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# Explaining Delaware's Dominance: Firm Heterogeneity and Demand for Legal Flexibility

Finance Working Paper N° 1093/2025
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# Abstract

This paper investigates why Delaware became the dominant jurisdiction for U.S. public firms. We argue that Delaware's advantage lies in its combination of flexible, judge-made standards, an expert judiciary, and a responsive legislature. We develop a model of incorporation choice by heterogeneous firms in which uncertainty over the appropriate balance between managerial discretion and shareholder authority makes adaptable standards valuable. The model predicts greater demand for Delaware when takeover activity makes that balance more context-dependent and when institutional ownership raises demand for shareholder protection. Consistent with these predictions, institutional ownership is strongly associated with choosing Delaware when firms go public, while takeover exposure predicts reincorporation into Delaware. Modelbased counterfactuals indicate that institutional ownership and acquisitions account for Delaware's rise in market share from 1980 to 2010. Our analysis highlights common-law flexibility as an important link between legal institutions and financial development.



**JEL Classification:** K22, G34, D02



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# Explaining Delaware's Dominance: Firm Heterogeneity and Demand for Legal Flexibility*

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**Abstract**

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# 1 Introduction

Influential research across economics and finance shows that legal regimes shape economic outcomes. At the global level, the law and finance literature links legal origin to financial development and firm value, often operationalizing investor protection through indices that summarize the presence of particular statutory provisions across jurisdictions (La Porta et al., 1997, 1998). Common-law systems are typically characterized in this literature as providing stronger protection to shareholders based on higher values of such indices.

While this approach has generated important insights, it does not focus on the central feature of common-law systems, namely their reliance on flexible, judge-made standards that evolve through adjudication (Gennaioli and Shleifer, 2007; La Porta, Lopez-de Silanes and Shleifer, 2008). In the United States, the clearest manifestation of this institutional design is Delaware corporate law, where most public corporations are incorporated (Romano, 1985). Delaware defines the fiduciary duties of managers to shareholders through open-ended standards crafted and refined by a specialized judiciary.

A distinctive feature of Delaware law is that corporations choose to subject themselves to it, which is consistent with the documented association between Delaware incorporation and higher shareholder value (Daines, 2001). U.S. firms may incorporate in any state, and many competing states offer regimes built around bright-line rules that sharply limit judicial review of managerial discretion (Eldar and Magnolfi, 2020). These alternatives provide managers greater certainty that their decisions will not be second-guessed in court. The recent reincorporations of several high-profile companies, including Tesla and TripAdvisor, to states such as Nevada and Texas illustrate this dynamic (Bainbridge, 2024; Fisch and Davidoff Solomon, 2025). Such moves, typically driven by founder- or CEO-controlled firms facing potential legal challenges, reflect a preference for predictable statutory regimes that minimize judicial intervention.

This trend invites a reassessment of Delaware's dominance as the cornerstone of the common-law system of investor protection. Why have corporations predominantly chosen to be governed by flexible fiduciary duties and to subject themselves to greater judicial scrutiny?

Why have they not instead opted for jurisdictions offering more predictable, litigation-averse rules?

These questions are especially puzzling in historical context. Delaware's share of U.S. public firms rose from about 35% in 1980 to almost 60% in 2010.[1] Yet this ascent coincided with a period when its fiduciary-duty doctrines were anything but predictable (Kahan and Kamar, 2002). As shown in Figure 1, Delaware's market share continued to rise as its courts oscillated between decisions that favored shareholder rights and decisions that protected managerial discretion.[2] This pattern is consistent with firms valuing the flexibility of Delaware law rather than any consistently pro-shareholder or pro-manager orientation. At the same time, many other states adopted statutory regimes that promised greater predictability by limiting judicial scrutiny and deferring to managers (Eldar and Magnolfi, 2020). Yet corporations continued to flock to Delaware. Explaining why firms embraced flexible standards over bright-line rules lies at the heart of understanding Delaware's enduring dominance and remains central to debates over its preeminence today.

We argue that, counterintuitively, Delaware's preeminence lies in its flexible rules—standards that judges continually refine through decisions and dicta (Fisch, 2000). A hallmark of the common law is this capacity to adapt to changing economic circumstances (Priest, 1977; Hayek, 1960; Levine, 2005; Gennaioli and Shleifer, 2007). Delaware judges adapt doctrines quickly, providing a more flexible decision-making process than traditional courts (Goshen and Stein, 2025). In applying flexible standards, Delaware courts balance managerial discretion with investor protection, calibrating fiduciary duties to changing business conditions. Because courts are not limited to business-judgment deference, flexibility can also provide greater investor protection than strict law when circumstances warrant. The resulting indeterminacy imposes uncertainty costs, but it also creates option value: firms can expect tailored standards for novel issues and adaptive responses as doctrine evolves.

[1] Our sample is based on data compiled by Roberta Romano and Sarath Sanga (Sanga, 2020), merged with CRSP-Compustat data on public corporations listed on major U.S. stock exchanges.

[2] Of course, the full nuance of these cases cannot be captured by a binary classification. We classify each decision according to its principal directional implication for the balance between shareholder rights and managerial discretion.

This institutional design helps explain why Delaware stands at the core of the common-law advantage in investor protection, even though it relies on standards and litigation rather than bright-line rules. Delaware's courts have functioned this way since the early 20th century, when the Court of Chancery established itself as the leading forum for business law (Parsons Jr. and Slights III, 2008).

Why, then, did demand for Delaware incorporation rise so sharply from the 1980s through the 2000s? Two contemporaneous shocks magnified the value of legal flexibility: merger waves and the rise of institutional investors.

Merger and hostile-takeover activity reached historic highs in the 1980s, with volume around 10 percent of GDP and nearly half of large firms receiving bids (Holmstrom and Kaplan, 2001). The optimal balance of power between managers and shareholders shifted away from pure managerial deference in many settings and became increasingly context-dependent, generating pervasive uncertainty about fiduciary duties and permissible defenses. Delaware's standards-based scrutiny allowed managerial innovation while requiring boards to justify antitakeover measures under flexible judicial review. The resulting outcomes were highly fact-specific: *Moran* (1985) upheld poison pills, the most potent antitakeover device, but Delaware later invalidated them in *Interco* and *Pillsbury* (1988), only to adopt a more permissive stance in *Unitrin* (1995).[3] Corporations continued to choose Delaware, even as the courts actively recalibrated the balance of authority between managers and shareholders.

Institutional ownership also rose sharply, so that by the 2000s these investors held most shares of public corporations (Backus, Conlon and Sinkinson, 2021; Ederer and Pellegrino, 2025). As their influence grew, institutional investors increasingly emphasized shareholder primacy and managerial accountability (Gompers and Metrick, 2001). Although some have questioned their incentives to monitor actively, there is ample evidence that they pressured corporations to adopt stricter governance norms (Gillan and Starks, 2000; Appel, Gormley and Keim, 2016). Consistent with this, Eldar and Magnolfi (2020) find that firms with greater institutional shareholding tend to prefer corporate laws less deferential to managers and to

[3]Likewise, *Revlon* (1986), which implied a duty to sell to the highest bidder, required extensive elaboration to define its triggers and scope (Allen, Kraakman and Khanna, 2021).

oppose anti-takeover statutes. Unlike many jurisdictions that automatically validate poison pill defenses, Delaware litigates such measures under flexible standards.

As illustrated in Figure 2, these patterns closely track incorporation decisions.[4] The share of newly public firms incorporating in Delaware rose from under 30 percent in the early 1980s to over 70 percent by the early 2000s, paralleling the dramatic increase in institutional ownership. Distinct waves of reincorporations into Delaware also align with spikes in M&A activity and the prevalence of takeover bids, particularly in the late 1980s and late 1990s. These trends strongly suggest that Delaware's increasing market share reflected rising firm demand for its distinctive institutional attributes in response to merger waves and changing investor preferences. In short, the combination of mergers as a dominant force in U.S. corporate governance and the rise of institutional investing offers a compelling explanation for Delaware's historical ascendancy.

This paper makes several contributions. First, it develops a simple theoretical framework for firms' incorporation decisions, emphasizing Delaware's unique attributes. Delaware offers a flexible legal regime that adapts to economic shocks, such as merger waves, unlike many other states that rely on bright-line rules. While other jurisdictions, such as California, may also be flexible, Delaware is distinctive because it pairs flexibility with an expert judiciary crafting standards that align managerial discretion with shareholder interests. Judicial expertise still carries risk of error, so a responsive legislature is essential to correct mistakes ex post. Demand for such a regime rises during periods of elevated deal activity and when the shareholder base is sophisticated. The model therefore predicts greater demand for Delaware during takeover waves and when institutional ownership is higher.

Second, we estimate an empirical specification of incorporation decisions grounded in our theoretical framework, distinguishing between Delaware incorporation when the firm becomes public, reincorporation into Delaware, and reincorporation out of Delaware. Our findings are consistent with the model's predictions: firms with greater institutional ownership

[4]Because incorporation decisions are subject to inertia (Eldar and Magnolfi, 2020), we focus on incorporations at the IPO stage and on reincorporations into Delaware, as they reflect active choices rather than instances of inertia.

are more likely to incorporate in Delaware when they go public, and takeover exposure is positively associated with reincorporation into Delaware.[5] Model-based counterfactuals indicate that institutional ownership and acquisitions account for virtually all of Delaware's rise in market share from 1980 to 2010. Accordingly, our analysis demonstrates that shifts in firm heterogeneity underlie Delaware's dominance.

Our results therefore offer an account of how Delaware became the cornerstone of the U.S. system of investor protection. The evidence is consistent with shifts in U.S. capital markets increasing demand for legal flexibility supported by an expert judiciary and a responsive legislature. Firms with significant institutional ownership and firms undertaking complex transactions prefer expert judicial review that balances managerial discretion with shareholder rights, rather than bright-line legal systems. The analysis is consistent with evidence that Delaware incorporation is a quality marker for venture-backed firms (Guzman and Stern, 2020) and is associated with higher shareholder value (Daines, 2001). These findings also speak to empirical finance designs that exploit cross-state corporate law changes (see Karpoff and Wittry, 2018), by highlighting that incorporation—and hence exposure to state law—is endogenously related to ownership structure and takeover vulnerability.

Relatedly, our account, which explains shifts in demand for Delaware law as a function of firm heterogeneity, is also useful for interpreting recent, albeit limited, reincorporations of prominent firms out of Delaware. These reincorporations are concentrated among founder-controlled firms and companies led by superstar CEOs who wield disproportionate influence over major corporate decisions (Aggarwal et al., 2022). Investors in these firms are often willing to trade monitoring rights and takeover discipline for founder leadership. For such firms, flexible fiduciary standards may add relatively little value, while predictable, bright-line rules that shield controllers can be more attractive.

Finally, our analysis has broader implications for the law and finance literature. While common-law legal origins have long been associated with stronger investor protection and deeper financial markets (La Porta, Lopez-de Silanes and Shleifer, 2008), much of this

[5]Our model's estimates predict Delaware's market share over time both in-sample and out-of-sample, and are robust to using index inclusion as an instrument for institutional shareholding.

literature has operationalized investor protection through indices based on specific legal rules, such as cumulative voting and preemptive rights. These measures capture formal statutory provisions, but may not fully reflect the extent to which legal systems provide investors with meaningful protection in practice.

Focusing on the primary system of investor protection in the United States—Delaware corporate law—our results help reconcile these findings by shifting attention away from the level of investor protection encoded in formal rules and toward the institutional features of common-law systems. By allowing standards-based adjudication to recalibrate the balance between managerial discretion and shareholder rights as governance needs evolve, common-law systems can deliver context-dependent investor protection that rigid, rule-based regimes cannot.

## 2 A Theoretical Framework for Incorporation Decisions

We develop a model of firms' incorporation choices that highlights how Delaware's flexible legal system creates value by allowing courts to adopt legal standards that respond to changing economic conditions. The model is related to common-law learning accounts, which emphasize that adjudication can reveal information about how legal rules should adapt to new circumstances (Gennaioli and Shleifer, 2007). We capture this channel in reduced form through legislative responsiveness, denoted by $\lambda$. The framework generates testable predictions about the circumstances under which firms choose Delaware over alternative jurisdictions.

**Setup.** Consider a continuum of firms indexed by $i$ that must choose where to incorporate. This choice affects a central governance problem: the optimal allocation of control between managers and shareholders. Firm value is denoted by $V(C, \theta)$, where $C$ represents the allocation of control and $\theta$ captures the firm's governance environment, including the economic and transactional circumstances that determine the efficient balance between managerial discretion and shareholder influence, such as takeover activity, conflicts of interest, shareholder

sophistication, monitoring capacity, and entrenchment or opportunism concerns. The optimal allocation is $C^*(\theta)$.

Each state $j$ offers one of two types of corporate law:

- **Strict law ($S$)**: Statutes fix the allocation of control between managers and shareholders at $C_S$. In the corporate-law context, $C_S$ represents judicial deference to managerial decision-making, akin to business-judgment protection. Courts cannot invalidate transactions, and managers are shielded from liability.

- **Flexible law ($F$)**: Courts apply fiduciary standards flexibly to determine the allocation of control based on economic conditions, aiming to implement the optimal allocation $C^*(\theta)$. Depending on the circumstances, $C^*(\theta)$ may coincide with $C_S$, meaning deference to managerial discretion, or it may require some degree of shareholder protection, judicial scrutiny, or shareholder influence over corporate decision-making. Relative to strict law, flexibility is therefore more investor-protective when the efficient allocation departs from business-judgment protection.

In practice, there is a spectrum between strict and flexible regimes, but for simplicity, we adopt a clear dichotomy. States that choose strict laws are generally those that have adopted anti-takeover statutes—such as provisions validating poison pills, limiting shareholders' ability to challenge managerial discretion, or exempting managers from the duty of loyalty (Eldar and Magnolfi, 2020). In these states, the allocation of control remains fixed at $C_S$ regardless of the economic environment, and litigation is rare. This category includes the majority of U.S. states.

The primary state that has adopted a flexible legal regime is Delaware. Its specialized business courts adapt the allocation of control to changing economic conditions, such as the merger waves of the 1980s. This adaptability is reflected in the evolving landscape of Delaware case law. Other states, such as California, also exhibit flexible characteristics in that they lack statutes validating managerial decisions. However, unlike Delaware, they lack a judiciary with comparable expertise in corporate law matters.

**Court adjudication under $F$.** Under a flexible regime, transactions may be adjudicated by the courts. Judicial expertise is represented by the probability $p$ that the court correctly sets the optimal allocation of control:

$$C = \begin{cases} C^*(\theta), & \text{with probability } p, \\ C_{\text{err}}, & \text{with probability } 1-p. \end{cases}$$

When the court errs, the court sets an allocation of control that differs from $C^*(\theta)$, producing a loss of $V^*(\theta) - V_e(\theta)$, where $V^*(\theta) = V(C^*(\theta), \theta)$ is the value under the optimal allocation of control and $V_e(\theta) = V(C_{\text{err}}, \theta)$ is the value under judicial error. Such errors may arise from judicial policy preferences (Gennaioli and Shleifer, 2007) or from the costs of detailed inquiry in novel cases (Baker and Mezzetti, 2012).

This risk is particularly salient when the strict law already yields optimal outcomes, i.e., when $C^*(\theta) = C_S$, and there is no efficiency-based justification for judicial scrutiny. In such cases, a court that departs from managerial deference creates a false-positive error: it imposes judicial scrutiny, liability, or shareholder protection even though deference to managerial decision-making would have been efficient.

Thus, under a flexible regime, judicial expertise, captured by $p$, is essential. Delaware made an early and sustained commitment to nonpartisan judicial expertise in corporate law to attract incorporations, and by 1980 it was widely recognized for its expert judiciary (Romano, 1985; Eldar and Rauterberg, 2023). That investment largely eliminates the cost of detailed doctrinal inquiry and mitigates the risk that open-ended standards reflect judicial ideology. By contrast, California, despite offering flexible statutes and being home to numerous corporations, did not attract a meaningful share of incorporations, in large part because it lacks a judiciary with business-law expertise. Flexibility without those institutions leaves more room for political and judicial bias (Gennaioli and Shleifer, 2007) and costly doctrinal inquiry (Baker and Mezzetti, 2012).[6]

[6]Unlike other states, Delaware has strong incentives to strengthen its institutional quality to attract incorporations, as it relies heavily on franchise-tax revenue, whereas California's large and diversified revenue base gives it weaker fiscal incentives to compete for out-of-state incorporations and franchise fees (Eldar and

**Responsive Legislature.** After a court ruling, the legislature may respond with probability $\lambda$[7] to information generated by the ruling and by the market reaction to it. Even in Delaware, judicial errors may occur despite its judicial expertise. A responsive legislature (high $\lambda$) can learn from judicial missteps and market reactions, and can identify categories of cases, corresponding to states of $\theta$, in which $C_S$, judicial deference to managerial decision-making, is the appropriate allocation. It may then adopt statutory clarifications or safe harbors that limit judicial intervention in those categories. Legislative correction, however, is second best rather than a pure substitute for accurate adjudication: let $k > 0$ denote the cost of correction, including harm to judicial legitimacy, reduced trust in Delaware law, and transaction costs or delay.

Delaware exemplifies this institutional design: its Court of Chancery provides judicial expertise (high $p$), while its legislature can respond quickly when market reactions reveal that legal doctrine has become miscalibrated (high $\lambda$). A classic example is the adoption of DGCL §102(b)(7), which permits corporations to exculpate directors from breaches of the duty of care. The statute was enacted following *Smith v. Van Gorkom*, which held directors liable for approving a merger without adequate information, even though there was no showing of bad faith (Goshen and Stein, 2025). The statute can be understood as a legislative response to the negative market reaction to *Van Gorkom*, which suggested that, for a category of duty-of-care cases, the appropriate rule was closer to $C_S$, meaning deference to managerial decision-making, than to judicial scrutiny.

By contrast, legislative learning plays a minor role in strict-law jurisdictions. The response to $\theta$ in these jurisdictions is simply to adopt $C_S$ ex ante, upholding all transactions—whether efficient ($C^*(\theta) = C_S$) or inefficient ($C^*(\theta) \neq C_S$). Such states may avoid some false-positive judicial interventions, but they do so at the cost of locking in suboptimal rules for cases in which shareholder protection, judicial scrutiny, or shareholder influence would be warranted.

Rauterberg, 2023).

[7]Equivalently, $\lambda$ can be given a reduced-form learning interpretation. If $H_j$ is the stock of adjudications, market reactions, and legal-practice information in jurisdiction $j$, and $B(s, H_j)$ is the posterior benefit of correcting a category of judicial error after signal $s$, then $\lambda_j(H_j) = \Pr(B(s, H_j) \geq k \mid \text{judicial error})$. We write $\lambda$ for notational simplicity.

The most conspicuous example is Nevada, which has adopted several anti-takeover statutes, a statute that explicitly grants judicial deference to managerial decisions, and laws that permit managers to be exempted from the duty of loyalty (Eldar and Magnolfi, 2020). Such laws generate limited litigation by validating transactions with minimal scrutiny, and therefore provide fewer opportunities for legal refinement through adjudication.

**Firm Incorporation Decisions.** The expected value to firm $i$ under strict law is:

$$E[V_S] = E_{\theta_i}[V(C_S, \theta_i)].$$

Suppose that the cost of applying allocation $C$ when the efficient allocation is $C^*(\theta_i)$ is

$$\ell(C, \theta_i) = (C - C^*(\theta_i))^2 .$$

Firm value under allocation $C$ is therefore:

$$V(C, \theta_i) = V^*(\theta_i) - \ell(C, \theta_i),$$

where

$$V^*(\theta_i) = V(C^*(\theta_i), \theta_i)$$

is firm value under the efficient allocation of control.

Under strict law, the allocation is fixed at $C_S$, so:

$$E[V_S] = E[V^*(\theta_i)] - E_{\theta_i}[\ell(C_S, \theta_i)].$$

Under flexible law, the court correctly implements $C^*(\theta_i)$ with probability $p$. When $C^*(\theta_i) \neq C_S$, an error means that flexible law fails to improve on the strict-law benchmark; for simplicity, we normalize the resulting loss to the mismatch loss created by applying $C_S$, meaning that $\ell(C_{\text{err}}, \theta_i) = \ell(C_S, \theta_i)$.

The most important judicial error for our purposes is false-positive intervention: cases

in which $C^*(\theta_i) = C_S$, so deference to managerial decision-making is efficient, but the court departs from $C_S$. Legislative responsiveness, denoted by $\lambda$, reduces the expected cost of this category of error by allowing lawmakers to learn from judicial rulings and market reactions and to adopt statutory clarifications or safe harbors.

Expected value under flexible law can then be written as:

$$\begin{aligned} E[V_F] = E[V^*(\theta_i)] - (1-p)E_{\theta_i}[\ell(C_S, \theta_i)] \\ - (1-p)\Pr(C^*(\theta_i) = C_S)\Big[(1-\lambda)E\left[\ell(C_{\text{err}}, \theta_i) \mid C^*(\theta_i) = C_S\right] + \lambda k\Big]. \end{aligned}$$

Define the flexibility premium as:

$$\Pi_i = E[V_F] - E[V_S].$$

Substituting the expressions above gives:

$$\Pi_i = pE_{\theta_i}[\ell(C_S, \theta_i)] - (1-p)\Pr(C^*(\theta_i) = C_S)\left[(1-\lambda)E\left[\ell(C_{\text{err}}, \theta_i) \mid C^*(\theta_i) = C_S\right] + \lambda k\right].$$

The first term is the expected gain from flexible adjudication. It reflects the fact that flexible law can avoid the mismatch created by fixing control at $C_S$. The remaining terms capture the expected cost of judicial overshooting: legislative responsiveness reduces the cost of uncorrected errors but introduces correction costs $k$. Firm $i$ chooses flexible law, meaning Delaware, when:

$$\Pi_i > c_i,$$

where $c_i$ represents the incremental costs of Delaware incorporation, including legal fees, franchise taxes, and litigation costs.

**Mismatch Under Strict Law.** Let

$$M_i \equiv E_{\theta_i}[\ell(C_S, \theta_i)] = E_{\theta_i}\left[(C_S - C^*(\theta_i))^2\right]$$

measure the expected mismatch created by applying the strict-law allocation $C_S$ to firm $i$.

Writing $\mu_i \equiv E_{\theta_i}[C^*(\theta_i)]$ and $\sigma^2_{C,i} = \text{Var}[C^*(\theta_i)]$, this mismatch can be decomposed as:

$$M_i = \sigma^2_{C,i} + (\mu_i - C_S)^2 .$$

Thus, strict law is costly when the efficient allocation is more variable, when its average lies farther from managerial deference, or both.

Substituting this expression into the flexibility premium gives:

$$\Pi_i = pM_i - (1-p)\Pr(C^*(\theta_i) = C_S)\left[(1-\lambda)E\left[\ell(C_{\text{err}}, \theta_i) \mid C^*(\theta_i) = C_S\right] + \lambda k\right]. \quad (1)$$

Differentiating Equation (1) with respect to strict-law mismatch gives:

$$\frac{\partial \Pi_i}{\partial M_i} = p - (1-p)\frac{\partial}{\partial M_i}\left\{\Pr(C^*(\theta_i) = C_S)\left[(1-\lambda)E\left[\ell(C_{\text{err}}, \theta_i) \mid C^*(\theta_i) = C_S\right] + \lambda k\right]\right\}. \quad (2)$$

The derivative in Equation (2) is positive, and flexibility therefore becomes more valuable as strict-law mismatch rises, when courts are sufficiently accurate and legislative responsiveness sufficiently limits the expected cost of false-positive judicial intervention:

$$p > (1-p)\frac{\partial}{\partial M_i}\left\{\Pr(C^*(\theta_i) = C_S)\left[(1-\lambda)E\left[\ell(C_{\text{err}}, \theta_i) \mid C^*(\theta_i) = C_S\right] + \lambda k\right]\right\}.$$

In the benchmark case in which the expected cost of false-positive intervention is held fixed with respect to $M_i$, this simplifies to:

$$\frac{\partial \Pi_i}{\partial M_i} = p > 0.$$

**Institutional Ownership.** Institutional ownership enters the model through the firm's governance environment $\theta_i$. Institutional investors can make shareholder intervention more credible, increase monitoring, and raise the likelihood that corporate decisions become contested. Large shareholders may have incentives to monitor and intervene in corporate

control decisions (Shleifer and Vishny, 1986), and ownership structure can affect the choice between trading and intervention (Kahn and Winton, 1998). Empirical work also shows that institutional investors affect voting on antitakeover amendments, shareholder proposals, governance preferences, activism, and board-level outcomes (Brickley, Lease and Smith, 1988; Gillan and Starks, 2000; McCahery, Sautner and Starks, 2016; Appel, Gormley and Keim, 2019; Brav et al., 2008).

This does not mean that shareholder intervention is always efficient. Rather, institutional ownership can affect both the average and the dispersion of the efficient allocation of control. Sophisticated, actively involved shareholders may make shareholder influence more efficient on average, while the relative advantage of managerial discretion may vary across governance disputes. In some states of $\theta_i$, deference to managers remains optimal; in others, shareholder protection, judicial scrutiny, or shareholder influence is warranted. In the notation above, institutional ownership increases the expected mismatch created by a fixed rule of managerial deference:

$$\frac{\partial M_i}{\partial IO_i} > 0.$$

Combining this condition with the effect of strict-law mismatch in Equation (2) gives:

$$\frac{\partial \Pi_i}{\partial IO_i} = \frac{\partial \Pi_i}{\partial M_i}\frac{\partial M_i}{\partial IO_i} > 0, \tag{3}$$

provided that courts are sufficiently accurate and legislative responsiveness sufficiently limits the expected cost of false-positive intervention.

The rise of institutional ownership is therefore a central source of demand for Delaware law. As institutional ownership increased over time, firms became more likely to face governance environments in which the efficient allocation of control depended on the particular circumstances rather than on a fixed rule of managerial deference.

**Takeover Activity.** Takeover activity also enters through $\theta_i$. The emergence of an active takeover market increased the risk of managerial opportunism, defensive entrenchment, and conflicted decision-making, making intervention in managerial discretion more likely to be

efficient in many transaction settings. At the same time, some takeover settings may still require managerial discretion to protect long-term value. Takeover activity therefore affects both the average allocation of control and the uncertainty around that allocation. In the notation above, it increases the expected mismatch created by a fixed rule of managerial deference:

$$\frac{\partial M_i}{\partial M\&A} > 0.$$

Combining this condition with the effect of strict-law mismatch in Equation (2) gives:

$$\frac{\partial \Pi_i}{\partial M\&A} = \frac{\partial \Pi_i}{\partial M_i}\frac{\partial M_i}{\partial M\&A} > 0, \tag{4}$$

again provided that judicial expertise and legislative responsiveness keep the expected cost of false-positive intervention sufficiently low.

Institutional ownership and takeover activity are therefore both proxies for governance environments in which a fixed rule of managerial deference is more likely to misallocate control. They increase demand for Delaware not because Delaware always favors shareholders, but because Delaware can tailor the allocation of authority between managers and shareholders to the relevant circumstances.

**Summary of Predictions.** The model yields two testable predictions. In both cases, the relevant shock changes the governance environment $\theta_i$ in ways that increase the expected mismatch from a fixed rule of managerial deference, whether by shifting the efficient allocation of control, making that allocation more context-dependent, or both:

1. **Institutional Ownership**: The probability of choosing Delaware increases with institutional ownership, as sophisticated and active shareholders make adaptive allocation of control more valuable.

2. **Takeover Activity**: During periods of high takeover activity, demand for Delaware rises because transactional conflicts and entrenchment concerns make flexible judicial review more valuable.

These predictions guide our empirical analysis of incorporation patterns from 1980 to 2010.

# 3 An Empirical Analysis of Delaware Incorporations

## 3.1 Empirical Model and Data

The theoretical framework predicts that demand for Delaware increases when fixed legal rules are more likely to misallocate control and when shareholders place more weight on governance quality. To test these predictions, we analyze incorporation behavior using a comprehensive panel of approximately 120,000 firm-year observations for U.S. public firms from 1980 to 2010. We combine incorporation data from Sanga (2020),[8] with CRSP-Compustat financials, institutional ownership from 13F filings, and M&A activity from SDC Platinum.

Our core variables are Institutional Ownership, measured as the fraction of shares held by institutional investors each year and used as a proxy for shareholder governance preferences, and three takeover-related measures that capture exposure to transactional settings in which fixed rules are more likely to misallocate control: (i) M&A Target$_{t-1\to t+1}$, an indicator for whether a firm became the target of a completed merger in year $t-1$, $t$, or $t+1$; (ii) Industry M&A, the fraction of firms in the same 2-digit SIC-year that were M&A targets; and (iii) Annual M&A, the fraction of public firms involved in a completed merger or acquisition in a given year.

Our empirical model builds on Eldar and Magnolfi (2020), who show that incorporation decisions are subject to inertia after firms go public, with reincorporations being rare. Accordingly, we jointly examine three types of decisions.

First, we analyze the *initial choice of incorporation state* when the firm becomes public, a deliberate assessment of legal infrastructure shaped by the preferences of the anticipated shareholder base. Institutional investors, who emphasize shareholder value and accountability, are more likely to favor Delaware's standards-based judicial scrutiny over rigid, bright-line

[8] We thank Roberta Romano and Sarath Sanga for constructing this dataset.

protections that shield managers from judicial review.

Second, we analyze *reincorporation into Delaware* by firms initially incorporated elsewhere. Reincorporations often occur around major transactions, especially mergers and acquisitions, or in anticipation of takeover activity (Romano, 1985). In our account, these transactional settings heighten conflicts of interest, make governance needs more context-dependent, and increase the value of shareholder protection. Firms are therefore more likely to choose Delaware when its adaptive legal standards and expert judiciary can provide a more efficient allocation of authority between managers and shareholders.

Third, we examine *reincorporation out of Delaware*. We expect the few Delaware firms that reincorporate elsewhere to be those not exposed to major transaction activity. For these firms, the value of flexible rules is limited, particularly given Delaware's high incorporation fees.

Consistent with the inertia of incorporation choices, we observe 726 switches into Delaware and 153 switches out of Delaware in the main estimation sample.

To test these hypotheses, we implement a joint maximum likelihood framework that estimates three logit specifications corresponding to the three transitions described above. Let $y_{it}$ denote the incorporation choice for firm $i$ in year $t$. The explanatory variables $x_{it}$ include Institutional Ownership, M&A Target$_{t-1\to t+1}$, Industry M&A, and Annual M&A, as well as standard financials: Market Value, ROA, R&D/Assets, PPE/Assets, Cash Ratio, and Leverage (see Table A1 for variable definitions). In additional specifications, we also include state and year fixed effects.

Table 1 reports summary statistics for the full sample and separately for firms incorporated in Delaware and non-Delaware jurisdictions. Delaware firms have substantially higher institutional ownership and are more likely to be exposed to takeover activity. They are also more innovative, as reflected in higher R&D intensity, and exhibit lower profitability on average, consistent with innovative firms that prioritize growth over current earnings. In addition, Delaware firms hold significantly more cash and operate with lower leverage. Together, these differences underscore the importance of accounting for endogenous selection

into Delaware.

The estimation distinguishes three cases based on the firm's incorporation history:

1. **First-time incorporation**: The firm chooses whether to incorporate in Delaware upon becoming public ($t = 1$). The probability is given by:

$$\Pr(y_{it} = 1) = \Lambda(x'_{it}\beta_1), \tag{5a}$$

   where $\Lambda$ is the logistic cumulative distribution function.

2. **Switching into Delaware**: The firm was incorporated outside Delaware in year $t-1$, where $t > 1$, and chooses whether to switch to Delaware. The probability is:

$$\Pr(y_{it} = 1 \mid y_{it-1} = 0) = \Lambda(x'_{it}\beta_2). \tag{5b}$$

3. **Switching out of Delaware**: The firm was incorporated in Delaware in year $t-1$, where $t > 1$, and chooses whether to exit. The probability is:

$$\Pr(y_{it} = 0 \mid y_{it-1} = 1) = \Lambda(x'_{it}\beta_3). \tag{5c}$$

Equations (5a)–(5c) are estimated simultaneously using maximum likelihood, with the log-likelihood contribution $\ell_{it}$ determined by the firm's prior incorporation status:

$$\ell_{it} = \begin{cases} \log(\Lambda(x'_{it}\beta_1)) & \text{if } t = 1,\ y_{it} = 1, \\ \log(1 - \Lambda(x'_{it}\beta_1)) & \text{if } t = 1,\ y_{it} = 0, \\ \log(\Lambda(x'_{it}\beta_2)) & \text{if } t > 1,\ y_{i,t-1} = 0,\ y_{it} = 1, \\ \log(1 - \Lambda(x'_{it}\beta_2)) & \text{if } t > 1,\ y_{i,t-1} = 0,\ y_{it} = 0, \\ \log(\Lambda(x'_{it}\beta_3)) & \text{if } t > 1,\ y_{i,t-1} = 1,\ y_{it} = 0, \\ \log(1 - \Lambda(x'_{it}\beta_3)) & \text{if } t > 1,\ y_{i,t-1} = 1,\ y_{it} = 1. \end{cases} \tag{6}$$

Summing Equation (6) over firm-years gives the total log-likelihood:

$$\mathcal{L}(\beta_1, \beta_2, \beta_3) = \sum_{i,t} \ell_{it}.$$

## 3.2 Results and Counterfactual Analysis

**Main Results.** The results in Table 2 show that institutional ownership is the strongest and most significant predictor of Delaware incorporation when going public. A one standard deviation increase in institutional ownership raises the likelihood of choosing Delaware by about 21 percentage points without fixed effects and 15 percentage points with state and year fixed effects, corresponding to roughly 37 percent and 27 percent of the baseline incorporation rate. Institutional ownership is also significantly positively associated with reincorporation into Delaware once state and year fixed effects are included. It is negatively associated with reincorporation out of Delaware in the specification without fixed effects, though the estimate becomes less precise once fixed effects are included. These results are consistent with the predictions of the theoretical framework and suggest that the rise in institutional ownership accounts for much of the increase in Delaware's market share over time.

With respect to takeover exposure, being an M&A $\text{Target}_{t-1\to t+1}$ has only a modest effect on the initial decision when going public, reflecting the fact that newly listed firms rarely position themselves as acquisition targets. For reincorporating firms, however, M&A target status is a strong predictor: target status raises the probability of switching to Delaware by about 40% relative to the base rate without fixed effects and by 30% with state and year fixed effects. At the same time, it reduces the probability of switching out of Delaware by roughly the full baseline exit rate. These results are consistent with the theoretical prediction that takeover exposure increases the expected mismatch under fixed rules and strengthens demand.

Industry M&A, measured as the share of industry peers subject to acquisitions, primarily affects reincorporations into Delaware. A one–standard deviation increase raises the probability of reincorporating into Delaware by roughly 10–12% of the baseline rate. This suggests

that reincorporating firms, often those operating in active transaction environments or seeking buyers, respond to industry takeover waves when considering Delaware.

Annual M&A, which reflects overall market merger activity, has a statistically significant but modest effect on Delaware entry at the IPO stage: a one–standard deviation increase raises the probability of incorporating in Delaware by about 3% of the baseline rate. The effect is much stronger for switches into Delaware, where it corresponds to nearly a 30% increase over the baseline rate. This switch-in effect is no longer statistically significant once year fixed effects are included, which is unsurprising because year effects absorb much of the annual variation in merger activity. Taken together with the firm- and industry-level measures, this evidence supports the prediction that broader takeover waves elevate demand for Delaware, especially among reincorporating firms.

Turning to financials, firms with higher market value are more likely to choose Delaware when going public, consistent with larger firms seeking Delaware's reputational and governance advantages. More innovative and high-growth firms, those with higher R&D/Assets and lower ROA, are also more likely to incorporate in Delaware, supporting the view that firms facing complex tradeoffs between short- and long-term value benefit from flexible governance arrangements. Finally, firms with higher Cash Ratios and lower leverage are more likely to enter Delaware, which is intuitive given both the direct and indirect costs of incorporation fees and the higher likelihood of litigation.

**Validation.** Figure 3 shows that the predicted Delaware market share aligns well with the actual market share in both in-sample and out-of-sample periods. For the out-of-sample prediction, the model is estimated using data from 1980–1999, and then used to predict market shares from 2000–2010. The close fit in both settings supports the model's predictive performance and provides a useful check before conducting the counterfactual analysis.

**Counterfactual Analysis.** To assess the impact of institutional shareholding and takeovers on Delaware's market share, we set Institutional Ownership, M&A Target$_{t-1\to t+1}$, Industry M&A, and Annual M&A to zero, approximating conditions prior to 1980. We then simulate

Delaware's market share and compare it to the actual market share and the in-sample predicted values.

As shown in Figure 4, the simulated market share remains largely flat over time and even declines in later years, suggesting that, within the model, the rise in institutional ownership and takeover activity accounts for a substantial share of Delaware's growing market dominance. By 2010, the simulated market share is 25 percent when these variables are set to zero, compared with an actual share of 57.6 percent and a predicted share of 64.9 percent. This gap of more than 30 percentage points illustrates the quantitative importance of institutional ownership and M&A activity within the model's account of Delaware's incorporation advantage.

In Figure A1, we further decompose the simulation into initial incorporation choices and reincorporations. Absent institutional ownership and takeover activity, firms are significantly less likely to choose Delaware at the time of IPO: by 2010, the fraction incorporating in Delaware would be about 40%, compared to nearly 70% in the prediction implied by the model.[9] Even more strikingly, the simulated number of reincorporations into Delaware remains very small, far below the levels observed during periods of high takeover activity.

# 4 Mitigating Endogeneity

As a robustness check, we instrument for institutional ownership using stock-index membership, which affects institutional holdings through index-fund demand (Aghion, Van Reenen and Zingales, 2013; Appel, Gormley and Keim, 2016). A potential criticism of this approach is that index membership may capture firm size and related characteristics rather than an exogenous change in institutional ownership (Wei and Young, 2024; Appel, Gormley and Keim, 2024). This concern is especially salient when Russell 3000 constituents are compared with much smaller non-index firms, and a linear control for market value may not fully absorb these differences.

[9]The mild changes in Delaware's simulated market share likely reflect other trends in firm characteristics, particularly the growth in firm size during the 2000s (see Figure A2).

Table 3 therefore reports four control-function designs, each with and without state and year fixed effects. We first use Russell 3000 membership as the instrument in the full sample and after removing firms in the top and bottom quintiles of firm-average log market value. We then restrict the sample to Russell 3000 firms, use Russell 1000 membership as the instrument, and repeat that analysis among the larger half of Russell 3000 firms. Across these specifications, the coefficient on fitted Institutional Ownership in the IPO equation remains economically large. It is positive and statistically significant in every specification with fixed effects and in all but the most restrictive specification without fixed effects. This stability supports the paper's main firm-level result: firms with greater institutional ownership are more likely to choose Delaware when they go public. By contrast, the estimates for reincorporations into and out of Delaware are generally insignificant in the more demanding restricted-sample specifications, particularly when fixed effects are included. Taken together, these results suggest that institutional ownership matters primarily for firms' initial decision to incorporate in Delaware when they go public.

# 5 Discussion and Implications

**Common Law and Investor Protection.** The "legal origins" literature identifies systematic differences between common law and civil law jurisdictions (La Porta, Lopez-de Silanes and Shleifer, 2008). Common law systems, originating in English law, tend to be associated with stronger investor protection and deeper financial markets relative to civil law systems, which rely more heavily on codified, bright-line rules. Early contributions to this literature sought to explain this association by coding differences in formal investor-protection rules across jurisdictions, often through indices that count the presence of particular statutory provisions (La Porta et al., 1997). Subsequent work has claimed that such index-based measures are noisy, calling into question whether common-law systems in fact provide stronger investor protection in any static or mechanical sense (Spamann, 2010).

Our analysis suggests that this focus on statutory content misses the central institutional distinction. The advantage of common-law systems does not lie in the level of investor

protection embedded in formal rules, but in the nature of the legal process itself—specifically, reliance on flexible, judge-made standards administered through adjudication. Civil law, by contrast, emphasizes ex ante regulation and comprehensive codes, which reduce discretion but can result in rigidity and misfit when firms face heterogeneous or evolving governance needs.

Our theoretical analysis shows that flexible law can serve as an effective governance system when supplemented by two institutional features: an expert judiciary that minimizes errors in applying open-ended standards, and a responsive legislature that can correct or refine doctrine when judicial mistakes occur. Studying incorporation choices within the United States provides a particularly sharp setting for isolating this institutional logic, because firms can choose among jurisdictions that differ starkly in their reliance on flexible fiduciary standards versus bright-line statutory rules.

Delaware is distinctive in this competitive landscape. It combines a standards-based corporate law with a specialized judiciary and an active legislature that routinely updates corporate statutes to preserve doctrinal coherence. Most other U.S. states, by contrast, rely more heavily on rigid statutory rules that limit judicial discretion and require less institutional investment in adjudication. By linking firms' jurisdictional choices to these institutional differences, our analysis connects a central insight of the law and finance literature—the value of adaptable legal institutions—to competition among U.S. corporate law regimes.

Our empirical results provide firm-level evidence consistent with this account. The demand for Delaware's standards-based corporate law rises when investors place greater weight on governance quality, as proxied by institutional ownership, and when governance needs become more context dependent, as in periods of heightened takeover activity. In this sense, the growth of institutional ownership and the rise of takeovers together help explain why a common-law system centered on flexible adjudication became increasingly valuable, and why Delaware's market share expanded so sharply between 1980 and 2010.

**The Current "DExit" Trend.** Our analysis sheds light on the recent reincorporations of large public companies such as Tesla and TripAdvisor from Delaware to Texas and Nevada. While Delaware previously faced some competition from Nevada, that competition involved relatively

small, thinly traded firms and did not pose a serious challenge to Delaware's dominance (Eldar, 2018). By contrast, the recent reincorporations are concentrated among firms controlled by founders or high-profile CEOs, including Tesla, Roblox, and Affirm (Bainbridge, 2024; Aggarwal and Eldar, 2026), a group that has grown substantially in recent years and now represents a significant segment of the economy (Aggarwal et al., 2022). Many of these innovative and profitable firms have expressed dissatisfaction with recent Delaware decisions that expand judicial review of transactions involving controlling shareholders, a shift that they view as interfering with founder-controlled firms' ability to pursue their vision and strategy for their companies (Goshen, Hamdani and Lund, 2025; Bainbridge, 2025; Fisch and Davidoff Solomon, 2025).

Consistent with our model, even expert judges can create uncertainty by making errors, and the legislature can then correct or recalibrate the law. Delaware responded with a legislative reform, SB 21, which provides greater certainty in the definition of controllers and creates broad safe harbors for controller transactions. By shielding controlling shareholders and influential CEOs from extensive judicial review, SB 21 shifts Delaware's approach from standards-based adjudication of fiduciary duties toward more predictable bright-line rules. These changes may be seen, on one reading, as a departure from the institutional features–flexible law administered by an expert judiciary and revised by a responsive legislature–that have historically underpinned Delaware's dominance.

Another reading, consistent with our framework, is that SB 21 exemplifies the correction mechanism that sustains Delaware's adaptability, with the legislature stepping in to address perceived judicial overreach in response to the rise of founder- or CEO-controlled companies. The governance structures of these firms differ systematically from the broader population. Investors in such companies often accept weaker monitoring in exchange for visionary leadership. Moreover, these firms are effectively insulated from takeovers, which reduces the importance of legal adaptability. Their governance is deliberately structured to empower entrepreneurial autonomy (Goshen and Hamdani, 2016), making flexible judicial standards less valuable ($C^*(\theta) = C_S$). For these firms, predictable bright-line rules that shield controller

transactions from litigation may be more efficient. In this context, SB 21 may help reduce reincorporation out of Delaware, even though the advantages that Delaware traditionally offers are less relevant for this subset of firms.

More broadly, this development illustrates that the tradeoff between flexible standards and bright-line rules—central to the legal origins debate—depends on firm heterogeneity: while most firms value adaptability, founder-controlled firms may instead prefer predictable rules that secure managerial autonomy.

**Other Explanations for Delaware's Dominance.** Three related explanations are often offered for Delaware's dominance. The first posits a discrete improvement in Delaware law around 1985–1986, notably the adoption of DGCL §102(b)(7), which allowed corporations to exculpate directors from monetary liability for duty-of-care breaches, and seminal Delaware court decisions, such as *Moran*, that redefined the balance between managers and shareholders in the takeover context (Sanga, 2020). This account is insufficient to explain the timing of Delaware's rise. The trend toward Delaware among firms that go public began before 1985, suggesting that other forces were at work (see Figure 2). Moreover, from an institutional perspective, Delaware was not unique, since most other states quickly adopted director exculpation statutes in the 1980s (Eldar and Magnolfi, 2020). Finally, as discussed above, mid-1980s Delaware case law did not yield stable or predictable standards (Kahan and Kamar, 2002).

The second explanation emphasizes "network effects" (Sanga, 2020). The idea is that firms benefit from using the same corporate law as their peers. Incorporating in Delaware provides access to a legal infrastructure that grows more valuable as more firms adopt it: directors, lawyers, and financial intermediaries become more familiar with Delaware law, reducing costs and uncertainty. Sanga (2020) estimates that most of the increase in Delaware's market share was due to network effects. The empirical intuition is that because Delaware's growth was gradual, it may reflect firms following peers. Network externalities may well contribute to the level of Delaware's market share, but they were already present in the early 1980s and therefore do not explain why that share rose so sharply in the following decade. As Figure 2

shows, incorporation decisions closely track dramatic changes in capital markets over time, and our empirical analysis is consistent with these changes explaining Delaware's rise.

Moreover, Delaware's fundamental institutional quality did not change dramatically between 1980 and 2010. Its judiciary was already recognized as highly expert in business law by the early 1980s (Romano, 1985). The takeover cases of the 1980s exemplified the kind of adaptive adjudication that Delaware courts are known for, and subsequent landmark decisions, such as *Paramount v. Time* (1989), *Airgas* (2011), and *Corwin* (2015), further refined standards of judicial review. Throughout, the legislature acted to correct judicial missteps, not only through §102(b)(7), but also through earlier and later amendments such as §144 (1967) on conflicted transactions (Goshen and Stein, 2025) and §122(17) (2000) permitting corporate opportunity waivers (Eldar and Grennan, 2024). The main change over the sample period was therefore in capital markets, which shifted firms' demand for Delaware's distinctive institutional attributes rather than a sudden improvement in Delaware law itself.

A related version of the network-effects account emphasizes investor and lawyer familiarity. Broughman, Fried and Ibrahim (2014) argue that Delaware incorporation by start-ups serves as a legal lingua franca for out-of-state venture capitalists. Familiarity may reduce the cost of learning a legal system, but it cannot eliminate uncertainty when the law itself remains unsettled and continues to change. Firms primarily seeking familiar and predictable law could instead remain in their home states, many of which adopted the Model Business Corporation Act (Guzman, 2025) and generally offer substantial deference to managers of locally headquartered corporations. Finally, familiarity, like network effects, was not new in the 1980s. It therefore cannot by itself explain why firms increasingly chose Delaware while its doctrine continued to evolve or why reincorporations into Delaware track firms' takeover exposure.[10]

[10]In fact, out-of-state venture financing may capture demand for flexibility rather than investor familiarity. Start-ups that attract nonlocal capital may be more likely to pursue an IPO or sale and to have complex financing arrangements, capital structures, and conflicts among founders and investors. These same characteristics can increase the value of flexible fiduciary law and expert adjudication. Broughman et al.'s findings are therefore consistent with greater demand for flexibility among firms with more complex governance needs.

The third potential explanation is that institutional ownership and takeover activity increased firm demand for predictable corporate law, and that Delaware satisfied this demand because its law was more predictable than the law of other states (Romano, 1985; Daines, 2001). This interpretation requires separating predictability of doctrine from predictability of enforcement. As a doctrinal claim, it is difficult to square with the timing of Delaware's rise: as shown in Figure 1, Delaware's market share expanded during a period when its takeover jurisprudence was unsettled and fact-specific (Kahan and Kamar, 2002; Fisch, 2000). As an enforcement claim, the argument is also incomplete. First, there is little evidence that non-Delaware courts systematically enforced corporate law capriciously. Second, strict-law jurisdictions leave relatively little room for judicial unpredictability because disputes between managers and shareholders are less likely to generate meaningful litigation. Third, most firms that do not incorporate in Delaware incorporate in their headquarters state rather than in an unfamiliar third jurisdiction (Bebchuk and Cohen, 2003); local courts and legislatures tend to be more favorable to locally headquartered corporations and their managers, which can provide relatively predictable enforcement even outside Delaware.

# 6 Conclusion

This paper revisits a central question in the law and finance literature: how an indeterminate system of fiduciary standards can protect investors. That literature has also struggled to explain the predominance of Delaware despite its unpredictability. We argue that Delaware's flexibility is not a flaw but a feature that allows the balance between managerial autonomy and shareholder rights to evolve with changing economic conditions and firm-specific needs. Flexible standards interpreted by expert judges and refined by a responsive legislature provide an institutional mechanism for adjusting this balance as ownership structures and takeover activity shift.

Our framework formalizes this mechanism. Firms with high institutional ownership or exposure to mergers value an adaptive legal system that can recalibrate fiduciary duties as circumstances change, even at the cost of legal uncertainty. Our results are consistent with

systematic sorting explaining Delaware's rise during the era of institutional investing and mergers, and with founder-controlled firms more recently preferring jurisdictions offering greater predictability. By quantifying how changes in capital markets accounted for Delaware's major rise during the era of institutional investing and mergers, the paper clarifies both the enduring appeal and the emerging limits of Delaware's flexible corporate law.

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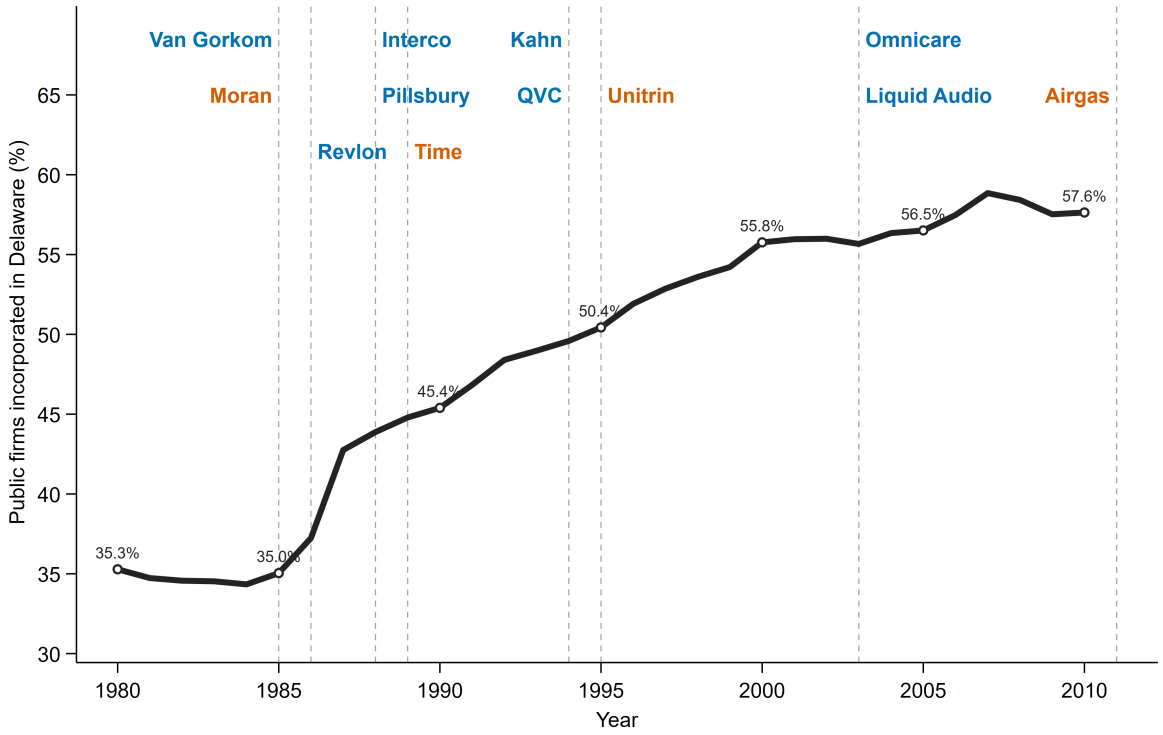
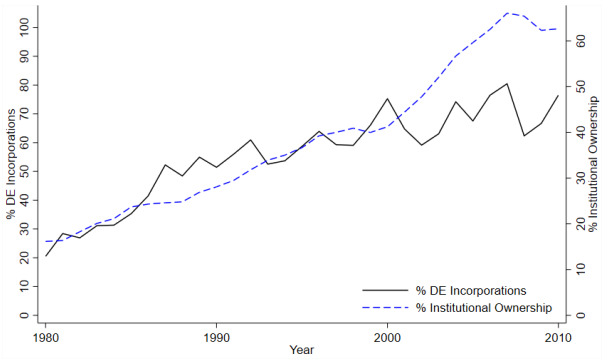
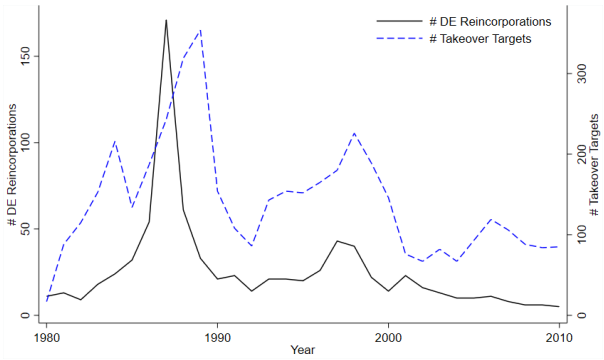



Figure 1: **Delaware Market Share and Judicial Flexibility.** This figure shows Delaware's share of U.S. public firms from 1980 to 2010 and selected Delaware corporate-law decisions. Blue labels indicate decisions that are relatively pro-shareholder, and orange labels indicate decisions that are relatively pro-manager. The cases shown are:

- *Smith v. Van Gorkom* (1985): held directors liable for approving a merger without being adequately informed.
- *Moran v. Household International, Inc.* (1985): upheld a board's adoption of a poison pill.
- *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.* (1986): required directors to seek the best value reasonably available once a sale became inevitable.
- *City Capital Associates Ltd. Partnership v. Interco Inc.* (1988): restricted continued use of a poison pill against a noncoercive, fully financed bid.
- *Grand Metropolitan Public Limited Company v. Pillsbury Company* (1988): required redemption of a poison pill once the bid no longer posed a cognizable threat.
- *Paramount Communications, Inc. v. Time Inc.* (1989): permitted the board to pursue its long-term strategy rather than accept a premium bid.
- *Paramount Communications Inc. v. QVC Network Inc.* (1994): required the board to seek the best value reasonably available in a change-of-control transaction.
- *Kahn v. Lynch Communication Systems, Inc.* (1994): kept controlling-stockholder cash-out mergers under entire-fairness review despite approval by an independent committee.
- *Unitrin, Inc. v. American General Corp.* (1995): broadened the range of defensive responses considered proportionate.
- *MM Companies, Inc. v. Liquid Audio, Inc.* (2003): applied heightened scrutiny to board action interfering with shareholder voting.
- *Omnicare, Inc. v. NCS Healthcare, Inc.* (2003): invalidated preclusive merger protections that left no effective fiduciary out.
- *Air Products and Chemicals, Inc. v. Airgas, Inc.* (2011): allowed the board to maintain a poison pill against a fully financed all-cash bid.

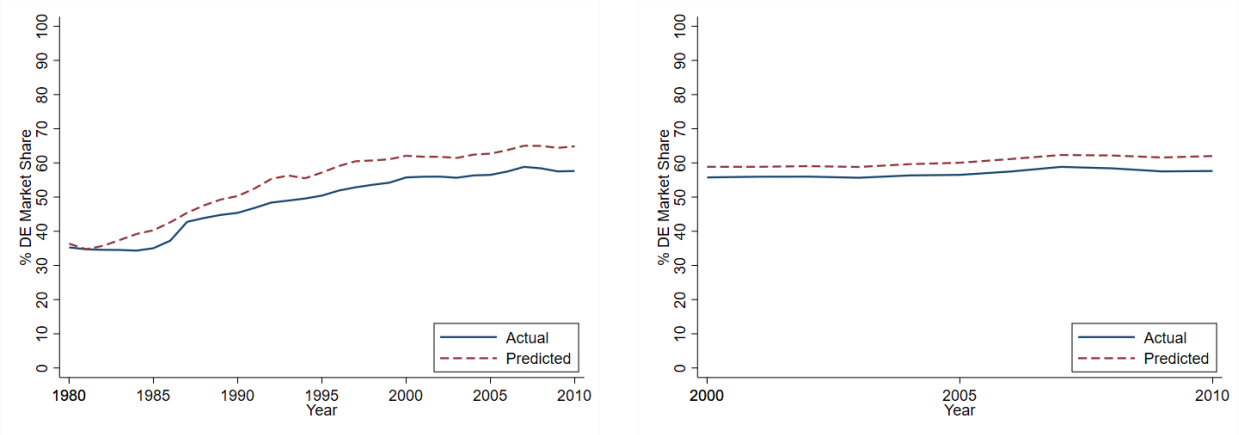



(a) Going Public and Delaware Incorporations




(b) Reincorporations into Delaware

Figure 2: **Trends in Delaware Incorporations and Reincorporations.** Panel (a) shows the percentage of firms going public that incorporate in Delaware (left axis) and the average institutional ownership of public firms (right axis) from 1980 to 2010. Panel (b) displays the number of annual reincorporations into Delaware (left axis) and the number of takeover targets (right axis). Data on firm incorporations were constructed and made publicly available by Roberta Romano and Sarath Sanga (Sanga, 2020).




(a) In-Sample Prediction

(b) Out-of-Sample Prediction

Figure 3: **Predicted and Actual Delaware Market Share of Public Firms.** Panel (a) shows in-sample predictions, comparing the model-predicted market share to the actual Delaware market share for each year. Panel (b) displays out-of-sample predictions: the model is estimated using data from 1980 to 1999 and used to predict Delaware market shares from 2000 to 2010, which are then compared to the actual market shares over the same period. The predicted market shares are based on coefficients estimated using the model described in Section 3.1 and reported in Columns (1)–(3) of Table 2. Model predictions are largely unchanged when using the coefficient estimates in Columns (4)–(6), which include state and year fixed effects.

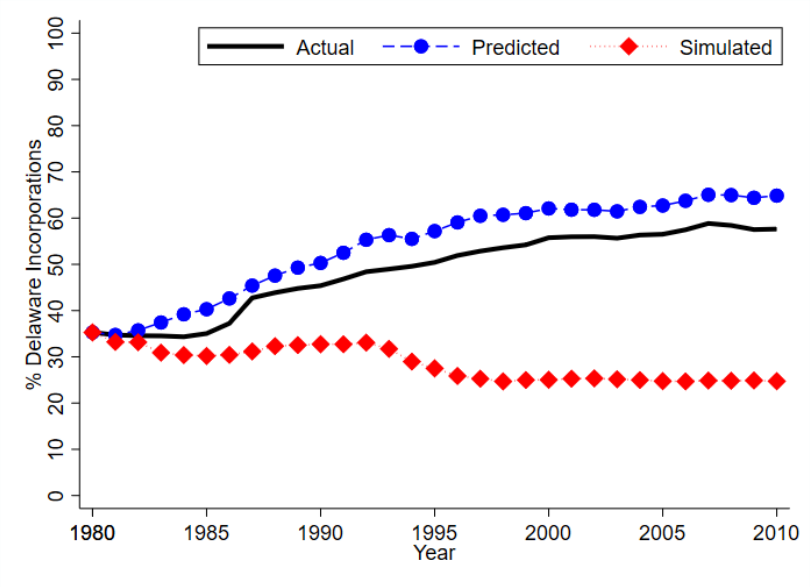



Figure 4: **Simulated Delaware Market Share.** The solid black line plots the actual share of firms incorporated in Delaware over time. The dashed blue line with circles shows the *predicted* Delaware market share implied by the model estimated in Columns (1)–(3) of Table 2, aggregating firm-level fitted probabilities of entry, switch-in, and switch-out. The red line with diamonds shows the *simulated* Delaware market share from a counterfactual experiment in which the variables for institutional ownership, firm-level M&A exposure ($M\&A\ Target_{t-1\to t+1}$), industry-level M&A intensity (*Industry M&A*), and annual M&A activity (*Annual M&A*) are set to zero. This simulation removes the influence of institutional ownership and takeover activity from the dynamic transition process and iterates the model forward year-by-year beginning in 1980.

Table 1: Summary Statistics: Delaware vs. Non-Delaware Firms

| | (1) **All Firms** | (2) **Delaware** | (3) **Non-Delaware** | (4) **Diff.** | (5) **t-stat** |
|---|---|---|---|---|---|
| Institutional Ownership | 0.381 | 0.448 | 0.318 | 0.130 | 74.917 |
| M&A Target ($t-1$ to $t+1$) | 0.092 | 0.095 | 0.088 | 0.007 | 4.443 |
| Industry M&A | 0.034 | 0.033 | 0.035 | −0.003 | −15.822 |
| Annual M&A | 0.034 | 0.034 | 0.035 | −0.002 | −18.725 |
| Market Value ($ millions) | 1690.120 | 2036.678 | 1358.178 | 678.500 | 23.905 |
| ROA | 0.072 | 0.064 | 0.080 | −0.016 | −14.836 |
| R&D / Assets | 0.037 | 0.048 | 0.028 | 0.020 | 42.502 |
| PPE / Assets | 0.264 | 0.253 | 0.275 | −0.022 | −15.765 |
| Cash Ratio | 0.767 | 0.918 | 0.619 | 0.299 | 29.078 |
| Leverage | 0.542 | 0.525 | 0.558 | −0.033 | −22.016 |

**Notes:** This table reports summary statistics for the full sample of U.S. public firms from 1980 to 2010 and separately for firms incorporated in Delaware and non-Delaware jurisdictions. The column "Diff." reports the difference in means between Delaware and non-Delaware firms. The reported t-statistics correspond to two-sided tests of equality of means. All variables are defined in Table A1.

Table 2: Delaware Incorporation Decisions: Main Specification

| | No Fixed Effects | | | State and Year Fixed Effects | | |
|---|---|---|---|---|---|---|
| | (1) Entry | (2) Switch In | (3) Switch Out | (4) Entry | (5) Switch In | (6) Switch Out |
| Institutional Ownership | 3.05*** | 0.16 | −0.51** | 2.44*** | 0.38** | −0.34 |
| | (0.145) | (0.150) | (0.252) | (0.149) | (0.166) | (0.318) |
| M&A Target$_{t-1\to t+1}$ | 0.11 | 0.41*** | −1.15** | 0.21* | 0.31*** | −1.07** |
| | (0.121) | (0.116) | (0.459) | (0.128) | (0.119) | (0.463) |
| Industry M&A | 0.08 | 3.63** | 1.47 | −0.12 | 4.23*** | 2.43 |
| | (0.916) | (1.522) | (3.238) | (0.971) | (1.493) | (3.103) |
| Annual M&A | 5.29*** | 18.78*** | −2.87 | 124.43*** | −17.36 | 23.53 |
| | (1.790) | (2.303) | (5.854) | (17.540) | (27.077) | (45.729) |
| Market Value | 0.00019*** | −0.00000 | −0.00004 | 0.00012** | −0.00000 | −0.00003 |
| | (0.00007) | (0.00001) | (0.00003) | (0.00005) | (0.00001) | (0.00003) |
| ROA | −0.40*** | −0.20 | −0.12 | −0.21* | −0.15 | −0.62 |
| | (0.117) | (0.255) | (0.511) | (0.130) | (0.247) | (0.516) |
| R&D / Assets | 0.88*** | 3.29*** | −3.40* | 1.10*** | 2.44*** | −3.18* |
| | (0.297) | (0.496) | (1.858) | (0.327) | (0.514) | (1.897) |
| PPE / Assets | 0.10 | −0.24 | 0.44 | 0.55*** | −0.29* | 0.40 |
| | (0.106) | (0.168) | (0.333) | (0.121) | (0.174) | (0.386) |
| Cash Ratio | 0.04*** | −0.00 | −0.14 | 0.04*** | −0.01 | −0.09 |
| | (0.010) | (0.024) | (0.105) | (0.011) | (0.026) | (0.083) |
| Leverage | −0.14 | −0.76*** | 0.44 | −0.34*** | −0.59*** | 0.28 |
| | (0.106) | (0.187) | (0.335) | (0.115) | (0.191) | (0.341) |
| Fixed Effects | No | No | No | State + Year | State + Year | State + Year |
| Pseudo-$R^2$ | | 0.064 | | | 0.145 | |
| Observations | 120,597 | 120,597 | 120,597 | 119,666 | 119,666 | 119,666 |

**Notes:** This table presents estimates from a joint maximum likelihood model of Delaware incorporation decisions across three transition types: initial incorporation in Delaware (Entry), reincorporation into Delaware (Switch In), and reincorporation out of Delaware (Switch Out). All variables are defined in Table A1. Specifications in Columns (4)–(6) include state and year fixed effects. All financial variables, Institutional Ownership, and Industry M&A are winsorized at the 1st and 99th percentiles. Standard errors are clustered at the firm level. The pseudo-$R^2$ is McFadden's measure relative to an intercept-only joint model. $^{*}p < 0.1$, $^{**}p < 0.05$, $^{***}p < 0.01$.

Table 3: Delaware Incorporation Decisions: Control-Function Estimates

| | Full Sample | | Middle 60% | | R3000 | | Large R3000 | |
|---|---|---|---|---|---|---|---|---|
| | (1) No FE | (2) FE | (3) No FE | (4) FE | (5) No FE | (6) FE | (7) No FE | (8) FE |
| *Panel A. First Stage: Institutional Ownership* | | | | | | | | |
| Instrument | R3000 | R3000 | R3000 | R3000 | R1000 | R1000 | R1000 | R1000 |
| Instrument coefficient | 0.307*** | 0.312*** | 0.179*** | 0.226*** | 0.136*** | 0.159*** | 0.044*** | 0.096*** |
| | (0.004) | (0.004) | (0.012) | (0.009) | (0.006) | (0.006) | (0.007) | (0.006) |
| First-stage F | 6,623.7 | 7,291.3 | 210.0 | 625.5 | 517.1 | 835.0 | 46.3 | 267.9 |
| *Panel B. Fitted Institutional Ownership in Joint Model* | | | | | | | | |
| Entry | 3.251*** | 3.280*** | 2.620*** | 3.213*** | 5.021*** | 3.633*** | 5.402 | 3.930** |
| | (0.233) | (0.242) | (0.428) | (0.409) | (1.200) | (1.046) | (3.834) | (1.990) |
| Switch In | 0.514* | 0.705** | 0.922 | 0.345 | −1.764* | −0.329 | −3.861 | −0.385 |
| | (0.297) | (0.304) | (0.620) | (0.525) | (1.008) | (0.906) | (3.574) | (1.761) |
| Switch Out | −1.051* | −0.607 | −1.211 | −0.476 | −4.134* | −3.450* | −11.716 | −5.848 |
| | (0.587) | (0.610) | (1.189) | (1.018) | (2.178) | (1.960) | (7.325) | (3.632) |
| State and Year FE | No | Yes | No | Yes | No | Yes | No | Yes |
| Pseudo-$R^2$ | 0.063 | 0.147 | 0.065 | 0.160 | 0.062 | 0.200 | 0.045 | 0.203 |
| Observations | 113,015 | 112,105 | 65,191 | 64,938 | 71,761 | 71,145 | 48,560 | 48,015 |

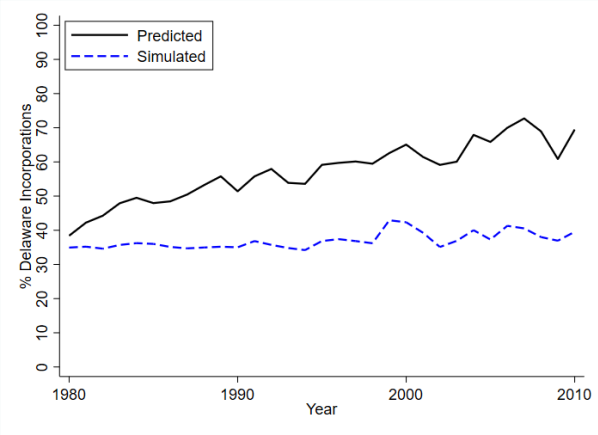
**Notes:** This table reports control-function estimates of Delaware incorporation decisions. Panel A reports the first-stage OLS coefficient on index membership from a regression of Institutional Ownership on the instrument and the controls used in Table 2; the first-stage F-statistic tests the excluded instrument. The instrument is Russell 3000 membership in Columns (1)–(4) and Russell 1000 membership in Columns (5)–(8). Panel B reports joint maximum likelihood coefficients on fitted Institutional Ownership for initial incorporation in Delaware (Entry), reincorporation into Delaware (Switch In), and reincorporation out of Delaware (Switch Out). The first-stage residual is included in each equation but is not reported. Columns (1)–(2) use the full sample. Columns (3)–(4) retain firms in the middle three quintiles of firm-average log market value. Columns (5)–(6) retain Russell 3000 member-years. Columns (7)–(8) retain the top half of firms by average log market value after restricting to Russell 3000 member-years. All specifications include the controls from Table 2, which are not reported; Columns (2), (4), (6), and (8) also include state and year fixed effects. Standard errors, reported in parentheses, are clustered at the firm level. The pseudo-$R^2$ is McFadden's measure relative to an intercept-only joint model. $^{*}p < 0.1$, $^{**}p < 0.05$, $^{***}p < 0.01$.

# Appendix to
# Explaining Delaware's Dominance:
# Firm Heterogeneity and Demand for Legal Flexibility

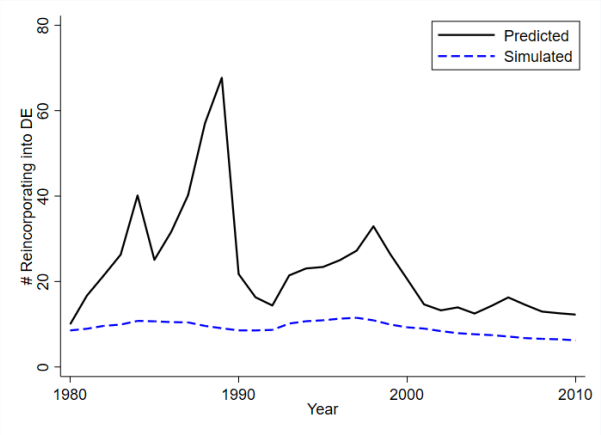
**Ofer Eldar**
UC Berkeley, IWH Halle, and ECGI

**Lorenzo Magnolfi**
Ohio State University

1. Figure A1: Predicted and Simulated Delaware Choices.
2. Figure A2: Firm Characteristics Over Time.
3. Table A1: Variable Definitions.




(a) Going Public and Delaware Incorporations




(b) Reincorporations into Delaware

Figure A1: **Predicted and Simulated Delaware Choices.** Panel (a) shows the predicted percentage of firms choosing Delaware upon going public. Panel (b) shows the predicted number of reincorporations into Delaware. The solid line in each panel displays model-based predictions using coefficients estimated from the model described in Section 3.1 and reported in Columns (1)–(3) of Table 2. The dashed line shows simulated outcomes when institutional ownership, firm-level M&A exposure ($M\&A\ Target_{t-1\to t+1}$), industry-level M&A intensity (*Industry M&A*), and annual M&A activity (*Annual M&A*) are set to zero. Model predictions and simulations are largely unchanged when using the coefficient estimates in Columns (4)–(6), which include state and year fixed effects.

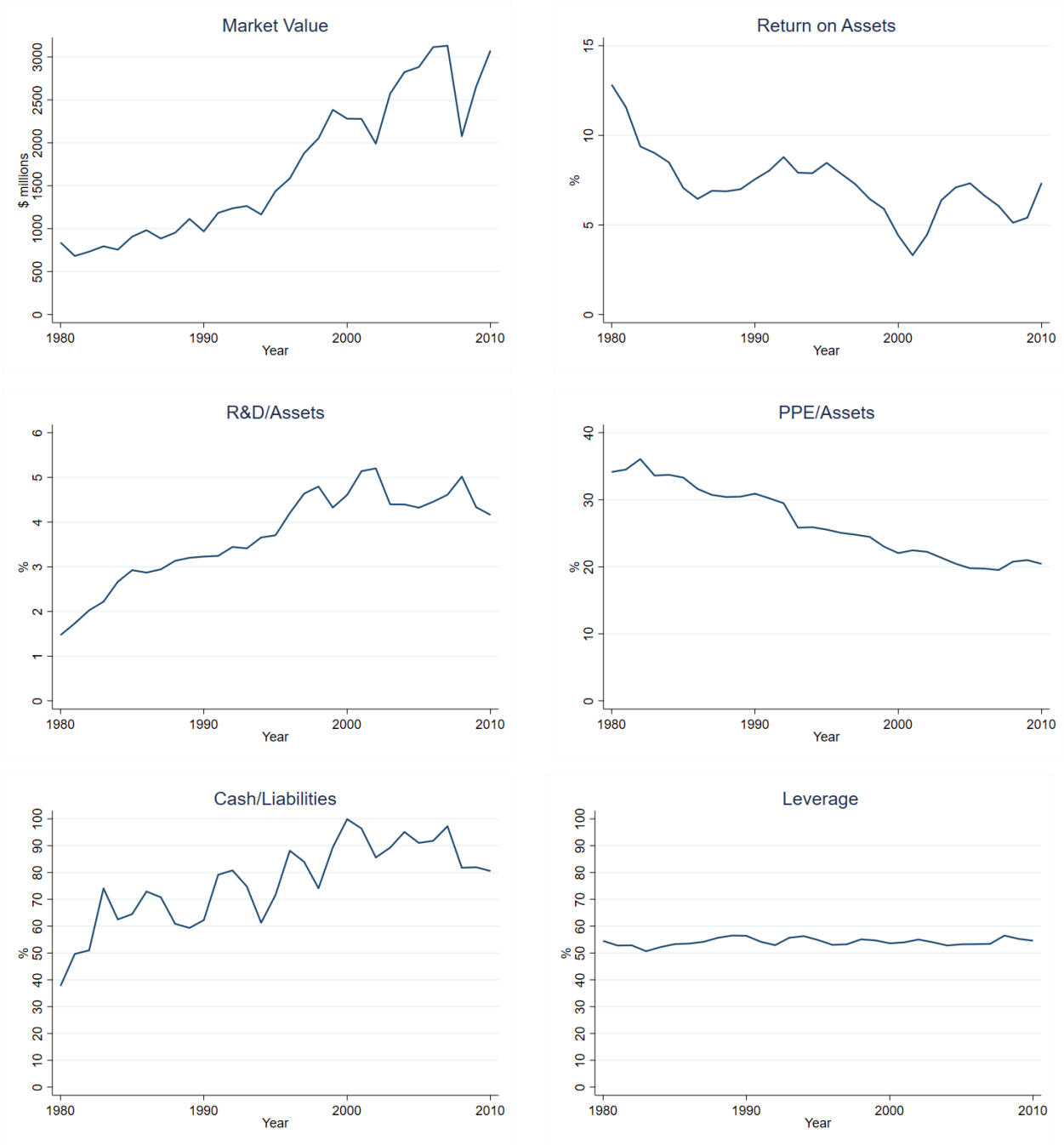



Figure A2: **Firm Characteristics Over Time.** Each panel plots annual means for the indicated variable. All variables are defined in Table A1.

Table A1: Variable Definitions

| **Variable** | **Definition** | **Source** |
|---|---|---|
| Annual M&A | Fraction of public firms involved in a merger or acquisition in a given year. | SDC Platinum |
| Cash Ratio | Cash and short-term investments (`che`) divided by total liabilities. | Compustat |
| Industry M&A | Fraction of firms in the same 2-digit SIC code that were targets of mergers or acquisitions in the same year. | SDC Platinum |
| Institutional Ownership | Fraction of shares held by institutional investors, based on 13F filings. | WRDS 13F Filings |
| Leverage | Total liabilities (`lt`) divided by total assets. | Compustat |
| M&A Target$_{t-1 \to t+1}$ | Equals 1 if the firm was a target in a merger or acquisition during year $t-1$, $t$, or $t+1$. | SDC Platinum |
| Market Value | Market capitalization of the firm, calculated as share price times shares outstanding (Compustat items `prcc_c` and `csho`), measured in $millions and adjusted to the Consumer Price Index. | Compustat |
| PPE / Assets | Net property, plant, and equipment (`ppent`) divided by total assets. | Compustat |
| R&D / Assets | Research and development expenditures (`xrd`) divided by total assets, with missing values coded as zero. | Compustat |
| ROA | Operating income before depreciation (`oibdp`) divided by total assets (`at`). | Compustat |

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