

HOW AND WHY OF INCORPORATION IN DELAWARE

BY S. SAMUEL ARSHT*

CHANCELLOR QUILLEN: The initial topic is *How and Why of Delaware Corporation Law*. Sam Arsht is a well-known Delaware corporate practitioner and probably has been in the public limelight in corporate discussions more than any other practitioner in this state. I spoke to both Sam and Lou Finger this morning on the way in and asked who was going to handle the topic and I told Lou a story. I said, "You know Sam sometimes has a little hesitancy in his speech." I commented on that to another corporate practitioner one day and he said, "Well don't you know that's because when you get him on the telephone, he pauses, you talk and he listens, and by the time the conversation is over he knows everything about your case and you know nothing about his." I suspect that's an art he has mastered very well. Lou Finger said he called him up about the presentation this morning and that's exactly what Sam did. He said, "What are you going to say?" And Lou told him what he thought he ought to say and Sam listened. As I arrived here this morning, I found that Sam is going to talk. It's a great pleasure to introduce Sam Arsht.

MR. ARSHT: Rather than take up the time of this group this morning telling you how to form a Delaware corporation, and what to put in corporate charters and corporate by-laws and what to avoid, I would like to address the question of why Delaware incorporation is so popular. It has to be conceded, and its critics continue to impress upon us the fact, that it is very popular. I attribute this popularity to Delaware's well deserved reputation, which it has worked to develop and to preserve now for about eighty years of having the best corporation law in the world.

The best corporation law, in my view, is one that enables a number of persons, be they few or many, to pool their capital in a venture, in an enterprise, to be conducted in their common interests for their mutual profit with only those restraints, be they procedural or substantive, that most people would regard as proper and reasonable and even desirable, with such additional restraints as the investors themselves choose to impose upon the managers whom they select or designate to manage their pool of capital. But the

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restraints, or rather absence of restraints, is only half of what goes to make up a good corporation law. The reason the Delaware law characterized by what I will call minimal restraints, is nevertheless so popular with investors — and it is the investors that in the final analysis demonstrate that the corporation itself is desirable or not desirable — is the principle that these managers who have been entrusted by the stockholders with the management of their capital are liable to the corporation and to the stockholders for any abuse of the powers that have been entrusted to them. It is this combination which exists in the Delaware law which to a very great degree makes the Delaware law the best corporation law or, to put it differently, the most popular corporation law.

Delaware has had such a law now since 1898, when it was copied word for word from the New Jersey law which had been enacted only a few years earlier. Why, then, is Delaware considered a more desirable place in which to incorporate than New Jersey? This disparity arose from what I call New Jersey's sins of commission and sins of omission. Its sin of commission occurred not too long after New Jersey adopted its law, in the era when President Theodore Roosevelt and Woodrow Wilson, in his successful campaign to become Governor of New Jersey, conducted a campaign, characterized by the phrase "trust busting." New Jersey amended its statute in several important respects designed, or thought to be designed, to discourage bigness, but which in fact only discouraged incorporation in New Jersey.

New Jersey's sin of omission, on the other hand, was, in my view, that its lawyers permitted their corporation law to be neglected in the years following its adoption. That law, which was innovative when it was enacted and responsive to what were the real needs of American business at the time, did not keep pace with the continuing and developing needs of the business community, both of the investors and of those who manage the investors' funds. In contrast, Delaware has always had a Corporation Law Committee of the Delaware Bar Association whose members have been attuned to the needs of the business world, both of management and stockholders. Whenever it seemed that a change would be in the interest of the corporate world, they have put their minds to work to get enacted a provision which would satisfy the need or remedy the wrong. In the course of the life of any statute there will become apparent aspects in which the law can be improved and aspects in which the law is mistaken and that correction is needed. The Delaware statute has been characterized by this constant monitoring by an informed and sympathetic group of persons having real expertise in the subject with which they were dealing. Again, this is

in great contrast to the situations that exist in many other states, indeed in most other states.

The Delaware legislature fortunately has respected the expertise of the Delaware Bar Association in the area of corporation law and has invariably seen fit to enact promptly the recommendations made by the Corporation Law Committee, and to ignore those recommendations which did not have the endorsement of the Committee. That is a unique situation. Compare the example of the American Bar Association Committee on Corporate Laws, which monitors and is responsible for the Model Business Corporation Act.¹ This Committee recently recommended, after some four or five years of study, an amendment to the Model Act which would state the standard of conduct to which directors must adhere. What they finally came up with was a two-sentence provision based on the rule of law announced by the Supreme Court of Delaware a few years earlier in the case of *Graham v. Allis-Chalmers*.² This rule stating the standard of care to which directors must adhere was presented in New York. It got nowhere in the legislature, for unclear reasons, except that it is known that labor groups and consumer groups did not see fit to endorse it. During an entire session of the New York legislature the bill rested in committee. It did get adopted this year because its sponsors, learning from their earlier experience, went to the labor leaders and the consumer group leaders, recommended the bill and asked for their endorsement. The endorsements were obtained and the bill passed. We do not have that sort of condition and system in Delaware, and I think that is a factor which enhances the quality of our corporation law.

No discussion of the reasons for Delaware incorporation would be complete without considering the role of the Delaware courts. The Delaware courts are distinct from the courts in most of the other commercial and populous states because of their volume of cases. The volume of litigation in Delaware is much smaller than it is elsewhere, and as a consequence, our judges, who may think they are overworked, have case loads, even today when they are burdened as they never have been before, which are significantly smaller than the case loads of judges in other states. This difference permits a better quality of justice in Delaware than there is elsewhere. The way in which our judges are selected, as compared to the way in which they are elsewhere also results in a better quality of justice in Delaware. Delaware judges are appointed by the Governor and confirmed by the Senate, but in almost every other state judges must

1. ABA-ALI, MODEL BUS. CORP. ACT ANN. (Supp. 1977).

2. *Graham v. Allis-Chalmers Management Co.*, 41 Del. Ch. 78, 188 A.2d 125 (Ch. 1963).

be nominated by a political party first and then run for election. As a result, notwithstanding there are outstanding judges and scholars adorning the benches elsewhere, the quality of the average judge in Delaware, in my view, is substantially superior to that of the average judge elsewhere. Delaware judges are therefore better to begin with and they have more time to give to the cases they hear. Finally, they simply have a great deal more exposure to corporate law problems than do judges elsewhere, and they develop an expertise in this field of law. While I do not by any means think that all their decisions are right, even those cases which I thought were erroneously decided when they were handed down I have cited many times subsequently in support of my arguments. The Delaware judiciary is recognized by corporate lawyers throughout the country as superior, and the way in which they have interpreted the law over the years has fostered in lawyers all over the country a greater confidence in the quality of the Delaware law than is the case generally in other jurisdictions where the judiciary does not function under similar conditions.

I should have pointed out that when Delaware copied New Jersey's law word for word there was one exception. The tax on incorporation and the annual franchise taxes were only a fraction of those of New Jersey. Again, unlike almost every other state, Delaware today has virtually the same incorporation and franchise taxes it had in 1898 when the first law was enacted. Our taxes are not quite the same now as they were in 1898, of course. Generally speaking, the franchise tax, which is the principal one, is 10% more than it was in 1898, and the minimum tax of \$10 fixed in 1898 is now \$20.³ The vast majority of Delaware corporations fall into that minimum tax group, so their franchise taxes today are \$20, whereas back in 1898 and up until a few years ago, they were only \$10. This stability reflects a reluctance on the part of the state legislature to tap that corporate source of income as the needs of the state increase or simply as the value of money changes, and this stability enhances Delaware's desirability as a place in which to be incorporated.

Contrary to the opinion of Ralph Nader and some academic commentators, a bias toward management is not one of the reasons for incorporating in Delaware. There is a bias in Delaware toward a corporation law that recognizes the interests of both stockholders and management, and we are constantly on the alert to strike a proper balance between them. Those who seek a place in which to incorporate where management can freely take advantage of stockholders should look elsewhere than Delaware.

3. DEL. CODE ANN. tit. 8, §503 (1974).