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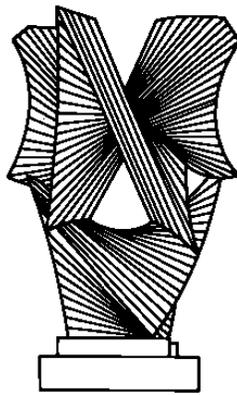
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Compensation*

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The Impotence of Delaware's Taxes: A Short Response to Professor Barzuza's *Delaware's Compensation*

Forthcoming, *In Brief, The Online Magazine of the Virginia Law Review*

M. Todd Henderson[◊]

Perhaps the most hackneyed and intractable debate in all of business law is the one about whether Delaware has incentives to provide an optimal corporate law, whatever that is. The world seems divided into the race-to-the-topers and the race-to-the-bottomers, with increasing amounts of scholarship piling up on both sides, none of which seems to be convincing the other side or moving policy forward in a meaningful way. When asked to respond to the latest salvo in this battle, my initial reaction was, "Oh no! Not another paper on states racing." But after reading Professor Michal Barzuza's thought-provoking article – *Delaware's Compensation* – I'm convinced that there are still interesting things to be said about the optimality of the state-as-competitor-for-charters model of modern American corporate governance. I don't find Professor Barzuza's proposal for making the franchise tax proportional to firm value convincing or necessarily desirable, but, because of the natural check provided by state competition, it is unlikely to do much harm.

In her words, Professor Barzuza's thesis is as follows:

If Delaware's [franchise] tax were more sensitive to firm value, or if Delaware increased its tax to reflect changes in the quality of its law, the state would have better incentives to invest in quality, even in the absence of competition, because Delaware would be rewarded for such changes with higher tax collections.¹

The idea is that the current system – basically a flat fee of \$165,000 for large firms – does not provide legislators with sufficient incentives to overcome the ability of managers to lobby for management-friendly legislation. Professor Barzuza claims that managers dominate the process of incorporation (both at the IPO and reincorporation stages), and that legislators rationally favor them over shareholders, in part because the benefits from favoring managers are real and sizable, while increasing shareholder value doesn't do much to attract or keep firms, and doesn't increase the state's take of \$165,000 per firm.

Professor Barzuza's paper makes an important point – taxes are not only a form of regulation, but also can be an incentive to efficient regulation.² To see

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¹ Michal Barzuza, *Delaware's Compensation*, 94 VA. L. REV. 521, 549 (2008).

² Alternatively, one might think that taxes are a substitute for regulation, since in most cases regulation decreases firm profitability and taxes are effectively a proxy for government ownership of a firm. In the case of corporate law, Professor Barzuza claims that regulations and

this, compare two worlds in which there is a single legislator who writes the rules for firm governance. In the first, much like modern-day Delaware, the legislator receives a flat fee from each firm to spend on public goods; and in the second, much like Professor Barzuza's imagined Delaware, the legislator receives a large percentage of firm profits (say 50%) that the legislator can dole out to constituents. All things else being equal, it is obvious that the legislator in the second world has a stronger incentive to increase firm value, as the benefits flow directly to the legislator.

It is difficult to object to this claim at a theoretical level, since it may improve incentives for legislators on the margin and if the legislators set the rate too high or enact changes that actually destroy shareholder value, companies will simply move to Maryland or lobby Delaware to change back. My guess is, however, that the impact of such a dramatic³ change in tax law is likely to be trivial (and potentially harmful for Delaware) for two reasons.

I.

First, Professor Barzuza's proposal omits any analysis of the legislative process that a proportional tax is designed to influence. There are two parts to this, roughly corresponding to the supply and demand of legislation. Legislators supply legislation, but Professor Barzuza offers no account of legislator motives to explain why the increase in state revenues that would come from a proportional tax would benefit the marginal Delaware legislator. On the other side of the coin, managers are part of the demand for corporate law legislation, but they too are missing from Professor Barzuza's calculus. Let's consider each of these in turn.

A.

Professor Barzuza notes that "Delaware" will be rewarded with higher taxes and this will encourage it to enact optimal (or more optimal) legislation. The problem is that Delaware doesn't act but through its legislators, and these legislators are missing in Professor Barzuza's account. Without a coherent claim about how legislators respond to the various incentives created by the parties in the legislative process, the argument she makes is less persuasive. The point here is simply that once we move from the single-legislator example above to a multi-member body, the calculus of weighing the benefits from a change in corporate governance is more complex. For example, do legislators only care about the size of the public fisc? Perhaps for some legislators sitting on key committees, the ability to pass out goodies to constituents may help them get reelected, but for others the opposite may be true. Legislators face constituencies with heterogeneous preferences, not all of which will view increased state revenues as

taxes are compliments, not substitutes, because certain governance regulations do not lower but rather increase firm value.

³ Professor Barzuza admits the new tax policy would be a radical change, when she claims that the federal government might be needed to force the change on an unwilling Delaware.

positive. Assuming that the utility function of the marginal legislator rises with increased tax revenues seems, at the best, overly simplistic. Isn't it just as likely that legislators in multi-member bodies might care about maximizing other things, for example, their likelihood of being reelected or their personal influence or prestige? And, if this is true, what about passing shareholder-wealth-maximizing legislation increases these?

Legislators who couldn't take credit for increased state revenues or wouldn't want to would not be influenced by a proportional tax. One might argue that for the latter group that the state could use the increased cash from the taxes raised from firms to reduce taxes on other entities, like individuals. But this account needs a theory of why increased taxes on firms relative to individuals is more efficient. Optimizing the mix of tax funding sources is a difficult calculation, considering the relative ability of firms and individuals to evade taxes (say, through structuring, compliance, or leaving the jurisdiction entirely), the impact on incentives to produce (that is, the choice between work and consuming leisure), the impact on other tax burdens, such as federal taxes and sales taxes, and so on. Substituting corporate taxes for individual taxes might seem desirable, but it could lead to unintended consequences or dry up the tax base in ways that might be difficult to replace because of the political stickiness of tax rates for individuals or corporations.

Another problem on the supply side is the uncertainty about incentives for legislators to prefer tax revenues over the number of firms incorporated in Delaware. There may in fact be an inverse correlation between the number of charters and the maximization of revenue, and the marginal legislator might sensibly prefer to have more companies chartered in Delaware than to maximize the treasury (or minimize other tax burdens). Maximizing the number of firms may mean more work for lawyers, judges, and other service providers in Delaware, and thus increase campaign contributions to and the prestige of legislators responsible for the attracting firms there. The public choice calculations about what legislators maximize is far from clear and not obviously pointed in the direction of "better" firm governance, even in a world of increased monetary incentives for the state as a whole.

B.

Professor Barzuzá's account also leaves out managers from the legislation process, and thus overestimates the potential impact the increased revenues will have on overall legislative incentives. Professor Barzuzá notes that managers are powerful players in the current legislative process (in fact, strong enough to distort it in perverse ways), but then underestimates the role they will have in objecting to any legislation designed to increase shareholder value but that will destroy manager value. This is especially odd, since the argument for the tax change is premised on how powerful managers are. Why would this power to influence legislators wane under a new tax regime? Presumably the answer is because the legislators now have a larger incentive (because of the increased tax revenues) to resist the managers. But one has to compare the relative impact of

the new tax revenues and the power of managers in the new world, and it isn't at all clear that the new incentives will be anywhere near high powered enough to make a difference. If managers are powerful enough to resist improvements in the law that would increase shareholder value as significant as Professor Barzuza believes are possible, taxes are unlikely to do anything to change this. To see this, consider a simple example.

Let's say the Delaware legislature is considering a bill that would require firms to destagger their boards. Professor Barzuza cites evidence suggesting that this would increase shareholder value by \$40 billion. We must consider the gains to legislators from both passage and defeat of particular legislation. If the bill is passed, Delaware's treasury will receive \$40 billion times some tax rate, T . Legislators who vote for the bill will benefit derivatively from this, receiving some benefit, B , for increasing state revenues. B is, by definition, less than \$40 billion times T , since the gains are divided up among many legislators, there exists some question about which legislators get "credit" for bills, and because the money is flowing to the state (and the people) instead of directly to the legislators themselves.

Managers will try to influence legislators too, by delivering benefits, call them B^* , to individual legislators. We can measure the upper bound of this influence by estimating the value managers would have from maintaining the status quo. Professor Barzuza claims that firms, acting through managers, do not have incentives to destagger their own boards, because managers prefer the private benefits of control, which would be diminished if the board were destaggered. To put a dollar amount on these private benefits, one need only estimate the dollar gains managers would share with shareholders if the board were destaggered. Assuming managers own, on average, 5% of firm shares, the managers would gain about \$2 billion from the change (\$40 billion x 5%), and thus the private benefits of control must exceed that amount. This means managers would be willing to pay over \$2 billion to avoid the legal change; this is the upper limit of B^* .

To determine whether legislators will have incentives to pass shareholder-friendly legislation, we simply compare B^* to B . B^* is likely to be much greater than B for an individual legislator, if for no reason other than that B^* is a direct benefit, while B is an indirect one in most cases. In fact, the directness of the benefit for legislators may be one reason why managers are able to currently exert a disproportionate influence on legislators compared with diffuse (and generally disinterested) shareholders.

This approach also allows us to estimate the tax rate necessary for B to exceed B^* . As noted above, the managers would be willing to "pay" \$2 billion to legislators to avoid this law to preserve their private benefits of control.⁴ In the

⁴ Managers would likely pay, say through campaign contributions, lobbying, charitable donations, or other means, to defeat the bill. Campaign finance laws are obviously relevant here, but managers can use a variety of mechanisms to deliver B^* to legislators, including ones clearly outside of the reach of even the toughest election laws.

extreme, this means that the tax rate, T , would have to exceed 5% for legislators to favor the bill. This is a ridiculously large increase in the tax rate, and one that would not be politically feasible.

II.

Second, even assuming that these issues are solved, there remains the question about how realistic it is for legislators to make judgments about what does and does not increase shareholder value. At some level, this is what legislators are supposed to do, but Delaware's corporate code is remarkably devoid of the governance gimmicks and the legislators have no experience in this policy making area. The conceit of the current code is to leave it up to the parties to contract from a bare base to those changes that will improve value. Although the supposition that parties will actually bargain or have incentives to strike efficient deals may be questioned, it is not at all clear that legislative incentives are the problem. After all, how are legislators to measure the merit of various academic studies suggesting governance improvements? The literature is rife with claims that doing X, Y, or Z will improve shareholder value, but also counterclaims on the merits or on theoretical grounds. Empirical scholarship is increasingly impenetrable by non-specialists, and, in the event of hearings on the merits of X, Y, or Z, we can be confident there will be as many adamant pros as cons, and even more estimates on the potential impact on firm value.

In addition, there is no way for legislative judgments about the impact of X, Y, or Z to be evaluated ex post, since numerous other variables, like general economic conditions, competition in the industry, and other regulations, may impact firm profitability. This means that there will be no (or a very noisy) feedback on the efficacy of governance changes and the merits of the proportional tax scheme. This will make legislation in subsequent periods claiming benefits to be less certain, and it may also undermine the political support for the tax or for particular governance changes, since causation will be so uncertain.

These problems simply raise the question of why legislators should prefer making these judgments instead of firm owners and managers. It is unlikely that the sum of decision costs and error costs is less for legislators/courts than for managers/shareholders. Legislators simply have no experience doing this kind of analysis given the history of corporate law legislation in Delaware. Moving to a new paradigm of making governance choices will need to overcome this deficiency in skills and information, as well as just the inertia of the current system. This means that the incentives, especially at the beginning of the new regime, will have to be much higher than would be necessary in equilibrium. As a result, the political resistance to getting this plan started may be greater than what one would think if just evaluating the steady-state case, thus making new regime less likely than it would otherwise be if Delaware legislators routinely made these kinds of calculations.

Unlike legislators, firm stakeholders are betting their own money, careers, and reputations, and are likely to know the idiosyncratic circumstances of their

firms. Firm-specific changes in governance are more likely to be narrowly tailored to firm and/or industry circumstances, are more likely to be capable of ex post analysis and reconciliation, and are more responsive to market forces that will weed out good from bad governance choices. In addition, the firm may be the only sensible locus of judging governance. Studies showing that certain governance changes (e.g., smaller boards or separating the chair and CEO roles) will increase firm value may be biased by omitting unobservable variables at a firm level,⁵ and therefore may be yielding false results or ones that are not generalizable across all firms.

In light of these problems, delegating this job to legislators seems sensible only if the other mechanisms for enacting governance changes that will increase firm value (while not doing other harms) are irretrievably broken. Instead of giving the power to legislators, who know less than managers, shareholders, and creditors, why not advocate repealing the Williams Act, changing the rules about how firms repay costs in proxy battles, or any number of other reforms that would keep the burden on firm stakeholders to make these decisions.

III.

Professor Barzuza's insight makes an important contribution to how we think about the interplay between taxes and regulation, and what we view as the most appropriate ways to optimize corporate default rules. The changes she envisions are unlikely to overcome the managerial power she presupposes, however, and, in any event, are a clear second best to a world of few mandatory rules and lots of freedom of contract about governance. Focusing on improving mechanisms of private ordering seems like a more sensible way of improving corporate governance than getting caught in legislative battles over governance.

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⁵ See, for example, Benjamin E. Hermalin & Michael S. Weisbach, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature," (June 15, 2000), available at SSRN: <http://ssrn.com/abstract=233111> or DOI: 10.2139/ssrn.233111 (arguing that governance is endogenous and studies claiming causal links between performance and governance are plagued by unobserved variables).

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