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The Market for Corporate Law Redux

Law Working Paper N° 270/2014

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Abstract

Corporations operate in numerous markets -- product markets, labor markets, capital-markets. This chapter focuses on the market that is the prerequisite for firms' successful operation in all other markets, as it is the market that frames their organizational structure and governance: the market for corporate law. In the United States, two features of the legal landscape have informed such a conceptualization of corporate law as a product: (1) corporate law is the domain of the states rather than the national government; and (2) under the internal affairs doctrine, the state whose corporate law governs a firm is the state of its statutory domicile. This arrangement provides firms with a choice, they can select their governing law from among the states regardless of their physical location, hence the notion that states offer a product that corporations purchase, by means of incorporation fees (referred to as franchise taxes). For the past century, remarkably, one small state, Delaware, has been the market leader, serving as the domicile for the overwhelming majority of U.S. corporations. The debate over the market for corporate law has focused, in large part, on whether the phenomenon of Delaware's dominance is for the better.

The first part of the chapter analyzes the dynamics of the U.S. market for corporate law, which can best be characterized as states competing for corporate charters, along with data pertinent to the question of whom this market organization benefits -- managers or shareholders– and explanations why Delaware has had a persistent and commanding position. The focus is on the market for public corporations, given their relative importance to the economy, the more extensive literature, and space limitations for this chapter. The second part of the chapter turns to explain Delaware's persistence as the preeminent incorporation state. This is a distinctive feature of U.S. corporate law. There are other federal systems of corporate law, but a similar "Delaware" phenomenon does not exist. The chapter concludes with a summary and suggestions for future research.

Keywords: market for corporate law; state competition for corporate charters; Delaware, race to the top, race for the bottom

JEL Classifications: K22, G34, G38

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Corporations operate in numerous markets -- product markets, labor markets, capital markets. This chapter focuses on the market that is the prerequisite for firms' successful operation in all other markets, as it is the market that frames their organizational structure and governance: the market for corporate law. In the United States, two features of the legal landscape have informed such a conceptualization of corporate law as a product: (1) corporate law is the domain of the states rather than the national government; and (2) under the internal affairs doctrine, the state whose corporate law governs a firm is the state of its statutory domicile. This arrangement provides firms with a choice, they can select their governing law from among the states regardless of their physical location, hence the notion that states offer a product that corporations purchase, by means of incorporation fees (referred to as franchise taxes). For the past century, remarkably, one small state, Delaware, has been the market leader, serving as the domicile for the overwhelming majority of U.S. corporations. The debate over the market for corporate law has focused, in large part, on whether the phenomenon of Delaware's dominance is for the better.

The first part of the chapter analyzes the dynamics of the U.S. market for corporate law, which can best be characterized as states competing for corporate charters, along with data pertinent to the question of whom this market organization benefits -- managers or shareholders– and explanations why Delaware has had a persistent and commanding position. The focus is on the market for public corporations, given their relative importance to the economy, the more extensive literature, and space limitations for this chapter. The second part of the chapter turns to explain Delaware's persistence as the preeminent incorporation state. This is a distinctive feature of U.S. corporate law. There are other federal systems of corporate law, but a similar "Delaware" phenomenon does not exist. The chapter concludes with a summary and suggestions for future research.

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I. Introduction

Corporations operate in numerous markets -- product markets, labor markets, capital markets. This chapter focuses on the market that is the prerequisite for firms' successful operation in all other markets, as it is the market that frames their organizational structure and governance: the market for corporate law. In the United States, two features of the legal landscape have informed such a conceptualization of corporate law as a product (Romano 1985): (1) corporate law is the domain of the states rather than the national government; and (2) under the internal affairs doctrine, the state whose corporate law governs a firm is the state of its statutory domicile. This arrangement provides firms with a choice, they can select their governing law from among the states regardless of their physical location, hence the notion that states offer a product that corporations purchase, by means of incorporation fees (referred to as franchise taxes). For the past century, remarkably, one small state, Delaware, has been the market leader, serving as the domicile for the overwhelming majority of U.S. corporations (e.g., Romano (1985:244) (reincorporations and Fortune top 100); Alva (1990:885) (largest); Daines (2001:538) (IPOs); Bebchuk and Cohen (2003:389) (Compustat database of public firms)). The debate over the market for corporate law has focused, in large part, on whether the phenomenon of Delaware's dominance is for the better.

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which can best be characterized as states competing for corporate charters, along with data pertinent to the question of whom this market organization benefits -- managers or shareholders– and explanations why Delaware has had a persistent and commanding position. The focus is on the market for public corporations, given their relative importance to the economy, the more extensive literature, and space limitations for this chapter. For analyses of the market for privately-held corporations and unincorporated firms, in which Delaware is also the most important state actor, although the features of the legal regime that attract firms differs, in ways related to the differing needs of their respective clienteles, see Kobayashi and Ribstein (1996, 2011) and Damman and Schündeln (2009, 2012). The focus is also on contemporary state competition (i.e., post-1960s corporation code reforms). For analyses of state competition in the Nineteenth and early Twentieth centuries, see Butler (1985) and Wells (2009).

The second part of the chapter turns to explain Delaware's persistence as the preeminent incorporation state. This is a distinctive feature of U.S. corporate law. There are other federal systems of corporate law, but a similar "Delaware" phenomenon does not exist. For analyses of the market for corporate law in other federal settings see, for Canada: Daniels (1991) and Cummings and MacIntosh (2000, 2002); and for the European Union: Enriques (2004); Becht et al. (2008); Enriques and Tröger (2008); Hornuf (2012) and Ringe (2013). The chapter concludes with a summary and suggestions for future research.

II. The Market for Corporate Law

The U.S. market for corporate law is a function of federalist political arrangements and the literature that has debated its efficacy is a microcosm of the literature on the broader question of political organization. A federal system of government provides a number of benefits for its

citizens. It protects the individual from the coercive power of government, as states can diffuse political authority and thereby provide a counterweight to a national government (de Tocqueville 1835). A federal system can also allocate public goods and services more efficiently than a centralized system, increasing the utility of its citizens, by being able to match specific government programs and policies with diverse citizen preferences, as lower level entities – states and municipalities – compete for citizens who choose to reside in the jurisdiction offering their preferred package of public goods (Tiebout 1956). This theoretical claim accords with the greater trust individuals in the United States have in the level of government that is closest to them (e.g., Pew Research Center 2013). Finally, federalism spurs innovation in public policy because of the experimentation afforded by the "laboratories of the states," maneuvering, that is, competing, to match the preferences of citizens (New State Ice Co. v. Liebmann, 285 U.S. 262, 311, 1932, Brandeis, J, dissenting).

But while the benefits of federalism are axiomatic in U.S. politics, so too is the recognition of costs from the workings of multiple layers of governments, which can impede effective administration and thereby diminish individual welfare. In particular, where the benefits and costs of a government policy or program do not fall squarely within the boundaries of a jurisdiction, the optimal quantity and quality of public goods or services will not be produced. States will tend to overprovide goods and services when they can export the costs to non-residents, and, conversely, underproduce goods and services whose benefits accrue to both residents and nonresidents (the utility or welfare of non-residents not being included in the political calculus). The contention is that because the national government includes all citizens, such jurisdictional spillovers would no longer result in production mismatches as governmental

decision-makers at the higher level can internalize appropriately all of a program's costs and benefits. The intellectual state of play is therefore an empirical question, and the answer may well vary with the context.

How does the broad statement of the benefits and costs of federalism map onto the corporate law setting? Corporate law governs relations between managers and shareholders. As a consequence, although those individuals do not physically reside in the domicile state, the costs and benefits of the corporate contract are borne by them, that is, there are no externalities or interjurisdictional spillovers in corporate law of any significance that would suggest the appropriate authority should be the national government. Accordingly, questions regarding the efficacy of the federal system of corporate law have been directed at whether it furthers the objective of safeguarding the economic interest of shareholders, the residual claimants.[1] The data indicate that this arrangement has been shareholder welfare-increasing: while certainly not perfect, the competitive process in which states seek to retain and attract domestic corporations has tended to result in corporation codes whose content is in accord with investors' preferences. This is, to be sure, in part a function of incentives brought to bear on managers from the numerous alternative uses to which investors' funds can be put, as well as from the other markets in which firms operate (see, e.g., Winter 1977), but it is also the product of the incentives of states competing in the market for corporate law.

A. The State Competition Debate

[1] The normative claim for advancing shareholder interests as the objective of corporate law is that operating firms in accordance with the interest of the residual claimant will maximize firm value, which benefits all parties in relationships with the firm. See, e.g., Easterbrook and Fischel (1991:38).

The classic positions in the state competition debate were formulated in the 1970s in two widely-cited articles by William Cary (1974) and Ralph Winter (1977). The two sides of the debate share assumptions regarding the behavior of firms and states: (1) firms will seek out the jurisdiction with their preferred corporate law, being able to change domicile (reincorporate) without significant cost; and (2) states will compete to offer laws that attract or retain domestic corporations in order to increase state coffers (domestic corporations pay franchise fees to incorporate, as well as to do business, in a state). The disagreement was over whose preferences informed the domicile choice, and thereby found expression in state law. Because Delaware (1) attracts the most corporations, including a majority of the largest publicly traded firms, firms going public for the first time, and firms changing their domicile (Romano 1985; Daines 2002; Moodie 2004); (2) obtains a large fraction of its total tax revenue from incorporations – an average of 17% over 1966-2000 which increased to 20% and higher since 1992 (Romano 2002) – and (3) is either a pioneer or early imitator of statutory innovations (Romano 1985, 2002, 2006), the debate over the efficacy of state competition devolves into one over the quality of Delaware law, and correlatively, to whose preferences it is responding when updating its code. Cary (1974:666) contended that managers' preferences governed, characterizing Delaware case law as unfavorable to shareholders, and, more famously, the development of state law as a "race for the bottom."

Winter, however, identified a critical omission in Cary's analysis that would point the "race" in the precise opposite direction: firms operating under a legal regime unfavorable to shareholder wealth would be outperformed by those operating under a favorable regime, which would put managers' employment in jeopardy. Namely, a higher cost of capital and

correspondingly lower stock price of underperforming firms, would drive them out of business, or subject them to a takeover, and the managers would be replaced by a creditor's committee or a successful hostile bidder. This omnipresent threat, Winter contended, would result in managers' selecting the domicile that was most likely to maximize shareholder wealth, that is, firm value. The many markets in which firms operate, then, align managers' and shareholders' interests with regard to domicile choice, leading states to compete toward the "top" rather than the "bottom."

B. Do States Compete?

More recently, some commentators have contended that, given Delaware's dominant position in the charter market, corporate law in the United States cannot accurately be described as the product of competition (Kahan and Kamar 2002). They advance a number of related claims as evidence that states do not compete: (1) other states have not sought to replicate key features of Delaware's legal regime by similarly charging high franchise fees and establishing a specialized court to hear corporate law cases,[2] (2) excluding Delaware, state officials do not express an active interest in attracting incorporations; and (3) there are not sufficient benefits to other states to compete. The characterization that states do not compete does not accord, however, with the behavior of states and firms that we observe.

1. Defensive Competition

States need not copy Delaware institutions to be competing for domestic corporations, nor is active recruitment of incorporations by government officials a prerequisite for competition.[3]

[2] The importance of franchise revenues and a specialized court for Delaware's success is discussed in part III.B, infra.

[3] For a more comprehensive critique of the position that there is no market for corporate law, see Romano (2002:75-83; 2005a).

As I have previously characterized the competitive process, given Delaware's dominance, other states engage in defensive competition, acting to retain domestic corporations, rather than seeking to lure corporations away from Delaware and unseat it as the market leader (Romano 1985). Defensive competition is an effective strategy because most newly public firms incorporate either in their home state or Delaware (Daines 2002).

Most certainly, many, if not nearly all, states do not behave as if they were indifferent to the number of corporations in their jurisdiction: for if that were the case, we would not observe states repeatedly revising their corporation codes in response to changes in Delaware law and loss of local firms to Delaware (Romano 2006; Moodie 2004). Nor would we observe Delaware assiduously responding to revisions in other state codes. It would furthermore not make strategic sense for states to compete with Delaware by charging as high a franchise fee,[4] whereas in terms of adjudicative strategy, some states have, in fact, created specialized business courts. Alternatively some states, particularly those with a relatively small number of public corporations, such as Connecticut, follow a less expensive strategy, adoption of the bright line

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[4] As discussed in part III.B, infra, the significance of high franchise fees is that when a large proportion of a state's tax revenues is derived from franchise fees, it attract corporations by functioning as a commitment device by the state to be responsive to changing business needs, and only a few states, similarly small as Delaware, could theoretically benefit from duplicating that aspect of Delaware's success. But even with considerably lower fees, many states raise in absolute dollars far more revenues from franchise fees than does Delaware (e.g., Romano 1985). Moreover, there is a positive relation between the proportion of total tax revenue states collect from franchise fees and their corporate law responsiveness (Romano 1985), which suggests that even relatively small dollar amounts influence behavior. To the extent, as discussed in part III.A infra, that a Delaware domicile is most apt for firms seeking to engage in specific transactions, such as mergers and acquisitions, other states can vie with Delaware by competing on price rather than quality: firms that do not anticipate engaging in transactions to which Delaware law adds value might prefer a package of lower franchise fees and lower quality law (such as no expert court and a less responsive code).

rule-based approach of the Model Business Corporation Act ("Model Act") instead of Delaware's standards-based approach that relies on judicial expertise, diminishing the need for a specialized court (Lotstein and Callo 2000:10).[5]

More important, not all states need compete with Delaware for it to behave as if it were an actor in a competitive market. Even if only a few states adapt their corporation codes to changing circumstances, Delaware would ignore that activity at its peril, as sluggishness in adaptation could cause domestic firms to migrate, paralleling the influx of firms into Delaware when their home states did not quickly adopt Delaware's statutory innovations (Romano 1985; Moodie, 2004). As long as there are not significant entry barriers to charter competition (a characterization of market structure that Kahan and Kamar do not question), the potential entry of competitors, without actual competition, could compel a producer such as Delaware, which otherwise would appear to be a monopolist, to behave as if there were perfect competition (Baumol 2002; Romano 2002:82-83). Indeed, a desire to retain existing, and attract additional, corporations is a straightforward explanation why Delaware attentively revises its corporation code. Further, as Baumol notes, innovation in capitalist economies requires constant investment, which result in minimal entry barriers (sunk investments do not matter), because the innovator has continually to expend funds on research and development to maintain its edge, expenditures

[5] There is an economy of scale in the production of legal precedents (see part III.B, infra), which makes it less cost-effective to operate a specialized court in a state where there are few corporations that could ever require its services. The Model Act is a product of a subcommittee of the American Bar Association's Corporate and Business Law Section, whose members are generally attorneys at large firms with public corporation clients. It provides a template for state corporation codes and has undergone several iterations since the initial draft of 1950. At present, thirty-two states and the District of Columbia have adopted a version of the Model Act, but most large states have not. For a discussion of its role in the making of state corporate law, see Carney (1998); Romano (2006).

no different from those which a new entrant must undertake. This feature also characterizes the corporate charter market: Delaware's costs of maintaining innovative activity through legislative updating and developing and appointing knowledgeable judges, are likewise those which would be born by an entrant.

2. Role of the Bar in Statutory Innovation

The pivotal factor for understanding the working of the charter market is that corporate law initiatives responding to changes in the business or legal environment are brought to legislators' attention and that legislators respond positively to such appeals. Kahan and Kamar's contention that the existence of competition is to be gauged by the presence of formal statements and actions of state government officials misses how lawmaking works on the ground and the modus operandi of state competition: *Legislative initiatives in corporate law originate with the corporate bar in Delaware, as well as other states*.

State officials in Delaware may well express a much more active interest in attracting corporations compared to those of other states, but the more crucial factor in generating competition is legislatures' responsive updating of corporation codes to changing business circumstances. The corporate bar, as the repository of knowledge and expertise related to those matters is the catalyst for nearly all such legislative activity. In keeping with the "fire alarm" characterization of congressional oversight of agencies in the political science literature (McCubbins and Schwartz 1984), the corporate bar monitors and identifies needed legislative changes, no doubt reflecting the needs of their clients (managers and investors), whether due to a changed business environment, judicial opinions, or laws adopted in other states, and the Delaware legislature in turn responds to the bar's pulling the "fire alarm" by enacting the

proposed initiatives (e.g., Alva 1990:900).

A good illustration of state competition at work is the diffusion of statutory innovations in response to the crisis in directors' and officers' liability ("D & O") insurance. By 1984, the market for D & O insurance had changed dramatically from the beginning of the decade, with firms having difficulty obtaining or renewing policies, as premiums skyrocketed, deductions increased yet coverage decreased (Romano 1989). While a tight reinsurance market due to natural disasters contributed to the market dislocation, a 1985 decision of the Delaware Supreme Court, Smith v. Van Gorkom, 488 A.2d 858 (1985), held outside directors had violated their duty of care when agreeing to a merger price at a substantial premium without sufficiently informing themselves of the firm's value. This decision, no doubt, exacerbated managers' and investors' anxiety over the market trend: difficulty in obtaining insurance for directors who were confronted with heightened potential liability would render more difficult retention or recruitment of quality outside directors, individuals whom many institutional investors consider an especially key governance device for monitoring managers.

States responded to the perceived D & O insurance crisis by seeking to lower directors' liability on the view that doing so would mitigate a potential recruitment problem created by inadequate liability insurance. By 1987, thirty-five states had modified their corporation codes to reduce directors' exposure to shareholder litigation (Romano 1989:30). After initial experimentation, with three different approaches adopted by Indiana, Delaware and Virginia, most states settled on the solution chosen by Delaware, which was not the most aggressive solution, to permit charter amendments that limit or eliminate director liability for monetary damages for breaches of the duty of care (i.e., the liability exposure in Smith v. Van Gorkom).

Most important, commentaries by practitioners and legislative histories in a number of states upon the enactment of their statutes explicitly stated that they were enacting the statute to deter local firms from reincorporating in Delaware (Romano 2006:224). Contrary to Kahan and Karmar's thesis, this behavior can only be coherently explained as evincing states competing for corporations; if states were indifferent to the number of domestic incorporations, they would not be concerned about the content of their corporation codes and we would not observe the rapid diffusion of limited liability statutes across the states, a pattern repeatedly observed of statutory innovations in the corporate context, although the speed of diffusion varies across provisions (Romano 2006).

Kahan and Kamar (2002:705) also contend that the bar's role as the leading source of legislation indicates an absence of state competition, asserting instead that lawyers are motivated to seek corporation code revisions in order to enhance their reputations, or solve clients' specific problems, in "ways not related to attracting incorporations." But that is a distinction without a difference: the effect of enhancing a reputation (whether for expertise or political connectedness) or solving a client's problem, through promoting legislation is not only to maintain that client relation but also to attract additional clients. Legislation that addresses one firm's problem typically resolves a problem confronted by numerous other firms, which will thereby be attracted to the state.

Kahan and Kamar would appear implicitly to acknowledge that the alternative explanations for lawyers' legislative activity that they provide are actually indistinguishable from the financial motive to increase the pool of in-state domiciled firms (i.e., potential clients). For they further seek to distinguish lawyers' motives to attract clients from motives to attract

corporations to the state, by suggesting lawyers obtain clients by promoting arcane legislation to benefit themselves at the expense of clients and other lawyers (since only the drafter would ostensibly understand such a law's operation), or laws very different from those of Delaware to limit competition from out-of-state lawyers (Kahan and Kamar 2002:705-06). But this speculation is inconsistent with state corporation codes as we know them, as well as the revisions urged by the bar that we observe: corporation codes do not consist of unduly complex or abstruse provisions, in contrast to other business-related federal statutes and their implementing regulations, of which the federal tax code is paradigmatic. Furthermore, there is substantial uniformity across the states, and the statutory innovations that rapidly course through states at the bar's behest, such as the limited liability statute, are quite transparent such that non-initiating attorneys can readily comprehend them (e.g., Romano 2006). In short, the most parsimonious and compelling explanation of the role of the bar in the making of corporate laws is that it is the motor force of charter competition: by prodding legislatures to innovate or imitate another state's innovation, in response to exogenous shocks caused by changing business and legal circumstances, they benefit their clients and thereby themselves, by maintaining, if not expanding, their practice, by making their state a more appealing domicile.

3. Evidence of Competition

There is additional evidence relating to the diffusion of legislative innovations across the states and flows of reincorporations that is consistent with characterizing the states as competing for corporations. First, corporate law innovations diffuse across the states in an S-shaped curve – the proportion of adopters increases with time (Romano 1985, 2006; Carney 1996) – which is similar to the diffusion of technological innovations in industry and of financial product

innovations that is conventionally interpreted as a sign of competition (e.g., Nabseth and Ray 1974; Molyneux and Shamroukh 1999). Second, the revenue that states obtain from the corporate franchise tax is significantly positively related to the responsiveness of a state's corporate law to firms' preferences (where responsiveness is measured as a function of the rate and extent to which the state enacts legal innovations considered desirable by reincorporating firms, see Romano 1985; Moodie 2004). This phenomenon comports with what, as earlier noted, can be best described as "defensive" competition, in which states compete with Delaware by seeking to retain local firms rather than attract foreign firms (i.e., by reducing outflows rather than increasing inflows of reincorporating firms) (Romano 1985; Moodie 2004). Third, firms changing domicile tend to move from less to more responsive states, or to put it another way, the more responsive states are less prone to lose in-state firms to Delaware (Romano 1985; Moodie 2004). In this regard, we also observe spurts of reincorporations to states – Delaware in particular – upon statutory innovations (Romano 1985; Moodie 2004). If states were not seeking to retain corporations, then we would not observe the positive relations between revenues, responsiveness, and reincorporation flows, nor would we expect to see the S-shaped pattern of legal diffusion.

Kahan and Kamar's multiple explanations, dismissing the presence of competition, cannot otherwise account for these pertinent facts. Their thesis would also appear to be premised on the view that the state competition literature is founded on the contention that all states are as vigorous as Delaware in engaging in legislative innovation to attract firms, and that the market for corporate law is one of textbook (perfect) competition. But that is not, and has not been for some time, the contention. The claim is more subtle. The definition of competition – there being

a market for corporate law -- is not that states act to “win” (see Moodie 2004:10), that is, to unseat Delaware as the market leader, but rather, that states act defensively – which they indeed do – to revise their corporation codes in response to Delaware’s legislative innovations, and for Delaware, in turn, to respond to other states’ innovations – which it does -- and for that dynamic process to affect – which it does – the number of firms incorporated in a state.

4. Competition from Nevada

There is one state besides Delaware that indisputedly actively seeks to attract corporations from other jurisdictions, Nevada. Historically referred to as the “Delaware of the West,” it is a state that, like Delaware, has had a net inflow of incorporations (e.g., Romano 1985:246; Barzuza and Smith 2013:41). It also engages in activity paralleling that of Delaware: state officials actively promote local incorporation, it has established a specialized business court, and it charges a much higher franchise fee – although lower than Delaware’s – than that of other states, which it has been increasing over time as its market share of incorporations has increased (Barzuza 2012). These features of corporate law production, as earlier noted, are characterized by Kahan and Kamar to be the sine qua non of state competition.

But there is also a distinct difference in the most recent pattern of Nevada’s activity that distinguishes it from the classic state competition story. In recent work, Michal Barzuza (2012) contends that Nevada competes with Delaware by means of product differentiation: evaluating the two states’ statutes, she reports that Nevada offers a code tailored to a clientele quite different from that of Delaware, firms seeking a “lax” corporate law that provides managers with heightened protection from liability to shareholders when compared to Delaware law. In her analysis, Delaware provides stronger protection to shareholders – a “Winter” or “top” view of

Delaware – while Nevada is the polar opposite, an exemplar of the "Cary" or "bottom" characterization. Barzuza (2012:948, 953) posits that Nevada's product differentiation of corporate law laxity is a recent competitive strategy, as the reforms to Nevada's code she identifies as distinctively more "lax" than Delaware's were enacted in the 2000s. Although Barzuza considers her hypothesis to be consistent with an absence of competition, this characterization is at odds with the data that she provides: if states can carve out distinctive market niches, they are, in fact, competing with Delaware by seeking to attract a subset of firms from the pool of all potential reincorporations (that is, firms considering migrating from their home state), reducing the attraction of Delaware or other states, whose products are not so differentiated.

Larry Ribstein (2011) questions Barzuza's assessment of Nevada as the embodiment of the managerialist regime that Cary had contended was Delaware's trophy. Offering a more benign self-selection explanation, Ribstein contends that Nevada's product differentiation can be understood as providing efficient contracting for firms for whom the monitoring and litigation costs they would bear as Delaware corporations would be unduly high and thereby reduce firm value. The idea is that for firms for whom litigation is more likely to be frivolous, diminishing the prospect of liability would be cost effective. This could be particularly true for small firms for whom the additional layer of costs of a Delaware domicile (compared to being incorporated in their home state) could lead to financial stress.[6]

Another feature of Delaware law that could increase litigation costs for some firms, that

[6] Seemingly small amounts related to incorporation fees matter even to publicly traded corporations: firms reincorporating out of Delaware to reduce taxes identified annual tax savings

Barzuza (2012:982) notes is the emphasis in Delaware jurisprudence on the decisions of independent directors for determining fiduciary liability. The reasoning is that because small firms have historically been less likely to have independent boards than large firms, the doctrine would render it more difficult for them to be absolved from liability, or impose considerable expense by having to increase the number of independent directors. This concern is not mere speculation. Such an effect has been observed for small firms from the independent director mandates of the Sarbanes-Oxley Act and stock exchange rules following the Enron accounting scandal (Linck et al. 2009). Barzuza (2012:982), however, rejects the reduced frivolous litigation-cost explanation in favor of the managerialist one, by contending that the issues that produce frivolous lawsuits are not related to legal differences between the two states.

Barzuza suggests (2012:936) that were Nevada's approach to be followed by other states, state competition would indeed be a "race for the bottom."[7] Research examining the diffusion of state corporate laws has up to now focused solely on innovations by Delaware and the Model Act (Romano 1985, 2006; Carney, 1996). Nevada's competitive presence is a topic where additional research would be quite useful, both to identify whether a similar diffusion pattern exists for innovations by Nevada and to sort out how the characteristics of Nevada firms identified by Barzuza relate to the probability of being subject to frivolous litigation or high litigation costs (versus a propensity to engage in fiduciary misconduct). Key questions, if other states have

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ranging between $2,000- $50,000 (Romano 1985:257 n.257).

[7] The conclusion is derived from data, discussed in part II.D.2, infra, indicating that Nevada companies have more frequent financial restatements than firms incorporated in other states, as well as her analysis of Nevada's revised code and the subsequent influx of incorporations.

mimicked the revisions to Nevada's code that Barzuza stresses, include what is the effect on the inflow and outflow of corporations in such states, and do the characteristics of firms incorporating in such states replicate those of Nevada firms?

C. State Takeover Regulation

Takeover regulation in the United States is an area of dual jurisdiction: though most of the contested activity is in the domain of the states, the ground rules for the making of tender offers are set forth in national legislation known as the Williams Act, Pub.L. No. 90-439, 82 Stat. 454 (2010). Because the Supreme Court (in Schreiber v. Burlington Northern, Inc, 472 U.S. 1, 1985) interpreted the federal antifraud provisions to cover only disclosure violations and not the fairness of a bid or appropriateness of management actions (matters covered by fiduciary duties at state law), the dual jurisdiction is largely divided such that actions of bidders are principally regulated at the national level while those of management are left for the most part to the states. Starting in the late 1960s, when hostile takeovers emerged as a key acquisitive mechanism for control changes in which incumbent management was replaced, by their avoidance of managerial consent as required for a merger (Manne 1965), and intensifying in the 1980s when hostile takeovers soared with innovation in financing, states responded by enacting statutes attempting to render such transactions more expensive.

1. The Debate over State Takeover Laws

The first generation of takeover statutes, structured similarly to the Williams Act in regulating bids, were struck down by the Supreme Court as burdens on interstate commerce (in Edgar v. MITE, Corp., 467 U.S. 624, 1982), but unfazed, states immediately responded by enacting new statutes (referred to as second generation statutes), whose content sought to track

more closely subject matter conventionally contained in state corporation codes (by restricting bidder voting rights and merger transactions), and these statutes were upheld as valid exercises of state law (in CTS Corp. v. Dynamics Corp. of America, 481 U.S. 69, 1987). Over forty states now have takeover statutes, and most of them have multiple statutes (Romano 2006:227-231). In addition, starting in the interval when the constitutional validity of takeover statutes was in flux, but continuing thereafter, creative lawyering devised self-help defensive tactics for adoption at the firm-level by management, most of which were upheld by courts.

There is a large literature on whether the effect of takeover regulation and firm-level defenses, which are widely perceived as encouraging bidding auctions, benefit shareholders, given a tradeoff between a higher premium conditional on the occurrence of a bid and an unconditional, lower probability of a bid in the first place (as the prospect of an auction deters initial bidders by reducing the return on investment in identifying potential targets). But implicit in that tradeoff regarding investor welfare is an observational problem for shareholders (and for courts' adjudication): managers have a conflict of interest regarding defenses, shielding their positions versus obtaining a higher premium for shareholders, and it is difficult to disentangle the motives even in a specific transaction context. While the conflict of interest can be mitigated by incentive compensation (such as, accelerated stock option vesting and golden parachutes, which are large severance payments paid upon a change in control), when managers bypass shareholders and seek instead a statutory solution to thwart a bid, it would seem plausible to characterize that behavior as primarily self-serving.

The endgame setting of hostile takeovers, in which the relation between managers and shareholders will end with the termination of the target corporation's independent existence,

undercuts the other market constraints that align managers' and shareholders' choice of a corporate law regime. Accordingly, some commentators believe that state takeover activity demonstrates that state charter competition is harmful to shareholders, the implication being that it should be replaced in toto by national regulation (e.g., Bebchuk and Ferrell 1999). But the import of state takeover regulation for an assessment of the efficacy of state competition is not that straightforward, as it depends on the answer to two further questions: 1) are the dynamics of state takeover regulation an anomaly or a paradigm for state competition? and 2) would the political economy of a national law produce a different and superior output from that of state competition?

2. Anomaly or Paradigm?

The political process, and the pattern of adoption, of takeover statutes indicate that they are an anomaly when compared to the ordinary course of corporate law legislation. Whereas the statutory innovations earlier discussed are sponsored by the corporate bar, outside of Delaware, takeover statutes are more typically promoted by managers of a local corporation, or the state chamber of commerce at the behest of a member, which is a target (or anticipates imminently becoming a target) of a hostile offer (Romano 1988:461). Even more striking, is the disparate pattern of innovation and diffusion of takeover statutes compared to other corporate law provisions. Delaware, invariably an early adopter of corporate law innovations, is a persistent laggard when it comes to takeover statutes. While it has been the first or one of the first states to adopt most statutory innovations over the past several decades dating from its 1967 code modernization, a dozen states had adopted a first-generation takeover statute over seven years prior to Delaware's enacting such a provision, and over twenty states had enacted second

generation statutes before it responded, which only followed the Supreme Court's decision upholding such a law (Romano 2006:218).

In addition to not replicating the typical diffusion process of statutory innovation, Delaware's takeover statutes have been considerably less restrictive of bids than the prototypes in other states. For example, its first generation statute provided greater flexibility and protection to bidders than other statutes by the absence of a hearing requirement – the prime mechanism by which the early statutes sought to defeat hostile bids by imposing an extensive delay – and making the statute's coverage optional (Romano 2002:95). Delaware's second generation statute, which regulates a successful hostile bidder's subsequent combinations and transactions with the target, shares those characteristics, providing a mechanism by which a hostile bidder could be exempt from the statute entirely (based on the percentage of shares acquired), reducing substantially the number of years to which the combination restrictions apply, and excluding a post-moratorium fair price requirement. Its legislation would appear to have had a moderating influence on subsequent statutory adoptions: a majority of states thereafter enacting the same type of statute as Delaware followed its lead by selecting the shorter interval of applicability and eliminating the post-moratorium fair price requirement (Romano 2006:232).

Several features of Delaware's legal landscape explain why it would take a more accommodating approach to hostile takeovers than other states. First, Delaware's corporate bar vets all corporation code revisions and the fact that there are more bidders as well as potential targets incorporated in Delaware than in other states results in a greater variety of perspectives informing the Delaware bar's deliberations over takeover regulation, than occurs in other states where the bar principally represents targets. Indeed, in contrast to Delaware's unvarying

legislative practice, in other states, takeover statutes have been enacted bypassing the corporate bar's input, entirely. Romano (1987) chronicles such an instance in Connecticut.

Second, and even more important, given the large number of Delaware-domiciled (but not physically present) corporations, no one target would have sufficient leverage in the legislature to obtain a specific statute, as occurs in other states, where a major corporation can sway legislators who may have personal relations with management, or may be worried over the potential loss not only of civic support but also of local employment, on the expectation that a successful hostile bidder would move the headquarters, or close down in-state facilities.[8] In sum, the widespread adoption of takeover statutes has been viewed as problematic by commentators on both sides of the state competition debate, but Delaware, with its distinctive corporate law politics, is hardly the source of the problem.

3. Would a National Takeover Regime Be for the Better?

Despite the problematic political dynamics of state takeover regulation, there are compelling reasons why a preemptive national regime would not be for the better. First, it is questionable whether the political dynamics of takeover regulation would be any different at the national level than it is in the states. To the extent that the problem with the enactment of takeover statutes is one of asymmetrical collective action – managers are better organized politically than shareholders – this holds true regardless of state or national forum. In addition, managers have a greater incentive than shareholders to lobby on takeovers because of greater

[8] A further factor differentiating the takeover legislative context from other corporate laws is that some states have enacted statutes to assist resistance to a hostile bid by local companies that are domiciled out-of-state (Romano 1988:460-461 n.11), suggesting that legislators considering takeover statutes in states other than Delaware may be motivated more by local employment than the number of in-state incorporations.

adverse personal stakes: individuals care more about preventing losses than achieving gains of equal magnitude (e.g., Hardin 1982:83, 120-121), and the loss to individual managers from loss of their positions is far more consequential than the premium gained by individual shareholders who hold small blocks of stock. To the extent that interest groups other than managers and shareholders, and in particular, labor unions, influence state legislators to enact takeover statutes, they tend to be equally, if not better, organized at the national level. For example, the Dodd-Frank Act, Pub.L. No. 111-203, 124 Stat. 1376 (2010), contains directives to the SEC concerning regulations that were high on labor's legislative agenda, some for years, and tangentially related to the ostensible focus of the law, the financial crisis (e.g., Romano 2005b:1596 n.214, labor unions' initial push for proxy nomination rule referenced in Dodd-Frank; Romano 2012:110, union source of statute's executive pay ratio disclosure rule).

Second, there is an instructive historical record of congressional activity regarding takeovers that mimics what occurred in the states. The Williams Act, enacted in 1969, was similar in structure to Virginia's earlier enacted takeover statute, and, as numerous commentators have noted, tilted the playing field for incumbent managers (e.g., Easterbrook and Fischel 1991:224-25). In addition, congressional action on takeovers - which peaked in the 1980s and consisted of numerous bills and hearings and enactment of tax code provisions increasing the cost of takeovers – was primarily directed at restricting bids, as was the state legislation being adopted at the time (Romano 1993:76-80). Just as many state takeover statutes were enacted at the behest of a local target, congressional bills and hearings were frequently sponsored by legislators of a target's state (Romano1988:482-484). Furthermore, the sole bill on takeover regulation ever to come out of congressional committee expressly reserved a role for state

regulation (Romano 2005a:228 n.24), thereby making plain that were legislation to have been enacted, it would surely have been closely aligned with managers' preferences, which is not what commentators have in mind when advocating national regulation.

Congressional activity diminished following the Supreme Court's decision upholding state takeover statutes, as managers refocused their efforts in state capitals and the Reagan and Bush Administrations made clear, through their selections of SEC chairmen, their opposition to adopting an additional layer of takeover regulation, the Williams Act having been adopted at the urging of the SEC chairman at the time (Romano 1988:489). But the pattern of congressional activity suggests that had the Supreme Court decided otherwise, Congress would, in all likelihood, have proceeded to enact regulation paralleling states' second generation statutes.

Finally, a national takeover regime would provide firms with far less flexibility in their approach to hostile takeovers than state regulation. There would be no safety valve through which firms could avoid restrictive legislation as there is when takeovers are regulated by the states and firms can choose from among regimes, such as Delaware's more bidder-, hence shareholder-, friendly statute or states with no takeover statutes. In fact, the existence of less restrictive options constrains managers from establishing fortress-like defenses. An informative example involves the Pennsylvania disgorgement statute. It was considered to be more Draconian than other statutes, and event studies uniformly identify its as having a significant negative stock price effect (Szewczyk and Tsetsekos 1992; Karpoff and Malatesta 1995). Following its enactment, institutional investors pressured managers to opt-out of the statute, and a majority of publicly traded firms did so (Romano 1993:68-69). By contrast, optionality is not, a characteristic of national legislation: the federal security laws are mandatory in nature, as is its component

takeover regulation, the Williams Act.

The widespread withdrawal by Pennsylvania corporations from inclusion under a value-decreasing statute makes plain the acuity of Winter's critique that capital markets discipline managers notwithstanding their best efforts at entrenchment, by placing a floor on deleterious state competition. Additional support for this contention is that in contrast to other innovations in takeover regulation, hardly any states followed Pennsylvania's lead in adopting a similar statute.

Could we do better than the existing regulatory regime for takeovers? Most certainly. A regime in which firms must opt in to be covered by a takeover statute, following the approach taken by Georgia and Tennessee and patterned after limited liability statutes, for instance, rather than the otherwise prevalent opt out formulation, would increase confidence that being subject to a statute meshes with shareholder preferences, as adopting a charter provision requires management initiation, and data suggest that statutory defaults can be sticky (e.g., Listokin 2009). Permitting shareholders to opt out of a takeover statute without management consent through bylaw provisions, which once adopted cannot be reversed by management, as is the true for adoption of bylaws requiring majority voting for directors (see Delaware Gen. Corp. Law § 216), would also be a useful improvement.

But perfection is not the proper yardstick for measuring the performance of state competition. When commentators contend that a national takeover regime would be superior to the states, they are operating under the illusion that Harold Demsetz (1969:1-2) famously referred to as the fallacies of the "nirvana approach," assuming that a perfect solution exists to critique real-world institutions when the appropriate comparison should be between realistic alternatives. State competition is no exception to this admonition: the reality is that it is a pipe dream of

commentators to believe that a national law would take the shape of their preferred, takeover-friendly regulation. There is no plausible reason to expect that takeover regulation at the national level would result in superior institutional arrangements than exist under state competition, while good reason to expect that it could make matters far worse.

D. Who Benefits from Competition?

The existence of a market for corporate law does not of itself provide information regarding to whose preferences, managers' or shareholders,' states are responding when they revise their corporation codes and compete for incorporations. The answer to that question requires an empirical inquiry.[9] A body of research has sought to address whether state competition for charters benefits manager or shareholders, that is, whether it has led to Cary's "race for the bottom" or, in keeping with Winter's analysis, has tended toward the "top." On balance, the data is most consistent with the latter view, as they indicate that shareholders have

[9] Cheffins et al. (2014) seek to demonstrate that U.S. state competition since the Nineteenth century has been a "race to the bottom" by calculating the change in value of an index to measure the "strength" of U.S. state laws related to indices used to evaluate shareholder "rights" across nations in contemporary comparative corporate governance research, first introduced in La Porta, et al. (1997). The analysis unfortunately does not demonstrate that state corporate law has, as is contended, been at the "bottom" for over a century, because the construction of the index defines away the issue: it classifies a statute as harmful to shareholders if it is enabling (as opposed to mandatory) or if it increases managerial discretion. To their way of thinking, the national securities laws, which are mandatory, are the sole component of US law that is at the "top." However, to ascertain the direction – "top" or"bottom" – of state competition, as is the paper's objective, it is necessary to measure the effect of enabling statutes and statutes increasing discretion on share value. Cheffins et al. assert further that the judgment of commentators who evaluate state competition as toward the "top" is derived from a "style" of legislation. To the contrary, the evaluation is informed by the substantial body of empirical research indicating a positive wealth effect. For an assessment of the empirical literature on the impact of the mandatory national securities laws on share value, which tends to be insignificant or negative, see Romano (2002).

benefitted from competition.[10]

1. Event Studies of Reincorporation

A good proxy for ascertaining whether the choice of legal regime benefits shareholders is to examine the effect of a change in domicile on share value. If such a move-- reincorporation-- increases share value, then it would be difficult to maintain that charter competition is harmful to shareholders. The conventional methodology for measuring such a wealth effect is an event study, which examines the stock price effect surrounding an unanticipated event (here, the announcement of a proposal to change domicile). The assumption of the technique is that in an efficient stock market, prices incorporate new information about a firm's prospects as soon as it is made public. Using a model of expected prices in the absence of the event, the difference between actual and predicted price on the announcement or event date, referred to as the abnormal return or average residual, measures the wealth effect of the event. The methodology is reviewed in Bhagat and Romano (2002). Hundreds of event studies have been undertaken to evaluate the wealth effects of public policies and firm-level actions, as well as to establish

[10] Macey and Miller (1987) suggest that a third group, corporate lawyers, are the principal beneficiaries of Delaware's success, noting that Delaware law is more favorable to shareholder lawsuits than that of other states, such as its absence of a "security-for-expenses" statute, a requirement that plaintiffs post a bond to cover defense costs should the lawsuit fail. No empirical research has been undertaken to test the hypothesis that state competition benefits lawyers at shareholders' expense – indeed it would be exceedingly challenging to formulate how such an effect could be measured. While the hypothesis is consistent with lawyers' key role in the development of corporate law, as has been detailed in part II.B, the evidence detailed in this part indicating positive wealth effects and the superior performance of Delaware firms is more consistent with a regime on balance benefitting shareholders; in other words, whatever lawyers may benefit from Delaware law, it is swamped by the benefits accruing to shareholders. In addition, Delaware law is not one-sidedly in favor of litigation. For example, plaintiffs are restricted by having to meet a strictly applied demand requirement before a shareholder derivative suit can be brought, and many firms, in fact, migrated to Delaware to take advantage of its limited liability statute (Heron and Lewellen,1998; Moodie, 2004).

requisite elements of federal securities law violations and the measure of damages, under Supreme Court jurisprudence (Bhagat and Romano 2007).

There have been eight event studies of the effect of a change in incorporation state. All of the studies find positive abnormal returns: in five they are statistically significant, while in two only marginally significant at 10% (Bhagat and Romano 2007:971).[11] These findings are consistent with Winter's perspective on competition, that it benefits investors. Were Cary's view correct, the wealth effect would be negative. But because reincorporation is often accompanied by new business plans (see part III.A.), a concern might be that the positive price impact was due to investors' valuation of the new plan, rather than the new legal regime. This does not appear to be the case, however, as an event study classifying moves by the type of accompanying business plan tested whether the abnormal returns differed significantly across the different classifications of reincorporations and found that they did not (see Romano 1985:272).[12]

The average abnormal return across the studies is 1.28%. Critics of state competition

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[11] The remaining study by Dodd and Leftwich (1980), which is also the earliest and therefore the only one to use monthly data, as daily data were not then available, finds statistically significant positive abnormal returns over two years prior to the reincorporation. Of the five studies reporting statistically significant positive abnormal returns, the significant positive result in one is for a subsample of reincorporations only.

[12] In contrast with Romano's finding, Heron and Lewellen (1998) find positive returns for firms reincorporating to limit directors' liability but negative returns for firms adopting defensive tactics when reincorporating. The negative returns are statistically significant only on an unconventional event date, the date of the shareholders' meeting, and not the date of the first public announcement of the reincorporation proposal (proxy mailing date), which is the more appropriate date on which to identify abnormal returns in accordance with the methodology, that is, the first public announcement of the event (Bhagat and Romano 2007:973). The significance of the finding is therefore problematic. In addition, contrary to Heron and Lewellen, both Romano (1985) and Netter and Poulsen (1989) find insignificant positive abnormal returns for reincorporations undertaken for takeover defensive purposes.

have sought to minimize the import of the event study data by describing this figure as “rather small” or “modest” (Bebchuk et al. 2002:1791). But such a depiction is mistaken: as a point of reference, an investment project that generates positive abnormal returns of even 1% is substantial in competitive capital markets. For instance, the magnitude of the price effect of announcements of capital expenditures, joint ventures, product introductions and acquisitions is less than 1% (Andrade et al. 2001:119). The most prominent critic of state competition has further sought to minimize the import of reincorporation event studies by contending that state competition may produce some harmful provisions even though the total package of statutes is not (Bebchuk 1992). But this critique misses the point: from the perspective of the efficacy of the output of competition, it is precisely the net wealth effect of state law on investors that is key, and the event studies indicate that effect is in general positive, and most certainly not negative.

2. Studies of the Effect of Domicile on Performance

Another analytical technique that has been used to examine whether shareholders gain from state competition is to compare the effect of a Delaware domicile on a measure of firm performance. The idea is that if Delaware firms outperform non-Delaware firms, then that is evidence that the direction of competition is toward the “top” and not the “bottom,” given Delaware’s dominant position in the chartering market. The analytical difficulty with such studies is a well-recognized problem in empirical corporate finance: the choice of domicile, as with other governance mechanisms, is endogenous, and therefore it is difficult to attribute causality to differences in performance, or even to expect to identify differences in performance, in relation to differences across firm characteristics. This is because in equilibrium firms would

be expected to have selected the domicile that maximizes their value, such that no performance difference would be uncovered across differently-domiciled firms, or if a positive (negative) performance difference is identified, it could well be due to the superior (inferior) quality of the firms selecting Delaware and not the other way around. The confounding of results due to self-selection is not an issue in reincorporation event studies because all of the sample firms have chosen to move.

There have been five studies examining the comparative performance of Delaware firms, three examining the change in several measures of accounting performance of firms before and after incorporating in Delaware, or between reincorporating and non-reincorporating firms; and two comparing the performance, as measured by Tobin's *Q*.[13] of Delaware firms to non-Delaware ones (Bhagat and Romano 2007:981). The accounting performance studies find no significant difference in performance in any comparison, except for a finding that the change in earnings before interest and taxes over the year after the domicile change was higher for firms reincorporating in Delaware than those reincorporating in other states (Wang 1995). The most plausible interpretation of the absence of significant accounting performance differences is that firms select the domicile that optimizes their future performance. The finding of a significant improvement post-reincorporation in Delaware compared to other domicile changes is consistent

[13] Tobin's *Q* is the ratio of a firm's market value to the replacement cost of its assets, and is conventionally interpreted as a proxy for a firm's investment or growth opportunities. In this context, business opportunities added by corporate law rules are considered to be a component of the value measured by Tobin's *Q*. For a discussion of a distinct endogeneity issue in using Tobin's *Q* to measure performance in relation to firms' corporate governance, such as the law of their domicile, because of the correlation between ownership and the inputs into the Tobin's *Q* calculation as well as governance choices, see Bhagat and Romano (2007:982). As a consequence, it is desirable to consider a variety of performance measures when seeking to

with the event study findings, that is, a positive price effect suggests that investors anticipated increased earnings, but it could equally indicate a self-selection effect, that higher quality firms (those with higher future earnings) relocate in Delaware.

The performance results are different when Tobin's *Q* is compared across domiciles. Daines (2001) finds that Delaware firms have significantly higher Tobin's *Q* values (by 5%), controlling for investment opportunities and other variables known to affect Tobin's *Q*, across the pooled 16 years of the sample and in 12 of the 16 years when the effect is estimated separately. The results hold for subsamples of firms: mature firms, IPO firms, and firms that had not reincorporated midstream, further bolstering the contention that a Delaware domicile adds value. Daines suggests the source of the value-added is either Delaware law's providing superior protection of public/minority shareholders from expropriation by managers/controlling shareholders, or its increasing the likelihood of firms being acquired at a premium. And there is support for the latter explanation, as Delaware firms are, in fact, more likely to be takeover targets (Daines 2001).

A subsequent study by Subramanian (2004) examining a different time frame, adding four later years (1997-2000), and subtracting the first ten years of Daines' study (1981-1990), reports a reduced, albeit still significantly higher Tobin's *Q* value for Delaware firms (2.8%), and that in the most recent years of the sample, the difference between Delaware and non-Delaware firms is no longer significant.[14] The absence of a difference in later years could suggest that

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evaluate the relation between governance, ownership and performance.

[14]One explanation for the disparate results could be a difference in samples that is not simply due to the different time intervals under study: Daines's study includes only firms for which data are available for at least five years whereas Subramanian's study has no such data

other states had “caught up” with Delaware by amending their codes to eliminate major differences, thereby reducing the value of a Delaware incorporation, or that the decline in the takeover market in the late 1990s was picked up in the Tobin’s *Q* values.[15]

Finally, Michal Barzuza and David Smith (2013) investigate a different performance measure to study the effect of a Nevada domicile: the filing of an accounting restatement. They find that Nevada firms have a significantly higher number of accounting restatements than firms in other states, including those in Delaware, consistent with Barzuza’s product differentiation thesis, that managers of Nevada firms sought out its “lax” laws to exploit shareholders. Namely, because restatements are events that produce significantly negative stock price effects, the claim is that the flow of firms into Nevada evidences an adverse effect of state competition on investors.

The Nevada firms are, however, by conventional measures riskier than other firms (they are younger, smaller and less profitable). Such a difference would seem, intuitively, to contribute to accounting troubles, complicating attributing the higher number of restatements to firms moving into a domicile that facilitates fraud, but an analysis pairing the Nevada firms with Delaware firms of similar characteristics still finds that the Nevada firms have significantly higher restatements.

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restriction. The directional impact of the difference in sample is ambiguous, however, as the more liberal selection method of Subramanian’s study would increase the number of both firms that have disappeared due to financial distress and young firms that have significant growth opportunities.

[15] Subramanian (2004:54-56) offers further possible explanations of the difference. This is an area where further research is needed to understand better the disparity in the studies’ findings and, accordingly, the import of the phenomenon originally reported by Daines.

To address the alternative “efficient contracting” product differentiation explanation of the effect of Nevada’s “lax” law, Barzuza and Smith examine Tobin’s *Q* values. Consistent with Daines’ study, the Delaware firms in their sample have significantly higher Tobin’s *Q* values.[16] Nevada firms do not. But as Nevada firms also do not have significantly lower Tobin’s *Q* values than firms in other states, one cannot readily conclude that the data demonstrate firms select Nevada to engage in misconduct.

Ribstein (2011) contends that Barzuza and Smith’s data are entirely consistent with efficient contracting because the firm characteristics (smaller, younger, less profitable) distinguishing Nevada firms suggest that they are firms that cannot afford the monitoring costs, such as the cost of setting up a complex internal control system, that could catch accounting errors or improprieties. Such an explanation would account for the more frequent restatements. The question, therefore, whether firms selecting Nevada for its more limited liability regime do so for efficiency or expropriation purposes is a conundrum at present, warranting further empirical investigation.

3. Event Studies of Changes in Delaware Law

Event studies of changes in Delaware law have also been undertaken as a means of evaluating state competition. As in the comparative performance studies, the idea is that because Delaware is the most successful incorporation state, the effect on stock prices of changes in its

[16] Barzuza and Smith do not report the time frame over which they analyze Tobin’s *Q,* but their data set, from 1990-2011, would indicate that the analysis includes all of Subramanian’s data, which would further suggest that Subramanian’s differential findings from Daines’ study (no “Delaware” effect over a few years), was a blip. But as Barzuza and Smith do not disaggregate the analysis into groups of years or individual years, as does Subramanian, the explanation for the difference across the studies remains unclear.

legal regime is equivalent to the effect of state competition on shareholder welfare. Event studies of legislation are considerably more challenging than those of reincorporations, however. Given the nature of the legislative process, it is difficult to pinpoint a point in time when the event is first publicly announced, yet accurate identification of an unanticipated event is critical to the proper use of the methodology (Bhagat and Romano 2002).[17] In addition, a legal rule applicable to all domestic corporations may not affect all firms equally, and in particular may affect some firms positively and others negatively (as well as still others not at all). Analysis of the price effect for a portfolio that does not control for heterogeneity across firms in relation to how they will be impacted by the rule could simply aggregate offsetting effects, and therefore not be able to isolate the rule's impact.[18] That is not an issue when the event study is of a firm-specific event, such as a reincorporation, because endogeneity is automatically controlled for by the composition of the test portfolio – it includes only firms experiencing the event.

Statutory changes in Delaware law that have been investigated are enactment of the limited liability statute and the second generation takeover statute. As there have been numerous event studies of takeover statutes, those examining Delaware's takeover statute are included in the discussion of the studies of all such statutes in part II.D.4. The three event studies of the

[17] To manage this problem, researchers typically identify specific key dates in the legislative process, such as a bill's introduction, approval by the committee with jurisdiction, approval by each of the legislative chambers, and sum abnormal returns across those dates, as uncertainty over adoption is resolved, to determine the wealth effect of a statute.

[18] There have also been event studies of Delaware court opinions. These are not reviewed given methodological interpretative difficulties that can confound interpretation of effects, related to the market's having formed an expectation of a lawsuit's outcome prior to the announcement date, and the Delaware legislature's frequent reversal or clarification of opinions perceived to impact firms adversely or uncertainly (Romano 2006:225 n. 42). For an evaluation of the studies, see Bhagat and Romano (2007:980-981).

limited liability statute find that it did not have a significant price effect (Bhagat and Romano 2007:977). Because firms had to opt into the statute to be covered, the insignificance could be a function of market uncertainty over whether firms would adopt a provision. Event studies of Delaware firms' adoption of limited liability charter amendments address that possibility. The answer would appear to not be clear cut. Depending on the event window examined or the portfolio of firms, the five such event studies report significantly positive, negative or insignificant stock price effects (Bhagat and Romano 2007:979-980). But as only one of the studies reported a significant negative finding over a single interval (seven-days), which was not replicated in the others, all of which report either significantly positive or insignificant results over a variety of intervals, it is most plausible to interpret the data as not being shareholder wealth-decreasing provisions.

The positive assessment of the impact of the limited liability statute is bolstered by two additional factors. First, shareholders voted overwhelmingly to amend charters to include limited liability provisions, and this cannot be adduced to shareholders blindly following management because institutional investors who in the same, and subsequent, time frames actively propose eliminating defensive tactics did not propose and have continued not to propose eliminating limited liability provisions (Bhagat and Romano 2007:980). Second, were state competition truly a race to the bottom, then states would have followed Indiana's more aggressive lead and adopted a statute that eliminated directors' liability for negligence altogether, rather than leave the choice of eliminating liability to the shareholders, following Delaware's approach.

4. Event Studies of Takeover Statutes

The wealth effects of state takeover statutes have been extensively studied and the

findings are less uniform in this context than that of reincorporations. Depending on the statute type, event date, and sample, studies report significantly negative, positive or insignificant results. For a tabulation, see Romano (1993:62-66). Consistent with intuition, statutes that are often characterized as more restrictive of bids are more likely to have significant negative effects (Bhagat and Romano 2007:976), but even then, except for the Pennsylvania statute discussed in part II.C, findings of statistical significance are not robust across studies. Moreover, as Karpoff and Wittry (2014:10), referencing Karpoff and Malatesta (1989) note, even in studies where the price effect of a specific type of statute is statistically significant, it is not significantly different from the stock price reaction of other types of statutes not found to be significant. In addition, there are no consistent results when firms are distinguished by the presence of firm-level defenses (i.e., whether the statute would have a more substantial impact as being a firm's primary protection).

The most comprehensive and influential event study of takeover statutes, by Jonathan Karpoff and Paul Malatesta (1989), includes forty statutes enacted in twenty-six states and finds that the statutes have a small significantly negative price effect (-0.4%). The finding of significance occurs only on the event date of a newspaper report concerning legislation; there are no significant abnormal returns on legislative event dates, in keeping with the challenges in using the methodology to evaluate legislation. But given the comprehensiveness of the data set, commentators view the Karpoff and Malatesta results as a credible measure of the overall impact of takeover statutes, although no doubt this view also accords with the belief that any action decreasing the possibility of a successful takeover, due to the loss of a potential takeover premium, would be shareholder wealth-decreasing.

When the impact of the Delaware statute is separately examined, the stock price effects are insignificant, or depending on the interval and sample, significantly positive (Karpoff and Malatesta 1989; Jahera and Pugh 1991). The different wealth effect of the Delaware statute compared to that of other states' statutes is consistent with a difference in the political economy in the making of takeover statutes between Delaware and other states that produced its less restrictive statute (as recounted in part II.C). The nonnegative impact of the Delaware takeover statute is also consistent with the characterization in the comparative performance studies that Delaware is more shareholder-friendly than other states (see part II..D.2).

The takeover statute event studies provide the most compelling evidence against state competition, given the finding of negative stock price effects in aggregate and for individual statutes, which diffused rapidly across the states although Delaware's behavior has not contributed to the problem. A fair conclusion is that state competition is not working well in this context because for at least some firms in some states, legislative initiatives to make takeovers more difficult were shareholder wealth-decreasing events. The irony is that from the Cary perspective the data adverse to state competition also cast Delaware in a most positive light.

5. Studies Comparing Firm Headquarters and Domicile States

A final body of research compares the domicile and physical location of firms to draw insights into state competition that may not be apparent when examining reincorporations. The implicit idea of these studies is that a firm's domicile decision is a nested one, first it considers whether it should take as its domicile the state in which it is physically located and then, if it decides not to do that, it considers where to relocate. Because the vast majority of firms not domiciled in their state of physical presence are incorporated in Delaware, the two steps are often

collapsed into deciding whether to stay "home" or go to Delaware. With this working assumption, the studies then examine characteristics of state corporate laws to see which states are more successful in retaining firms, that is which states have a higher ratio of headquartered firms also domiciled therein, a measure consistent with states engaging in defensive competition (see part II.B).[19] The comparison is expected to shed light on who benefits from state competition, by determining whether the more (or less) successful states are also states with codes thought to be more likely to benefit shareholders.

Of four studies taking this approach, two focus on the number of takeover statutes in the headquarters state, as the determinant of states' success in local company domicile retention (Subramanian 2002; Bebchuk and Cohen 2003). They focus on takeover statutes because they consider obstruction of takeovers as adverse to shareholders' welfare. The authors count the number of takeover statutes enacted in a state, with the sum referred to as an "antitakeover index." (Bebchuk and Cohen use a subset of five possible statutes, Subramanian tallies six statutes but emphasizes an analysis treating each statute separately.) Both studies find that the more takeover statutes a state has, the more firms it retains (i.e., the less likely firms headquartered in the state are incorporated in Delaware). In addition, when firms are incorporated in a state different from the headquarters state but not in Delaware, the domicile state has a higher antitakeover index than the headquarters state. They interpret these two pieces of data as evidence supporting Cary's position that state competition is a race for the bottom, harming

[19] A corporation's domicile for U.S. federal jurisdictional purposes is either its statutory domicile or the state in which its headquarters is located, and the state of physical presence of corporations identified in these studies (and its referent when the term is used in the text), is the headquarters state. I also on occasion refer to the headquarters state as the home state for ease of exposition.

shareholders.

In contrast to Bebchuk and Cohen's (2003) study, Subramanian's analysis (2002:1840) finds that states with the most egregiously restrictive takeover statutes (i.e., those for which event study data is significantly negative, Ohio's and Pennsylvania's disgorgement statute and Massachusetts' staggered board mandate) have a *lower* retention rate than states with less restrictive statutes. That finding is at odds with a race for the bottom story, for if managers are selecting a domicile that expropriates shareholders, then they should not avoid, but rather seek out, states with the most effective statutes for blocking takeovers (just as noted earlier, the race to the bottom thesis would expect all states to adopt the most lax liability rule, yet, curiously, they do not).

It is also wholly unrealistic to assume that a firm's choice of domicile is so uni-dimensional as to consider only a state's takeover statutes. Research on reincorporation decisions indicates that in selecting a domicile, firms are attentive to numerous features of state codes along with a states' corporate law environment, such as the legislature's responsiveness to changing business circumstances, the quality of the judiciary, and rules related to acquisitions and to directors' and officers' liability and indemnification (Romano 1985; Moodie 2004).

For example, although Bebchuk and Cohen and Subramanian contend the absence of a takeover statute in California explains why a large proportion of California-headquartered firms are incorporated in Delaware, there is another, more compelling explanation for the phenomenon: California corporate law is viewed as quite uncertain, which creates uncertainty for business planning. Corporate law cases in California can come before any of a multitude of state trial judges who often have minimal expertise in corporate law and business practices, in contrast

to the Delaware chancery court.

In fact, California attorneys surveyed in the early 1980s, well before the Supreme Court had upheld state takeover laws, before Delaware had a second generation takeover statute and before Delaware courts had validated poison pill takeover defenses, stated that they recommended reincorporating in Delaware because they could comfortably provide legal opinions about transactions under Delaware law but not so much under California law (Romano 1985). The survey responses tracked firm behavior: there was a large outflow of firms from that state well before hostile takeovers and state takeover laws became prevalent (Romano 1985). Some firms did adopt takeover defenses upon reincorporating, but the numbers were small – only 11% of the Romano (1985:252) sample, a figure that aggregates firms migrating from and to all states, not solely California and Delaware, respectively. Accordingly, Bebchuk and Cohen's and Subramanian's ahistorical thesis does not explain California's long history of corporate migration to Delaware, which predates takeover statutes.

The multiple dimensions of state law relevant to firm decisions are incorporated in the design of the other two headquarters-domicile studies by Daines (2002) and Kahan (2006). When variables used to proxy for state law features known to matter to reincorporating firms are included in the econometric analysis, the statistical significance of the number of takeover statutes in determining states' retention rate vanishes. Daines, whose sample consists of IPO firms, rather than the broader set of public companies used in the other studies, finds that following the Model Act, and in some formulations, the responsiveness to statutory innovations measure of Romano (1985), explain states' retention rates; takeover statutes do not. Kahan finds that states offering more flexible statutes (where the flexibility provisions are unrelated to

takeover defenses) and higher quality judicial systems (identified by rankings in a 2001 survey of 824 in-house counsel and other senior litigators at large companies) have higher retention rates, while, again, takeover statutes do not.

One might have contended that the difference in studies could be a function of sample differences (Daines examines IPO firms, while Bebchuk and Cohen and Subramanian study established firms), but Kahan's findings hold for both IPO firms and for the same data set of public firms used by Bebchuk and Cohen and Subramanian. This suggests that the difference in findings is most likely due to model specification, that is, omitted state law variables in the models of Bebchuk and Cohen and Subramanian resulted in a spurious finding of significance for the number of takeover statutes.

Daines further finds that whether the IPO corporation is advised by a national or local law firm is a significant predictor of whether the firm goes public with a Delaware domicile. This finding is consistent with earlier survey data of reincorporating firms indicating that the move was suggested by outside counsel (Romano 1985:275). Daines views these findings as suggestive of a lawyer-client agency problem, given his finding that Delaware firms have higher Tobin's *Q* values (Daines 2001:1585, 1595). The reasoning is that local lawyers would advise their clients to retain a local domicile because they would be unable to provide counsel regarding Delaware law, or would face heightened competition (the many lawyers in Delaware and other states knowledgeable about Delaware law).

Daines' hypothesis that local lawyers who do not recommend Delaware are unfaithful agents may be correct. But an alternative efficiency explanation is that firms with local counsel are not likely to be those that would benefit from a Delaware domicile, which entails higher

operating costs. (Delaware franchise taxes are not only higher than those of other states, but impose an additional layer of tax because firms must pay taxes in their home state where they are doing business regardless of statutory domicile.) For instance, they could be firms not planning to engage in transactions for which a Delaware domicile adds value, such as mergers and acquisitions (see part III.B). Alternatively, they may be firms whose future profitability is highly uncertain, making the need to conserve cash essential. Correlatively, firms with such characteristics would also not be likely to hire national law firms whose fees would be considerably higher than local counsel.

Daines does estimate a model that controls for the endogeneity of choice of attorney and of domicile, by a two-state regression modeling law firm choice and then domicile choice and reports the results regarding the significant impact of a national law firm are unchanged.[20] But while the model includes a variable for subsequent acquisitions (one possible alternative explanation), it does not include a proxy measure for future profitability (another one). The extent to which lawyers affect the choice of domicile, more specifically, the direction of the effect – whether failure to incorporate a firm in Delaware is a value-decreasing decision, or more pointedly, a decision benefitting counsel at the firm's expense – is an area where further empirical work would be fruitful.

E. Is the National Government a Competitor?

A master proposition of the U.S. Constitution is that the national government is supreme when there is a conflict with the states and, under the contemporary understanding of the

[20] Daines does not specify the instruments used to identify the variables or report tests of the effectiveness of the instruments, or the results of the first stage, so it is not possible to assess how well the two-stage model addresses the endogeneity concern.

commerce clause, it can preempt most state law. Mark Roe has asserted that because of this fundamental arrangement, that the national government, not other states, is Delaware's "competition" and that it dictates the content of corporate law by enacting laws or threatening to do so, leaving to Delaware only those matters that it considers unimportant or those of which it approves of what Delaware has done (e.g., Roe 2003, 2005). Although variations of the thesis that Delaware responds to threats of preemption have episodically appeared in the state competition literature (e.g., Gordon 1991), in a set of recent papers Roe has developed the most full-throated elaboration of the proposition.

From Roe's perspective, Delaware law exists at the whim of the federal government, either because Delaware officials serve as its instrument, due to fear of preemption, or because it would be preempted were Delaware officials not to hew to the law the national government desired. Such a thesis is inherently not testable, because it would be confirmed by whatever occurs. If, for example, a particular Delaware law is not preempted, then the claim would be it is because Delaware is doing what the national government wants it to do, regardless of what national or Delaware officials might say or do, or whether there is any data suggesting that any member of Congress was even dimly aware of the matter. It is true that Delaware officials do, on occasion, comment on the possibility of preemption in statements outside of their judicial or legislative rulemaking function, as would any sentient state actor in a federal system. But Roe does not explain why the existence of such comments demonstrates that the national government is master-like determining the content of state corporate law in the absence of specific preemptive decisions, or that those state individuals actually alter their decisions in order to please the national government.

Roe does not, for instance, acknowledge Delaware officials's far more frequent expression of anxiety over the possibility of losing corporations to other states, were the state not to act, as evidence that Delaware's most pressing focus is other states rather than the national government. More to the point, ascertaining the perspective of the national government, particularly when it has not acted preemptively, is not at all self- evident as Roe's thesis would have it. The difficulty of divining the intent of a collective entity, such as Congress, even when it has enacted legislation, let alone a more amorphous "national government" that has not taken any explicit action on a matter, is a well-recognized analytical problem in the literature (e.g., Shepsle 1992; Easterbrook 1994:68), which Roe does not address. Yet this goes to the heart of his thesis, for if Delaware officials are to behave as he posits, they must be able to intuit what the national government desires so as to avoid preemption.

Moreover, as I have elaborated elsewhere (Romano 2005a), except for the contention that Congress could theoretically preempt nearly all state law and has not, and could not, as it would necessitate something akin to a political revolution to do so, Roe's thesis is not convincing. A good example of the difficulty with Roe's notion that Delaware officials act in constant apprehension of preemption is one of Roe's own, the enactment of Delaware's second generation takeover statute. Contrary to his thesis, the statute was enacted despite SEC officials' explicit communications to the Delaware legislature of their opposition to the statute and assertion that as crafted it would be preempted (Romano 2005a:225). Moreover, numerous individuals participating in the hearings on the bill, as well as the press coverage, referred to other states' takeover laws, and potential reincorporations elsewhere, hence reduced franchise taxes, were no statute to be enacted (Romano 2005a:224). Hence, the focus of debate was other states and not

the federal government. Only one Delaware attorney made any reference to concern over federal preemption, and that was late in the legislative process. Yet Roe cites only that reference, overlooking all statements inconsistent with his thesis, as well as expressly rejecting the role of the distinctive factors related to Delaware's legislative process (see part II.C) in shaping the statute's more moderate form, to assert instead that it was generated by fear of preemption.

Further, to make his case about the importance of the federal government in corporate law, Roe contends the national government is constantly enacting legislation in the area. But, to the contrary, Congress's attentiveness to corporate law is rare and episodic. It has enacted amendments to the federal securities laws once every decade or two, primarily in the wake of a collapsing stock market and financial crisis (e.g., Romano, 2005b:1591-1593), whereas Delaware updates its code on virtually an annual basis. Given the remote probability of preemption, the responsiveness of states to the activities of one another, along with Delaware's continual statutory tweaking, it strains plausibility to describe Delaware as "looking over its shoulder [at the federal government]... when it crafts its corporate law" (Roe 2003:605). Indeed, in subsequent work, Roe appears to recognizes the problematic posture of the facts for his thesis, as he notes (2005:238) that states "have much room to maneuver," suggesting that the best the national government can do is "weaken the mechanisms of the state-to-state race." If this is the thesis, it would be difficult to characterize it as identifying the national government, and not other states, as Delaware's principal competitor.

Roe seeks to bolster his thesis by contending that the national government has consistently acted on the most important issues of the day. This contention is mistaken. Since the 1980s, the most active and important area of state corporate law has concerned acquisitions, and

in particular, management's conduct in response to both friendly and hostile offers. Yet Congress has engaged in no substantive regulation of such transactions, while leaving standing the Supreme Court decision eliminating such conduct from the scope of private litigation under the securities law.[21] In addition, the corporate law-related provisions of the Dodd-Frank statute are certainly not related to important issues: requiring disclosure of conflict minerals and the ratio of the CEO's pay to that of the median employee are trivial matters, though costly to compute, that are not of great moment to shareholders. The Act included no provisions related to management's fiduciary obligations, the core of state law, which implicate critical issues raised by the financial crisis, such as responsibility for the risk management of financial institutions; those matters remain to be determined by state law. Moreover, when Congress preempted private lawsuits under state securities laws in order to prevent the circumvention of restrictions it had enacted on private rights of action under the federal securities laws, it explicitly excluded state law fiduciary claims, in a provision known as the "Delaware carve-out" (Romano 2005a:229). This is not the behavior of an entity that perceives itself to be Delaware's "competitor."

The inclusion of the Delaware carve-out highlights another factor missing from Roe's analysis that undercuts the claim regarding the potency of preemption. Congress is constituted by representatives of states, and those individuals shape what Congress will and will not preempt.

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[21] Roe (2003:615) also contends that the SEC's disclosure requirements (which include disclosures for going-private transactions) dictate the substance of corporate law because they control what transactions are undertaken. This assertion is inaccurate: disclosure rules do not prevent transactions from occurring, nor state courts from adjudicating transactions' fairness or appropriateness. And because disclosure requirements do not dictate what state courts consider in evaluating a transaction, state law has an immediate and far greater impact upon managers' and

The states, in other words, collectively through their representatives, have leverage in the making of legislation, and federal lawmaking is not a one-way street. Delaware elects two senators, who, in a coalition with other like-minded legislators, can engage in a variety of blocking strategies were proposed legislation to jeopardize its domain. Because preempting a lawmaking activity of one state often has implications for a number of states, typically more than a few legislators' interests are at stake on any particular issue. Moreover, even legislators in states having no specific stake in an area may not be favorably disposed to preemption as legislation is a game of repeated play and their state might be similarly situated in the near future and could need the support of the legislators of the states whose domain is currently at risk.

Finally, Roe (2005:235) asserts that the national government has made rules on the "central legal institution," shareholder voting rights, but that claim is overstated. Congress has not, in fact, attempted to enact rules regarding corporations' substantive voting rights, nor has it expanded the SEC's authority in the area beyond the authority granted in the New Deal legislation, to regulate the proxy voting process and to regulate mutual funds. The SEC has used that authority to require mutual funds to disclose their votes and voting policies (which Roe references), but this regulation has had no discernible impact on state corporate law (mutual funds having been regulated by the SEC since 1940), nor would it appear to have had much of an impact on mutual fund voting and hence firm policy (see Cremers and Romano 2011). This is not to say that there has been no impact on corporations' substantive rights at state law by SEC action. The agency has used its authority over stock exchanges to compel them "voluntarily" to adopt a listing requirement prohibiting firms already listed from creating dual class stock, which

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firms' behavior than national disclosure requirements.

is a substantive rule.[22] But again this has not had any meaningful impact on corporate law: neither Delaware nor any other state of which I am aware revised its statutes or judicial doctrine regarding voting rights in response to those rules, to eliminate the ability of companies to adopt such voting shares, nor, of course, was there any necessity to do so.

Understanding that state competition is the motor force of state corporate law does not imply, as Roe would seem to do, that Congress, the SEC and the stock exchanges are not integral components of the body of law governing corporations, along with state law – that is Corporate Law 101, and no advocate of state competition would deny the ability, in principle, of those actors to impose restrictions on corporations. Rather, in generating a positive explanation of what informs Delaware lawmaking, one cannot look, as Roe seeks to do, to the national government, as the best available data indicate that the determinative influences are the preferences of corporations – their managers and investors – and the responses of other states to those preferences, not an apprehension of federal preemption.

III. Why is Delaware the Preeminent Incorporation State?

The key to Delaware's sustained market share can be extrapolated from the revealed preferences of the marginal consumers in the market for corporate law, which are reincorporating

[22] The SEC's prodding was not in response to any state action of which it disapproved, but rather, a response to stock exchanges under its jurisdiction, which had sought to alter one-share one-vote listing requirements to permit midstream restructuring of voting rights by already-listed firms. More to the point, the SEC initially sought to regulate voting rights directly, requiring the exchanges to prohibit the listing of firms which did not follow the norm of one-share one-vote. That rule was invalidated by the federal court of appeals as beyond the agency's authority, as a matter left to the states in Business Roundtable v. SEC, 905 F. 2d 406 (D.C. Cir. 1990). Yet again, Congress did not, in response, overturn the decision and provide the agency with authority to regulate voting rights, which would be expected were the national government to ensure that it, and not states, would be making rules for, as Roe puts it, the "central legal institution."

firms. Those firms, in general, seek two key features in a legal regime: 1) a reduction in the cost and uncertainty of doing business; and 2) assurance that the domicile state will maintain, and not welch, on the desirability of its corporate law which led the firm to locate there in the first place. Delaware's legal regime is uniquely favorable on both dimensions.

A. Why Do Firms Reincorporate?

Most firms do not change domicile over their corporate lives. Given that there are costs to undertaking a domicile change (costs to organize a new corporation and merge the two, for example), a firm must expect to increase firm value by operating under the new legal regime. In particular, a firm anticipating undertaking new activities may conclude that it can reduce the cost of doing business were it to be subject to a different regime. A legal regime can directly reduce transaction costs (for example, different rules governing acquisitions, such as shareholder voting requirements, impose differential costs on transactions). It can also influence transaction costs indirectly, by its impact on the cost, or likelihood of litigation over transactions (for instance, varying levels of clarity regarding how a board can meet its fiduciary duty in considering a takeover offer).

The most comprehensive study of why firms reincorporate, which examined the reincorporations of over 500 public corporation from 1960-82, through surveying firms and collecting public information, found that the motivation for nearly three-quarters could be grouped into three transactional categories, undertaking public offerings, mergers and acquisitions, or takeover defenses, and over 85% of these reincorporations were into Delaware (Romano, 1985:250-251, 256). The fourth largest category consisted of firms seeking tax savings through a domicile change, and most of those firms (74%) were migrating out of

Delaware to avoid the higher, as well as additional layer of, Delaware franchise taxes (Romano 1985:255-258). A more recent study identified a large flow of reincorporations in Delaware in the late 1980s to take advantage of the limited liability statute, as firms migrated from states that had not yet enacted such a provision (Moodie 2004).

The three largest categories in the Romano study comprising reincorporations in Delaware all involve activities that increase the likelihood of a firm's being subject to a shareholder suit, and suggest a straightforward explanation why domicile choice and reincorporation types are paired. When managers expect a change in corporate activities that increase the probability of shareholder litigation, specific characteristics of a legal regime become important, such as a well-developed case law, which facilitates obtaining legal opinions on the validity of transactions, along with clearly specified indemnification rules, because such a regime provides greater predictability for structuring transactions, reducing the probability of litigation (or costs of defending). Concern over transaction uncertainty and litigation costs is also the explanation why firms reincorporated in Delaware to take advantage of the limited liability statute.

B. Why Delaware Is the Domicile of Choice: Corporate Charter as Relational Contract

A corporate charter is a relational contract, an association between parties that lasts over a long period, over which numerous exchanges occur (here, the firm selects a domicile, and pays franchise taxes over time, and thereafter as conditions change, the state revises - or fails to revise – the laws governing the contract accordingly). Because in such contracts, one side's performance is not simultaneous with the other's, unforseen contingencies are likely to occur over the life of the contract, making it difficult to specify in advance all of the parties' rights and obligations, a

situation creating possibilities for opportunistic breach. The problem is exacerbated when one party is the state, given its additional role as contract enforcer. That is to say, a party entering into a long-term contract with the state must consider the additional difficulty that there may be no legal recourse against an opportunistic breach by the state. Delaware's preeminence in the market for corporate law follows from its ability to resolve credibly such a commitment problem in relational contracting.

1. Credible Commitments

An important mechanism for resolving the opportunistic breach problem of relational contracts is the parties' investment in assets, referred to as transaction-specific assets, whose value is highest when used in a specific relation rather than in any other use (Williamson 1983). In the corporate chartering context, for example, the state must invest in assets whose return is highest when used to procure incorporations and to service the needs of domestic firms. This investment protects firms from a state's collecting franchise fees and then opportunistically repealing desirable code provisions or not attentively updating its code, as the firm anticipated it would when it initially relocated in the state. Similar investments by firms' counsel in mastering the domicile's law, along with the additional out-of-pocket costs that would be incurred from reincorporating, protect the state's investments.

Delaware's most important transaction-specific asset is an intangible one, its reputation for responsiveness to corporations' concerns. This reputation is derived not simply from its pioneering role in statutory innovation, but also from the substantial revenues that Delaware obtains from corporate franchise taxes. The large proportion of its budget financed by such taxes renders the state responsive to firms' preferences because it has so much to lose were firms to be

dissatisfied and migrate (or new firms dissuaded from locating there). It would be extremely difficult, if not impossible, for Delaware to maintain the services it provides to its citizens with an alternative revenue source, given its small size, were its franchise tax collections to decline. Delaware's high ratio of franchise taxes to total revenues is an intangible asset that precommits it not to renege on contracts with its corporate customers, for it renders the state vulnerable to breach. Delaware is, in short, a hostage to its success in the chartering market.

The hostage-like dependence on franchise tax revenues is not the only investment that serves as a credible commitment to firms. Its comprehensive body of case law, judicial expertise in corporate law, at both the Chancery Court and Supreme Court levels, along with administrative expertise in the expeditious processing of corporate filings in the Office of the Secretary of State, are assets that have no use outside of the chartering business. This nonredeployable asset is of considerable value to firms: the stock of precedents and specialized court of original jurisdiction, along with experienced business lawyers on the Supreme Court (the sole appellate court) facilitate business planning, which is key for the reduction in transaction costs sought by reincorporating firms. It is also related to the transaction-specific asset on the corporation side – counsel specializing in Delaware corporate law have an incentive to maintain the Delaware domicile, as that preserves the return on their human capital investment. Delaware also facilitates attorneys' ability to maintain the value of that investment by circulating unpublished opinions and hearing transcripts, and consulting prominent members of the bar, outside as well as within the state, on corporate law revisions. These advantages for attorneys also benefit shareholders, by reducing the cost of legal services.

The final, rather unique, institutional arrangement fostering credible commitments, by

which Delaware maintains its dominant market position, is a constitutional provision that requires a supermajority vote of two-thirds of both houses of the legislature to revise the corporation code.[23] This provision makes it difficult for Delaware to renege on the direction of its code, as occurred in New Jersey toward the outset of the Twentieth Century, which enabled Delaware to replace it as the leading incorporation state (Romano 1993:42-43), and therefore increases the likelihood that the legal environment can be no worse than it was at the time of an firm's initial incorporation in the state. This is a desirable feature if corporations are risk averse, and seek a statutory domicile that minimizes the worst-case scenario. The supermajority requirement also preserves the personal investments in expertise of Delaware citizens who service corporations, by requiring what would be a critical election, revolutionizing state politics, to alter the character of the code and reverse the flow of corporate revenues in the state on which those citizens depend. While the supermajority provision could slow the updating of the corporation code, in practice that has not been the case, as Delaware has been a persistent innovator over the years. Rather, the supermajority provision and Delaware's dependence on franchise taxes are complementary mechanisms functioning to ensure a responsive code: the former is backward-looking, as a reversal of policy is difficult, while the latter is forward-looking, incentivizing the state to be responsive to changing business circumstances in order to retain and expand in-state corporations.

Delaware's successful creation of a credible commitment is exceedingly difficult for other

[23] Article IX section 1 of the Delaware Constitution is derived from a provision in the state's Constitution of 1831, when a legislative grant of a special charter was required for a firm to do business, but the provision was retained in the Constitution of 1897 despite the enactment of a general incorporation statute. Besides Delaware, Iowa is the only other state that has such a constitutional provision (Article 8, section 12).

states to replicate. Only a relatively small state could be in a position where franchise fee collections could be substantial enough compared to total tax revenue to have hostage-like qualities. In addition, in contrast to statutory innovations, it would be difficult to duplicate Delaware's legal capital. Although specialized courts can be established, and states can incorporate, legislatively or judicially, the existing stock of Delaware law as their own precedents, the dynamic nature of corporate law adjudication requires the development of in-state judicial expertise, and a small state is not likely to have at the ready a pool of judges having the requisite familiarity with business law and practices.

But the essential problem for another state to unseat Delaware in attracting reincorporating firms (compared to retaining local firms) stems from what can be described as a first mover advantage. Once Delaware established its dominant position, it became cheaper for it to maintain a commanding lead over a newcomer because there is value in numbers. As I have put it previously (Romano 1993:44), "[t]he more firms there are in Delaware, the more franchise tax receipts it receives and the more it will rely on its charter business, making it even more important to be responsive. In addition, the more firms there are in Delaware, the more legal precedents will be produced, further providing a sounder basis for business planning, which attracts even more firms to that state. Finally, the more corporate law cases that are brought, the greater will be the expertise of the Delaware judges, as will be the value to an individual from developing such expertise as a member of the judiciary." This competitive advantage is the reason why the most effective strategy of other states is to engage in defensive competition, to induce local firms to remain domiciled in-state, rather than seek to attract firms away from Delaware (see part II.B.1)

2. Network Externalities

Michael Klausner (1995) identified the description of Delaware's first mover advantage as equivalent to the economics of networks. A product that becomes more valuable as its use becomes more widespread, the paradigmatic example being the telephone, and like the telephone, Delaware law is a product whose market exhibits what is referred to as a "network externality." That is, each user of the product confers a benefit on other users; a telephone is more useful, the more individuals have one, and the more firms incorporate in Delaware, as already noted, the more value there will be in a Delaware domicile as there will be greater legal certainty from precedents on more matters, and greater responsiveness, as there will be more revenue for Delaware to lose.

The benefit of use of the product in a network is independent of the merit or benefit of the product itself,[24] and Klausner contends that a network can have adverse lock-in effects. There may be a superior corporation code in a state other than Delaware, but firms would not relocate out of Delaware, despite its inferiority because of the benefit of being part of its larger network of legal precedents (which is due to the presence of many firms). Similarly, there may be a superior

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[24] Bebchuk et al. (2002) contend, for instance, that the positive price effects of reincorporation event studies (see part II.D.1) are due to a network effect unrelated to the content of Delaware law, i.e., investors value being in a network, even if its precedents are harmful to their interest, favoring managers (for if the precedents benefitted shareholders, the network effect would work in the same direction as the quality of the substantive law, and it would be of no import for evaluating the price effects). It is difficult to imagine that the positive value of a network could outweigh the negative value of precedents benefitting managers at shareholders' expense over time, as we would expect to see either a negative price effect in later event studies – which is not observed – or a decrease in the number of reincorporations or IPOs in Delaware – which also is not observed – or negative a performance effect – again, which is not observed (see part II.D).

code that has yet to be enacted by any state, but a network lock-in effect would discourage innovation.

It is, however, analytically difficult to characterize Delaware's successful legal network as producing inferior (inefficient) laws, which are then subject to lock-in. Indeed, there are compelling reasons not to expect there to be a significant, adverse lock-in effect in this context. As S.J. Leibowitz and Stephen Margolis (1998) have suggested, network effects produce negative externalities, such that a more efficient network will not replace an inferior less efficient one, only when market participants cannot internalize those effects. But as they explain (Leibowitz and Margolis 1994), if the dominant network is inefficient compared to a competing one, the owner of the superior network will internalize the network costs and with a more efficient product can subsidize switchers.

While a single corporation cannot internalize the costs of a corporate law regime, a legislating state can. Moreover, there are well-informed specialists – attorneys and investment bankers – who are repeat players in the charter market and advise many firms. These experts also can internalize the cost of becoming informed about inefficient choices and encourage a state with the leading network to revise an inefficient provision or advise clients to switch to a more efficient regime. These features of the corporate law market would displace an inefficient network, whether the lock-in problem is thought to be due to imperfect information (early adopters, i.e., reincorporators, lack information regarding superior law), or the size of the network (later adopters join a known inefficient market because of the many early adopters).

3. Evidence of Network Effects

There has been limited research exploring the presence of network effects in corporate

law. In his study of IPO firms' domicile choice, Daines (2001:1596) finds only mixed evidence in support of the presence of such effects. He finds that retention rates are higher for states with large numbers of firms, as well as for Model Act states (this assumes that it functions as a network because one state's precedents can be used by all Model Act states). However, the significance of these findings is not robust, dependent on the model specification. In addition, as he notes, the analysis cannot distinguish a network benefit from an alternative explanation, that firms value the Model Act's substantive rules, an alternative that could also explain why the number of in-state incorporations is positively related to retention rates (i.e., those states also have more valuable corporate laws).[25].

There are data on the question whether a corporate law network would exhibit lock-in effects, suggesting that a dominant corporate law network can, indeed, be replaced by a more efficient one (i.e., no lock-in effect). A study of Australian corporate law (Whincop 2003) studying competing clusters or networks of indemnification and liability release provisions in corporate charters found that a new mix of the provisions emerged and came to predominate despite the existence of a substantial older network. This research parallels what casual empiricism would suggest about U.S. corporation codes. Delaware is attentively revising and refining its code as business conditions change, despite its large stock of precedents that under a network externality or lock-in analysis, should discourage, if not prevent, the state from updating to superior provisions.

In addition, Ribstein and Kobayashi (2001) examined the choice of form decisions of

[25] For additional problems involving interpretation of a statistical effect of the Model Act on retention rates, see Kahan (2006:347). In contrast to Daines, neither Bebchuk and Cohen (2000) nor Kahan (2006) find the Model Act to be significant.

small businesses to investigate whether there are network externalities that could result in inefficient organizational choices. They compare the choice of organizing as a limited liability company ("LLC") or a limited liability partnership ("LLP"). The idea is that because LLPs can take advantage of an existing stock of precedents of partnership law whereas, as an entirely new business form, there is no comparable stock of precedents usable by LLCs, if network effects mattered for firms, then the LLP should be the preferred form. They find instead that the LLC dominates the LLP, which is at odds with a network being an impediment to the development of alternative organizational forms (or to put it another way, at odds with there being value in a network, compared to other substantive law factors, such as state tax implications), at least with respect to small businesses. Whether Ribstein and Kobayashi's finding can be extrapolated to the choices of public corporations is an open question. Investigating the presence of network effects and their relation to firm value is another important area for future research.

IV. Conclusion

Under US law, firms' governing law depends on a statutory domicile, rather than their physical location, which permits them to select their corporate law regime from among the states. This institutional arrangement has led commentators to conceptualize corporate law as a product states offer (with franchise fees the purchase price). This market has been dominated by one state, Delaware, and its large number of incorporations has given it a competitive edge, the development of a large stock of precedents providing legal certainty, and a financial dependence on its incorporation business, which creates a credible commitment that it will maintain a responsive corporate law environment, thereby attracting even more firms, a phenomenon also referred to as a "network effect." Individual firms tend to choose between their state of physical

presence and Delaware, and as a result, the competitive strategy of other states is a defensive one, which seeks to retain local firms, rather than attract firms away from Delaware. States respond to statutory innovations by Delaware and the loss or potential loss of incorporations by similarly revising their codes, and Delaware, when not the innovator, is quick to follow, other states' innovations, as the business environment changes. Nevada is an exception to that pattern, as it attracts an inflow of firms headquartered in other states. Contemporary research suggests that Nevada is competing with Delaware by developing a differentiated niche offering reduced liability of managers for shareholder lawsuits.

The market for corporate law raises several questions, which can be addressed empirically. The classic debate is over whose preferences in the firm, managers or shareholders, are driving the making of state law, famously phrased as whether state competition is a "race for the bottom" or to the "top." The empirical research on this issue suggests that, for the most part, the direction is to the top. More recently commentators have questioned whether states compete at all, and whether it is the national government, given its preemptive authority, and not the states, with whom Delaware is competing. While there has been less empirical work investigating these latter questions, insofar as they can be tested, the available evidence indicates that states do compete and that they, not the national government, are the competitors to which Delaware assiduously responds. The national government's activity in the corporate law domain is, however, rare and episodic, and not only has Congress not preempted the core of state law, managers' fiduciary duties, but it also has even carved those actions out of its preemption of private litigation under state securities laws.

There are questions in the state competition discourse for which further empirical

research would be quite valuable. These include resolving conflicting findings regarding whether Delaware firms' valuation is higher than firms in other states; updating reincorporation event studies to see if the positive effect found in studies now decades old persists, and if it is due to the content of the law, or a network effect; determining whether Nevada attracts firms with a propensity to engage in accounting misconduct or firms with high litigation costs seeking to avoid frivolous lawsuits, and whether its competitive strategy is being followed by other states; and developing a better understanding of the role of the bar in firms' domicile selections. Although state competition has now been examined empirically for decades, as a central theme in US corporate law, it remains a remarkably open area of research.

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