Supply-Side Inefficiencies in Corporate Charter Competition: Lessons From Patent, Yachting and Bluebooks, 43 Kansas Law Review 541 1995

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A Dedication to Judge Logan

Judge James K. Logan has taught me a great deal about how to lead a well-integrated professional life. My mind's ear can hear Judge Logan's voice admonishing me to clear my desk of correspondence and other chores before tackling the day's task of writing. I also hear Judge Logan telling me to develop an expertise in one of the private law areas so that my inclination for government intervention will not be marginalized for failure to consider the private reaction of the regulated.

Judge Logan takes tremendous interest in the lives of his clerks. He showed us by example that there need not be a sharp dichotomy between the professional and personal spheres. It was fitting that Judge Logan married Jennifer Brown and me just two years ago in my parents' house in Kansas City.

My clerkship also helped begin my academic career. Op-eds that I unsuccessfully submitted to newspapers during my clerkship were later published in my first book, and perverse Oklahoma precedent that Judge Logan struggled to distinguish in one of his diversity cases provoked me to write my first consumer-protection piece.

But most important, Judge Logan's example has taught me how to live a responsible professional life. Judge Guido Calabresi (whose own career has tracked Judge Logan's: moving from a deanship to the Court of Appeals) has stressed the cumulative importance of small deeds. Hannah Arendt has detailed the "banality of evil," but Judge Calabresi has praised the "banality of good." Judge Logan has excelled in the banal details of professional life. To be sure he has participated in many larger moments of heroism. In my year of clerking alone, Judge Logan crafted opinions striking down both the per se exclusion of deaf jurors from criminal cases and the per se exclusion of student corporal punishment claims under 42 U.S.C. S 1983.

But to assess Judge Logan's professional righteousness merely by looking at these heroic moments would miss a much larger picture. I most admire Judge Logan's conscientious and empathetic struggle to decide case after case, year after year. Each of his clerks has seen at least one year of his consistent attentiveness to the duties of office. This cumulative record of faithful service richly deserves to be honored. This Article is dedicated to him.

I. Introduction

The ongoing debate about whether Delaware's dominance in the market for corporate charters is a race-to-the-top or a race-to-the-bottom often turns on whether one believes corporate managers are driven to incorporate (or reincorporate) in the state that provides the most efficient law: William Cary and his followers have argued that managers abuse their discretion to incorporate in states that benefit managerial interests at the expense of shareholder interests; Ralph Winter and his followers have argued that because managers' discretion is constrained by promoters or by the threat of a potential takeover, managers will tend to incorporate in states that provide laws which maximize the value of corporate equity. Thus, in the end, much of the debate about corporate competitive federalism turns out to be a question about agency costs and whether these agency costs are constrained by various forms of market discipline.

This Article explores different types of inefficiencies that may be generated even if the managers faithfully try to maximize shareholders' interests. Thus, the Article examines inefficiencies that might persist even if firms were wholly owned by managers, so that there were no separation of ownership from control. Extending Roberta Romano's image that corporate statutory law is a "product" supplied by the franchising state and purchased (as an input) by the firm, this Article focuses on supply-side inefficiencies, while the race-to-the-bottom theorists of Cary's ilk focus on the demand-side failure of self-serving managers to seek the corporate franchises in states which maximize firm value.

As Romano observes, both traditional race-to-the-top and race-to-the-bottom theorists share a belief that racing states try to supply the legal product demanded in the marketplace. And Romano was the first to provide some evidence that speed of responsiveness was associated with success in attracting corporate charters. The widely held belief that the states respond quickly to changing demand is part of a general belief in competitive federalism as a laboratory for democracy. But this Article suggests that state competition may not efficiently respond to changes in demand--even if we make the extreme assumption that managers demand value-maximizing corporate law.

This Article tells three different stories about why states might not supply value-maximizing statutes. Besides focusing on supply-side market failure, each of these stories is evolutionary in character in that it focuses on the possible failure of competitive federalism to respond to changing demands over time. It should also be stressed that my goal is to merely explore the theoretical possibility of supply-side ineffi-ciency; while I relate two of my stories to the development of antitakover legislation in the United States, I do not (for now) wish to assess the extent to which these stories can be used to explain the actual evolution of corporate governance.

Although this Article focuses on the possibility of market failure in the supply of corporate charters, none of the stories amounts to a "race to the bottom"--especially if that term takes on its original sense of systematically selling out shareholder interests to further the interests of management. Instead, the inefficiencies uncovered here suggest that within the broad incentives that states have to supply the most desired product there can be impediments along the way that forestall first-best efficiency (or in Winter's original parlance a "race to the top"). These models thus complement William Bratton's theory of corporate law's race "to nowhere in particular."

For convenience, I refer to these stories as patent, yachting and bluebook models. The "patent" model suggests that individual states may have insufficient incentives to innovate because statutory innovations are not accorded intellectual-property protection. The "yachting" model suggests that a dominant state such as Delaware may have strategic incentives to mimic (or, in yachting terms, "cover") the inefficient statutory innovations of other states. Finally, the "bluebook" model suggests that a dominant state such as Delaware may have an incentive to promulgate innocuous updates of its corporate statutes both to create additional litigation for its attorneys and to increase the difficulty of replication by competitor states.

This Article's focus on supply-side market failure is inspired in part by the seminal work of Jonathan Macey and Geoffrey Miller. While previous analysis of competitive federalism stressed states' desire to maximize charter revenues, Macey and Miller argue that states might decide to indirectly extract some of the rents (for supplying desirable corporate law) to benefit private interest groups within the state--chiefly local bar members. This interest-group distortion represents one type of supply-side inefficiency that would obtain even without any demand- side agency costs. This Article explores three other types.

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