partners in the three biggest law firms in Delaware at that time. The three drafters were members of a revision committee appointed by Governor Carvel to modernize the existing 1953 corporation law (the principal draftsman in 1953 was Arsh). The revision committee consisted of Arsh, Canby, and Corroon plus Morris and Calorn (two more attorneys from major firms), Sutherland, a Delaware Supreme Court Justice, Duke, the Secretary of State, the Assistant Secretary of State/Director of the Division of Corporation Administration and Policy, and the heads of the three largest corporation service companies. *Id.* at 14. The Committee hired Ernest L. Folk as reporter and Stapleton, now Third Circuit Judge, and Crompton and Richards, now senior partners in two of Delaware's largest firms, as committee clerks. *Id.* at 15, 16 n.96.

Folk has since made a career out of writing about his experience with the revision committee. See E. FOLK, R. WARD & E. WELCH, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* (2d ed. 1987); E. FOLK, *AMENDMENTS TO THE DELAWARE GENERAL CORPORATION LAW* (1970) (published by Corporation Service Co.); E. FOLK, *THE RED BOOK DIGEST OF THE NEW DELAWARE CORPORATION LAW—1967* (1968) (published by Corporation Service Co.); E. FOLK, *THE NEW DELAWARE CORPORATION LAW* (1967) (published by Corporation Service Co.); E. FOLK, *REVIEW OF THE DELAWARE CORPORATION LAW—1965-67* (1967); Folk, *Some Reflections of a Corporation Law Draftsman*, 42 CONN. BAR J. 409 (1968); Folk, *Corporation Law Developments—1969*, 56 VA. L. REV. 755 (1970); Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 BUS. LAW. 1031 (1976).

76. Interview with Donald Pease, Visiting Professor, Widener University School of Law, in Wilmington, Delaware (Aug. 14, 1987) [hereinafter Pease Interview]; interview with a senior partner in a large Wilmington law firm, in Wilmington, Delaware (Aug. 19, 1987) [hereinafter Attorney 2 Interview].

77. Attorney 1 Interview, *supra* note 73; Attorney 2 Interview, *supra* note 76. Any amendment to the Delaware General Corporation Law must receive a minimum two-thirds majority vote. DEL. CONST. art. IX, § 1 (1897).

78. For example, when the current § 102(b)(7) (limiting directors' and officers' liability) was under consideration by the Corporate Law Section, it was strongly opposed by an attorney who was a partner in a large Wilmington law firm. He

parties who lobby for specific reforms in the Delaware General Corporation Law—for example, Delaware attorneys, in-house corporate counsel, out-of-state “Delaware” attorneys, corporate managers, and corporation service companies—all give their input to the Corporate Law Section, not the General Assembly.<sup>79</sup>

#### D. Corporation Service Companies

Delaware law requires that a corporation incorporated within the state have a registered agent to accept service of process.<sup>80</sup> Corporation service companies serve that function. They also prepare corporate formation papers, check proposed new corporate names for preemption, prepare certificates of incorporation, file incorporation papers with the Secretary of State, record those papers with the county recorder, prepare corporate name changes, and prepare certified copies of documents, including certificates of good standing.<sup>81</sup> These services are provided expeditiously, giving Delaware a time advantage over other states. That advantage can be important in the sometimes lightning-paced world of corporate takeovers. For example, in New York, the state prepares certificates of good standing, and it takes three weeks.<sup>82</sup> In Connecticut, they are prepared by the state in three or four weeks. In Delaware, certificates of good standing are prepared by corporation service companies instantly.<sup>83</sup> In New York, it takes four to six weeks to process an incorporation;<sup>84</sup> in Connecticut, it takes three or four weeks. In Delaware, the Special Services Section of the Division of Corporation Administration and

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lost his fight within the section and could have taken his opposition to the General Assembly, but he did not because he believed that, in general, it was a much better practice to let the Corporate Law Section decide such controversies than it was to let the General Assembly decide them. Interview with a partner in a large Wilmington law firm, in Wilmington, Delaware (Aug. 24, 1987) [hereinafter Attorney 3 Interview]. This contradicts Macey and Miller's assertion that lawyer-legislators dominate the *legislative committees* that draft the Delaware General Corporation Law. See Macey & Miller, *supra* note 10, at 506. In truth, committees that draft corporate legislation are not committees of the General Assembly.

79. Attorney 1 Interview, *supra* note 73; Attorney 3 Interview, *supra* note 78.

80. DEL. CODE ANN. tit. 8, §§ 131(a), 132(a) & 321(a) (Supp. 1988).

81. These services are not trivial. For example, in 1987, corporation service companies provided 50,000 certified copies to corporations. Interview with George Coyle, Vice-President, the Corporation Trust Company (Aug. 26, 1987) [hereinafter Coyle Interview].

82. They have recently begun, however, providing certificates within 24 hours upon payment of an additional \$10.

83. Coyle Interview, *supra* note 81.

84. They have recently begun, however, processing incorporations within 24 hours upon payment of an additional \$10.

Policy processes incorporations within twenty-four hours<sup>85</sup> or, for an additional fee, on the same business day.<sup>86</sup>

There are many corporation service companies in Delaware. The three largest, The Corporation Trust Company, Corporation Service Company, and U.S. Prentice-Hall, collectively control a majority of the market,<sup>87</sup> and each has a representative to the Corporate Law Section of the Delaware Bar Association.<sup>88</sup> The corporation service companies do not lobby the General Assembly.<sup>89</sup> They do meet regularly with the Secretary of State and the Assistant Secretary of State/Director of the Division of Corporation Administration and Policy to discuss, among other things, legislative reform. They also meet annually with the Corporate Law Section of the Delaware Bar Association to give their legislative recommendations to the bar.<sup>90</sup>

#### *E. The Judiciary*

The Delaware judiciary is divided into eight courts.<sup>91</sup> Jurisdiction over corporate cases is in the court of chancery, and appeal is directly

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85. An additional \$50 fee is charged for this expedited service. Templeton Interview, *supra* note 69.

86. An additional \$100 fee is charged for this expedited service. *Id.* Templeton describes the special services section of his division as the "SWAT team" of incorporation. *Id.*

87. The Corporation Trust Company, the largest in the state, alone controls 35% of the market.

88. *Id.*

89. *Id.*

90. *Id.* For example, the corporation service companies proposed the reform that amended §§ 251(b)(3) and (b)(4), 252(c)(5), and 254(d)(4) and (d)(5) of the Delaware General Corporation Law in 1987. *Id.* These sections concern services provided by corporation service companies—providing and filing certificates of incorporation. These sections provide that parties to a merger or consolidation agreement may not choose the certificate of incorporation of a constituent corporation which is not the surviving corporation in the merger as the certificate of incorporation of the surviving corporation and that in a consolidation the certificate of the resulting corporation is to be attached to the agreement of merger. DEL. CODE ANN. tit. 8, §§ 251(b)(3), (b)(4), 252(c)(5), 254(d)(4), (b)(5) (Supp. 1988).

91. The Delaware courts of limited jurisdiction are: court of common pleas (civil actions where amount in dispute is less than \$15,000 and misdemeanors outside Wilmington); justice of the peace court (civil actions where amount in dispute is less than \$2,500 and minor misdemeanors); alderman's court (municipal offenses, minor civil actions, and minor misdemeanors); municipal court of Wilmington (municipal violations and misdemeanors); and family court (family law disputes, intrafamily misdemeanors, and juvenile delinquency). Courts of general jurisdiction are: supreme court (Delaware's highest court), superior court (original

to the Delaware Supreme Court.<sup>92</sup> There are no jury trials in the court of chancery. Delaware is one of only three states to continue the historic division between law and equity, and the court of chancery is Delaware's sole court of equity.<sup>93</sup> Delaware has one chancellor, four vice-chancellors, and five supreme court justices.<sup>94</sup> The chancellor and vice-chancellors are appointed by the governor, with the consent of the Senate, to fourteen year terms. Litigation in the court of chancery consists of corporate disputes, trusts and estates, other fiduciary matters, disputes involving the sale of land, questions of title to real estate, and commercial and contractual matters in general,<sup>95</sup> although approximately seventy-five percent of the court's pending cases are corporate, and each judge spends about seventy-five percent of his or her time on corporate matters.<sup>96</sup>

#### IV. INNOVATION IN THE DELAWARE GENERAL CORPORATION LAW

This part of the article discusses the political process that produces amendments to the General Corporation Law of Delaware. That process is highly uniform and largely private. The recent amend-

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civil (except equity), original criminal, appellate from family court, court of common pleas, justice of peace courts, and administrative agencies); court of chancery (exclusive jurisdiction in equity, corporate cases, real property disputes, trusts and estates, and commercial matters). WANT'S FEDERAL-STATE COURT DIRECTORY: 1988 EDITION 84 (1987).

92. The decisions of Delaware courts are widely cited by other courts and law reviews. For example, Shepardizing four familiar Delaware cases, all decided within the last decade—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); and Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983)—reveals that one or more of these four cases were cited in reported decisions by federal appeals courts in 6 of the 11 federal appeals circuits; cited by federal district courts in California, Florida, Illinois, Michigan, Minnesota, Missouri, New Jersey, New York, North Carolina, Ohio, Pennsylvania, and Texas; and cited by state courts in California, Florida, Illinois, Kentucky, Maryland, Massachusetts, Minnesota, New Jersey, New York, Ohio, Tennessee, and Texas. A LEXIS search reveals that one or more of these four decisions were also cited by the law reviews at the University of California at Berkeley, University of California at Los Angeles, Columbia University, Cornell University, Harvard University, University of Michigan, University of Minnesota, Northwestern University, New York University, University of Pennsylvania, Stanford University, University of Texas, University of Virginia, Widener University School of Law, University of Wisconsin, and Yale University.

93. Chancery Report, *supra* note 8, at 6.

94. *Id.*

95. *Id.* at 11.

96. *Id.* at 12.

ment to the takeover statute is an exception to both of those generalities, and it is discussed first. The amendment to the statute limiting the liability of officers and directors was universal in the amount of controversy generated by it within the bar. It is discussed next, and finally, the article discusses the 1987 amendments to the General Corporation Law of Delaware, which were adopted by a process that typifies the political process used to adopt every other amendment since 1967.

*A. Consideration of a Control Share Acquisition Statute to Amend Existing Takeover Statute*

The Corporate Law Section of the Delaware Bar Association has had an organized committee dedicated to considering changes to the antitakeover section of the Delaware General Corporation Law, section 203, since 1982.<sup>97</sup> More recently, the Corporate Law Section and the Delaware Bar Association have considered several specific proposed amendments; two of which were given serious consideration: a modified Ohio-Indiana type control share acquisition statute and a modified New York type business combination moratorium statute.<sup>98</sup>

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97. The then existing takeover Delaware statute was a first generation statute adopted in 1976. 60 DEL. LAWS ch. 371, § 1 (1976). After the Supreme Court's decision in *Edgar v. MITE Corp.*, 457 U.S. 624 (1982), the unconstitutionality of existing § 203 became clear, and its enforcement was routinely enjoined. *See Loral Corp. v. Sanders Assocs., Inc.*, 639 F. Supp. 639 (D. Del. 1986) (enjoining enforcement of § 203 and recounting more than 45 other cases of such an injunction).

98. Second generation takeover statutes are generally of four types: Maryland type fair price statutes, Ohio-Indiana type control share acquisition statutes, Pennsylvania type redemption rights statutes, and New York type business-combination moratorium statutes. Romano, *Political Economy*, *supra* note 1, at 115-17. Maryland type fair price statutes typically require approval of "business combinations" by a supermajority of shareholder votes unless the combination is approved by a majority of the disinterested board members or is supported by the payment of a "fair price" (the higher of any price previously paid by the interested party or the market price at the time of the combination). Firms can opt out by board resolution within two months of the statute's effective date or at any time by supermajority shareholder vote. *Id.* at 116.

Ohio-Indiana type control share acquisition statutes typically require that a majority of disinterested shareholders approve the acquisition of a "control share." A control share acquisition is defined as any purchase that moves the purchaser from one percentage-of-ownership category into any higher category. The categories are: none to one-fifth, one-fifth to one-third, one-third to one-half, and more than one-half. Firms can opt out by charter provision or bylaw amendment. *Id.* at 115-16.

Pennsylvania type redemption rights statutes typically require that upon acquisition of 30% of the firm's shares, all remaining shareholders are entitled to receive from the acquiror, upon demand, an amount equal to the fair value of the

Almost immediately after the supreme court decision in *CTS Corp. v. Dynamics Corp.*, in April 1987, upholding Indiana's second generation takeover statute, the council of the Corporate Law Section began considering recommending a similar statute to the General Assembly.<sup>99</sup> The section 203 committee considered several modified control share acquisition statutes, as did the council of the Corporate Law Section.<sup>100</sup> Finally, a discussion draft dated May 28 was circulated.<sup>101</sup>

The draft proposal provided that any person who acquired a control share in a Delaware corporation could not vote his shares unless he was granted voting rights by the affirmative vote of a majority of all other shareholders at the next annual shareholders' meeting or at a meeting held not more than fifty days after a control share acquisition statement was filed by the acquiring person. A control share was defined as an acquisition that removed the acquiring person from any ownership category to a higher category. The categories were: from no shares to one-fifth of all shares, from one-fifth to one-third, from one-third to one-half, and greater than one-half.<sup>102</sup>

The corporation, by bylaw or charter provision existing before the control share acquisition, may provide for redemption, at fair value, of all, but not less than all, of the acquiring person's shares acquired within sixty days of the acquisition that triggered the statute, if no control share acquisition statement is filed or if the control

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stock (including any control premium). The firm can opt out by board resolution within 90 days of the statute's effective date or at any time by charter amendment. *Id.* at 116-17.

New York type business-combination moratorium statutes prohibit business combinations with interested shareholders for three or five years after the acquisition of the interest, with very few exceptions, and majority approval by the disinterested shareholders is required after the waiting period. *Id.* at 117 n.17.

99. M. GOLDMAN & E. McNALLY, THE PROPOSED DELAWARE TAKEOVER STATUTE: A REPORT TO THE DELAWARE GENERAL ASSEMBLY 2 (1987), reprinted in C. SMITH & C. FURLOW, *supra* note 2, app. P, at 241. Even before *CTS*, the Corporate Law Section had considered recommending an Indiana type statute to the General Assembly and decided against it. Attorney 2 Interview, *supra* note 76.

100. Attorney 2 Interview, *supra* note 76.

101. *Id.*; Letter from Marshall L. Small, a partner and corporate attorney with Morrison & Foerster, to Lewis Black, Jr. and Norman Veasey, members of the Corporate Law Section (Dec. 7, 1987) (discussing the proposed business-combination moratorium statute), reprinted in C. SMITH & C. FURLOW, *supra* note 2, app. N, at 228.

102. Proposed DEL. CODE ANN. tit. 3, § 203: Control Share Acquisitions (May 28, 1987) (available from the Corporation Law Section, Delaware State Bar Association).

shares are not granted voting rights. The firm may similarly provide that if the acquiring person is granted voting rights and has a majority of the firm's shares, then all other shareholders may be granted appraisal rights by the Delaware Court of Chancery. Firms would have to opt in to be protected by the statute.<sup>103</sup>

In early June, after receiving more than 100 comments, the council unanimously voted not to recommend a takeover-law proposal to the sitting General Assembly.<sup>104</sup> The day before that vote, the chairman, A. Gilchrist Sparks, received letters from Joseph Flom of New York's Skadden, Arps, Slate, Meagher & Flom, and Martin Lipton, of New York's Wachtell, Lipton, Rosen & Katz, each separately indicating that he thought that the proposed amendment to section 203 was ill-advised.<sup>105</sup> Mr. Flom argued first that there was some significant likelihood of federal action in the takeover area, possibly by Congress or the Securities and Exchange Commission, or by the securities exchanges that might preempt a Delaware statute; and second, the impact on shareholders and firms was highly uncertain; and finally, Mr. Flom saw no significant likelihood that any consequential number of corporations would leave Delaware if no takeover statute were adopted by the state in that legislative session.<sup>106</sup>

On June 10, Chairman Sparks convened a meeting of the section, to receive comments from the members in preparation for a meeting of the council immediately following. At the meeting Sparks summarized the comments the council had received from outside people. The comments, he said, were of three types: concerns about federal or other preemption, concerns about the substantive content of the proposal, and concerns about minor suggestions.<sup>107</sup>

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103. *Id.*

104. *Id.*; Schwadel, *Delaware Fails to Adopt Law on Takeovers*, Wall St. J., June 16, 1987, at 2, col. 1.

105. Franklin, *Wait and See: Delaware Puts Off Anti-Takeover Legislation for Now*, N.Y.L.J., June 11, 1987, at 5, col. 2; confidential interviews.

106. The argument against the likelihood of a significant exodus of corporations seeking the protection of other states with takeover statutes is persuasive. Management of a Delaware corporation seeking stronger antitakeover protection, assuming no takeover statute was adopted in Delaware, has two options: reincorporate in another state with a second generation takeover statute or adopt antitakeover charter amendments that provide the functional equivalent of the protections of a takeover statute. In either event shareholder approval is necessary and full disclosure of the antitakeover motivation for reincorporation would be legally mandated. What reason is there to think that a corporation that has already demonstrated that it values the legal environment provided by Delaware would choose to give up those environmental advantages to choose the first of two roughly equivalent options? See Letter from Joseph Grundfest, *supra* note 2, at 175.

107. Remarks of A. Gilchrist Sparks, III, chairman, corporate Law Section,

The outsider comments about preemption concerned possible tender offer legislation that might be adopted by Congress, possible tender offer regulation that might be adopted by the Securities and Exchange Commission, and a proposed NASDAQ model rule that might be adopted by the New York Stock Exchange and/or the American Stock Exchange that would delist any corporations that did not provide a one-share-one-vote rule.<sup>108</sup>

The outsider comments about the substance of the proposal concerned the supposed promanagement effect of the draft. The consensus was that: (a) the proposal could be used to put almost any firm into "play," (b) it effectively extended the tender offer period from twenty to fifty days, and (c) it made possible targets of firms that otherwise could not be taken over because an acquiror could take a small position in a company, file his control share acquisition statement and then, during the fifty days, the shares of the firm would become concentrated in the hands of arbitrageurs who would vote for sale of the firm to obtain even a very small premium.<sup>109</sup> Furthermore, by providing for a guaranteed shareholder vote, there was concern that the draft would take away management's other potential defensive tactics.<sup>110</sup>

Sparks told the members that the council had considered redrafting the proposal to respond to the received outsider comments, but that there was insufficient time to do so before the end of the legislative session.<sup>111</sup> He concluded by saying that it appeared that most of Delaware's corporate citizens did not want this proposal.<sup>112</sup> The meeting was then opened for questions from the floor.<sup>113</sup>

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Delaware State Bar Association, at a meeting of the section (June 10, 1987) [hereinafter Sparks Remarks].

108. *Id.* See also Franklin, *supra* note 105, at 5, col. 2.

109. Sparks Remarks, *supra* note 107; Franklin, *supra* note 105, at 5, col. 2; Attorney 1 Interview, *supra* note 73; Interview with a senior partner in a large Wilmington law firm, in Wilmington, Delaware (Aug. 24, 1987) [hereinafter Attorney 4 Interview].

110. Sparks Remarks, *supra* note 107. See Franklin, *supra* note 105, at 5, col. 3.

111. Sparks Remarks, *supra* note 107. Reforms considered included the following: (1) freeze the record date to prevent shares that flowed into the hands of arbitrageurs after the announcement date from affecting the vote, the problem was defining the announcement date effectively; (2) redraft to prevent a single purchaser from repeatedly triggering the shareholders' vote; and (3) place a sunset provision on the opt-in rights. *Id.*

112. *Id.*

113. Time may tell whether the predictions of the Corporate Law Section about the flaws of Indiana type statutes are true. Given that all states that have

Section members had several concerns. First, they worried that managers generally might perceive the proposal as being promanagement (even if it actually was not). What would be the effect of refusing to recommend such a proposal? Sparks replied that he was convinced that a majority of Delaware corporate citizens knew that the statute was in fact not promanagement, but the section must, nevertheless, educate the remaining corporate citizens as to the actual nature of the proposed statute's effects.<sup>114</sup>

Second, at least one section member wondered whether this proposal was merely a continuation of the race for corporate charters and of little merit otherwise. Sparks replied that Delaware is not part of any race for the bottom. Rather, the General Corporation Law of Delaware is the best corporate code for firms, and Delaware is serving the interests of the United States in continuing to provide the optimum corporate environment. He admitted that there was now, and had been before, intense pressure from third parties to "see things from only a business point of view, but there is also great pressure to see things from only an electoral point of view."<sup>115</sup>

Third, a section member asked whether passing this proposal would be the proverbial camel-back-breaking straw that would force Congress to enact national corporate chartering? Sparks replied that any effects of that type were uncertain and indeterminable.<sup>116</sup> Fourth, some asked if Delaware was risking its tax base by not recommending this proposal? Sparks replied that he was of the opinion that this was not a significant risk because the comments from the Business Round Table had been ambivalent, and failing to recommend a statute now would not foreclose recommending a statute in the future.<sup>117</sup>

Finally, some wondered if there was any risk that the section failed to recommend a statute, the General Assembly would enact some takeover legislation of its own? Sparks did not comment on

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enacted similar statutes have done so for the purpose of strengthening the position of target managements, vis-à-vis acquirors, if the flaws are genuine this raises the question of why the drafters of the Delaware General Corporation Law were able to see flaws that were missed by the drafters of the corporation codes of the 14 states that passed control share acquisition statutes. *See supra* note 98.

114. Sparks Remarks, *supra* note 107.

115. *Id.*

116. *Id.*

117. *Id.*

the likelihood of such an act by the General Assembly, but he did say that if the section were to decide not to recommend any takeover legislation, then it should be certain to educate the General Assembly of the reasons justifying that decision.<sup>118</sup>

Secretary of State Harkins attended the meeting and informed the section that in his estimation, based on comments received by his office, four corporations wanted the statute. He also told them that if the section recommended no legislation then none would pass the General Assembly, and that in this "complex matter" he would defer to the judgment of the section.<sup>119</sup>

Chairman Sparks announced that the council would meet after the adjournment of the section meeting and that the council would be advised of the section's concerns.<sup>120</sup> At that subsequent meeting, the council then voted unanimously to not recommend the proposal and the council afterwards informed Secretary of State Harkins that the Corporate Law Section would not be recommending any proposed changes to the existing section 203 during that legislative session.<sup>121</sup>

### *B. Consideration of an Involuntary Redemption Statute*

After the Delaware Bar Association decided not to recommend an Ohio-Indiana type control share acquisition statute to the General Assembly there were no draft proposals before the section 203 committee until two senior partners of the Wilmington branch of the New York law firm Skadden, Arps, Slate, Meagher & Flom, who represented Boeing Corporation, presented an "eminent domain for the involuntary redemption of shares owned by persons with evil designs" proposal to Secretary of State Harkins.<sup>122</sup> The proposal was a response to the aggressive acquisition of Boeing stock by well-known corporate raider T. Boone Pickens, Jr. Typically, such proposals are recommended to the council, not the Secretary of State,

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118. *Id.*

119. Remarks of Michael Harkins, Delaware Secretary of State, at a meeting of the Corporate Law Section of the Delaware State Bar Association (June 10, 1987).

120. Sparks Remarks, *supra* note 107.

121. Letter from A. Gilchrist Sparks, III, Chairman of the Corporate Law Section of the Delaware State Bar Association, to Michael Harkins, Delaware Secretary of State (June 10, 1987) (available at the Secretary of State's office); Pease Interview, *supra* note 76.

122. Attorney 1 Interview, *supra* note 73. See *Strategists Hit Wall on Delaware Takeover Law*, Legal Times, Feb. 15, 1988, at 7, cols. 1-2.

but the partners thought that their client's interests required them to pigeon-hole Harkins before notifying the council.

A senior partner for the Wilmington firm representing Boeing and a senior partner for the Wilmington firm representing Pickens were both members of the section 203 committee. After the acquisition of Boeing stock by Pickens and the proposal on behalf of Boeing, both members were temporarily excused from the section 203 committee to avoid conflicts of interest.<sup>123</sup> Harkins presented the proposal to the council, but the proposal was soon rejected. In August the council began weekly meetings to consider a New York type statute.<sup>124</sup>

The section 203 committee revised the New York statute and presented a draft to the council. The council made additional changes and on November 19, 1987 produced a draft for private circulation and comment.<sup>125</sup> The council received more than 150 comment letters, including letters from three of the five commissioners of the Securities and Exchange Commission, and letters from the Federal Trade Commission, corporate law departments, corporate lawyers, stockholders, and "players" in takeover activity.<sup>126</sup> The majority of the letters criticized the draft proposal.<sup>127</sup>

This initial draft prohibited business combinations with interested shareholders (holders of more than ten percent of that firm's stock) for three years after the acquisition of the interest unless the transaction resulting in the shareholder's becoming interested was approved in advance by the board, or unless the interested shareholder simultaneously obtained at least ninety percent of the firm's shares, or unless subsequent to becoming an interested shareholder such shareholder acquired ninety percent of the stock and the business combination was approved by a majority of the shares (excluding the shares of the interested shareholder and those of any director or

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123. Attorney 1 Interview, *supra* note 73.

124. M. GOLDMAN & E. McNALLY, *supra* note 99, reprinted in C. SMITH & C. FURLOW, *supra* note 2, app. P, at 3, at 241-42; *Strategists Hit Wall*, *supra* note 122, at 7, col. 2; Attorney 1 Interview, *supra* note 73.

125. M. GOLDMAN & E. McNALLY, *supra* note 99, reprinted in C. SMITH & C. FURLOW, *supra* note 2, at 242.

126. Testimony of Sparks, *supra* note 48, reprinted in C. SMITH & C. FURLOW, *supra* note 2, app. Y, at 298; Labaton, *Anti-Takeover Move Advances in Delaware*, N.Y. Times, Jan. 5, 1988, at D4, col. 1. The SEC commissioners were Joseph Grundfest, David Cox, and Charles Ruder, the chairman of the commission.

127. Attorney 1 Interview, *supra* note 73; *Business and the Law: Compromise Near in Delaware*, N.Y. Times, Dec. 21, 1987, at D2, col. 1 [hereinafter *Business and the Law*].

officer of the corporation). The proposal would not apply to companies who, within forty-five days from the day of the statute's passage, opted-out of the statute's protection by resolution of their board, or to companies who opted-out at any time beyond the initial forty-five days by amending their bylaws, though the latter action would not become effective until eighteen months after the bylaw change.<sup>128</sup>

The Corporate Law Section met on December 10, 1987, to reconsider the discussion draft in light of the comments received.<sup>129</sup> After discussion it directed the council and section 203 committee to redraft the proposal.<sup>130</sup> On December 22, 1987, the council voted fourteen to one to support and issue a revised proposed section 203.<sup>131</sup> Its substantive changes included the following: the amount of stock a person must hold in order to be considered an interested shareholder was raised from ten percent to fifteen percent; the amount of stock a bidder must finally control to be allowed to complete a merger was lowered from ninety percent to eighty-five percent; shares held by inside directors and certain employee stock ownership plans would be excluded in calculating the eighty-five percent; the shareholders could approve a business transaction with an interested shareholder by a two-thirds vote (excluding the votes controlled by the bidder and interested board members); companies would now have ninety days from the day of passage, instead of forty-five, to opt out of the statute's protection by resolution of the board; and finally, the company could still opt-out any time beyond the initial ninety days by changing its bylaws but this action would become effective in twelve months instead of eighteen.<sup>132</sup>

On December 23, 1987, this revised bar association proposal was submitted to the General Assembly and circulated among members of the Corporate Law Section and more widely circulated, again, for comments. The council voted nearly unanimously to recommend

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128. Exposure Draft of Section 203 of the Delaware General Corporation Law (Nov. 19, 1987), reprinted in C. SMITH & C. FURLOW, *supra* note 2, at 143-49; *Business and the Law*, *supra* note 127, at D2, col. 3; Attorney 1 Interview, *supra* note 73.

129. C. SMITH & C. FURLOW, *supra* note 2, at 9.

130. *Id.*

131. M. GOLDMAN & E. McNALLY, *supra* note 99, at 2, reprinted in C. SMITH & C. FURLOW, *supra* note 2, at 242.

132. C. SMITH & C. FURLOW, *supra* note 2, at 9; *Business and the Law*, *supra* note 127, at D2, cols. 2-3; Attorney 1 Interview, *supra* note 73.

the draft.<sup>133</sup> Then, on January 4, 1987, members of the Corporate Law Section debated the proposal and voted 101 to twenty-four<sup>134</sup> to recommend it to the Executive Committee of the Delaware Bar Association.<sup>135</sup> On January 5, 1988, the Executive Committee of the Delaware State Bar Association unanimously voted to recommend the proposal to the General Assembly.<sup>136</sup>

As House Bill No. 396, the Bar-Association-drafted-and-approved proposal was sponsored by the Speaker of the House, Representative Charles Hebner, Republican.<sup>137</sup> On January 12, 1988, the first day of the second half of the 134th General Assembly,<sup>138</sup> a competing bill, Senate Bill No. 311, was introduced by Senator Thomas Sharp, the Chairman of the Senate Judiciary Committee.<sup>139</sup> Senate Bill No. 311 was substantially similar to House Bill No. 396 except that the Senate Bill was an opt-in statute, rather than an opt-out statute and it would not be retroactively effective.<sup>140</sup> Senate Bill No. 311 represented the first time in at least twenty years that a bill amending the Delaware General Corporation Law that had not been previously approved by the Delaware State Bar Association was introduced in the General Assembly.<sup>141</sup>

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133. There were two negative votes. Attorney 1 Interview, *supra* note 73.

134. The Corporate Law Section of the Delaware State Bar Association has a membership of approximately 224. Bar Interview, *supra* note 72.

135. C. SMITH & C. FURLOW, *supra* note 2, at 10; M. GOLDMAN & E. McNALLY, *supra* note 99, reprinted in C. SMITH & C. FURLOW, *supra* note 2, app. P, at 242; Labaton, *supra* note 126, at D4, col. 1. Many of the 24 opposed were members of the firm that represented T. Boone Pickens, Jr.; Attorney 1 Interview, *supra* note 73.

136. M. GOLDMAN & E. McNALLY, *supra* note 99; C. SMITH & C. FURLOW, *supra* note 2, at 10; Labaton, *supra* note 126, at D4, col. 1; Attorney 1 Interview, *supra* note 73.

137. Proposed amendments to the Delaware General Corporation Law usually have at least two sponsors: the chairman of the Senate Judiciary Committee, and the Speaker of the House or the chairman of the House Judiciary Committee but, in this case, the chairman of the Senate Judiciary Committee opposed House Bill No. 396. Committee Member Interview, *supra* note 59.

138. C. SMITH & C. FURLOW, *supra* note 2, at 10. Technically, the Bar Association bill was now Substitute Bill Number 1 to House Bill No. 396. The original House Bill No. 396, submitted on December 23, 1987, contained a blank space where the effective date would appear. Substitute Bill Number 1 filled in the blank with a retroactive date, December 23, 1987, the same date that would have applied to House Bill No. 396 if it were to become effective on the day it was introduced in the assembly. *Id.*

139. *Id.* The Senate Judiciary Committee is the senate committee with jurisdiction over the Delaware General Corporation Law. Committee Member Interview, *supra* note 59.

140. C. SMITH & C. FURLOW, *supra* note 2, at 10.

141. Attorney 1 Interview, *supra* note 73; Committee Member Interview, *supra* note 59; Pease interview, *supra* note 76.

On January 20 and 21, the General Assembly conducted joint Senate-House hearings.<sup>142</sup> And for the first time in the history of the Delaware General Corporation Law, significant lobbying of legislators occurred.<sup>143</sup>

The joint session retained a former chancellor of the Delaware Court of Chancery, Grover Brown, to advise it on the matter.<sup>144</sup> After all of the lobbying,<sup>145</sup> House Bill No. 396 was passed in the House thirty-nine yes, two absent, and in the Senate nineteen yes, one no, one abstaining.<sup>146</sup> There were no substantive amendments.<sup>147</sup> Governor Castle signed the bill into law on February 2, 1988,<sup>148</sup>

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142. Attorney 1 Interview, *supra* note 73; Committee Member Interview, *supra* note 59; Pease Interview, *supra* note 76.

143. See *Strategists Hit Wall*, *supra* note 122, at 7; Committee Member Interview, *supra* note 59.

Testifying in favor of the House Bill were: A. Gilchrist Sparks, III, chairman of the General Corporate Law Section of the Delaware State Bar Association; Irving S. Shapiro, former chairman and CEO of E.I. du Pont de Nemours & Co., member of the board of directors of Boeing, and senior partner at the Wilmington office of Skadden, Arps, Slate, Meagher & Flom; Bruce Atwater, chairman and CEO of General Mills, Inc.; Elmer Johnson, executive vice president of General Motors Corporation; Delaware Secretary of State Michael Harkins; Victoria Frankovich, president of Independent Federation of Flight Attendants; Donald Margotta, assistant professor of Finance, Northeastern University; and Ronald E. Queen, president of the Delaware State United Auto Workers CAP Council. Testifying in opposition to the House Bill were T. Boone Pickens, Jr.; Joseph Grundfest, commissioner of the United States Securities and Exchange Commission; James E. Heard, executive director of United Shareholders Association; Robert Monks, Institutional Shareholder Services, Inc. (representing Alliance Capital Management, California Public Employees Retirement System, FMR Corporation, New Jersey Division of Investment, Pension Reserves Investment Management Board, California State Teachers Retirement System, Wells Fargo Bank, College Retirement Equities Fund, California Senate Commission on Corporate Governance, Shareholder Rights, and Securities Transactions); and Greg Jarrell, an economist and senior vice-president of Alcare Corporation. C. SMITH & C. FURLOW, *supra* note 2, at 257-338; *Strategists Hit Wall*, *supra* note 122, at 7; Labaton, *supra* note 126, at D4, col. 1; *Business and the Law*, *supra* note 127, at D2, col. 1.

144. C. SMITH & C. FURLOW, *supra* note 2, at 10.

145. United Shareholders Association estimates the coalition opposed to the Bill spent \$50,000. *Strategists Hit Wall*, *supra* note 122, at 7, col. 2.

146. C. SMITH & C. FURLOW, *supra* note 2, at 10; Telephone interview with Walt Feindt, attorney for the Division of Research, 133d Delaware General Assembly (Aug. 27, 1987) [hereinafter Telephone Interview of Walt Feindt]. The single opposing vote was cast by Senator Thomas Sharp, the sponsor of the competing Senate Bill. *Id.*

147. There was one technical amendment to House Bill No. 396, House Amendment 3, which corrected a typographical mistake. Telephone Interview of Walt Feindt, *supra* note 146.

148. 66 Del. Laws ch. 204, § 1 (1988) (to be codified at DEL. CODE ANN. tit. 8, § 203); C. SMITH & C. FURLOW, *supra* note 2, at 10. Delaware's first generation

with a retroactive effective date of December 23, 1987 designed to accommodate Texaco, Inc. in its struggle with its largest shareholder, Carl Icahn.<sup>149</sup>

*C. Other Examples of the Process Used by the Delaware State Bar Association, Corporate Law Section*

With the exception of the unprecedented lobbying of the General Assembly by outside interest groups, the procedure employed by the Corporate Law Section in considering a business combination moratorium statute and in twice considering a control share acquisition statute is strongly similar to the process it has used for every proposed amendment to the Delaware General Corporation Law considered since 1967.<sup>150</sup> This part of the article very briefly discusses one proposal that generated unprecedented controversy within the bar and one that typifies the remaining amendments.

1. Consideration of a Statute to Limit the Liability  
of Corporate Directors

In response to the decision of *Smith v. Van Gorkom* and the director's and officer's insurance crisis, in 1986 the Council of the Corporate Law Section appointed a committee whose purpose was to draft a statute to limit the liability of directors of Delaware corporations.<sup>151</sup> The committee produced several drafts, some of which were circulated for comments,<sup>152</sup> but unlike every other amendment to the Delaware General Corporation Law that had been recommended and enacted from 1968 to 1986, this proposal generated significant controversy within the Delaware Bar Association.<sup>153</sup> Bruce

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takeover statute, also denominated § 203, was repealed effective July 1, 1987. 66 Del. Laws ch. 204 (1988).

149. Labaton, *A Debate Over the Impact of Delaware Takeover Law*, N.Y. Times, Feb. 1, 1988, at D4, col. 2.

150. Before the 1967 revision, many proposed amendments to the Delaware General Corporation Law came from the New York Bar Association. Attorney 4 Interview, *supra* note 109.

151. 488 A.2d 858 (Del. 1985); Attorney 2 Interview, *supra* note 76. The Delaware Supreme Court overturned the court of chancery and held that the directors of Trans Union Corporation had breached their duty to make an informed decision about a proposed merger, *Van Gorkom*, 488 A.2d at 874-78, and found the directors personally liable for damages resulting from board actions that were found to be grossly negligent. *Id.* at 884.

152. Attorney 4 Interview, *supra* note 109.

153. Attorney 1 Interview, *supra* note 73; Attorney 2 Interview, *supra* note 76; Pease Interview, *supra* note 76; Attorney 3 Interview, *supra* note 78.

Stargatt, of the Wilmington firm of Young, Conaway, Stargatt & Taylor, strongly opposed the proposal. Stargatt, who was not then a member of the Corporate Law Section (though he is now), was dissatisfied with the Delaware Bar Association's recommendation of the indemnification proposal to the General Assembly and with the procedure used by the bar in generating the proposal. For a brief period he considered taking his arguments to the General Assembly, but he never did so. Shortly before the General Assembly's consideration (and overwhelming approval) of the amendment, Stargatt became convinced that the bar was the better place, overall, for resolving controversies concerning the General Corporation Law.<sup>154</sup>

## 2. Consideration of Miscellaneous Amendments to the Delaware General Corporation Law

Senate Bill No. 93 of the 134th General Assembly of the State of Delaware is typical of the great majority of amendments to the Delaware General Corporation Law. Its numerous provisions amended twenty-three sections of the Delaware General Corporation Law.<sup>155</sup>

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154. Confidential Interviews; Attorney 1 Interview, *supra* note 73; Attorney 4 Interview, *supra* note 109.

155. Specifically, they are: amendments to § 102(a)(4), clarifying the General Assembly's intent that a board of directors has the power to specify the number of shares in any series of stock; amendments to § 141, providing that when a majority vote of directors is required, "majority" refers to number of votes rather than the number of directors voting, and providing that directors may in good faith rely on all company records and advice of experts selected with reasonable care acting within their expertise; amendments to § 151(g), providing that the board of directors may amend the terms of a class or series of stock if no shares have yet been issued, that the board of directors may not reduce certain classes of stock, and that the board of directors is generally free to adopt resolutions; amendments to § 172, providing that in decisions regarding dividends and stock redemption, the board may rely in good faith on all company records and on the advice of experts reasonably selected acting within their expertise; repeal of § 203, repealing Delaware's first generation takeover statute; amendments to § 213, concerning record dates; amendments to § 216, defining when a quorum exists at shareholders meetings and providing that a plurality vote is sufficient to elect directors; amendments to § 228, regulating written consents; amendments to § 243, deleting surplus and confusing language concerning retired shares; amendments to §§ 251, 252, 254, and 255, providing that the parties to a merger may not choose the certificate of incorporation of a constituent corporation which is not the surviving corporation as the certificate of incorporation of the surviving corporation, and regulating when the board of directors must submit an agreement of merger to the stockholders; amendments to § 253, regulating approval of short form mergers with parent corporations that are not Delaware corporations; amendments to § 262, defining when a stockholder must be a stockholder to qualify for appraisal rights; amendments

The bill's various provisions were drafted by committees within the Corporate Law Section and debated and revised by the Corporate Law Section and its council; some provisions were circulated for comment. Senate Bill No. 93 was sponsored by the chairmen of the House and Senate judiciary committees, Charles Hebner and Thomas Sharp, among others. It was overwhelmingly passed without debate or amendment.<sup>156</sup>

## V. AGENCY THEORY

This article uses agency theory to suggest answers to the following questions: Why does Delaware dominate the corporate charter market? Is the market for charters in the interests of shareholders generally?

Agency exists when (a) one person, the principal, engages another person, the agent, to perform some service on the principal's behalf; and (b) the principal delegates some decision-making authority to the agent.<sup>157</sup> Assuming both principal and agent are rational maximizers of personal utility, there will be some divergence of interests between the principal and agent. The principal can decrease the amount of divergence through appropriate incentives and by monitoring the agent. The agent, on the other hand, can decrease the amount of divergence by offering certain bonds to the principal. The costs of incentives, monitoring, and bonding are always greater than zero, and in spite of these measures there will always be some remaining divergence, which is called the residual loss.<sup>158</sup>

Thus, total agency costs equal the sum of the costs of incentives, monitoring, bonding, and the residual loss.<sup>159</sup> Those costs are affected

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to § 274, providing a simplified method of dissolution for firms that have not yet issued any stock; amendments to § 275, generally regulating dissolution; amendments to § 276, providing procedures parallel to § 274; amendments to § 278, regulating the continuing legal existence of dissolved corporations; amendments to § 279, providing that the director of a dissolved corporation is the party entitled to petition court of chancery for the appointment of a trustee; amendments to §§ 280 and 281, regulating the "winding up" of a firm; and amendments to § 282, regulating the liability of stockholders to corporate creditors where corporate assets have been distributed. S. 93, 134th Gen. Assembly, 66 Del. Laws ch. 136 (1987).

156. Committee Member Interview, *supra* note 59.

157. Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976), reprinted in R. POSNER & K. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 39 (1980).

158. *Id.*

159. *Id.* at 40.

by (a) the magnitude of the divergence in the preferences of principal and agent; (b) the costs of measuring the agent's performance; (c) the cost of enforcing rules of behavior; (d) the markets for agents, capital and products;<sup>160</sup> (e) the efficiency of the agents; and (f) the number of agents used. The conclusion of this article is that Delaware is able to maintain its foremost position in the market for corporate charters because it is best able to reduce agency costs.

#### VI. DELAWARE AS A MODEL OF EFFICIENCY

The ubiquity of agency relationships and their costs in the market for corporate charters has yet to be considered in the debate about Delaware and state chartering.<sup>161</sup> Properly considered, the market for charters involves large numbers of complex agency relationships. The important agency between managers and shareholders is well recognized, but many other agency relationships exist.

For example, shareholders, as principals with a preference for maximum monetary returns, will hire managers to incorporate in a state whose corporate law most efficiently allows private parties to maximize joint wealth. However, managers must depend on secondary agents to draft that law and enact it. Whenever these secondary agents are used, agency costs are incurred, and the relative efficiency of these secondary agents in drafting and enacting law becomes important.

Delaware, for several reasons, is the secondary agent best able to reduce agency costs. First, Delaware's small General Assembly uses fewer secondary agents—62, as compared to 210 in New York or 187 in Connecticut.<sup>162</sup> Using fewer agents reduces agency costs. Second, as the above examination of the statute's amendment process shows, Delaware uses its General Assembly to enact, but not to draft or redraft or (most times) even to debate corporate amendments. This reduces the number of drafting agents. It also keeps drafting within the control of an expert group whose interests are closely aligned with those of corporate management and shareholders.

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160. *Id.* at 44.

161. One exception is Romano, who recognized the existence of an agency relationship between the corporation and its legal counsel, including both in-house and outside counsel, and between management and state legislators, Romano, *Law as a Product*, *supra* note 1, at 228 n.3, 236, 240-41, 273-74 n.69, 276 n.74.

162. BOOK OF THE STATES, *supra* note 53, at 189.

Additionally, the small, expert, and nondiverse<sup>163</sup> Delaware judiciary reduces agency costs in two ways. First, Delaware has only one trial court with jurisdiction to hear corporate cases, the court of chancery (in which no jury trials occur). Appeals go directly to the Delaware Supreme Court which has only five justices.<sup>164</sup> By comparison, in Connecticut, 131 trial court judges and six supreme court justices<sup>165</sup> may hear corporate cases—with juries used at the trial court level. In New York there are 542 trial court judges and juries, and 69 appellate court judges may hear corporate cases.<sup>166</sup> Thus, Delaware uses significantly fewer agents.<sup>167</sup>

Second, as with the Corporate Law Section, the judges in Delaware are expert in corporate law. They are highly able to understand, interpret and enforce the statute provided them. A senior partner in one of the largest corporate law firms in the United States called them, overall, “the most skilled judges for corporate cases in the United States.”<sup>168</sup> The Assistant Secretary of State/Director of the Division of Corporate Administration and Policy and his division and the corporation service companies are further examples of Delaware’s use of expert agents.

Delaware reduces agency costs in two other ways: the super-majority vote required to change the Delaware General Corporation Law, and the very large, in absolute terms, and even larger, in relative terms, revenue coming into Delaware because of its corporation code.<sup>169</sup> These bonds reduce agency costs by increasing the value the principal will place upon the services of the agent and by decreasing the ability and incentive of the agent to act divergently.

Finally, the relative absence of competing local interest groups also acts to decrease agency costs. As shown above, political parties and candidates do not get involved in Delaware corporate law, and

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163. This refers only to the diversity of their opinions about the goals of an optimum corporate code.

164. WANT’S FEDERAL-STATE COURT DIRECTORY, *supra* note 91, at 88.

165. *Id.* at 83.

166. *Id.* at 110.

167. Delaware’s advantage, a senior partner in a Wilmington firm explained to me, is not that its judges are pro-management, rather it is because Delaware is the only state with no anti-management judges. Attorney 4 Interview, *supra* note 109. Certainly, adding one judge who has an entirely different estimation of the optimum corporate code (e.g., full corporate democracy) can significantly raise agency costs.

168. *Id.* He continued, saying that Delaware’s only rival is the Second Circuit, which has some judges as skilled but also has some less skilled.

169. See *supra* note 10.

very few of the corporations domiciled in Delaware have any employees or major physical assets there. Competing interest groups would be secondary principals to the General Assembly and their interests would require the agent (the General Assembly) to diverge more from the interests of shareholders than the agent otherwise would.<sup>170</sup>

## VII. CONCLUSION

Delaware dominates the charter market because it is the state best able to reduce agency costs. Delaware has a strong incentive to reduce agency costs because the charter market allows corporations to relocate their domicile (and taxes and attorneys' fees) to the most cost efficient agent. Thus, the charter market is in shareholders' interests generally because it allows corporations to reduce their agency costs. Delaware's efficiency advantage is, in large measure, a factor of its small size and its strategy of keeping the number of all the participants in the corporate law industry small—one trial court with corporate jurisdiction, one appellate court with corporate jurisdiction, one group to do all corporate law drafting, one agency in the executive branch to participate in corporate law. Because cost efficiency in the business of providing corporate law is a factor of size, it is easy to conclude that national corporate chartering would impose a substantial welfare loss on corporations and shareholders. The additional loss of incentive to continually update corporate law to preserve market share or to keep with evolving corporate practices would impose an additional welfare loss on shareholders. Likewise, Romano's proposal to require public hearings on all proposed corporate legislation would increase the number of agents, both legislators and members of the public, involved these increasing agency costs.

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170. The variations in agency costs among states may also partially explain the variations in state corporate codes. If we assume that shareholders, as principles, want to maximize private wealth and that shareholders employ states as their agents to accomplish that goal, then the states whose governments disagree most strongly with that goal will have higher agency costs. When those agency costs are greater than the economic benefits predicted to result from attracting additional incorporations, such states will not amend their corporate codes in response to innovations in the corporate codes of other states. Seen in this way, Romano's statistical analysis of the responsiveness of states to innovations in corporate law is also a measure of relative state agency costs to shareholders. Romano, *Law as a Product*, *supra* note 1, at 236-41.

In Delaware, the corporate bar is the driving force behind the Delaware General Corporation Law, and it is in shareholders' interests to have it so because the corporate bar is the group whose interests are most closely aligned with shareholders. Their livelihood depends on providing the optimum corporate environment. Delaware's almost exclusive reliance on the corporate bar to do what state legislatures do in other states is cost efficient. It also poses little risk to the interests of shareholders because competing states would eagerly step in should the Delaware corporate bar begin taking abnormal economic returns for itself.

In terms of shareholder welfare, whether Delaware attorneys design legal rules that maximize returns to themselves instead of to state tax coffers, as Mace and Miller conclude, is unimportant, but the total cost of all direct and indirect charges to shareholders is important. State legislatures are too unsophisticated about corporate law to draft efficient statutes by themselves. They must rely on some agent and incur agency costs. Given that secondary agents must be used, the question is, which agents are most efficient, and what compensation should flow to each agent for her relative contribution? Seen in these terms, Macey and Miller's conclusion that it is legitimate for a state to earn income from the charter market but that any income to the bar is "democracy subverted by federalism and opportunism" is unpersuasive. The task for these secondary agents is to provide an optimum legal environment. Providing this environment entails drafting an optimum corporate code and legitimizing it by state authority. In Delaware the first is done by the Corporate Law Section of the Delaware Bar Association, and the second is done by the State. Both agents are entitled to a fair return for their contributions.