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ARTICLES

DELAWARE'S COMPENSATION

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THIS Article illuminates the interdependence between the structure of Delaware's franchise tax and Delaware's corporate law. It makes three major arguments. First, different franchise tax structures would create different regulatory incentives for Delaware. Second, the current structure of Delaware's franchise tax law is suboptimal. A franchise tax that is sensitive to firm performance would be superior to Delaware's current franchise tax. It would align Delaware's incentives with those of shareholders and induce Delaware to offer corporate law that maximizes shareholder value. It will have this effect even if Delaware faces no competition from other states over incorporations and even if shareholders are passive. Third, Delaware may not have sufficient incentives to reform its franchise tax law. The Article derives policy implications.

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INTRODUCTION

Is the structure of Delaware's franchise tax law—the way it charges firms for incorporation-related services—optimally designed to provide Delaware with incentives to maximize corporate value? While the vast scholarship on Delaware's behavior has overlooked this question, this Article will answer it in the negative. It will argue that Delaware's franchise tax structure should be sensitive to firm performance, aligning Delaware's interests with those of shareholders and thereby providing the state with continuous incentives to improve its corporate law.

Much has been written on the merits of our system of state corporate law, a regime that allows corporations to choose their state of incorporation and the corporate law that governs them. While some suggest that this system creates competition which drives states to offer corporate law that is by and large efficient,[1] others

[1] See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 5–6, 213–14 (1991); Roberta Romano, The Advantage of Competitive

argue that it creates a race to the bottom by incentivizing states to cater to managers' interests at the expense of shareholders.[2] Recently, scholars have expressed doubt that states actually compete for incorporations with Delaware, whose law currently governs the majority of publicly-traded firms.[3]

However, three decades of intensive debate have overlooked one important issue: the way the *structure* of Delaware's incorporation tax influences its regulatory incentives in developing corporate law.[4] This oversight is especially surprising given that the incorporation tax is widely considered both an important, if not the most important, source of incentives for Delaware in shaping its corporate law, as well as a major advantage of our system of state-made corporate law.

Indeed, Delaware's revenue from providing incorporation services, collected primarily through an annual franchise tax imposed on firms incorporated in the state, comprises approximately twenty

Federalism for Securities Regulations 63–64 (2002); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2361 (1998) [hereinafter Romano, Empowering Investors]; Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225, 246 (1985) [hereinafter Romano, Law as a Product]; Roberta Romano, The Need for Competition in International Securities Regulation, 2 Theoretical Inquiries L. 387, 493–507 (2001) [hereinafter Romano, The Need for Competition].

[2] See, e.g., Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1435, 1440–41 (1992); William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L.J. 663, 668–70 (1974); see also Michal Barzuza, Price Considerations in the Market for Corporate Law, 26 Cardozo L. Rev. 127, 168 (2004) (arguing that Delaware's best strategy is to race to the middle, namely, to produce law that suffers from some bias in favor of managers but that is not as biased as the law in other states).

[3] See, e.g., Lucian Arye Bebchuk & Assaf Hamdani, Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters, 112 Yale L.J. 553 (2002); Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679 (2002); see also Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588 (2003) (arguing that Delaware's competition comes primarily from the federal government rather than from other states).

[4] One paper discussed the structure of Delaware's tax. Professors Marcel Kahan and Ehud Kamar have shown that Delaware's franchise tax creates price discrimination among public and nonpublic firms and among large and small firms. Marcel Kahan & Ehud Kamar, Price Discrimination in the Market for Corporate Law, 86 Cornell L. Rev. 1205, 1218–32 (2001). Their paper did not focus, however, on how the structure of Delaware tax law influences its regulatory incentives.

percent of its annual tax revenue[5] and translates annually to $3,000 per family of four.[6] The risk of losing this income arguably induces Delaware to provide law that firms desire.[7]

Given that the franchise tax is such a significant source of revenue, not only its size but also its structure should influence Delaware's incentives. In other words, if the tax matters, then its structure matters, too. This Article will illuminate the interdependence of Delaware's franchise tax structure and its regulatory incentives. Part I will show that, while the literature has widely assumed that the franchise tax influences Delaware's behavior, no one has paid attention to the tax structure.

The second point that this Article will make is that Delaware's franchise tax structure is suboptimal. Part II will discuss Delaware's franchise tax structure and analyze how it affects Delaware's corporate law. It will first note that the tax, being significantly higher than the incorporation tax in any other state, prevents Delaware from racing toward the bottom. As I have argued elsewhere, in order to charge the relatively high tax that it charges, Delaware must consider shareholders' interests.[8]

Yet, this Part will also argue that, while the tax constrains Delaware from racing to the bottom, it does not motivate Delaware to race all the way to the top, as it is not sensitive to firm performance. Currently, Delaware's franchise tax is not based on firm income or market value but rather functions much like a lump-sum

[5] Romano, Empowering Investors, supra note 1, at 2429 tbl.1 (using 1996 census data).

[6] Bebchuk & Hamdani, supra note 3, at 583 (using 2001 data).

[7] See, e.g., Romano, Law as a Product, supra note 1, at 238–42 (finding that states' responsiveness to corporate needs is correlated with the ratio of incorporation tax revenue to total tax revenue and arguing that Delaware's reliance on this revenue creates a credible commitment by Delaware to remain responsive to corporate needs). Federal officials, however, do not have the same financial incentives to invest in producing efficient corporate law. Bebchuk, supra note 2, at 1500–07 (acknowledging that federal law officials may have less information and incentives to improve corporate law but arguing against state competition because of states' bias in favor of managers); Romano, The Need for Competition, supra note 1, at 528 ("Not only would [the federal government have] reduced incentives to respond due to the absence of competition, but [it] also would [have] little financial incentive to respond, as the revenues from the incorporation business . . . would be an insignificant percentage of the federal budget.").

[8] Otherwise, Delaware could not attract firms in their IPO stage and reincorporations from other states which require shareholder approval. See infra Section II.A.

tax.[9] To begin with, nearly half of Delaware's revenue comes from firms who pay the maximum tax rate.[10] For the rest of the firms, Delaware's franchise tax is based primarily on the number of authorized shares, a number that is typically set when the firm is established and, as firms seldom increase their number of authorized shares, has little to do with firm performance.[11]

As a result, Delaware's franchise tax revenue is overly dependent on the number of incorporated firms in the state, rather than on the aggregate value of incorporated firms. To understand the nature and magnitude of this problem, assume hypothetically that Delaware could adopt corporate law amendments that would enhance shareholder protection and would increase firm value by two percent, but might also antagonize managers and cause one percent of Delaware's firms to leave the state. Even though such amendments could produce efficiency gains in the magnitude of $180 billion,[12] Delaware lacks incentives to adopt them.

Because its tax is not tied to firm performance, even those corporate law amendments that could increase firm value significantly would not increase the amount of tax per firm that Delaware would generate. As such, aggregate tax revenue would not increase in proportion to the increased firm value. In fact, if such amendments resulted in firms reincorporating outside the state, Delaware would lose revenue. Continuing the example above, a one percent reduction in franchise tax revenue would cost Delaware around $5 million annually.[13]

[9] For a detailed description of Delaware's franchise tax, see infra Section II.B.

[10] Kahan & Kamar, supra note 4, at 1251 tbl.3 (using data from fiscal year 1999, in which the maximum tax was $150,000). The maximum tax was increased to $165,000, effective January 1, 2003. 74 Del. Laws 69 (2003).

[11] For a third small group of firms, the tax is based on, among other things, their assets. Yet, if the tax increases as a result of an increase in assets, Delaware law allows firms to switch to the authorized shares method. For a detailed description of Delaware's franchise tax, see infra Section II.B.

[12] Using Compustat share counts as of August 23, 2006, Delaware had 4,203 companies, with aggregate market capitalization of $9.324 trillion, two percent of which is equal to approximately $190 billion. Standard & Poor's, Compustat Database, http://www.compustat.com (providing fundamental and market data) (last visited Aug. 23, 2006).

[13] See Barzuza, supra note 2, at 181 tbl.1 (showing that annual revenues from incorporation fees between 2000–2002 topped $500 million).

To be sure, even if such amendments would not result in higher tax collections per firm, Delaware would still have incentives to adopt them if they resulted in more firms incorporating in the state, rather than fewer as the illustration assumes. Yet, this is not likely to happen. To start with, reincorporation requires managers' initiation, and managers are unlikely to be lured by rules that benefit shareholders at managers' expense. In fact, as the example suggests, some dissatisfied managers may attempt to exit Delaware. While shareholder approval, which is required for reincorporation, may restrain managers from leaving Delaware under such circumstances, not all shareholders have sufficient incentives to become informed and act; thus, in some firms, shareholders may approve hasty managerial proposals to exit Delaware.[14]

Moreover, even if shareholder approval is an effective constraint in all firms, adopting a more proshareholder law is not likely to help Delaware attract incorporations. Firms that do not incorporate in Delaware typically incorporate in their home state,[15] and they make this choice based on reasons other than the extent to which the corporate law protects shareholders.[16] Indeed, evidence on antitakeover law suggests that offering protection to shareholders either hurts or does not influence states' abilities to attract and retain corporations.[17]

[14] See, e.g., Bebchuk, supra note 2, at 1470–75.

[15] See Lucian Arye Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J.L. & Econ. 383, 386 (2003); Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. Rev. 1559, 1562 (2002).

[16] See Bebchuk & Cohen, supra note 15, at 397–400 (finding indications that firms' tendency to incorporate in their home state is influenced by use of local law firms and the potential for local favoritism); Daines, supra note 15, at 1599–1600 (finding evidence that lawyers influence incorporation decisions); cf. Marcel Kahan, The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?, 22 J.L. Econ. & Org. 340, 340 (2006) (finding that firms' decisions are influenced by the flexibility of the law and by the quality of the judicial system). However, the flexibility of the law and the quality of the judicial system do not necessarily benefit shareholders. Id. at 363–64.

[17] See Bebchuk & Cohen, supra note 15, at 383 (finding that states that provide stronger antitakeover protection to managers lose less firms to Delaware than states that provide weaker management protection); Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. Pa. L. Rev. 1795 (2002) (finding the same as Bebchuk and Cohen, except for several extreme antitakeover statutes); Daines, supra note 15, at 1600–04 (finding no significant effect of antitakeover law on firms' incorporation choices at the IPO stage and suggesting that firms choose to remain in their

Since improving Delaware corporate law will neither increase the tax that the state receives from each firm nor increase the number of firms it attracts, Delaware lacks incentives to maximize shareholder value. This result, which does not rely on any significant assumptions about the market for corporate law, should concern scholars from all sides of the debate, as the problem exists whether one believes that the corporate law market creates a race to the bottom, a race to the top, or no race at all.

The magnitude of the problem can be quite significant. For instance, staggered boards are associated with an economically meaningful reduction in firm value.[18] More generally, a recent study shows that certain corporate governance terms (such as defensive tactics for delaying hostile bids and liability protection for directors and officers) correlate with a significant difference in firm Q.[19] Nevertheless, with its current tax, Delaware does not seem to have incentives to improve its law. Indeed, Delaware antitakeover law, while being better than other states' laws, still stops short of being optimal.

Corporate law would improve, however, if Delaware's franchise tax were sensitive to firm performance via a proportional tax.[20] Part III will propose that Delaware add a proportional component to its current incorporation tax and will analyze the resultant effects on Delaware corporate law. Though offering an exact structure for Delaware franchise tax is beyond the scope of this Article, this Part will discuss some desirable features and relevant considerations to determine that structure. First, it will argue that adopting a propor-

home state because of other factors, such as advice of local law firms or potential political influence); Kahan, supra note 16 (finding no significant correlation between states' antitakeover law and firms choice where to incorporate).

[18] See Lucian A. Bebchuk & Alma Cohen, The Costs of Entrenched Boards, 78 J. Fin. Econ. 409 (2005).

[19] The authors found that by 1999 a one point change in their index was associated with an 11.4 percentage-point difference in Tobin's Q. See Paul Gompers et al., Corporate Governance and Equity Prices, 118 Q. J. Econ. 107, 128 (2003). Tobin's Q, by and large, is the ratio of a firm's market value to the value of its assets. Yet, these studies do not necessarily show causal connection between the corporate governance terms and firm value. See, e.g., Sanjai Bhagat et al., The Promise and Peril of Corporate Governance Indices 5 (European Corporate Governance Inst., Working Paper No. 89, 2007), available at http://www.ssrn.com/abstract=1019921.

[20] The term "proportional tax" denotes a tax that has a component that correlates with firm performance. For a more detailed discussion of this tax, see infra Part III.

tional tax would not require overhauling Delaware's franchise tax structure. Merely adding a tax component based on changes to corporate value or income on top of the current tax would improve the current system by rewarding Delaware for increasing shareholder value. Second, Part III will discuss some measurements on which the tax could be based, such as Tobin's Q or corporate income. Lastly, it will explain why such a component will not result in a tax that is too high or in Delaware attempting to attract high-value firms instead of producing law that increases firm value.

A proportional tax would better align the state's incentives with those of shareholders, since Delaware's income would be positively correlated with share value. Unlike in the earlier hypothetical example, if Delaware changed its law to produce an increase in firm value of approximately two percent, franchise tax revenue would also rise. Importantly, even if Delaware realized only 0.5% of this increase in firm value, it would gain almost $1 billion annually,[21] more than Delaware's current annual franchise tax receipts.[22] Thus, a proportional tax would dissipate the pressure Delaware judges currently face to avoid harming the state budget with proshareholder decisions. Moreover, a proportional tax would provide Delaware with ongoing incentives to promote shareholders' interests, even if shareholders are not informed or active and even if Delaware does not face competition from other states.

Part IV will discuss Delaware's and other states' incentives to adopt a proportional tax. It will argue that even though a proportional tax is likely to create significant efficiency gains, Delaware may not have sufficient incentives to adopt it. First, this Part will argue that risk aversion and lack of information make Delaware reluctant to reform its franchise tax law. Thus, scholars from all sides of the debate should not presume that the current tax is efficient. In addition, this Part will show that the current tax, even though suboptimal, serves Delaware's interests by creating a commitment that the state will cater to managers' needs on an ongoing basis, inducing managers to incorporate in Delaware. Furthermore, this Part will demonstrate that states face a collective action prob-

[21] One half of one percent of $180 billion equals $900 million.

[22] See Barzuza, supra note 2, at 181 tbl. 1 (reporting Delaware's annual franchise tax revenues for 1997–2002).

lem in establishing incorporation tax laws. If states acted collectively, they would likely adopt a proportional incorporation tax, resulting in improved corporate law and more revenue to share. However, each state, acting alone, has incentives to adopt a more rigid tax in order to attract managers from other states. Part V will address possible objections to the idea that a proportional tax would result in better corporate law.

Part VI will discuss normative implications. Since Delaware lacks incentives to adopt a proportional tax, federal intervention may be necessary to improve Delaware's franchise tax structure. So far, corporate law reform proposals have focused on direct federal intervention in corporate law, such as the recent Sarbanes-Oxley Act. However, federal intervention in corporate law has significant disadvantages, for the most part stemming from the fact that federal officials do not have the same information and financial incentives as do the states.[23] A more recent proposal suggested that shareholders should be permitted to opt-in to federal corporate law.[24] This proposal is effective only to the extent that shareholders are informed and active. However, federal intervention to improve Delaware's franchise tax structure, as well as those of other states, would not be subject to these shortcomings. Rather than replacing Delaware as the main legislature in corporate law, federal intervention would improve states' regulatory incentives, and it would do so even if shareholders are passive. Moreover, improving incorporation tax laws can significantly reduce the need for, and thus save the costs of, direct federal intervention in corporate law.

Lastly, the analysis has implications for the market for corporate law. In particular, it suggests that there is neither a race to the bottom nor race to the top, but rather a race to the middle, with Delaware's law being superior to that of other states, but still suboptimal.

[23] While incorporations revenues constitute a significant portion of Delaware's revenues, they would constitute only a negligible part of a national budget.

[24] See Lucian Arye Bebchuk & Allen Ferrell, A New Approach to Takeover Law and Regulatory Competition, 87 Va. L. Rev. 111, 113 (2001). This proposal, too, is problematic, however, for it depends on shareholder activism, which is by all accounts limited.

I. THE LITERATURE ON STATE COMPETITION AND THE FRANCHISE TAX

The literature on state competition is vast and divided. Yet, despite their differences, all scholars agree that Delaware's franchise tax influences its regulatory incentives and corporate law. However, the literature has never considered the influence of the *structure* of the tax on the state's regulatory incentives. Hence, Section A shows that scholars assume that franchise tax revenue matters to Delaware, for if Delaware were indifferent to its tax collections there could be neither a race to the bottom nor race to the top. Section B argues that the literature has overlooked the relationship between the tax's structure and Delaware's regulatory incentives and has therefore missed the potential of the franchise tax as an additional method of improving corporate law.

A. The Literature Assumes that the Tax Influences Delaware's Incentives

Race-to-the-top scholars have pointed to the franchise tax as a crucial source of incentives for Delaware. Professor Roberta Romano has shown that franchise tax revenues constitute around twenty percent of Delaware's annual tax revenue.[25] Romano argues that because the franchise tax comprises almost one-fifth of the state budget, it motivates Delaware to produce value-maximizing corporate law.[26] Furthermore, Delaware's dependence on this tax creates a credible commitment to continue to provide value-maximizing corporate law in the future.[27] Indeed, Romano has demonstrated that a correlation exists between states' dependence on incorporation taxes and their responsiveness to corporate needs.[28] As a result, the current system is superior to a system of corporate law managed by federal officials who would lack strong

[25] See, e.g., Romano, Empowering Investors, supra note 1, at 2429 tbl.1.
[26] See Romano, Law as a Product, supra note 1, at 235, 277–78.
[27] See id. at 235.
[28] See id at 233, 237–40 (finding a correlation between the frequency of adoption of four legal provisions and the percentage of state tax revenue obtained from incorporation tax).

financial incentives to invest in producing high quality corporate law.[29]

Race-to-the-bottom scholars similarly assume that franchise tax revenues affect Delaware's regulatory incentives.[30] They recognize that the tax provides advantages relative to a regime of federal corporate law wherein incentives are lacking.[31] Yet, they argue that since managers have veto power over choosing a state of incorporation, franchise tax revenues and related benefits encourage Delaware to cater to managers' interests.[32] Thus, the current system provides incentives to produce efficient law with respect to issues that do not involve significant conflicts between managers and shareholders, but not with respect to issues that do involve such conflicts.[33] Accordingly, race-to-the-bottom scholars advocate direct federal intervention in corporate law only for issues that involve conflicts of interests between managers and shareholders.[34]

Taking a different approach, a recent line of literature argues that Delaware does not face substantial competitive pressure from other states.[35] Other states do not compete in part because, given their low incorporation tax rates, they do not stand to gain significant revenues from incorporations.[36] Yet, while doubting the extent

[29] See, e.g., Roberta Romano, The Genius of American Corporate Law 75 (1993); Frank H. Easterbrook, Managers' Discretion and Investors' Welfare: Theories and Evidence, 9 Del. J. Corp. L. 540, 571 (1984) (arguing against imposing national corporate rules that "still the power of competition").

[30] See, e.g., Bebchuk, supra note 2, at 1451 (arguing that states have an interest in attracting in-state incorporations, since incorporations bring with them franchise tax revenues and work for local law firms); Cary, supra note 2, at 697–98 (suggesting that states compete to attract the lucrative business of incorporations).

[31] See, e.g., Bebchuk, supra note 2, at 1500–07.

[32] Id. at 1458–61.

[33] See, e.g., Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, The Market for Corporate Law, 162 J. Institutional & Theoretical Econ. 134, 135–36 (2006) (constructing a formal model showing that competition among states results in optimal rules with respect to issues that do not involve high private benefits for managers but not with respect to issues that do involve such conflicts); Bebchuk, supra note 2, at 1440–41.

[34] See, e.g., Bebchuk, supra note 2, at 1441 (arguing for federal rules, or at least federal minimum standards, for self-dealing transactions, appropriation of corporate opportunities, freeze-out mergers, takeover bids, and proxy contests).

[35] See, e.g., Bebchuk & Hamdani, supra note 3, at 555–56; Kahan & Kamar, supra note 3, at 684–85.

[36] See Kahan & Kamar, supra note 3, at 700 (arguing against the apparent correlation on the basis that "Delaware aside, no state gains material franchise tax revenues by attracting incorporations").

to which other states are driven by incorporation tax revenue, these studies do not challenge the assumption that the tax matters to Delaware.[37] Quite the contrary, they argue that, unlike other states, Delaware stands to lose or gain significantly from its incorporation business. As these studies show, Delaware's market power allows its tax revenue to far exceed marginal costs, underscoring the importance of the tax to Delaware.[38] Furthermore, some of these scholars even argue that Delaware's power to charge monopolistic prices provides Delaware with incentives to innovate and improve its corporate law.[39]

In short, despite much disagreement about the nature, and even the existence, of the market for corporate law, scholars on all sides of the debate agree that franchise tax revenue plays an important role in shaping Delaware corporate law.

B. The Literature Has Not Considered How the Structure of the Tax Affects Delaware's Incentives

Although there is widespread recognition that franchise tax collections greatly influence Delaware's behavior, the literature has failed to consider how the *structure* of the tax affects Delaware corporate law. No piece of literature has ever asked whether the structure of the tax is optimal for Delaware's regulatory incentives or even looked into the relationship between the structure of the tax and Delaware law.[40] This void also extends to the leading proposals to reform American corporate law. For decades, critics of the existing system have primarily advocated federal intervention in corporate law.[41] One relatively recent proposal suggested giving shareholders the power to opt-in to federal antitakeover laws.[42] However, no proposal has examined the role of incorporation

[37] See id.
[38] See id. at 742.
[39] See, e.g., id. at 741–42. Kahan and Kamar also point out that its market power may lead Delaware to produce an overly indeterminate law since these strategies would maximize its profits as a monopolist. Id.
[40] Marcel Kahan and Ehud Kamar discussed the structure of the franchise tax in showing that it creates price discrimination among firms. They did not focus, however, on how this structure affects Delaware's regulatory incentives. See Kahan & Kamar, supra note 4.
[41] See, e.g., Bebchuk, supra note 2, at 1510; Cary, supra note 2, at 700–05.
[42] Bebchuk & Ferrell, supra note 23, at 116–17.

taxes. By overlooking the influence of the structure of Delaware's franchise tax on the state's law-making incentives, scholars have missed an effective means by which to improve our system of corporate law: designing a better franchise tax. Yet, if one takes seriously the argument that Delaware's franchise tax revenue provides the state with strong incentives, then, this Article argues, one should assume that its structure matters as well.

It is worth noting that the tax literature has also not explored the relationship between franchise tax structure and corporate regulation. While there is extensive literature on tax structure and incentives in general, it focuses on how taxes affect the incentives of those who pay the taxes—the individuals or the corporations—rather than the incentives of the authority that collects them.[43] This paper, however, focuses on the collector's incentives.[44] By analyzing the franchise tax as compensation, this Article points out that the franchise tax structure affects Delaware's regulatory incentives.

So far, this Article has shown that all scholars agree that the franchise tax influences Delaware's behavior, but none has paid attention to the tax structure. The following Parts discuss the relationship between Delaware's tax structure and the state's law-making incentives and suggest that changes to Delaware's franchise tax structure could induce Delaware to improve its corporate law.

II. DELAWARE'S CURRENT FRANCHISE TAX PROVIDES SUBOPTIMAL INCENTIVES

This Part analyzes the structure of Delaware's franchise tax and how exactly it affects Delaware's regulatory incentives. Section A argues that the tax discourages Delaware from racing all the way to the bottom. Section B shows that the structure of the current tax is not sensitive to firm performance. Section C explains that, as a result, Delaware has no incentive to race all the way to the top.

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[43] See, e.g., Harvey S. Rosen, Public Finance 399–404 (4th ed. 1995).

[44] Whether the structure of the tax is sensitive to performance would not significantly influence firms' investment choices, since the franchise tax is sufficiently small to be negligible relative to these choices.

A. The Franchise Tax's Limited Role

Before discussing the shortcomings of Delaware's franchise tax structure, it is important to realize that the current tax structure plays an important role in restricting Delaware from catering to managers' preferences. In particular, as I argued in a previous article, the tax that Delaware charges serves as a lower bar that constrains Delaware from racing all the way to the bottom.[45]

Delaware is the only state that imposes significant corporate franchise taxes.[46] In order to do this, Delaware must provide a package of legal rules that satisfies the interests of shareholders more than if it charged a negligible tax, as other states do. If it did not, shareholders, whose approval is required for reincorporation, would not approve a migration to Delaware, and firms at their IPO stage would not choose Delaware as their initial place of incorporation.[47] Put differently, Delaware faces a tradeoff between price and quantity. The more promanager its law is, the more managers it can attract from other states, but the less it can charge from each of the corporations that it attracts.[48]

Thus, the tax that Delaware currently charges forces it to take into account the interests of shareholders, even if only to a limited extent. The fact that Delaware charges a relatively high tax also forces it to maintain high-quality law, even though it does not face real competitive threats.[49] However, while the current tax keeps Delaware from racing to the bottom, its influence is limited, for, as the following Sections show, it fails to strongly motivate Delaware to race toward the top.

B. The Tax Is Not Sensitive to Firm Performance

Though Delaware's franchise tax constrains Delaware from racing to the bottom, it does not incentivize Delaware to race to the top. As this Section shows, Delaware's franchise tax revenue does

[45] See Barzuza, supra note 2, at 189–200.
[46] See Kahan & Kamar, supra note 3, at 687–92, 724.
[47] For a detailed analysis of how Delaware's corporate tax rates strengthen the state's incentives to maintain efficient corporate law, see Barzuza, supra note 2, at 163–67, 197–200.
[48] Id. at 163.
[49] Id. at 171.

not rise with increases in firm value or other performance measurements. As a result, the current tax structure does not reward Delaware for producing a corporate legal regime that maximizes shareholder value.

There are two different ways in which Delaware's franchise tax could be tied to increases in firm value. First, if, like many other taxes, the franchise tax was structured as a percentage of either income or firm value, then Delaware could gain revenue by improving the quality of its corporate law. Such quality improvements would presumably improve firm performance, which would be reflected in higher firm value or income, and, in turn, higher taxes. Yet, the franchise tax is not sensitive to either measurement and generally is not structured to be sensitive to firm performance.

Delaware offers corporations two methods for computing their franchise tax: an authorized shares method and an assumed par value capital ("APVC") method.[50] Under the authorized shares method, a firm's tax burden depends solely on the number of its authorized shares.[51] Under the APVC method, a firm's franchise tax is calculated based on the firm's assumed par value capital, which is the ratio of the firm's total gross assets to its issued shares, multiplied by the number of its authorized shares.[52] Under either method, the maximum tax that a firm in Delaware may owe is $165,000 per year.[53]

For several reasons, the structure of Delaware's franchise tax, described above, is almost entirely insensitive to firm performance. To begin with, approximately forty-six percent of Delaware's franchise tax revenue comes from firms that pay the maximum franchise tax.[54] With respect to these firms, an increase in firm value, even if significant, would not lead to an increase in taxes paid.

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[50] See Del. Code Ann. tit. 8, § 503(a) (2006).

[51] Id. at § 503(a)(1). In particular, a firm with more than 10,000 shares pays $112.50 plus $62.50 for each additional 10,000 authorized shares. In addition, the rates are: $35 for firms with 3,000 shares or fewer; $62.50 for firms with a number of shares between 3,001 and 5,000; and $112.50 for firms with a number of shares between 5,001 and 10,000.

[52] Id. at § 503(a)(2). Under this method, firms with an APVC above $1 million pay $250 per million or portion of one million of the APVC. If the APVC is less than $1 million, the tax is pro-rated.

[53] Del. Code Ann. tit. 8, § 503(c) (2006).

[54] Kahan & Kamar, supra note 4, at 1251 tbl.3 (using 1999 data when the maximum tax was $150,000). This figure is not surprising since any firm with more than 26.4 mil-

For the firms that do not pay the maximum, the current franchise tax is similarly unlikely to be sensitive to firm performance, since most firms in Delaware pay according to the authorized shares method, which does not reflect firm value or performance.[55] The number of authorized shares is set when the firm is established and, as firms seldom increase their number of authorized shares, does not generally track firm value or performance.[56] Furthermore, the tax revenue generated by APVC firms that pay less than the maximum also does not vary significantly with firm performance. At first glance, it may seem that stronger firm performance would often lead to the firm's having more assets and, in turn, to higher franchise tax liability under the APVC method. Better firm performance, however, does not always translate into more assets. Firms that perform better may, for instance, distribute dividends to shareholders rather than buy assets to hold in the corporation's name. More importantly, Delaware allows firms to switch to the authorized shares method from the APVC method if the tax burden under the former becomes lower. Thus, firms that acquire new assets can switch the method they use to calculate their franchise tax liability and pay taxes based on the number of their authorized shares instead. The ability to choose between the two methods significantly reduces the tax's sensitivity to firm performance and value. Thus, the current tax structure is not sensitive to changes in the value of Delaware firms.

Even under its current tax structure, however, Delaware could be rewarded for improvements to its law if it simply increased its franchise tax every time it made its corporate law more efficient. Presumably, firms should be willing to pay a higher price for better

lion authorized shares and assets over $660 million (in the rare case in which the firm has issued 100 percent of their authorized shares) or less (in the more common case that the number of authorized shares significantly outweighs the number of issued shares) has to pay the maximum amount.

[55] As of July 1, 2006, out of 230,551 firms that submitted franchise tax payments to Delaware, only 19,005 paid according to the APVC method. Telephone Interview with Eileen Simpson, Franchise Tax Admin., Del. Div. of Corp. (Aug. 22, 2006).

[56] In a randomly selected group of thirty Delaware companies, over a period of twelve years, firms changed the number of their authorized shares as seldom as 1.13 times. Statistical Analysis of U.S. SEC EDGAR database, http://www.sec.gov/edgar.shtml (last visited Feb. 2, 2008) (on file with the Virginia Law Review).

corporate law, and given its market power Delaware should be able to reap these benefits.

Yet, for several reasons, discussed in Section V.C below, Delaware tends not to increase its franchise tax rates to reflect enhancements in corporate law quality. Rather, Delaware's tax rates are very rigid. Delaware increases its tax rates about once per decade and, typically, only enough to keep up with inflation.[57]

C. How the Current Tax Structure Affects Delaware's Incentives

The previous Section established that Delaware's franchise tax is not sensitive to firm value. This Section discusses the implications of this structure for Delaware's corporate law. Subsection 1 shows that Delaware's current tax structure strengthens the bias of Delaware law in favor of managers. Subsection 2 shows that the structure of Delaware's tax aggravates the shortcomings that result from lack of competition from other states.

1. The Current Franchise Tax and Promanagement Bias

Race-to-the-bottom scholars argue that, since managers have substantial power over a corporation's decision to incorporate in a given state, and since managers' and shareholders' interests are not perfectly aligned, our system creates incentives for states to benefit managers at shareholders' expense. As a result, those scholars advocate federal intervention in corporate law.

Race-to-the-top scholars disagree, arguing that our system largely provides states with incentives to produce efficient corporate law. Yet, while race-to-the-top scholars argue that our system is superior to a federal system of corporate law, they do not argue that our system is optimal.[58] Rather, they also recognize that managerial opportunism may lead to managers favoring corporate law with inefficient redistributive rules,[59] and that our system has produced some inefficient rules.[60]

[57] See infra Section IV.A.

[58] See, e.g., Roberta Romano, Competition for Corporate Charters and the Lesson of Takeover Statutes, 61 Fordham L. Rev. 843, 859–62 (1993).

[59] See, e.g., Easterbrook & Fischel, supra note 1, at 217 ("Once they are ensconced, and have raised the capital the firm needs, managers may elect to behave opportunistically."); Daniel R. Fischel, The "Race to the Bottom" Revisited: Reflection on Recent Developments in Delaware's Corporate Law, 76 Nw. U. L. Rev. 913, 918 (1982)

In order to mitigate this problem of promanagement bias, an optimal compensation scheme should create incentives for Delaware to maximize shareholder value, similar to the way an optimal compensation scheme for managers would align their incentives with those of their shareholders. The current franchise tax structure does not create these incentives. Rather, under the current tax, if, for example, Delaware adopts a law that increases shareholder value by two percent, which could create $180 billion in shareholder value but also would upset managers, Delaware is likely to lose revenue. This could also be the case for much larger improvements.[61]

The problem arises since Delaware does not benefit from an increase in the value of its firms. As explained above, most of Delaware's franchise tax revenue comes from firms that pay nearly the maximum tax, and, for the rest of the firms, a change in their value is not likely to change the tax that they have to pay. Thus, under the current structure of Delaware's franchise tax, a change in the value of its firms, however significant, is not likely to create a meaningful increase in Delaware's revenue from these firms.

Even if Delaware does not collect higher taxes from its own firms as a result of such a change, it may still have incentives to amend its laws if that would help it attract more firms, rather than lose firms as the example assumes. Yet, that is not likely to be the result. Managers must initiate a reincorporation, and many managers would not be enticed by rules that transfer value from them to shareholders. In fact, adopting a more proshareholder strategy may

("In any agency relationship—such as the relationship between shareholders and managers—the interests of the agent will diverge from those of the principal."); Romano, supra note 58, at 843 (stating that the separation of ownership and control "creates an agency problem because management's operation of a firm may deviate from the shareholders' wishes in maximizing firm value"); Ralph K. Winter, The "Race for the Top" Revisited: A Comment on Eisenberg, 89 Colum. L. Rev. 1526, 1528 (1989) (acknowledging 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").

[60] See, e.g., Easterbrook, supra note 29, at 542–43; Romano, supra note 58, at 857–59.

[61] For very large improvements, both managers and shareholders may find the change desirable, but as long as managers are dissatisfied with the change, Delaware does not seem to have incentives to adopt it, regardless of how large the change would be.

harm Delaware, since it may cause some dissatisfied managers to initiate reincorporation from the state. To be sure, such reincorporation requires shareholders' approval, and shareholders may resist a move out of Delaware if it is not in their favor. Nevertheless, shareholders are often uninformed, sometimes rationally so. Thus, while the requirement of shareholder approval is likely to block the reincorporation of some firms, it is not likely to do so in all cases.

Moreover, even if the requirement of shareholder approval does block reincorporation in all firms, Delaware is still unlikely to attract more incorporations by improving its law. Delaware already offers the best corporate law package relative to other states, as it has many advantages that other states do not offer, including a specialized judiciary, a developed body of case law, an efficient administrative system, and significant network externalities.[62] As a result, Delaware possesses a significant market power—so significant that other states do not pose any meaningful competition to Delaware.[63] Given this market power, improving Delaware's corporate law to protect shareholders is not likely to affect firms' choice between Delaware and another state.[64] Indeed, it has been shown that firms that do not incorporate in Delaware, almost without exception, choose to incorporate in their home state.[65] Firms can be attracted to their home state for reasons other than the extent to which corporate law protects shareholders; for example, because of recommendations from local law firms.[66]

Indeed, evidence on state antitakeover law suggests that catering less to managers and offering a more shareholder-protective law either hurts or does not influence states' ability to attract and re-

[62] See, e.g., Bebchuk & Hamdani, supra note 3, at 585–89; Kahan & Kamar, supra note 3, at 725–26.

[63] Bebchuk & Hamdani, supra note 3, at 555; Kahan & Kamar, supra note 3 at 684–85.

[64] See Bebchuk & Hamdani, supra note 3, at 557.

[65] See Bebchuk & Cohen, supra note 15, at 386; Daines, supra note 15, at 1562.

[66] See Bebchuk & Cohen, supra note 15, at 397–400; Daines, supra note 15, at 1598–99 (finding evidence that lawyers influence incorporation decisions); cf. Kahan, supra note 16, at 340 (finding that incorporation choices are influenced positively by the flexibility of the law and by the quality of the judicial system). However, the flexibility of the law and the quality of the judicial system do not necessarily benefit shareholders. See id at 363–64.

tain incorporations. Professor Lucian Bebchuk and Alma Cohen,[67] and Professor Guhan Subramanian[68] have shown that states which offer their managers protective antitakeover law lose fewer firms to Delaware than states which offer their managers only weak protection. Professor Robert Daines[69] and Professor Marcel Kahan[70] have found that antitakeover law does not have a significant influence on incorporation decisions. No paper has reached the opposite conclusion from Bebchuk, Cohen and Subramanian: that states which provide strong protection to managers lose more firms to Delaware than states which do not.[71]

Since improving Delaware's corporate law will neither increase the tax that it receives from each of its own firms nor increase the number of firms it attracts, Delaware lacks incentives to maximize shareholder value. This result, which does not rely on any significant assumptions about the market for corporate law, should concern scholars from all sides of the debate. Some examples will help illustrate the severity of this problem. The following examples detail the potential effects of the tax structure on shareholder value and demonstrate how those effects are reflected in the decisions of Delaware's courts.

a. Corporate Governance Provisions and Shareholder Value

To get a flavor of the magnitude of the problem and the potential power that a different tax structure could have, this Subsection discusses some concrete examples from recent studies that attempt to assess the relationship between corporate governance features and firm performance.

One example, for which there is already a significant body of evidence, is a staggered board provision. In firms in which the board has not been explicitly staggered, all board members are elected

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[67] See Bebchuk & Cohen, supra note 15, at 387.

[68] Subramanian, supra note 17, at 1801 (showing that except for extreme antitakeover statutes, protection for managers helps states in attracting and retaining incorporations).

[69] See Daines, supra note 15, at 1559 (finding no significant correlation between states' antitakeover law and firms' choice of state of incorporation).

[70] Kahan, supra note 16.

[71] Moreover, Professor Daines focuses on the IPO stage, which by nature does not involve a conflict of interests between managers and shareholders.

yearly. In firms with a staggered board, however, only a third of the board is elected each year. Thus, to take over the board, a bidder needs to win not just one, but two proxy fights in two separate annual meetings over the span of an entire year.[72] As a result, staggered boards are considered an effective entrenching device to discourage hostile takeovers.[73] However, the entrenching effect of staggered boards has efficient aspects too, as it may alleviate undesirable pressure put on managers to maximize short-term gains at the price of long-term performance.[74]

Existing data suggests that the overall effect of staggered boards is negative. It has been shown that staggered boards almost double the probability that firms will remain independent and reduce returns for shareholders of hostile takeover targets.[75] Bebchuk and Cohen have demonstrated that staggered boards are associated with an economically meaningful reduction in firm value,[76] and Professor Faleye has found that the value of companies with staggered boards is lower even among firms that are most likely to benefit from staggered boards.[77]

[72] See generally Lucian Arye Bebchuk et al., The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 Stan. L. Rev. 887, 919 (2002). Most bidders will not leave an offer open for a whole year, as the price of the shares may decline in the interim, making acquisition at the initial price no longer profitable for the bidder. See id. at 918–19.

[73] This combined defense is so effective that a study on staggered boards researching hostile takeovers between the years 1996 and 2000 found that not even a single hostile bidder succeeded against an effective staggered board. Id. at 887.

[74] See, e.g., Steven M. Bainbridge, Director Primacy in Corporate Takeovers: Preliminary Reflections, 55 Stan. L. Rev. 791, 812–13 (2002) ("[T]here are good reasons for shareholders to prefer—and thus contract for—director primacy even in the takeover setting."); Mark Gordon, Takeover Defenses Work. Is That Such a Bad Thing?, 55 Stan. L. Rev. 819, 830–31 (2002) (arguing that takeover defenses are legitimate and useful and can provide a company leverage to negotiate a better offer or remain independent); Martin Lipton, Takeover Bids in the Target's Boardroom, 35 Bus. L. 101, 108–09 (1979) ("Experience does not prove that the shareholders of the target are better off if the target accepts a takeover bid.").

[75] See Bebchuk et al., supra note 72, at 887.

[76] See Bebchuk & Cohen, supra note 18.

[77] Olubunmi Faleye, Classified Boards, Firm Value, and Managerial Entrenchment, 83 J. Fin. Econ. 501, 503 (2007) (showing significant correlation between staggered boards and lower firm value). Faleye also found that, in companies with staggered boards, CEO turnover and compensation are less sensitive to performance. Id.

Whether these studies show causality and can support policy proposals is debated, especially due to endogeneity concerns.[78] For instance, rather than corporate governance terms, such as staggered boards, adversely affecting firm performance, these studies may suggest that poor performing managers seek to entrench themselves by adopting poor corporate governance.[79] Thus, to address the issue of causality, Bebchuk and Cohen assess the correlation between staggered boards and firm value between 1995 and 2002, even though most firms decided to implement staggered boards before the 1990s, and control for firm value before the 1990s in the cases in which the values before the 1990s and after 1995 are correlated.[80] Their results suggest that staggered boards may reduce firms' average Tobin's Q by three to four percent.[81] Faleye adds to the causal link by, among other things, showing how staggered boards work to insulate management from market discipline.[82]

Even if staggered boards cause no more than a one percent reduction in firm value, the benefits to Delaware of prohibiting staggered boards would be substantial. The value of firms incorporated in Delaware is more than $9 trillion; more than half of these firms have staggered boards.[83] Thus, a law that prohibited staggered boards, or at least limited their power to resist hostile takeovers, could create efficiency gains of more than $40 billion.

Nevertheless, under its current franchise tax structure, Delaware would gain little, if anything, from such a change. As explained above, an increase in firm value is likely to have little effect on the revenue that Delaware collects from its own firms. In fact, Delaware may even lose tax revenue as a result of prohibiting staggered boards, as managers are likely to be dissatisfied with such a change

[78] See, e.g., Bhagat et al., supra note 19, at 4 (suggesting that studies on corporate governance terms and firm value raise endogeneity concerns).

[79] See id. at 35–36.

[80] See Bebchuk and Cohen, supra note 18, at 426–28.

[81] See id. at 428.

[82] See Faleye, supra note 77, at 528.

[83] See Bebchuk & Cohen, supra note 18, at 422 fig.3; see also supra note 12 and accompanying text.

and may initiate reincorporation from the state.[84] Indeed, in most companies in which precatory shareholder proposals to dismantle staggered boards were passed, management chose to ignore them.[85] It is not surprising, then, that Delaware law does not prohibit the use of staggered boards and does not limit their power significantly.[86]

Second, and more generally, in addition to specific evidence on staggered boards, there is evidence to suggest that the overall potential effect of corporate law on firm value is larger than a few percentage points. In an influential study, Professors Paul Gompers, Joy Ishii, and Andrew Metrick showed that firms with stronger shareholder rights have significantly higher value and higher returns.[87] In assessing shareholder rights, the study used data available from the Investor Responsibility Research Center on corporate governance provisions for individual firms. Based on this data, the study constructed a twenty-four point corporate governance index, G.[88] The higher shareholder protection in a firm, the lower its G score. The authors found that by 1999 a one point change in their twenty-four point index, G, was negatively associated with an 11.4 percentage-point difference in Tobin's Q.[89] They also found that firms with weak shareholder rights were less profitable and had lower sales growth than industry peers.[90]

[84] To be sure, reincorporation outside of Delaware requires shareholders' approval. However, as discussed above, this constraint is not likely to completely block a migration of managers out of Delaware. See discussion supra Subsection II.C.1.

[85] See Lucian Ayre Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833, 854 (2005) (finding that more than two-thirds of the resolutions to dismantle staggered boards that were passed between 1997 and 2003 still had not been implemented in Fall 2004).

[86] See discussion infra Subsection II.C.2.

[87] See Gompers et al., supra note 19, at 107.

[88] The corporate governance index relates to five corporate governance categories: tactics for delaying hostile bids, protection for directors and officers from liability, voting rights for shareholders, other takeover defenses, and state laws. Id. at 111.

[89] Id. at 109–10. They also found that an investment strategy that bought firms in the lowest decile of the index (better corporate governance firms) and sold firms in the highest decile would have earned abnormal returns of 8.5 percent.

[90] Id. at 129, 130 tbl.IX. Following this study, other studies have called into question the reliability of the G index and promoted competing indices to predict corporate governance performance. See, e.g., Lucian Bebchuk et al., What Matters in Corporate Governance? 1–2 (John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 491, 2005), available at http://ssrn.com/abstract=593423 (arguing that the correlation

While the authors found some support for the hypothesis that corporate governance influences firm value,[91] they remained careful not to suggest that their results prove a causal relationship between their G index and firm value.[92] Still, these studies, along with others, have established a basic notion that corporate governance affects firm value.[93] Yet, it may be difficult to offer policy recommendations based on these studies as it is difficult to know which corporate governance terms in the G index affect firm value, how much weight should be given to each of those terms, and whether or not these terms interact with each other [94]

Yet, given its longtime, dominant position in the market for corporate law and the expertise of its judiciary, it is possible that Delaware has superior information regarding which corporate governance terms could significantly affect firm value. Indeed, as explained in the next Subsection, firms in Delaware used to have higher Tobin's Q than firms in other states.

Thus, this Article does not take a position on the desirability of any particular policy proposal; rather, it argues that, if some corporate governance terms affect firm value, as most scholars agree,[95] and even if Delaware knows which terms can have this effect, Delaware may not have sufficient incentives to adopt them because its tax is not sensitive to firm value. Instead, the current tax struc-

between governance provisions and shareholder value is driven by only a subset of the corporate governance terms in the G index).

[91] See Gompers et al., supra note 19, at 130, 132–37 (reporting that firms with higher G have higher capital expenditures and are engaged in more inefficient investments than firms with lower G). Accordingly, they did not find support for the alternative hypothesis that entrenching governance terms were adopted by managers who predicted poor performance of their firms. Id. at 131, 143.

[92] See id. at 144–45. The authors found some evidence supporting an alternative hypothesis that while governance provisions do not cause higher agency costs, their adoption is correlated with other characteristics that earned abnormal returns. See id. at 131, 143.

[93] See Bebchuk et al., supra note 90, at 1 ("[T]here is now a widespread recognition—as well as growing empirical evidence—that corporate governance arrangements can substantially affect shareholders.").

[94] See Bhagat et al., supra note 19, at 30–31; see also Bebchuk et al., supra note 90 (arguing that only a subset of the G index influences firm value).

[95] Even the harshest critics of these studies, such as Baghat, Bolton, and Romano, do not deny that a relationship exists between corporate governance terms and corporate value. Rather, they suggest that those relationships are firm-specific and difficult, if not impossible, to assess. See Bhagat et al., supra note 19, at 5.

ture pressures lawmakers and judges to cater to management in order to maintain or increase the number of firms incorporated in Delaware. Indeed, the next Subsection provides examples illustrating that such pressure actually exists.

b. The Current Franchise Tax and Managerial Favoritism in Delaware Antitakeover Law

The preceding Parts have argued that, given the current structure of its franchise tax, while Delaware is constrained from racing to the bottom, it does not have sufficient incentives to race to the top. This Subsection argues that Delaware antitakeover law reflects these incentives, as it is better than other states' antitakeover law, but at the same time falls short of being optimal.

Traditionally, Delaware's takeover policy has been considered more proshareholder than that of other states. Delaware has lagged behind other states in adopting antitakeover statutes that entrench managers defending against hostile takeovers.[96] Furthermore, while many states have adopted laws that allow the use of poison pills, an especially potent defensive tactic, Chancellor Allen determined in *City Capital Associates v. Interco Inc.* that managers of Delaware corporations may only make limited use of the pill either to get a better offer for shareholders or to suggest a superior alternative plan.[97] Consistent with the view that Delaware antitakeover law is relatively mild, Robert Daines found that during the period of his study, Delaware firms were more likely to receive a takeover bid and to be acquired than firms in other states.[98] Daines also showed that, between the years 1981 and 1996, the Tobin's Q of firms in Delaware was higher than the Tobin's Q of firms in other states.[99] Daines and others attributed the higher Tobin's Q of Delaware firms to, among other things, Delaware's superior antitakeover law.[100]

[96] See Romano, The Need for Competition, supra note 1, at 531–33 (noting the relative mildness of Delaware's antitakeover statute in comparison to those of other states).

[97] City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 798 (Del. Ch. 1988).

[98] Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. Fin. Econ. 525, 525 (2001).

[99] Id. at 527.

[100] An interesting question is why Delaware has been relatively proshareholder in the past, even though the tax code does not appropriately reward such a result. One

Still, while noting that Delaware antitakeover law is better than other states' law, scholars from all sides of the debate, including race-to-the-top scholars, did not view it as optimal.[101] Moreover, over time, things have gotten progressively worse. Given the structure of its franchise tax, Delaware was not benefiting from its firms' higher market values. Meanwhile, the pressure to maintain quantity also grew after the prominent mergers and acquisitions litigator, Martin Lipton, who typically represents the target's management, distributed a memo suggesting the time had come for firms to leave Delaware.[102] The Delaware Supreme Court reacted quickly in *Paramount Communications v. Time Inc.*, determining that the board is "not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."[103] Following the *Paramount* decision, during the mid-1990s, three hostile takeovers that had significant support from shareholders failed.[104] In all of these cases, although the majority of shareholders had tendered their shares, and the bidders had won a proxy fight to replace the third of the board up for election, the bids still failed due to board resistance.[105] Indeed, a subsequent study by Guhan Subramanian has shown that, from the mid-1990s onward, the Tobin's Q of firms in Delaware has decreased significantly, possibly as a result of the

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possible answer is that Delaware has charged a higher tax compared to other states, which forced it to take into account the interests of shareholders. See Barzuza, supra note 2 at 168. Nevertheless, once Delaware accumulated a comparably large share of market power, the tax became a weaker constraint, allowing Delaware to change its law in favor of managers without significant repercussions. Id. at 168–69. Another possible reason for the proshareholder climate, even absent optimal tax incentives, is that Delaware judges preferred to benefit shareholders so long as it was not affirmatively harming the state budget.

[101] See, e.g., Lucian Arye Bebchuk & Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, 99 Colum. L. Rev. 1168, 1193–97 (1999) (citing race-to-the-top scholars' objections to states' antitakeover laws); see also Easterbrook & Fischel, supra note 1, at 221–22; Romano, supra note 58, at 859–60.

[102] See Memorandum from Martin Lipton, Wachtell, Lipton, Rosen & Katz, to Clients (Nov. 3, 1988) (on file with the Virginia Law Review); see also Roe, supra note 3, at 625–26.

[103] Paramount Commc'ns v. Time Inc., 571 A.2d 1140, 1154 (Del. 1989).

[104] See Guhan Subramanian, The Disappearing Delaware Effect, 20 J.L. Econ. & Org. 32, 52 (2004).

[105] See id.

weakening of shareholder protection and the related negative effect on Delaware corporations.[106]

Delaware antitakeover law is still better than the law in other states.[107] While several states have adopted five antitakeover statutes, Delaware has adopted only one, which is relatively mild.[108] Moreover, Delaware enacted that statute seven years after similar statutes were introduced in other states.[109] In addition, it is far from clear that *Paramount* has established a "Just Say No" defense. In fact, *Paramount* involved unique circumstances that account for its results.[110] Indeed, the question whether a staggered board can just say no after losing a proxy fight is an open question under Delaware law.[111] Yet, as this Part demonstrates, given its tax structure, the pressure to maintain quantity, and the insufficient reward for quality create pressure on Delaware lawmakers to benefit managers, even if to a lesser extent than in other states.

Besides, the fact that Delaware law is still better than the law in other states strengthens the point that the tax structure influences the content of Delaware law. While the fact that Delaware races to the middle is irreconcilable with both the race-to-the-bottom and the race-to-the-top schools, tax considerations can account for such a result. As I have argued in another paper, the tax also constrains Delaware from racing to the bottom. Yet, it does not provide Delaware with sufficient incentives to race to the top, but only to the middle.

As the following Subsection suggests, adopting a different tax structure could relieve, or at least weaken, the pressure Delaware

[106] Id. Subramanian raises two possible reasons for his findings: one is this trilogy of failed takeover bids and the other is the possibility that, because of the increased use of options, managers' incentives improved, so they did not impede any more hostile takeovers. Subramanian finds support for both explanations. Id. at 52–55.

[107] See generally Barzuza, supra note 2, at 190–97.

[108] See Romano, The Need for Competition, supra note 1, at 531–33.

[109] See Romano, supra note 29, at 59; Romano, The Need for Competition, supra note 1, at 531.

[110] Barzuza, supra note 2, at 193.

[111] William T. Allen et al., The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide, 69 U. Chi. L. Rev. 1067, 1080 n.39 (2002) (noting that *Moore Corp. v. Wallace Computer Serv., Inc.*, 907 F. Supp. 1545 (D. Del. 1995), which permitted a staggered board to use a poison pill after losing a proxy fight, "is nonauthoritative, since the Delaware state judiciary has not yet spoken on the issue").

officials face to maintain quantity by catering to managers' interests.

2. The Current Franchise Tax and Delaware's Market Power

The previous Subsection suggested that the current tax structure creates pressure on Delaware to produce law that caters to managers. This Subsection argues that the current tax structure also does not provide Delaware with optimal incentives with respect to rules that not involving conflicts of interests between managers and shareholders. In particular, since Delaware faces only weak, if any, competitive threats from other states, it can maintain its primacy with less than optimal law. State officials, therefore, may not have sufficient incentives to produce law that maximizes shareholder value regardless of whether they face pressure from management.[112] Delaware's current tax structure aggravates this under-investment problem. If Delaware's 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.

This problem, however, is less severe than that of promanagerial bias. With respect to the race-to-the-bottom problem, Delaware may face a real conflict, which the current tax exacerbates: if it produces a law beneficial to shareholders, it may lose firms and income. However, with respect to problems arising from Delaware's lack of competition and resulting monopolistic power, Delaware does not face a significant conflict. To be sure, investing in quality may involve costs, and if Delaware is not being compensated for these costs, then it may not invest. Yet, it is not clear that the costs of producing high quality law, as opposed to mediocre law, are prohibitively high. Moreover, Delaware has other reasons to invest in the quality of its law, even if it has not always been rewarded for such investment, including the desire to maintain its reputation.

[112] See Bebchuk & Hamdani, supra note 3, at 596–99.

III. A NEW APPROACH: A PROPOSED TAX THAT IS SENSITIVE TO PERFORMANCE

The previous Part showed that the incentives created by Delaware's franchise tax are not optimal. This Part presents an alternative tax, based on firm performance, and shows that it will create better incentives for the development of Delaware's corporate law. Section A discusses the desirable features of this tax. Section B analyzes its advantages relative to Delaware's current tax.

A. How to Create a Tax that Is Sensitive to Performance

This Section discusses the practical implementation of a proportional tax and addresses desirable features of the tax structure. There are different schemes that could link Delaware's revenue to firms' performances, but it is beyond the scope of this Article to choose an exact design. What is clear is that regardless of the precise form of the tax, there are many possible structures that could improve upon the current regime.

1. A Proportional Component

Certainly, one should be cautious in restructuring Delaware's franchise tax. After all, Delaware relies on a predictable flow of income, and completely revamping the current tax structure could make tax revenues excessively unpredictable. Making the franchise tax sensitive to firm value, however, would not require a complete overhaul of the current tax structure. Instead, an additional component could be included in the structure of the tax, whereby increases in firm value could be captured by Delaware in the form of a proportionate increase in tax revenue. This component, unlike Delaware's current tax, would reward Delaware for producing law that benefits shareholders. At the same time, it would not risk Delaware's current income from incorporations. In other words, if Delaware improves its law, it will be rewarded beyond its current collections. If it does not improve its law, Delaware will continue to collect as it does now.

Though not necessary, it is preferable that the additional component rewards Delaware for relative improvements rather than absolute ones. A relative assessment could assure that Delaware would be rewarded only for its own efforts rather than for overall price movements in capital markets and, accordingly, that firms are not paying too much. Yet, even if Delaware is rewarded for absolute performance, a proportional component would provide it with better incentives than the current system. Under either a relative or absolute proportional tax, Delaware will collect more revenue if it produces a law that increases shareholder value.

2. Will Tax Rates Be Too High?

If firms have to pay for market increases in Delaware and not in other states, then they may find incorporation in Delaware no longer profitable. Thus, a tax structure that will result in an excessively high tax will not create incentives for Delaware to improve the quality of its law but may, in fact, create opposite incentives. If the tax is based on relative changes in Delaware's firms compared to other states' firms, however, then there is no concern that firms will be overcharged. In that case, firms will be charged only if Delaware law increases their value and then only in an amount that is smaller than that increase in value. Thus, they will gladly pay such an amount to incorporate in Delaware.

A concern arises only if the tax is based on absolute measurements of firms in Delaware, such as absolute changes to a firm's Tobin's Q. In that case, the additional tax may be higher than a firm's gain in value in Delaware relative to its potential gain in value in other states. For instance, under a proportional tax system, if the market increased significantly, then the franchise tax in Delaware would increase as well, as would the gap between the franchise tax in Delaware and other states. At some point, the gap might be so large as to justify reincorporating outside of Delaware.

This problem, however, is less severe than it may appear at first glance. To begin with, it has been shown that the benefits of incorporating in Delaware increase with firm size.[113] Second, this problem can be treated by charging only a small percentage of the increase in firm value. Delaware could also have the option to reduce this percentage in the future.

[113] Kahan & Kamar, supra note 4, at 1227–29.

3. Possible Measurements: Tobin's Q and Corporate Income

Below, I discuss two firm performance measurements on which Delaware's franchise tax could rely: Tobin's Q and firms' income. These two measurements are by no means exclusive; one could certainly rely on other measurements. The discussion is meant to illustrate the benefits of tying Delaware's franchise tax to firm performance rather than to suggest the optimality of reliance on any one particular measure.

Tobin's Q is an accepted measure for the value of a state's corporate law. Since this measure has already been used to show the relative superiority of Delaware law, it seems like a natural measure to reward Delaware for its performance. The downside, however, is that Tobin's Q is sensitive to movements in the market. That is, the Delaware tax base may be influenced by mere movements in the market rather than by changes Delaware makes to its law. One way to deal with this downside is to reward Delaware only for changes in the value of the Tobin's Q of its firms relative to the average Tobin's Q in the market. Clearly, this method entails some administrative costs, yet they may be outweighed by the resulting benefits. Even if Delaware was being rewarded for overall movements in the market, however, it still would have incentives to produce value-increasing laws, as that would further increase the value of its own firms.

Another possible measurement for corporate performance, which does not suffer from the same downside, is corporate income. Corporate governance studies have shown that it is not only firm value, but also corporate income, that improves with better corporate governance rules.[114] In fact, it is often the case that the country that legislates corporate law also collects taxes from its firms. As a result, if the country produces corporate law that improves firm performance, it is rewarded by collecting higher tax revenues. However, in the U.S., there is typically a difference between the state of incorporation and the state in which the company is headquartered. This creates a unique situation in which the state that charges income tax to a firm is not the state that produces the law by which that firm is governed.

[114] See, e.g., Gompers et al., supra note 19, at 144–45.

There are several difficulties in tying Delaware's compensation to corporate income. To start with, charging tax on corporate income might induce firms to manipulate their accounting profits. The franchise tax, however, is relatively low and should not have a significant effect on firms' accounting methods; it simply would not be worth the risk of manipulating their accounting statements.

A greater concern is that income does not fully reflect the potential for future growth and profitability that will result from the improved law. Unlike market value, which presumably reflects prospects for future performance, it may take a long time for the benefits of corporate law to be reflected in firms' profits. As a result, taxing corporate income may not reward Delaware promptly for every improvement that it makes to its law and therefore will provide it with only limited incentives to increase firms' values.

Yet, as studies show, in the long run the profits will materialize, and a tax on income will still reward Delaware for value-enhancing changes to its law.[115] More importantly, a tax on income, even if it does not reward Delaware completely for every improvement it makes to its law, will at least reward it for some improvements, whereas the current franchise tax structure offers Delaware no reward.

In the end, the choice between these two measures—Tobin's Q and firm income—will depend on different factors, such as the administrative costs each of them entails. The important point, however, is that reliance on either of the two would improve the current franchise tax system.

4. Will These Measures Create Incentives for Delaware to Attract Firms with High Tobin's Q or Greater Income Instead of Improving Firm Value?

One complication associated with a tax component that relies on Tobin's Q or corporate income would be separating the influence of corporate law from other firm-specific differences that might affect these measures.[116] In other words, the concern may be that

[115] See id.

[116] See, e.g., Feng Chen et al., Are Delaware Firms Oranges? Fundamental Attributes and the Delaware Effect 5 (2006) (unpublished Annual Conference on Empirical Legal Studies paper, available at http://ssrn.com/abstract=912942) (suggesting

Delaware will have incentives to attract only firms with high Tobin's Q or income, rather than to work on improving its own law. For instance, if large firms tend to have higher Tobin's Q or higher income, then Delaware could have incentives to attract large firms in lieu of improving its law.

This does not appear to be a strong objection. First, there are ways to neutralize this selection effect. Indeed, to avoid this problem of selection bias affecting his results, Daines controlled for factors that reflect differences among firms.[117] The same can be done in computing Delaware's franchise tax. Second, and more importantly, even if one does not control for differences among firms, rewarding Delaware for increases in its Tobin's Q or income is better than the current system. Even if Delaware can increase the aggregate Tobin's Q or corporate income by attracting specific firms, it does not follow that Delaware will no longer have an incentive to produce good law. On the contrary, once Delaware has taken steps to attract firms with high Tobin's Q or income, it will benefit by creating value-maximizing corporate law. By creating law that increases the value of its firms, albeit firms that already have a comparatively high Tobin's Q or income, Delaware will reap the rewards of any additional value this law generates.

Finally, even if Delaware chooses to design its law to attract firms with higher Tobin's Q or income, a high-quality, proshareholder law is more likely to achieve that than a less efficient law that caters to managers. If Delaware produces a law that is more shareholder-oriented, then naturally it should attract more firms whose managers are less likely to extract private benefits from control, namely those firms that are likely to have better performance and higher valuation by the market, which, in turn, is reflected in higher Tobin's Q and higher income.[118]

that the higher Tobin's Q in Delaware could be explained by self-selection of firms with higher Tobin's Q rather than by Delaware law).

[117] Daines controlled for characteristics like firm size, industry, investment opportunity, profitability, and level of diversification. Daines, supra note 98, at 530.

[118] See Gompers et al., supra note 19, at 126–29 (showing that firms with better corporate governance terms, that is, firms whose managers have chosen to extract fewer personal benefits of control, have higher Tobin's Q). Indeed, the higher Tobin's Q of the Delaware firms in Daines's study may be partially attributed to the fact that Delaware law attracts firms with lower agency costs. See Chen et al., supra note 116,

B. The Advantages of a Tax that Is Sensitive to Firm Performance

1. A Proportional Tax Would Align Delaware's Incentives with Those of Shareholders

A tax that is sensitive to firm performance would better align Delaware's interests with those of shareholders, would strengthen its incentives to maximize shareholder value, and therefore would mitigate the incentives to cater to managers' interests. With such a tax, the revenues collected by Delaware could be strongly affected by the quality of its corporate law. Enticing managers with redistributive, inefficient corporate rules might attract more managers, but it would impair the profitability and value of the firms Delaware retains and ultimately would reduce Delaware's tax revenue.

To be sure, improving Delaware law in favor of shareholders may cause some firms to leave Delaware. In particular, those managers who extract more private benefits of control may be interested in leaving and could succeed in doing so if their shareholders are sufficiently passive. Nevertheless, relative to the current tax, under which Delaware's revenue depends excessively on the quantity of firms it attracts rather than on quality, a proportional tax would give quality more weight. As evidence shows, the increase in tax from the firms that stay in Delaware could be so significant that, at least for some corporate law amendments, it is likely to outweigh the loss from the firms that leave Delaware.

The studies discussed above all show a significant difference in the performance of firms with better corporate governance law. Gompers, Ishii, and Metrick show an improvement of around eleven percent in the Tobin's Q for one point in their twenty-four point index.[119] Daines has shown a Tobin's Q in Delaware that was significantly higher than that typically found in other states.[120] Staggered boards were shown to decrease firm value significantly.[121] With a proportional tax, the effect of adopting law to mitigate these costs could substantially affect Delaware's tax revenues. For instance, if Delaware prohibits staggered boards and charges one

at 22 (showing that firms in Delaware report more conservatively biased accounting numbers, which is arguably an indication of lower agency costs).

[119] Gompers et al., supra note 19, at 128.

[120] See Daines, supra note 15, at 1560.

[121] See Bebchuk & Cohen, supra note 18, at 428.

percent of the increase in firm value, it will collect no less than $400 million, which is more than half of Delaware's annual franchise tax revenues.[122] As a result, with a proportional tax, if Delaware judges felt the need to limit staggered boards, for example, they should be able to do that with fewer concerns regarding the state budget or a legislative response.

Lastly, though a proportional tax would improve on the current system even if only Delaware adopts it, its influence on Delaware would be stronger if other states adopted it as well. If other states had a proportional tax they too would be reluctant to attract firms by excessively catering to managers interests. As a result, Delaware would have to worry less about dissatisfied managers migrating to other states. However, no state currently possesses an incorporation tax for out-of-state incorporations that is significantly sensitive to firm performance.

2. A Proportional Tax Would Lessen the Need to Rely on Competition

With a proportional tax, Delaware would have incentives to maintain high quality and to protect shareholders regardless of the level of competition from other states. Even if Delaware faces no competition from other states, it still has incentives to invest in the quality of its law and to take into account shareholders' interests. The reason for this is simple: if the tax is correlated with firm performance, then, under a high-quality law, tax collections will be higher than under a low-quality law.

The longstanding race-to-the-top literature has relied on competitive pressures to push Delaware to the top. Yet, as explained above, Delaware faces at best weak competitive threats. The virtue of a proportional tax is that it would incentivize Delaware to protect shareholders even in the absence of competition.

3. A Proportional Tax Would Lessen the Need to Rely on Shareholder Activism

Another advantage of a proportional tax is that it would provide Delaware with ongoing incentives to promote shareholders' inter-

[122] See, e.g., Barzuza, supra note 2, at 181 tbl.1 (reporting Delaware's annual franchise tax revenues for 1997–2002).

ests, even if shareholders are not active and do not know the difference between good and bad law. With a proportional tax, when Delaware improves firm value it is rewarded not by shareholders, but rather by the link between the tax and firm performance.

This is an important advantage. Current proposals to improve corporate governance rely heavily on the effectiveness of shareholder activism. Along these lines, it has been suggested that shareholders should be empowered to initiate reincorporation decisions, amend their firms' charters, and have access to their firms' proxy materials.[123] However, the effectiveness of these proposals depends on the extent to which shareholders would find it profitable to acquire information and act upon it. Supporters of these proposals acknowledge that this extent is quite limited.[124] Thus, a proportional tax opens a new path to improving corporate governance that does not suffer from the shortcomings of previous proposals.

4. A Proportional Tax Would Not Make the System Optimal

While this Article suggests that a proportional tax is likely to make the system better, it is not likely to make it optimal; that is, it is not likely to result in Delaware producing optimal corporate law.

In the trade-off that Delaware is facing between quantity and quality, a proportional tax would incentivize Delaware to give more weight to quality. Still, that does not mean that Delaware will cease to take quantity into account. Thus, Delaware may still prefer rules that will not maximize shareholder value if failing to adopt these rules could antagonize managers and result in many firms leaving Delaware. Yet, the argument that this Article makes is that

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[123] See, e.g., Bebchuk & Ferrell, supra note 23, at 113 (arguing that shareholders should have the power to initiate reincorporation decisions); see also Lucian Arye Bebchuk, The Case for Increasing Shareholder Power, 118 Harv. L. Rev. 833, 851 (2005) (proposing to give shareholders the power to adopt rules-of-the-game decisions); Lucian A. Bebchuk, The Myth of the Shareholder Franchise, 93 Va. L. Rev. 675, 694, 696, 711–14 (2007) (arguing and presenting evidence to show that shareholders should be able to add their director nominees to their firms' proxy materials).

[124] See, e.g., Lucian A. Bebchuk, Reply: Letting Shareholders Set the Rules, 119 Harv. L. Rev. 1784, 1798 (2006) (responding to a critique of his proposal to empower shareholders by emphasizing that his "proposal has taken into account the economic forces that discourage institutional investors from being active").

there should be fewer of these cases with a proportional tax than with the current tax.

IV. IF IT IS EFFICIENT, WHY HAVE STATES NOT ADOPTED IT?

Delaware has not chosen to adopt a tax that is especially sensitive to firms' market value or income. The same is true for other states. If such an intervention is desirable, then why do we not see states, or at least Delaware, adopting such a structure for their franchise tax? This Part provides possible explanations for the rigidity of Delaware's franchise tax and touches on possible explanations for the rigidity of other states' taxes.

A. Risk Aversion and Imperfect Information

The first possible explanation builds on Delaware's general reluctance to change any aspect of its franchise tax. This reluctance is reflected in three dimensions of Delaware's tax. First, the structure of the tax has not been changed since 1937.[125] Second, Delaware changes its tax rates only every decade.[126] Third, Delaware increases its revenues from tax rates every decade only in the range of twenty to forty percent, and tries to remain on the lower side of this range.[127] The increase of Delaware's maximum franchise tax rates, for example, is too low to reflect inflation rates over the years.[128]

Arguably, Delaware could have made more profit by making a few quite small changes to its tax, such as increasing its tax rates more frequently to reflect inflation and increased market power. Likewise, it could have created better price discrimination—that is, it could have charged more from firms that are willing to pay more. Indeed, scholars and practitioners have the impression that, at least with respect to the large firms it attracts, Delaware can charge more than it does.[129]

[125] Barzuza, supra note 2, at 186.
[126] Id.
[127] Id. at 185–86 tbl.2.
[128] The maximum franchise tax rate in Delaware was $110,000 in 1969 and $130,000 in 1984. See Consumer Price Indexes: Inflation Calculator, Bureau of Labor Statistics, U.S. Dep't of Labor, http://www.bls.gov/cpi/ (last visited Apr. 4, 2008) (calculating that the relative worth in 1984 of $110,000 in 1969 was $311,416.89).
[129] See Kahan & Kamar, supra note 4, at 1229.

What could explain why Delaware foregoes significantly higher revenues? Delaware officials have limited information on firms' preferences and, as a result, are very cautious in increasing their tax rates. In addition, a governor who deviates from past precedents and causes migration is more likely to be viewed as personally liable, in the public eye, than a governor who simply follows precedent. Consequently, no one wants to take such a responsibility upon himself. As Rick Geisenberger, Delaware's Assistant Secretary of State, explains, nobody knows the threshold that could cause firms to leave Delaware: "We know what worked in the past and we follow it."[130] There is some level that will push firms out of the market, he continues, but it is not clear what this level is exactly, and "no one wants to be the one who breaks the camel's back."[131]

This risk aversion, reflected in almost every aspect of Delaware's franchise tax, could explain why Delaware has not adopted a proportional tax which would require a change to the tax structure and result in more frequent changes to the amounts firms would have to pay.

The following Section suggests that Delaware may have an additional reason not to adopt a proportional tax. In particular, it suggests that having a different tax structure would make it more difficult for Delaware to attract managers. Yet, before we move to discuss reasons that are rooted in the agency problem, it is important to stress that, for the main argument of this Article to be valid, it is sufficient to be convinced that, as a result of risk aversion and lack of information, Delaware is not likely to change its tax structure. Thus, even if one does not agree that Delaware's incentives are distorted in favor of managers, this Part has offered a sufficient explanation as to why one should not presume that the structure of Delaware's tax is efficient.

B. The Tax's Rigid Structure Creates a Commitment to Benefit Managers

In addition to risk aversion, Delaware may not have strong incentives to change its tax structure if the current tax serves Dela-

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[130] See Barzuza, supra note 2, at 184.
[131] Id.

ware's goals better than a proportional tax would. In particular, with a proportional tax, management would be able to anticipate Delaware's proshareholder incentives. That is, managers would know that, once Delaware established a proportional tax and attracted a sufficiently large number of firms, it would have incentives to cater to shareholders' interests. Importantly, once managers decided to migrate into Delaware, they would be, to a certain extent, locked in, since they could not leave without getting shareholder approval. Thus, if Delaware were to adopt a proportional tax, managers might be reluctant to initiate a move into Delaware, even if Delaware tried to tempt them with other promanagerial rules, especially since other states' incorporation taxes are not proportional.

Conversely, with Delaware's rigid tax structure, managers are much less concerned that the state will have incentives to become more proshareholder in the future. The current tax structure therefore serves as a commitment to managers to continue to be responsive to their interests.[132] This is not to argue, however, that Delaware's tax was initially designed for that purpose. The argument merely suggests that Delaware does not have strong reasons to change the tax structure that was put into place in the 1930s.

Delaware's need to have a credible commitment to managers could be mitigated if other states also had proportional tax structures. However, all states currently possess an incorporation tax for out-of-state incorporations that is not significantly sensitive to firm performance. Thus, if Delaware was to adopt a proportional tax, it might face competition from other states that offer stronger commitments to managers, via their taxes, than Delaware does.

C. States' Collective Action Problem

Since, as this Article shows, a proportional tax is more efficient, states as a group should have an interest in the enactment of a proportional tax. If all states had proportional incorporation taxes, they would all produce better corporate law, which would, in turn,

[132] Obviously, Delaware could change the structure of its tax in the future. Yet, such a change requires a supermajority vote. Moreover, seven decades without change has created an expectation that Delaware will not significantly alter the tax structure in the future.

generate efficiency gains and larger tax collections. Thus, a tax that provides states with better incentives would create a larger surplus for them to divide.[133]

Acting alone, however, each state has an incentive to deviate from a proportional tax structure. If all of the states have a proportional tax, a state that deviates and adopts a different tax can use it to entice managers to reincorporate their firms. In other words, a collective commitment, although theoretically desirable, would not be stable. Thus, states face a collective action problem in designing the structure of their franchise taxes.

V. POSSIBLE OBJECTIONS

This Part addresses four possible objections to the propositions that the structure of the tax matters and that it is not optimal and should be changed. It concludes that tying Delaware's franchise tax to its firms' performance would make Delaware invest in improving its corporate law, even if Delaware's judges and legislators do not maximize revenues and even if one believes that there is a race to the top. It also explains why the usual objection to intervention in market prices does not apply to our case.

A. Delaware's Legislature Does Not Maximize Revenues

One possible objection questions the importance of tax differences for Delaware. One could argue that the Delaware legislature does not maximize revenues and therefore would not alter its behavior after changing its franchise tax structure.[134]

For the proportional tax to be preferable, however, one does not need to assume that Delaware maximizes revenues. Ultimately, if Delaware officials care about revenues, even to a limited extent, a proportional tax would create better incentives than the ones present under the current tax. Furthermore, the change in tax structure will make a difference when the potential efficiency gains are particularly large, as happens in the cases that concern us the most.

[133] Delaware, the dominant player, could promise to pay states some of its profits if those states bind themselves to enacting a proportional tax.

[134] See Gillian Hadfield & Eric Talley, On Public Versus Private Provision of Corporate Law, 22 J.L. Econ. & Org. 414 (2006) (suggesting that legislators generally maximize their reelection prospects rather than revenues to the state).

In these cases, the benefits from changing the law, reflected in the tax charged to each of the firms in Delaware, are likely to be sufficiently large to outweigh the loss resulting from some firms leaving Delaware.

Indeed, even though Delaware officials do not maximize revenues, they are not, and should not be, completely oblivious to the franchise tax revenues, which constitute twenty percent of the state revenues.[135] In fact, the franchise tax has been an important source of revenue in difficult times. Recently, Governor Ruth Ann Minner increased Delaware's franchise tax rates to raise an additional $99 million in revenue to cover an expected deficit in the state's 2004 budget.[136]

This level of interest in the budget, albeit limited, should be sufficient to provide lawmakers an incentive to create efficient corporate law, given the size of the potential gains to Delaware revenue. The aggregate market capitalization of firms incorporated in Delaware is approximately $9 trillion.[137] By improving its corporate law to increase the value of firms in Delaware by one percent, Delaware could add $90 billion to those firms' market values. Even if it charges only one percent of that increase, it could add $900 million in revenue.

Finally, the Delaware legislature's influence on Delaware law is mainly manifested in its acquiescence to judicial decisions. In fact, the Delaware legislature has intervened primarily when decisions that were considered proshareholder created a risk of firms leaving Delaware. The main goal of having a proportional tax, therefore, is less to encourage Delaware's officials to act, but rather to release them from the pressure to act in such circumstances.

B. Judges Do Not Care About Tax Revenues

Even if Delaware's legislature is responsive to the state's financial needs, it is far from clear that a proportional tax would affect Delaware judges. Unquestionably, judges have goals in mind other than just the state's revenues, and it is Delaware's judges, rather

[135] Romano, Empowering Investors, supra note 1, at 2429 tbl.1.

[136] Barzuza, supra note 2, at 181–82. For additional discussion suggesting the importance of the Delaware franchise tax, see id. at 179–82.

[137] See supra note 12.

than its legislature, who make Delaware corporate law. It is not clear, however, that Delaware's judges ignore the state budget. Judges are nominated by a governor and therefore could feel obliged to fulfill the state's goals.[138] Moreover, Delaware judges are aware that the Delaware legislature, when not satisfied with their decisions, will step in with overriding legislation.[139]

Even more importantly, a law that maximizes revenues under a proportional tax is likely to align with judges' preferences. Judges have their own incentives to produce law that maximizes shareholder value. First, decisions that are designed to that end contribute to their reputation and fit better with their professional integrity. Second, such decisions would attract the better corporations, which, in turn, are less likely to be involved in scandals that afflict the reputation of Delaware law.[140]

Indeed, the history of Delaware antitakeover law is consistent with this prediction. As shown in Part II, in cases in which Delaware judges produced decisions that were not in accordance with the state's needs, their deviation was typically in favor of shareholders. This is also true outside of antitakeover law. For instance, in what is considered to be a proshareholder decision, the court imposed liability on insufficiently informed directors for selling their firm. The *Smith v. Van Gorkom* decision[141] generated significant criticism and created a risk that firms would leave Delaware.[142] The Delaware legislature responded to this threat by immediately passing Section 102(b)(7), which allows firms to release their directors from liability for breaching their duty of care.[143]

Delaware judges thus have revealed their preference on certain occasions for a law that is more favorable to shareholders. Once it was clear, however, that these decisions could result in a migration of firms out of Delaware, either the legislature or the judges themselves responded to change the situation. Therefore, even if Delaware judges are not, or are only weakly, responsive to changes in

[138] Barzuza, supra note 2, at 177; Bebchuk, supra note 2, at 1453 n.74.
[139] See Barzuza, supra note 2, at 177.
[140] Id. at 176 n.201 (referring to an interview with Vice Chancellor Leo Strine, who suggested that Delaware officials may prefer to attract the "better firms," that is, those that are less vulnerable to expropriation by managers).
[141] Smith v. Van Gorkom, 488 A.2d 858 (Del. 1985).
[142] Bebchuk, supra note 2, at 1453 n.74.
[143] Del. Code Ann. tit. 8, § 102(b)(7) (1991).

the state budget, a proportional tax will release them from the pressure to produce decisions that favor managers.

Lastly, even if Delaware judges were not affected positively by a proportional tax, such a tax might induce the Delaware legislature to become more active and leave less discretion to judges to create corporate law on a case-by-case basis. Legislative intervention may be a positive development since Delaware judge-made law has been criticized as having excessive indeterminacy.[144]

C. It Is Inefficient to Intervene in Prices

One could argue against intervention in Delaware's franchise tax based on the general inefficiency of intervention in prices. No producer is forced to have its price tied to quality, and we never think of it as a problem. Why, then, is this the right solution in the market for corporate law?

There are two reasons why Delaware is different than a typical producer. First, unlike a typical producer, the price that Delaware charges is rigid, that is, it does not change constantly to reflect changes in quality. To understand this difference, imagine a producer that, like Delaware, has significant market power. Such a producer does not have to increase quality to attract consumers. Since it faces almost no competition, it can sell even if its quality is significantly less than optimal. Yet, the producer still has incentives to increase quality, since improving quality would enable the producer to raise the price of its product to capture the benefits of the higher quality. Thus, price is the major source of incentives for a monopolist.[145]

Unlike this producer, however, Delaware's price is rigid. For several reasons, ever since Delaware became the dominant state in the market for corporate law, and even before that, Delaware has increased its price no more than once every decade. Unlike a typical producer, Delaware is required to use the political process to change its franchise tax rates. In particular, changing the franchise

[144] See, e.g., Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908 (1998).

[145] To be sure, the monopolist will not have the other incentives to produce optimal quality goods. See, e.g., A. Michael Spence, Monopoly, Quality & Regulation, 6 Bell J. Econ. 417 (1975).

tax requires a supermajority vote of both houses of the state legislature.[146] Moreover, different constituencies in Delaware, such as the Delaware Bar, may be inclined not to support raising franchise taxes often. Second, other considerations, such as a concern about federal intervention, risk aversion, or a desire not to be perceived as rapacious, might limit Delaware's ability to increase its tax. Third, and most important, as explained above, by changing its tax rarely Delaware creates a credible commitment to managers to continue to protect their interests.[147]

Since, due to this price rigidity, Delaware increases its price only once every decade, the state has no incentive to improve its law until the end of the decade, right before the price of its laws increases.[148] Thus, in order to provide optimal incentives, the compensation should be constructed in a way that constantly rewards Delaware for improvement.

Another way in which Delaware is different than a typical producer is the possibility of agency costs on the demand side of the market for corporate law. Extensive literature exists on the potential race-to-the-bottom problem. Since managers have influence on where to incorporate, Delaware may cater to managers' interests at the expense of shareholders. This problem is similar to the agency problem between managers and shareholders, in which a solution is usually achieved through compensation. Thus, the right point for comparison is not necessarily the price that a typical producer charges, but rather management's compensation. The same way that compensation packages for managers should be designed to align their incentives with the incentives of shareholders, Delaware's compensation should align its incentives with the incentives of shareholders.

[146] The franchise tax is part of the corporate code. The Delaware Constitution requires at least two-thirds of the votes in each house to support an amendment to the corporate code. Del. Const. art. IX, § 1; see also Romano, Law as a Product, supra note 1, at 241–42 (arguing that this requirement creates a commitment by Delaware for stability and predictability).

[147] For a broader discussion of the rigidity of Delaware's franchise tax, see supra Section IV.B.

[148] The price still serves an important role in restricting Delaware from degrading its law too much in favor of managers. Barzuza, supra note 2, 162–69. Nevertheless, since Delaware does not increase its price frequently, the price does not push it to produce optimal law.

D. There Is a Race to the Top

One could claim that the argument that Delaware corporate law would be better with a different tax is valid only if one believes that there is a race to the bottom. The dominant view in the market for corporate law, however, is that the race is actually to the top, and a significant body of evidence supports this view.

The argument does not assume, however, that states are racing to the bottom. To begin with, race-to-the-top scholars have never argued that the interests of shareholders and managers are perfectly aligned, or that Delaware law is optimal.[149] Instead, they argue that although the current system does not lead to an optimal law, it is superior to a system of federal corporate law.[150] Thus, race-to-the-top scholars recognize the agency problem and its influence on the market for corporate law, and therefore should be worried that the current tax aggravates Delaware's tendency to benefit managers, and recognize the potential advantages in a proportional tax.

Furthermore, even if one believes that the interests of shareholders and managers are aligned, one should be concerned that Delaware's tax does not sufficiently reward it for maximizing shareholder value. Without such a reward, Delaware may not have sufficient incentives to produce optimal law, even if that is what firms (that is, both managers and shareholders) desire. As explained in Section II.C., Delaware does not face competition from other states; firms that do not incorporate in Delaware are, in the vast majority of cases, incorporated in their home states, and there is very little, if anything, that Delaware can do to attract them. Thus, Delaware has nothing to gain from improving the quality of its law, even regarding changes that are desired both by managers and shareholders.

Lastly, the argument that Delaware does not have sufficient incentives to adopt a proportional tax, even though such a tax is efficient, is not inconsistent with a race-to-the-top view, nor with an extreme view under which managers' and shareholders' interests never conflict. While one possible explanation for failing to adopt a proportional tax is that Delaware fears antagonizing management,

[149] See supra Section II.C; supra notes 58–59 and accompanying text.
[150] See supra Section II.C; supra notes 58–59 and accompanying text.

another plausible explanation, offered in Section IV.A, suggests that risk aversion and imperfect information make Delaware reluctant to make such a change, especially when other states have not made it either. Thus, even if one does not believe that agency costs influence Delaware law, one need not presume that Delaware's franchise tax is efficient.

VI. NORMATIVE IMPLICATIONS

This Part discusses the implications of the forgoing analysis. Section A suggests that states, and especially Delaware, should adopt a proportional tax and that federal intervention may be required to reward Delaware more appropriately for its law. Section B discusses the implications for the different views on the market for corporate law.

A. Implications for Incorporation Taxes

1. Incorporation Taxes Should Be Sensitive to Firm Performance

The first step this Article takes is to suggest that different tax structures create different sets of incentives to produce corporate law. In particular, it shows that Delaware's current incorporation tax is not sensitive to firm performance and hence creates inefficiencies, as it stresses quantity of firms over quality of law. A franchise tax that has a proportional component would result in a better corporate law than the current tax.

Thus, the most important policy implication of this Article is that Delaware should have a franchise tax that is more sensitive to firm performance than is its current franchise tax. With such a tax, Delaware would have better incentives to protect shareholders. This would be the case even if Delaware faces no competition and shareholders are passive.

A proportional tax would be more effective if all states adopted it. If all states had a proportional tax, each of them would have fewer incentives to race to the bottom by offering promanagement, value-decreasing corporate law. That in turn would weaken the pressure on Delaware to cater to managers' interests.

The debate to date has focused solely on Delaware corporate law, without paying attention to franchise tax law and its influence on corporate law. The primary goal of this Article is to take the first step toward change by putting the structure of the franchise tax and its implication for Delaware corporate law on the agenda.

2. Federal Intervention in Incorporation Tax Laws

Although it would be better if a proportional tax were adopted by Delaware voluntarily, for various reasons detailed in Part IV, this might not be possible. Moreover, as explained above, the proportional tax would be more effective if all states had the same system, but other states are not any more likely to change the structure of their own taxes. Thus, federal intervention may be required in order to implement a nationwide proportional tax system. Federal intervention may take several different forms, and it is beyond the scope of this Article to advocate a specific form. Although a federal mandate that states charge a certain percentage of firm value as franchise tax would raise constitutional concerns,[151] Congress can, in effect, implement a proportional tax by using its constitutional powers in other ways.[152]

At the same time, many legitimate concerns have been raised against federal intervention in corporate law. The longstanding debate has, for the most part, focused on the desirability of direct federal intervention in corporate law.[153] The current system, it has

[151] Direct intervention in state franchise tax law may be inconsistent with the Tenth Amendment. See, e.g., New York v. United States, 505 U.S. 144, 162 (1992) (holding that the federal government cannot commandeer a state government to achieve its own objectives).

[152] For instance, Congress could implement a proportional tax using a combination of its taxing and spending powers as follows: Congress could raise firms' income taxes by a small percentage and pass that money on to the states in which the firms are incorporated. That way, Delaware and other states would be rewarded in proportion to their firms' performances. Thus, if Delaware were to improve its law, firms in Delaware would do better, that is, their income—and income tax—would increase, which, in turn, would raise Delaware's reward. Alternatively, Congress might be able to use its spending power conditioned on the fact that states change their incorporation tax to a proportional tax. The goal of these examples is not to delineate the preferred constitutional way to implement a proportional tax scheme, but rather to suggest that the constitutional concerns surrounding this proposal are not insurmountable.

[153] See Bebchuk, supra note 2, at 1510 (arguing for federal rules, or at least federal minimum standards, with respect to self-dealing transactions, taking of corporate opportunities, freeze-out mergers, all aspects of takeover bids and proxy contests, and limitations on dividends); Cary, supra note 2, at 701 (proposing that Congress adopt federal standards for corporate responsibility); see also Bebchuk & Ferrell, supra note 23, 162–63 (advocating a middle ground between federal nonintervention and manda-

been argued, provides states, or at least Delaware, with strong incentives to invest in corporate law,[154] as well as to obtain information about corporations' needs.[155] Federal law lacks the incentives and the information that competition provides, and is less likely to be responsive to changes in corporate needs over time.[156] Furthermore, federal corporate law is likely to suffer from a promanagement bias as a result of pressure from organized management lobbies.[157]

These concerns, however, are less valid for the type of federal intervention that would be involved here. First, unlike federal intervention in substantive corporate law, intervention in the way states are rewarded for incorporation will preserve the benefits of the current system. While direct federal intervention in corporate law would replace the states as the main legislators of corporate law, the proposed intervention in this case would leave the substantive power to legislate corporate law with the states. Federal law would intervene only in an indirect way to better shape the states' incentives. Second, federal intervention in the state tax law system does not require knowledge of firms' preferences with respect to corporate law. Third, though opposition by managers is possible, for several reasons it is less likely to form than management opposition to direct federal intervention.[158] Fourth, unlike some proposals, this proposal does not count on shareholder activism.[159] Lastly, and

tory federal regulation, including a federal process rule that would establish a process by which companies could switch from one state to another).

[154] See, e.g., Fischel, supra note 59, at 923.

[155] See, e.g., Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251, 291 (1977) ("Because federal legislation does not face direct competition with other legal systems, the behavior of investors under differing rules cannot be observed and we can only theorize about which rules optimize the underlying economic relationships.").

[156] Fischel, supra note 59, at 922; Winter, supra note 155, at 291.

[157] Stephen J. Choi & Andrew T. Guzman, Choice and Federal Intervention in Corporate Law, 87 Va. L. Rev. 961, 965 (2001).

[158] To start with, some of the opposition to direct federal intervention in corporate law, such as Sarbanes-Oxley, had some basis. Sarbanes-Oxley imposed significant costs on firms that many viewed as excessive. Moreover, while it is easy for management to raise arguments in favor of existing corporate law and the expertise of Delaware judges, it would be much harder to raise arguments in favor of Delaware's current tax system.

[159] In particular, Lucian Bebchuk and Allen Ferrell promote a novel form of federal intervention, which they label "choice enhancing intervention." Their proposal has

most importantly, the proposal could result in less intrusive federal intervention. The federal intervention would focus on the structure of the tax, not corporate law. Once the bias in favor of managers is mitigated, there is much less need for federal legislation that intrudes upon state corporate law, and any further intervention would be less legitimate.

B. Implications for the Debate over the Market for Corporate Law: A Race to the Middle

The analysis of this Article has implications for the debate over the market for corporate law. Even if one does not agree with these implications, however, one may still support the conclusion that a different tax structure could lead to a more efficient market and a better corporate law.

For the debate between race-to-the-top scholars and race-to-the-bottom scholars, the analysis suggests that Delaware does not have incentives to produce optimal corporate law under the current tax structure, and thus is short of racing to the top. Recall Judge Ralph Winter's strong argument in support of a race-to-the-top view that, if Delaware were to produce rules that benefited managers at the expense of shareholders, the share price of firms incorporated in Delaware would decline.[160] With the current tax, Delaware is not being penalized for declines in the stock price of its firms, as long as the decline is not sufficiently large to push firms out of Delaware. At the same time, as explained above, Delaware's tax provides it with some incentives to protect shareholders. If Delaware did not take the interests of shareholders into account, at least to some extent, it could not charge the high tax that it currently charges.[161]

Thus, the analysis suggests neither a race to the top nor to the bottom but rather a race to the middle, in which Delaware pro-

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two components: first, an optional body of federal takeover law, and second, federal law enabling shareholders to opt into and out of antitakeover law, even without initiation by managers. See Bebchuk & Ferrell, supra note 23, at 113. The effectiveness of Bebchuk and Ferrell's proposal depends to a significant extent on the effectiveness of shareholder voting. See Choi & Guzman, supra note 157, at 986–88 (noting problems with shareholder voting).

[160] See Winter, supra note 155, at 256.

[161] Barzuza, supra note 2, at 168.

duces a law that is better than the law of other states but is still short of being optimal.

This view is consistent with, and helps in explaining, the evidence. Race-to-the-top scholars have offered significant evidence showing that Delaware is better for firms than other states. For example, reincorporation into Delaware is associated with positive price reaction,[162] firms in Delaware have higher Tobin's Q than firms in other states,[163] Delaware is the most responsive in amending its law to address corporate needs,[164] and Delaware law has been less promanagement than other states' law.[165] Meanwhile, race-to-the-bottom scholars have offered evidence that the current system has produced promanagerial, inefficient law.[166]

Taken together, the evidence may seem to have inconsistencies. On the one hand, the fact that the leading state adopts a law that is better than the law in other states seems to suggest that states are being rewarded for, and have incentives to continue, racing to the top. On the other hand, the same state has adopted antitakeover rules and case law that are considered inefficient, even among the race-to-the-top proponents. If there is a race to the bottom, why does the market reward Delaware for adopting a mild antitakeover law rather than a strong one? If there is a race to the top, why has Delaware adopted inefficient antitakeover law?

The analysis here is consistent with, and helps to explain, the evidence that so far has seemed puzzling. The answer is related to

[162] See, e.g., Michael Bradley & Cindy A. Schipani, The Relevance of the Duty of Care Standard in Corporate Governance, 75 Iowa L. Rev. 1, 65–69 (1989); Peter Dodd & Richard Leftwich, The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation, 53 J. Bus. 259, 281 (1980); Randall A. Heron & Wilbur G. Lewellen, An Empirical Analysis of the Reincorporation Decision, 33 J. Fin. & Quantitative Analysis 549, 550 (1998); Allen Hyman, The Delaware Controversy—The Legal Debate, 4 Del. J. Corp. L. 368, 385 (1979); Jeffry Netter & Annette Poulsen, State Corporation Laws and Shareholders: The Recent Experience, 18 Fin. Mgmt. 29, 39 (1989); Pamela P. Peterson, Reincorporation: Motives and Shareholder Wealth, 23 Fin. Rev. 151, 151 (1988); Romano, Law as a Product, supra note 1, at 279–80.

[163] Daines, supra note 98, at 525.

[164] Romano, Law as a Product, supra note 1, at 240.

[165] See Easterbrook & Fischel, supra note 1, at 222–23; Romano, supra note 58, at 857–58; Romano, The Need for Competition, supra note 1, at 530–37; Winter, supra note 155, at 288.

[166] See, e.g., Bebchuk & Cohen, supra note 18, at 409.

Delaware's tax.[167] The tax does not create sufficient incentives to race to the top but at the same time constrains the incentives to race to the bottom. Thus, Delaware will never get to the top or to the bottom, and the debate will never be resolved. Rather, unless its tax structure changes, Delaware will continue to race to the middle, producing corporate law that is better for shareholders than other states' law, but short of being optimal—that is, a law that suffers from some inefficient bias in favor of managers.

The analysis also has implications for the no-race view. In particular, it shows that in the absence of competition, Delaware's incentives are actually worse than the incentives of a typical monopolist. Unlike Delaware, a monopolist may have incentives to invest in quality and to innovate, sometimes to a larger extent than if it faced competition, because producing a higher-quality product would enable it to charge a higher price.[168] Since Delaware's price is rigid, however, its incentives are limited.

Thus, the analysis supports the view that our system is not optimal. Yet, it also suggests that improving it does not entail direct federal intervention into the substantive content of states' corporate law. Rather, an improvement of the structure of Delaware's tax could improve the state's corporate law and lessen the need for such intervention.

CONCLUSION

This Article highlighted the interdependence of the structure of Delaware's franchise tax and the state's incentives in producing corporate law. It argued that the current structure is not optimally

[167] In an influential paper, Mark Roe has raised and addressed this puzzle, arguing that the phenomenon is brought about by competition with the federal government. See Roe, supra note 3. According to his explanation, Delaware's choices are significantly influenced by the threat of federal intervention, which could account for Delaware's tendency not to choose between the bottom and the top. Indeed, the tax explanation complements this theory by filling in its gaps. Considering the fact that federal intervention has always occurred with the intent to protect shareholders, Roe's federal theory cannot explain why Delaware does not race to the top. The suboptimal structure of the tax, however, can provide such an explanation.

[168] See Kahan and Kamar, supra note 3, at 742 (suggesting that Delaware's monopolistic position provides it with stronger incentives to innovate than if there was competition in the market for corporate law "[b]ecause monopolists reap the full benefit of their innovative efforts without sharing it with imitators").

designed to provide Delaware with incentives to produce corporate law that maximizes firm value. It showed that making Delaware's revenues sensitive to its firms' performance would induce Delaware to produce better law and better corporate governance. A proportional tax would provide Delaware with ongoing incentives to increase its firms' value. In contrast to other reform proposals, it would work even if shareholders are inactive, and even when other states do not try to compete with Delaware. The Article recognized that Delaware may currently have strategic reasons not to adopt this structure. Ultimately, if Delaware overcomes its traditional aversion to making changes to its franchise tax structure, or is otherwise compelled to change it because of federal intervention, our corporate law and corporate value would improve.