North Dakota Law Review

Volume 84
Number 4 *Corporate Governance and Shareholder Rights in a Time of Financial Crisis: How the North Dakota Publicly Traded Corporations Act Changes the Landscape*

Article 3

1-1-2008

Why the North Dakota Publicly Traded Corporations Act Will Fail

Stephen M. Bainbridge

WHY THE NORTH DAKOTA PUBLICLY TRADED CORPORATIONS ACT WILL FAIL

STEPHEN M. BAINBRIDGE*

Most commentators believe that states compete in granting corporate charters. After all, the more charters (certificates of incorporation) the state grants, the more franchise and other taxes it collects. This competition can take a number of forms. The state can offer such inducements as attractive tax treatment, a dedicated business law court, and statutes whose terms are attractive to the relevant decision maker.

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 sixty percent of the Fortune 500 corporations are incorporated in Delaware.[1]

Those who believe that state competition results in a "race to the bottom" believe that Delaware's corporate statute is skewed to favor the interests of corporate managers rather than those of investors. As the story goes, because it is corporate managers who decide on the state of incorporation, Delaware caters to management, allowing them to exploit shareholders.[2]

An alternative view claims that state competition leads to a race to the top.[3] According to this account, investors will not purchase, or at least not pay as much for, securities of firms incorporated in states that cater excessively to management. Likewise, lenders will not lend 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

---

*William D. Warren Professor of Law, UCLA School of Law. I thank William Chandler and William Klein for their thoughtful comments. All remaining errors are my fault.

1. STEPHEN M. BAINBRIDGE, CORPORATION LAW AND ECONOMICS 16 (2002).

2. *See generally* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663, 663 (1974) (providing a classic statement of the "race to the bottom" hypothesis).

3. *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254-58 (1977) (offering the seminal response to Cary). There is a third view, which is that most states do not compete for chartering revenues, leaving the field to Delaware. *See, e.g.*, Mark J. Roe, *Does Delaware Compete?* (Dec. 12, 2008), *available at* http://ssrn.com/abstract=1315342.

business in a state offering rules preferred by investors and, as a result, competition for corporate charters should lead to statutes that maximize shareholder wealth.

Although the empirical evidence is highly contested, there are good reasons to believe that the race is to the top rather than the bottom. Roberta Romano's event study of corporations' changing their domicile by reincorporating in Delaware, for example, found that such firms experienced statistically significant positive cumulative abnormal returns.[4] In other words, reincorporating in Delaware increased shareholder wealth. This finding strongly supports the race to the top hypothesis. If shareholders thought that Delaware was winning a race to the bottom, shareholders should dump the stock of firms that reincorporate in Delaware, driving down the stock price of such firms. As Romano found, and all of the other major event studies confirm, there is a positive stock price effect upon reincorporation in Delaware.[5]

The event study findings are buttressed by a well-known study by Robert Daines in which he compared the Tobin's Q of Delaware and non-Delaware corporations.[6] Daines found that Delaware corporations in the period 1981-1996 had a higher Tobin's Q than those of non-Delaware corporations, suggesting that Delaware law increases shareholder wealth.[7] Although subsequent research suggests that this effect may not hold for all periods, Daines' study remains an important confirmation of the event study data.

Additional support for the event study findings is provided by takeover regulation. Compared to most states, which have adopted multiple antitakeover statutes of ever-increasing ferocity, Delaware's single takeover statute is relatively friendly to hostile bidders. An empirical study of state corporation codes by John Coates confirms that the Delaware statute is the least restrictive and imposes the least delay on a hostile bidder.[8] Given the clear evidence that hostile takeovers increase shareholder wealth,[9] this finding is

---

4. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, *passim* (1985).

5. *See generally* ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 64-73 (2002) (discussing the relevant studies and criticisms thereof).

6. Tobin's Q is the ratio of a firm's market value to its book value and is a widely accepted measure of firm value.

7. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 525 (2001).

8. John C. Coates IV, *An Index of the Contestability of Corporate Control: Studying Variation in Takeover Vulnerability* (June 1999) (working paper, on file with the author).

9. BAINBRIDGE, *supra* note 1, at 612-14.

especially striking. Delaware thus turns out to be quite takeover-friendly and, by implication, shareholder-friendly.

In 2007, North Dakota threw down the gauntlet to Delaware by adopting the Publicly Traded Corporations Act, which "is designed to strengthen corporate democracy and improve the performance of publicly traded corporations."[10] It is specifically designed to give shareholders greater rights and to reflect "the best thinking of institutional investors and governance experts."[11] The idea, presumably, is that North Dakota will attract incorporations away from Delaware by being more shareholder-friendly than Delaware.

I am confident in predicting that the North Dakota experiment will fail. First, the Act does nothing to address Delaware's other advantages. 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 sensitive.[12] At least in the near term, North Dakota cannot replicate these advantages.

Second, turning to the statutes, North Dakota inevitably loses whether state competition is a race to the top or to the bottom. If state competition is a race to the bottom, which Delaware wins by catering to management interests at the expense of shareholders, the managers who control the incorporation decision will continue to choose Delaware. Incorporation in North Dakota would limit managers' ability to extract private rents, so they have no incentive to do so.

If state competition is a race to the top, the position I believe both theory and the empirical evidence supports, North Dakota will still lose. Corporate law in almost all states places sharp limits on shareholder

---

10. NORTH DAKOTA CORPORATE GOVERNANCE COUNCIL, EXPLANATION OF THE NORTH DAKOTA PUBLICLY TRADED CORPORATIONS ACT 1 (2007), http://ndcgc.org/Reference/Explain405.pdf. The Act also offers a franchise tax rate fifty percent of that imposed on public corporations by Delaware. *Id.*

11. North Dakota Corporate Governance Council Homepage, http://ndcgc.org/ (last visited Mar. 27, 2009).

12. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1077 (2000).

involvement in corporate decision-making.[13] Taken together, these myriad rules form a regime I have called "director primacy."[14]

The director primacy account of corporate governance begins with the observation that the size and complexity of the public corporation ensures that stakeholders face significant collective action problems in making decisions, suffer from intractable information asymmetries, and have differing interests.[15] Under such conditions, consensus-based decision-making structures are likely to fail. Instead, it is cheaper and more convenient to assign the decision-making function to a central decision maker wielding the power to rewrite intra-corporate contracts by fiat.

The analysis to this point, of course, suggests only that the decision-making structure should be one based on authority rather than participatory democracy. Yet, it turns out that corporate law also was wise to assign ultimate decision-making authority to a group—i.e., the board of directors—rather than a single individual. Groups have significant advantages vis-à-vis individuals at exercising critical evaluative judgment, which is precisely the skill set principally needed at the top of the corporate hierarchy. In addition, groups solve the problem of "who watches the watchers" by placing a self-monitoring body at the apex of the corporate hierarchy. The chief economic virtue of the public corporation thus is that it provides a hierarchical decision-making structure well suited to the problem of operating a large business enterprise with numerous employees, managers, shareholders, creditors, and other inputs. In turn, it is the separation of ownership and control that makes this structure viable.

While it is true that "Delaware has not explicitly embraced director primacy, the relevant statutory provisions and the [case law] have largely intimated that directors retain authority and need not passively allow either exogenous events or shareholder action to determine corporate decision-making."[16] In contrast, North Dakota's statute displaces this efficient and long-established system of director primacy in favor of shareholder primacy. Yet, if the race to the top account is to be believed, shareholders prefer director primacy to shareholder primacy.

---

13. *See* BAINBRIDGE, *supra* note 1, at 512-14 (discussing "a host of other rules that indirectly prevent shareholders from exercising significant influence over corporate decision-making").

14. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy: The Means and Ends of Corporate Governance*, 97 NW. U. L. REV. 547, *passim* 547 (2003) (setting out director primacy model).

15. STEPHEN M. BAINBRIDGE, THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE 23-104 (2008).

16. Harry G. Hutchison, *Director Primacy and Corporate Governance: Shareholder Voting Rights Captured by the Accountability/Authority Paradigm*, 36 LOY. U. CHI. L.J. 1111, 1194 (2005).

Pointing out that the "mechanism by which stocks are valued ensures that the price reflects the terms of governance and operation,"[17] Frank Easterbrook and Daniel Fischel posit a logical negative inference to be drawn from the race to the top account:

> Although agency costs are high, many managerial teams are scrupulously dedicated to investors' interests. . . . By increasing the value of the firm, they would do themselves a favor (most managers' compensation is linked to the stock market, and they own stock too). Nonexistence of securities said to be beneficial to investors is telling.[18]

By the same token, if investors valued the rights North Dakota confers upon them, we would expect to observe entrepreneurs taking a company public to offer such rights either through appropriate provisions in the firm's organic documents—which has always been possible in Delaware—or by lobbying the Delaware Legislature to provide such rights off the rack in the corporation code. Because we observe neither, we may conclude investors do not value these rights.[19]

In sum, if investors valued the provisions of the North Dakota Act, Delaware would have gotten there first. When the North Dakota shareholder primacy statute fails in the market for corporate charters, we will have one more piece of evidence that investors prefer director primacy.

---

17. FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 18 (1991).

18. *Id.* at 205.

19. Note that my argument differs from The Economist's observation that, if the North Dakota statute is successful, "Delaware is highly likely to respond with reforms of its own. Experience suggests that Delaware understands very well the cost of losing its edge in this lucrative business." *Anywhere but Delaware*, THE ECON., April 17, 2007, *available at* http://www.economist.com/business/displaystory.cfm?story_id=E1_JDNRQNG. My point is that, if the provisions of the North Dakota statute were preferred by investors, Delaware would have already adopted them. If I am wrong and The Economist is right, moreover, the North Dakota statute will still fail to prevail in the market for corporate charters.