THE "RACE FOR THE TOP" REVISITED: A COMMENT ON EISENBERG

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I do not intend to offer a critique of any portion of Professor Eisenberg's paper other than the portion that is itself a critique of my article¹ regarding Delaware's role in the development of American corporate law.

His statement of my position is occasionally overdrawn but largely accurate.² I do indeed argue that if Delaware fashions laws that allow side payments out of corporate assets to management to induce it to incorporate in Delaware, then the earnings per dollar of investment in Delaware corporations will be lower than earnings per dollar of investment in corporations governed by laws that do not permit such side payments. This will in turn put Delaware corporations at a competitive disadvantage in the capital market, and ultimately the product market, vis-à-vis corporations whose earnings per dollar of investment are higher. Professor Eisenberg is also quite correct in stating that my "claim is driven purely by the argument concerning the cost of capital."³ Whether it is therefore also "fatally defective" for the reasons asserted by him⁴ in his discussion of the market for capital is another matter.

Professor Eisenberg advances five arguments in support of his conclusion that the capital market does not discipline management. I will deal with these arguments seriatim.

His first argument is that legal rules allowing side payments do not create present inefficiencies but only future inefficiencies. Because legal rules do not affect present cash flow, he argues, an impact on a corporation's ability to raise capital in the future may be of "little or no significance to present managers."⁵ This I believe to be incorrect. Even if the side payments will have an effect only in the future, investment analysts will know (if true) that the earnings of Delaware corpora-

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1. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977).

2. A minor point. The Eisenberg Article states that my argument claims that all states will be induced to offer optimal charters. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461, 1507 (1989). I believe I limited my argument to states that seek to maximize franchise taxes.

3. Eisenberg, *supra* note 2, at 1509.

4. *Id.*

5. *Id.* at 1500.

tions are lower in the long run than the earnings of businesses incorporated elsewhere, and this recognition would have a present effect on investors. That effect will necessarily be of significance to managers. My argument thus does not critically depend upon whether the decrease in earnings happens immediately upon incorporation in Delaware or two years later.

Eisenberg's second argument is that the option of internal financing tends to release corporations from the discipline of the capital market.⁶ That also seems incorrect. The cost of internal financing is the opportunity cost or the highest return available from investment outside the firm. If a corporation can earn 15 percent on an outside investment, then the cost of investing internally is also 15 percent. Efficient corporations that can borrow at 9 percent and invest retained earnings at 15 percent are thus far better off than less efficient firms that must borrow at 16 percent. Conversely, efficient firms that can earn 20 percent on internal financing are better off than less efficient firms that can earn less on internal financing than on outside investment. Internal financing thus does not release management from the discipline of the capital market.

The third argument Professor Eisenberg makes is that the capital market will not discipline management if state law rules have "no effect on profits or cash flow."⁷ If by that he means that legal rules that do not affect earnings or the return on investment will not affect investor behavior, then of course I agree. My point is only that when a legal rule does reduce a firm's earnings, this will negatively affect the firm's ability to raise debt and equity capital.

His fourth argument relies upon the following hypothetical:

[S]uppose that because C Corporation has adopted a poison pill, C's stock sells for \$49 instead of \$50. C wants to raise \$500,000 in the capital market for equity. The poison pill will not raise C's out-of-pocket cost of capital: C simply issues 10,204 shares instead of the 10,000 shares it would have issued without the rule.⁸

This hypothetical appears to be based on the assumption that share price is independent of the number of shares issued. That assumption is plainly unsound. If it were correct, C Corporation would issue 39 trillion shares at \$49 instead of the 10,204 Eisenberg postulates. If sound, moreover, competing corporations without a poison pill could also issue 10,204 (or 39 trillion) shares at \$50 a share and still raise more than C.

Professor Eisenberg's final argument, sprinkled throughout his discussion, is that the effect of what he calls managerial rules may be so

6. *Id.* at 1501.

7. *Id.*

8. *Id.* at 1503 (citation omitted).

small as to be economically irrelevant.⁹ If value decreasing rules resulting from incorporation in a state like Delaware have only a *de minimis* effect, it is hard to see why anyone would care or even describe them as value decreasing.

My bottom line remains that, if Professor Cary¹⁰ is right, earnings per dollar of investment in Delaware corporations must be less than earnings per dollar of investment in corporations that do not permit such side payments. Indeed, the entire point of Professor Cary's article was that investors do worse under Delaware law than under other corporate codes. If he did not mean that, it is difficult to perceive why the article became so famous. It therefore follows that, unless the market for capital is indifferent to a firm's earnings, Delaware corporations will be at a disadvantage in raising capital. This is a consequence that is hardly likely to maximize Delaware's franchise tax revenues.¹¹

I want to leave Professor Eisenberg's paper now and to propose some qualifications to my original position. I am far more confident that Professor Cary's argument about the race to the bottom is wrong than I am that my argument that Delaware is leading the race to the top is right.

First, Professor Eisenberg is entirely correct in pointing out that state legislatures are political bodies and may be governed by a variety of motives.¹² A race to the top argument applies only when a state legislature is guided solely by a desire to maximize franchise taxes. Other motives may well prevail, however.

Second, he is correct in asserting that there are cases in which management may seek legal rules allowing side payments where those payments outweigh the negative effects of the capital market.¹³ These cases seem limited to changes in legal rules, including charter amendments or reincorporation in a new state, that occur after investors have become locked in and that involve, or are accompanied by, measures that impede takeovers. States that offer such impediments to takeovers may thus attract some chartering business. Of course, as I stated in my

9. *Id.* at 1502-05, 1508.

10. See Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 *Yale L.J.* 663, 668-70 (1974).

11. In a revision after the conference, Professor Eisenberg responded to this paragraph with two observations. The first was that all states' corporate codes have reached the "bottom." See Eisenberg, *supra* note 2, 1508. This is something of a fantastic claim in light of the fact that maximizing franchise taxes is not politically important in many states. Moreover, it is hard to understand how any equity capital can be raised if every state legal system is rigged against it.

The second observation, that the side payments to management obtainable under a legal code may outweigh negative effects in the capital market, is to a limited degree well-taken, and I have added a comment of my own in the text. See *infra* text accompanying note 13.

12. See Eisenberg, *supra* note 2, at 1511.

13. See *supra* note 11 and accompanying text.

article,¹⁴ the purpose of impediments to takeovers is precisely to reduce the discipline of the capital market and that may well seem attractive to inefficient managers.

Third, the race to the top may be slow because Delaware is the only state devoted exclusively to maximizing franchise taxes and may need only to offer a code marginally more efficient than other states which may be influenced by law professors, the American Law Institute or management. It thus may not be difficult for Delaware to compete with such states for franchise taxes. In fact, the history of state antitakeover statutes may support the view that the race to the top is a leisurely walk. In both the first and second generation of takeover statutes, Delaware waited until its principal competitors had passed such legislation¹⁵ and then enacted a relatively mild statute.¹⁶ It may thus be that what we need is not a federal chartering statute but rather a second Delaware that pursues franchise taxes and nothing else.

14. Winter, *supra* note 1, at 287-89.

15. See, e.g., N.Y. Bus. Corp. Law § 912 (McKinney 1986).

16. See Del. Code Ann. tit. 8, § 203 (1983 & Supp. 1989).