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DELAWARE'S DECISION

VIEWING FEE SHIFTING BYLAWS THROUGH A PUBLIC CHOICE LENS

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In a recent WSJ column,[*] Lisa Rickard did a great job analyzing the decision Delaware's legislature will soon face with respect to fee shifting bylaws:

> Specifically, the controversy hinges on whether a company can adopt bylaws allowing it to claw back some of its legal costs if plaintiffs lawyers bring an abusive shareholder lawsuit and lose in court. . . .
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> The debate over fee shifting was ignited in May, after ATP Tour Inc., the Delaware-incorporated company that oversees men's professional tennis, tried to enforce a fee-shifting provision in its bylaws after it won a lawsuit brought by members challenging changes to the tour schedule and format. The Delaware Supreme Court ultimately determined that ATP was within its rights to adopt the provision under state law.
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> Weeks after the court's ruling, the Delaware legislature, cheered on and supported by the powerful state plaintiffs bar, attempted to pass a law "fixing" the Delaware Supreme Court's decision. Far from a fix, the bill would have outlawed a company's ability to use the fee-shifting tool to protect itself against frivolous litigation.
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> Loud protests from national, state and local business groups, as well as individual companies caused the legislature to rethink its approach.

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[*] www.wsj.com/articles/lisa-rickard-delaware-flirts-with-encouraging-shareholder-lawsuits-1416005328?tesla=y&mg=reno64-wsj.

> But the legislature hit only the pause button, asking the Delaware Bar's leadership to "study" the matter this fall before recommending to the legislature a revised provision to be considered early next year.

In an earlier post, I made the case that the Delaware legislature ought to authorize and validate fee shifting bylaws. But will it?

In this post, I view the problem through a public choice lens. As I see it, there are two questions: (1) What's in the state of Delaware's best interest? (2) What's in the best interest of the key interest group that would be affected by fee shifting bylaws? As we'll see, I think those questions have different answers. Predicting what Delaware will decide is thus quite difficult.

THE LEGISLATURE'S INCENTIVES TO PRESERVING DELAWARE'S DOMINANCE

Back in the nineteenth century state corporation laws gradually moved in the direction of increased liberality, making the incorporation process simpler on the one hand, while at the same time abandoning any effort to regulate the substantive conduct of corporations through the chartering process. In later years, this process became known as the "race to the bottom."[1] Corporate and social reformers believed that the states competed in granting corporate charters. After all, the more charters (certificates of incorporation) the state grants, the more franchise and other taxes it collects. According to this view, because it is corporate managers who decide on the state of incorporation, states compete by adopting statutes allowing corporate managers to exploit shareholders.

Many legal scholars reject the race to the bottom hypothesis.[2] According to a standard account, investors will not purchase, or at least not pay as

[1] See generally William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974) (classic statement of race to the bottom hypothesis); see also Lucian Ayre Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1437 (1992).

[2] See Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977) (the seminal response to Cary); see also William J. Carney, The Political Economy of Competition for Corporate Charters, 26 J. Legal Stud. 303 (1997); Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540, 654-71 (1984); Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law, 76 Nw. U. L. Rev. 913 (1982); Roberta Romano, The State Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709 (1987); cf. Jonathan R. Macey and Geoffrey P. Miller, Toward an Interest Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469 (1987) (public choice-based theory of state competition).

much for, securities of firms incorporated in states that cater too excessively to management. Lenders will not make loans to such firms without compensation for the risks posed by management's lack of accountability. As a result, those firms' cost of capital will rise, while their earnings will fall. Among other things, such firms thereby become more vulnerable to a hostile takeover and subsequent management purges. Corporate managers therefore have strong incentives to incorporate the business in a state offering rules preferred by investors. Competition for corporate charters thus should deter states from adopting excessively pro-management statutes. The empirical research appears to bear out this view of state competition, suggesting that efficient solutions to corporate law problems win out over time.[3]

Whether state competition is a race to the bottom or the top,[4] there is no question that Delaware is the runaway winner in this competition. More than half of the corporations listed for trading on the New York Stock Exchange and nearly 60% of the Fortune 500 corporations are in-

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[3] See Roberta Romano, The Genius of American Corporate Law (1993) (setting forth both an empirical analysis and theoretical arguments challenging race to the bottom hypothesis). As even many advocates of the race to the top hypothesis concede, however, state regulation of corporate takeovers appears to be an exception to the rule that efficient solutions tend to win out. See, e.g., Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 Fordham L. Rev. 843 (1993); Ralph K. Winter, The "Race for the Top" Revisited: A Comment on Eisenberg, 89 Colum. L. Rev. 1526 (1989); see also Lucian Ayre Bebchuk and Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, 99 Colum. L. Rev. 1168 (1999) (contending that the race to the bottom in takeover regulation may be a general phenomenon).

[4] The empirical data, however, imply a much less vigorous competition than either story claims. At most, it seems that states compete with Delaware to retain local incorporations. With few exceptions (perhaps Pennsylvania and Nevada), states generally are not competing with Delaware for out-of-state incorporations.

The empirical data only comes as a surprise, however, to those bemused by the popular caricature of the debate. Race to the top theorists like Ralph Winter or Roberta Romano never claimed that a Los Angeles-based lawyer sits down and thumbs through all 50 state statutes before deciding where to incorporate a client.

We all know that lawyers play a big role in the decision of where to incorporate. Lawyers are subject to the same bounded rationality constraints everybody else is, as well as the familiar incentives of agency cost economics. Under such conditions, lawyers naturally will adopt a decision-making heuristic; and, home state versus Delaware is far and away the most sensible heuristic.

So the market for corporate charters is better described as a leisurely walk than a race. But so what? Even though Delaware doesn't face as much competition as the caricature of the debate claims, there is still competition: When a firm is incorporated, the lawyer and client often decide between Delaware and the home state. And, of course, many firms periodically consider whether to change their domicile to Delaware via reincorporation.

corporated in Delaware. Proponents of the race to the bottom hypothesis argue that Delaware is dominant because its corporate law is more pro-management than that of other states. Those who reject the race to the bottom theory ascribe Delaware's dominance to a number of other factors: There is a considerable body of case law interpreting the Delaware corporate statute (DGCL), which allows legal questions to be answered with confidence. Delaware has a separate court, the Court of Chancery, devoted largely to corporate law cases. The Chancellors have great expertise in corporate law matters, making their court a highly sophisticated forum for resolving disputes. They also tend to render decisions quite quickly, facilitating transactions that are often time sensitive.[5]

Whether one thinks Delaware's dominance is because the state is winning the race to the top or the race to the bottom, there is no doubt that Delaware benefits significantly from its dominance. Delaware does get an astonishing percentage of state revenues from incorporation fees and franchise taxes. In some years, Delaware's annual revenues from these sources constitute up to 30% of the state's budget – an estimated equivalent of $3,000 for each household of four in the state. Given the importance of franchise taxes and other corporate fees to Delaware's budget it would be surprising if such competition did not suffice to keep Delaware on its toes. If Delaware isn't racing, it is at least fast walking.

The question thus becomes: How would banning fee shifting bylaws affect Delaware's competitive position. In my view, Delaware's competitive position would be adversely affected by doing so.

As I observed in an earlier post,[*] quoting Kevin LaCroix:

> . . . while the Delaware legislative initiative is on hold, at least one legislature has gone forward to provide for the awarding of fees against unsuccessful derivative lawsuit claimants. . . .
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> . . . the "loser pays' model that the Oklahoma legislation adopts is extraordinary – It represents a significant departure from what is general known as the American Rule, under which each party typically bears its own cost. And unlike the fee-shifting bylaws being debated in Delaware –which would in any

[5] See generally Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. Cin. L. Rev. 1061 (2000).

[*] www.professorbainbridge.com/professorbainbridgecom/2014/10/oklahoma-leads-on-fee-shifting-bylaws-will-delaware-and-mbca-follow.html.

> event require each company to decide whether it was going to adopt the bylaw (and might therefore be subject to shareholder scrutiny) – the Oklahoma legislation applies to any derivative action in the state, even if the company involved is not an Oklahoma corporation.
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> If more states follow Oklahoma's lead, Delaware's need to remain at the forefront of corporate law may be enough to overcome the self-interested lobbying by lawyers (both defense and plaintiff) who hate loser pays.

John Coffee has similarly observed* that a ban by "Delaware might fuel an interjurisdictional competition, as other, more conservative states (think, Texas) might seek to lure companies to reincorporate there to exploit their tolerance for such provisions."

The effect of banning fee shifting bylaws on Delaware's dominance might only be marginal, but Delaware has kept its position at the top of the corporate law heap by responding to even marginal threats.

So what's in Delaware's best interest? If you're a Delaware taxpayer, the answer is clear: Endorse and validate fee shifting bylaws.

THE INTEREST GROUP THAT MATTERS

My late friend Larry Ribstein once observed that:

> Professors Jonathan Macey and Geoffrey Miller argue that lawyers may be the group that most influences Delaware corporate law. Delaware lawyers have all of the attributes of a politically powerful interest group: they are already organized into bar associations and maintain an advantage over other groups because they continually learn about the law as a consequence of their profession; they are centered in a single city (Wilmington), in a small state and, therefore, can communicate with each other at minimal costs; and they provide an important service for legislators in drafting legislation on complex commercial and corporate matters.
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> Delaware lawyers, in essence, are the Delaware legislature, at least insofar as corporate law is concerned. Delaware has one of the three smallest legislatures in the country. Its legislative committees are virtually inactive. Most striking, however, is that few of Delaware's legislators are lawyers. Such legislators are likely to rely on lawyers to

* clsbluesky.law.columbia.edu/2014/10/14/fee-shifting-and-the-sec-does-it-still-believe-in-private-enforcement/.

> supply sophisticated commercial and business legislation. As a result, virtually all of Delaware corporate law is proposed by the Delaware bar, and the bar's proposals invariably pass through the legislature.[6]

The Macey and Miller article to which Ribstein refers exhaustively reviews the various interest groups that might influence the production of Delaware law and conclude that "the bar is the most important interest group within this equilibrium. Thus, the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state."[7] They further explain that:

> The Delaware bar is interested in maximizing one specific portion of the indirect costs of Delaware incorporation – fees to Delaware lawyers paid for work on behalf of Delaware corporations. These legal fees are functionally related to the number of charters in Delaware in the sense that the expected legal revenues will increase as the number of corporations chartered in the state increases. Accordingly, the bar would tend to favor low franchise fees, because keeping the fees low will tend to increase the number of Delaware corporations. But the bar could also benefit from legal rules that increase the amount of expected legal fees per corporation, even if such rules, by imposing additional costs on Delaware corporations, reduced the absolute number of firms chartered in the state. If the legal fees gained exceed the fees lost by deterring Delaware incorporation, the bar would prefer to adopt rules that did not serve the interests of the other interest groups within the state. In this respect, the bar's interests are opposed to the interests of all other groups.[8]

How then would fee shifting bylaws affect the income of Delaware lawyers? It seems fair to assume that there will be a net reduction in shareholder litigation as a result of fee shifting bylaws becoming widespread. As Kevin LaCroix observed,[*] quoting the Delaware Supreme Court's ATP Tour decision:

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[6] Larry E. Ribstein, Delaware, Lawyers, and Contractual Choice of Law, 19 Del. J. Corp. L. 999, 1009-10 (1994).

[7] Jonathan R. Macey, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469, 472 (1987).

[8] Id. at 503-04.

[*] www.dandodiary.com/2014/07/articles/corporate-governance/though-delaware-legislature-has-tabled-action-upcoming-judicial-review-of-fee-shifting-bylaws-seems-likely/.

> Fee shifting provisions "by their nature, deter litigation."

This would adversely affect not just plaintiff lawyers, but also defense lawyers. After all, fewer lawsuits mean less work for defense litigators too:

> The bar . . . does benefit from increasing the amount of litigation and accordingly would tend to favor litigation-increasing rules . . . . Delaware could stimulate litigation [by making] litigation cheaper by reducing the costs to the parties, especially plaintiffs who make the initial choice of forum.[9]

Both sides of the litigation bar thus have a strong interest in banning fee shifting bylaws. Such bylaws would raise plaintiff costs, deterring lawsuits, reducing fees for all litigators.

Widespread adoption of fee shifting bylaws could also adversely affect transactional lawyers. Litigation risk is a major driver in the level of advisory work. As Jonathan Macey observed, for example, Delaware case law has given corporate directors "significant incentives to cloak their decisions in a dense shroud of process and to take other steps that will generate high fees for lawyers, investment bankers, and other advisors (who, incidentally, are precisely the same people who advise companies to incorporate in Delaware in the first place)."[10] Fee shifting bylaws would reduce those incentives and thus decrease the demand for advisory work by lawyers.

All corporate lawyers – litigators and transactional – have a strong incentive to oppose fee shifting bylaws. Hence, it was no surprise that the Delaware legislature – dominated in this area by the Delaware bar – leaped to ban such bylaws. The business groups that favor fee shifting bylaws were able to delay that action. But the final decision remains pending.

Update: You should check out Brett McDonnell's comment below. Also consider the point being made by Usha Rodrigues[*]:

> Certainly litigators want litigation. But deal lawyers don't want it – at least, not this particular kind of litigation. Indeterminacy over doctrinal areas like good faith is good for transactional types as well as litigators, because it gives them more nuances and risks to have to explain at length to boards as they advise on various types of action. The type of

[9] Id. at 504.

[10] Jonathan Macey, Delaware: Home of the World's Most Expensive Raincoat, 33 Hofstra L. Rev. 1131, 1137 (2005).

[*] www.theconglomerate.org/2014/11/bainbridge-on-fee-shifting-bylaws.html.

fee-shifting bylaw we're discussing, in contrast, is bad for deal lawyers – at least, if you think, as Steve does, that

> There is a serious litigation crisis in American corporate law. As Lisa Rickard recently noted, "where shareholder litigation is reaching epidemic levels. Nowhere is this truer than in mergers and acquisitions. According to research* conducted by the U.S. Chamber Institute for Legal Reform, lawsuits were filed in more than 90% of all corporate mergers and acquisitions valued at $100 million since 2010." There simply is no possibility that fraud or breaches of fiduciary duty are present in 90% of M&A deals. Instead, we are faced with a world in which runaway frivolous litigation is having a major deleterious effect on U.S. capital markets.

If these suits amount to nothing more than a litigation tax on deals, then they discourage deals. And that's bad for deal lawyers.

CONCLUSION

The debate over fee shifting bylaws will come to a head in the Delaware legislature early in 2015. It is shaping up to be a fascinating test of whether the Delaware bar's grip on Delaware corporate law will be strong enough to overcome the incentives Delaware legislators have to remain the most attractive state of incorporation. Because endorsing fee shifting bylaws is the right answer from a policy perspective, those of us who do not have a dog in that specific fight can only hope that the latter position prevails. To end with a classic cliché, however, only time will tell.

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* www.instituteforlegalreform.com/uploads/sites/1/M_and_A.pdf.