
**A Regulatory Competition Theory of Indeterminacy
in Corporate Law
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[*1908] A REGULATORY COMPETITION THEORY OF INDETERMINACY IN CORPORATE LAW

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This Article revisits the debate on the desirability of interstate competition in providing corporate law. It argues that the market for corporate law is imperfectly competitive, and therefore may not yield the optimal product to either shareholders or managers. Delaware dominates the market as a result of several competitive advantages that are difficult for other states to replicate. These advantages include network benefits emanating from Delaware's status as the leading incorporation jurisdiction, Delaware's proficient judiciary and Delaware's unique commitment to corporate needs. Delaware can enhance these advantages by developing indeterminate and judge-oriented law, even if such law is otherwise undesirable. Indeterminacy makes Delaware laws inseparable from its application by Delaware's courts and thus excludes non-Delaware corporations from network benefits, accentuates Delaware's judicial advantage, and makes Delaware's commitment to firms more credible. Whether state competition constitutes a race to the top, to the bottom, or somewhere in between, excessive indeterminacy may add an additional degree of inefficiency to the law

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[*1909] INTRODUCTION

Federalism in American corporate law is widely thought to have bred a system of regulatory competition in which states formulate law to attract incorporation. While commentators disagree about the desirability of this regulatory competition—with race-to-the-bottom theorists arguing that it spawns overly pro-managerial laws, and race-to-the-top theorists arguing that it results in laws beneficial to shareholders—they agree that it induces states to play to corporate decisionmakers. They also agree that Delaware

has emerged as a clear winner in this system, attracting over half of the large, publicly traded corporations.¹

Yet state competition theories fail to explain the well-documented indeterminacy of Delaware corporate law, which is evident in the state's ample use of vague standards that make prediction of legal outcomes difficult. While Delaware law offers relatively clear rules that govern technical aspects of corporate governance, the fiduciary duties at its core are open-ended. They define only crudely the guidelines for managerial behavior, and rely heavily on ad hoc judicial interpretation. Indeterminacy poses a challenge to both race-to-the-bottom and race-to-the-top theories [*1910] because it obstructs business planning and thereby harms managers and shareholders alike.

This Article suggests an explanation for Delaware's legal indeterminacy based on a view of state competition as imperfect competition. While current theories assume perfect competition among states and hence optimal law (either for shareholders or for managers), this Article claims that Delaware has market power that allows it to engage in anticompetitive behavior.² Specifically, I argue that Delaware law may be less determinate than is optimal and yet still stimulate demand.³ Although indeterminacy diminishes the value to corporations of Delaware law, it diminishes the value of rival laws to a greater extent by stymying their compatibility with Delaware law.

1. See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *Yale L.J.* 663, 666 (1974) (arguing that state competition constitutes a race to the bottom); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251, 256 (1977) (arguing that state competition constitutes a race to the top). For recent incorporation data, see Demetrios G. Kaouris, Note, *Is Delaware Still a Haven for Incorporation?*, 20 *Del. J. Corp. L.* 965, 966, 999-1003 (1995).

2. While I refer to Delaware's actions as anticompetitive, I do not suggest that Delaware lawmakers consciously designed its law strategically. For example, judges may be inclined to develop ambiguous corporate law that allows them to decide important, publicized, and challenging cases. Similarly, the corporate bar benefits from the increased demand for its services that is associated with legal indeterminacy and litigation. Delaware's actions are anticompetitive, however, in that *but for* the fact that indeterminacy enhances Delaware's competitive position, competitive pressures would have forced Delaware to adopt substantively superior and less ambiguous legal rules.

3. The main attempt thus far to reconcile the indeterminacy of Delaware law with regulatory competition is based on an interest group theory. See Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 *Tex. L. Rev.* 469 (1987). This theory takes Delaware's competitive advantage over other states as a given. Delaware's competitive edge means that Delaware can charge a higher price for its law. The interest group theory posits that the corporate bar, particularly the Delaware bar, captures some of the premium through increased demand for legal services in the presence of legal indeterminacy. The indeterminacy of Delaware law reduces the attractiveness of Delaware, but Delaware lawmakers nevertheless choose indeterminacy due to pressure from the bar. In contrast to Macey and Miller, this Article argues that indeterminate law may in fact increase Delaware's attractiveness.

Commentators generally agree that Delaware possesses several competitive advantages that account for its dominance in the market for corporate chartering. These advantages include network benefits emanating from Delaware's longstanding status as the leading incorporation jurisdiction;⁴ Delaware's proficient judiciary;⁵ and Delaware's unique commitment to corporate needs.⁶ In contrast, the substantive content of [*1911] Delaware law is unlikely to form a major basis of Delaware's competitive advantage, since other jurisdictions can easily copy this content; in fact, Nevada adopted Delaware law wholesale and yet failed to make significant inroads into Delaware's market share.⁷

Indeterminacy enhances all these advantages. Consider first the competitive advantage derived from network externalities in corporate contracting. Network externalities are the positive returns that flow from using a law that many other firms also use. A widely used law has the benefit of being frequently interpreted and clarified in legal cases and commentary. The popularity of the law also means that firms using it have access to readily available legal and financial services. Furthermore, use of the law by many firms makes their securities comparable with each other and hence more marketable. The indeterminacy of Delaware law excludes non-Delaware firms from these externalities by making it incompatible with rival laws. Other states may adopt indeterminate legal standards identical to those adopted by Delaware, but their courts will apply the standards differently from the Delaware courts, and non-Delaware firms will be excluded from the

4 . See Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting* (or "The Economics of Boilerplate"), 83 Va. L. Rev. 713, 763-64 (1997) [hereinafter Kahan & Klausner, *Economics of Boilerplate*]; Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 Va. L. Rev. 757, 841-47 (1995) [hereinafter Klausner, *Networks of Contracts*]; see also Mark J. Roe, *Takeover Politics*, in *The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Governance* 321, 351 (Margaret M. Blair ed., 1993) (arguing that the value of legal standardization helps Delaware retain its lead); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225, 277-78 (1985) [hereinafter Romano, *Law as a Product*] (same).

5 . See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. Rev. 542, 590 (1990); Romano, *Law as a Product*, supra note 4, at 280.

6 . See Roberta Romano, *The Genius of American Corporate Law* 37-44 (1993); Romano, *Law as a Product*, supra note 4, at 240-41. Analytically, judicial proficiency and credible commitment can also be seen as forms of network externalities, as they emanate from wide use of the law. See Leo Herzel & Laura D. Richman, *Forward: Delaware's Preeminence by Design*, in R. Franklin Balotti & Jesse A. Finkelstein, 1 *The Delaware Law of Corporations and Business Organizations* F-1, F-15 to F-16 (3d ed. 1998) (describing Delaware's judicial proficiency, rich body of precedents, and specialized bar as different manifestations of scale economies); Klausner, *Networks of Contracts*, supra note 4, at 845-46 (referring to Delaware's judicial proficiency as an aspect of its network externalities). For expositional clarity, I discuss these three competitive advantages separately.

7 . See Cary, supra note 1, at 665; Macey & Miller, supra note 3, at 488.

Delaware network. Delaware can thus profit from adopting ambiguous legal standards, even if they render Delaware law suboptimal.

Consider next the proficiency of Delaware courts, which commentators widely acknowledge to be a competitive advantage.⁸ This advantage is difficult for other states to emulate. First, it is costly for them to form specialized courts and recruit expert judges. Second, a newly formed specialized court is likely to be inferior to a Delaware court, the judges of which possess experience as a group. Third, even if a state recruits high-quality judges to its court, the court will subsequently lose its initial advantage if few cases are filed in it. Delaware's legal indeterminacy brings its judicial advantage to bear by eliciting litigation and granting broader judicial discretion. This allows Delaware judges both to utilize their superior skills and to sharpen them. If another state adopted Delaware's indeterminate law, the relative inexperience of its judiciary would become apparent, and it still could not ensure compatibility of outcomes with Delaware. If it adopted clear law, it would explicitly forgo compatibility with Delaware.

[*1912] The effect that legal indeterminacy has on Delaware's implicit commitment to corporate needs is similar. Delaware assures corporations of its commitment to their future needs through its reliance on corporate chartering. Legal indeterminacy makes Delaware's commitment more credible by increasing that reliance. Delaware has invested heavily in a legal infrastructure that is valuable only for corporate adjudication. It has invested in expert judges, elaborate case law, a court administration system, and local legal services. The increased volume of litigation that results from legal indeterminacy raises the value of these assets, and guarantees that the state will be attentive to its corporate clients.

Several observations follow from the above. First and foremost, this cursory analysis implies that corporate law may be inefficiently vague. This inefficiency raises the social cost of state competition in corporate charters. The result is that, even if competition improves the law, it might be said that the race between states stops short of the top; if competition worsens the law, then the race ends at a new, lower bottom. Furthermore, this Article reveals a fertile area for future study of regulatory competition. Traditional theories assume that legal regimes involve either perfect competition among regulators or a perfect monopoly by a single regulator.⁹ This Article suggests that imperfect competition is a more accurate description of the regulatory market. Under imperfect competition, regulators can employ various strategies to enhance their market position, even if these strategies are detrimen-

8. See *infra* Part II.B.

9. See Winter, *supra* note 1, at 257-58 (describing the market for corporate law as perfectly competitive); see also Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359, 2386 (1998) [hereinafter Romano, *Empowering Investors*] (contrasting the federal monopoly over securities law with a proposed state competition).

tal to consumers of law.¹⁰ While this Article focuses on the strategic effects of legal indeterminacy on state competition in the market for corporate law, future research may explore other strategies and other contexts. For example, imperfect competition and the potential for anticompetitive strategies are likely to result if securities regulation becomes a matter of state law, as has [*1913] recently been proposed.¹¹ Finally, the indeterminate and judge-oriented nature of Delaware law offers a new explanation for the notorious fragmentation and passivity of shareholders in the United States.¹² Judicial activism in corporate governance allows shareholders to relax their ties with the corporate market, thus discouraging concentration of ownership and active monitoring of firms. Although reliance on courts for corporate monitoring may not be ideal, the fragmentation and passivity of shareholders that has developed buttresses this suboptimal equilibrium.

The Article proceeds as follows. Part I describes the indeterminate and judge-oriented nature of Delaware corporate law and claims that its level of indeterminacy may be too high. Part II presents the various competitive advantages that account for Delaware's persistent market power. These advantages include network externalities, judicial proficiency, and a credible commitment to corporate needs. Part III develops the claim that legal indeterminacy may allow Delaware to enhance its competitive advantages. The discussion first analyzes the effect of indeterminacy on excluding non-Delaware firms from network externalities, accentuating Delaware's judicial advantage, and making Delaware's commitment to firms more credible. It then explores possible responses of other states to Delaware's legal indeterminacy. Part IV provides the political-economy background to the evolution of Delaware's indeterminate law. It argues that the corporate bar, Delaware's judiciary, and the general legal culture have all fostered a judge-oriented corporate law, and that these forces have prevailed because of the

10. Previous scholarship has recognized that network benefits may allow Delaware to offer suboptimal law without losing market share. On this view, other states cannot compete with Delaware simply by offering better law, because that law must be sufficiently superior to Delaware law to overcome Delaware's network advantage. Moreover, even if other states do offer such law, Delaware can emulate it. See Klausner, *Networks of Contracts*, supra note 4, at 849-50; see also Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 *Colum. L. Rev.* 1461, 1511-12 (1989). This Article extends that insight by explaining how Delaware can actually benefit from offering suboptimal law, and what type of suboptimal law is to be expected. In general, Delaware should offer optimal law, notwithstanding its competitive advantage, in order to be able to charge a maximum price to chartered firms. But legal indeterminacy is a special type of suboptimality, in that it supports Delaware's advantage. Delaware should therefore offer indeterminate law not merely due to regulatory slack, but as a necessary means for maintaining its lead.

11. See Romano, *Empowering Investors*, supra note 9. In the international arena, a similar proposal is advanced in Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 *S. Cal. L. Rev.* 903 (1998).

12. See Adolph A. Berle, Jr. & Gardiner C. Means, *The Modern Corporation and Private Property* 47-68, 277-87 (1932).

advantageousness of legal indeterminacy to Delaware. Part V highlights some of the implications of this theory for corporate and securities law. First, it demonstrates how legal indeterminacy may be inefficient irrespective of whether state competition is otherwise desirable. Second, it suggests that other forms of imperfect regulatory competition may be an area for future study. Third, it predicts that, should a market for securities law be formed, that market may not be competitive for reasons similar to those affecting the market for corporate law. Fourth, it hypothesizes that the judge-oriented nature of corporate law may have facilitated the pacification of investor voice over this century.

I. THE INDETERMINACY OF DELAWARE CORPORATE LAW

Delaware has been praised for its elaborate body of corporate case law, which is argued to be the reason why many firms choose to incorporate there. According to this view, the mass of corporate litigation channeled to Delaware has culminated in a comprehensive set of precedents [*1914] that facilitates business planning.¹³ Nevertheless, a multiplicity of precedents does not necessarily result in optimal predictability. In the case of Delaware corporate law, court decisions merely reiterate and apply to different fact patterns a small number of fit-all legal standards, leaving much uncertainty to be resolved.¹⁴ To be sure, the large conglomerate of precedents in Delaware may well lend a higher degree of predictability to the law than that achieved by other states with fewer precedents. Corporate actors in Delaware do have an idea of which practices increase the risk of liability, and which reduce it.¹⁵ Compliance with the recommended practices, however, only reduces the risk, and never eliminates it. While the existence of a large stock of precedents makes Delaware law more predictable and hence more conducive to business planning than the laws of other states, the law is less predictable than it could be. The discussion below will elaborate on these

13. See Romano, *Law as a Product*, supra note 4, at 280.

14. See David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 Va. L. Rev. 127, 136 (1997) (noting that, while stability is often cited as a reason for Delaware's success in attracting corporations, instability is a more accurate description of Delaware law). The confusion surrounding some issues of Delaware law is indeed acknowledged by the courts. See *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1287-88 (Del. 1989) (expressing awareness that the application of the proportionality test to antitakeover defensive measures may have caused confusion); *Kahn v. Lynch Communication Sys., Inc.*, 19 Del. J. Corp. L. 784, 791 (Del. Ch. 1993) (noting that there are differing views in Delaware Court of Chancery decisions on how the approval of a cash-out merger by a special committee of disinterested directors affects the controlling or dominating shareholder's burden of demonstrating entire fairness); but see *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1115-16 (Del. 1994) (criticizing that remark).

15. For instance, Delaware case law made it clear that boards should normally seek a fairness opinion from an investment bank whenever they contemplate a merger. See *Smith v. Van Gorkom*, 488 A.2d 858, 876-78 (Del. 1985).

points. After illustrating the open-ended nature of Delaware law, it will argue that, in light of the importance of certainty in corporate law, Delaware law seems too indeterminate.

A. *Fact-Intensive Standards*

Legal norms can be sorted along a continuum, with the two poles being rules and standards. Rules delineate the law *ex ante*. Their application in court requires determination only of whether their preset conditions were met. Standards do not provide a clear pronouncement of the law *ex ante*. Rather, they lay out general principles to be applied by judges to particular sets of facts. The more judicial discretion a law permits, the closer it is to a standard; the more it constrains judicial discretion, the closer it is to a rule.¹⁶

[*1915] Delaware law is at one end of this continuum. It relies extensively on broad legal standards that grant courts wide discretion in deciding corporate disputes.¹⁷ Delaware courts are reluctant to provide corporate actors with bright-line rules distinguishing legitimate from illegitimate actions.¹⁸ Instead, their decisions involve loosely defined legal tests whose precise meaning depends on the particular facts of each case. It is difficult to generalize from these tests. Their meaning is revealed only when they are applied by the court to specific scenarios.

The following three examples of fact-intensive legal standards illustrate this point. Consider first the proportionality test governing antitakeover

16. See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L.J.* 557, 559-60 (1992); see also Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 *Yale L.J.* 65, 67-68 (1983); Isaac Eherlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 *J. Legal Stud.* 257, 258-59 (1974); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 *Harv. L. Rev.* 1685, 1687-88 (1976).

17. The discussion here refers to the fiduciary duties owed by corporate insiders to shareholders, which are the centerpiece of corporate law. While the rules regarding other matters, such as shareholder meetings, indemnification, and procedures for protecting appraisal rights are more determinate, they are less important, as compliance with these rules does not relieve corporate insiders from their fiduciary obligations. See, e.g., *Schnell v. Chris-Craft Indus.*, 285 A.2d 437, 439-40 (Del. 1971); Douglas M. Branson, *The Chancellor's Foot in Delaware: Schnell and Its Progeny*, 14 *J. Corp. L.* 515, 516-17 (1989) (describing an overriding test of equitableness to which all corporate actions are subject).

18. See *Barkan v. Amsted Indus.*, 567 A.2d 1279, 1286 (Del. 1989) ("[T]here is no single blueprint that a board must follow to fulfill its duties."). This phrase has since been quoted in no fewer than nine Delaware cases. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1175 n.30 (Del. 1995); *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, 44 (Del. 1994); *Golden Cycle, LLC v. Allan*, No. CIV. A. 16301, 1998 WL 276224, at *11 (Del. Ch. May 20, 1998); *In re Talley Indus., Inc. Shareholders Litig.*, No. CIV. A. 15961, 1998 WL 191939, at *11 (Del. Ch. Apr. 9, 1998); *Rand v. Western Airlines, Inc.*, 19 *Del. J. Corp. L.* 1292, 1302 (Del. Ch. 1994); *In re KDI Corp. Shareholders Litig.*, CIV. A. No. 10278, 1990 WL 201385, at *3 (Del. Ch. Dec. 13, 1990); *Roberts v. General Instrument Corp.*, 16 *Del. J. Corp. L.* 1540, 1554 (Del. Ch. 1990); *Sutton Holding Corp. v. Desoto, Inc.*, 16 *Del. J. Corp. L.* 434, 446 (Del. Ch. 1990); *Norberg v. Young's Market Co.*, 16 *Del. J. Corp. L.* 351, 357 (Del. Ch. 1989).

defensive measures. It requires showing that the board had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed,” and that the defensive action was “reasonable in relation to the threat posed.”¹⁹ The law does not define what constitutes a cognizable threat in this regard, nor does it clarify what defensive measures are reasonable. Instead, it lists a host of considerations that may be relevant: “inadequacy of the price offered, nature and timing of the offer, questions of illegality, the impact on ‘constituencies’ other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally), the risk of nonconsummation, and the quality of securities being offered in the exchange,” as well as the “basic stockholder interests at stake, including those of short term speculators, whose actions may have fueled the coercive aspect of the offer at the expense of the long term investor.”²⁰ At a certain stage during the evolution of the proportionality test, Court of Chancery decisions did seem to clarify what would amount to a cognizable threat by distinguishing between coercive [*1916] and noncoercive takeover bids.²¹ The Delaware Supreme Court, however, overturned these decisions as unduly restrictive of the flexible proportionality test.²² To the dismay of many, the proportionality test is as indeterminate today as when the court first articulated it in 1985.²³

Consider next the doctrine of corporate opportunity. To determine whether a business opportunity belongs to the corporation and cannot be usurped by officers or directors, the court examines whether the corporation is financially able to exploit the opportunity, whether the opportunity is in the corporation’s line of business and is of practical advantage to it, whether the corporation has an interest or reasonable expectancy in the opportunity, and whether seizing the opportunity will bring the interest of the officer or director into conflict with that of the corporation.²⁴ These tests, however,

19. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

20. *Id.* at 955-56.

21. See *Grand Metro. Pub. Ltd. v. Pillsbury Co.*, 558 A.2d 1049, 1058 (Del. Ch. 1988); *City Capital Assocs. v. Interco, Inc.*, 551 A.2d 787, 796-98 (Del. Ch. 1988). The court in these cases based its analysis on commentary calling for clarification of the proportionality test in this spirit. See *Interco*, 551 A.2d at 796-98; Ronald J. Gilson & Reinier Kraakman, *Delaware’s Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 *Bus. Law.* 247, 248 (1989).

22. See *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, 1153 (Del. 1990); see also *Unitrin, Inc. v. American Gen. Corp.*, 651 A.2d 1361, 1374 (Del. 1995) (describing the proportionality test as a “flexible paradigm that jurists can apply to the myriad of ‘fact scenarios’ that confront corporate boards”).

23. See, e.g., Ronald J. Gilson & Bernard S. Black, *The Law and Finance of Corporate Acquisitions* 895 (2d ed. 1995). But see Alan E. Garfield, *Paramount: The Mixed Merits of Mush*, 17 *Del. J. Corp. L.* 33, 46-47 (1992); Charles M. Yablon, *Poison Pills and Litigation Uncertainty*, 1989 *Duke L.J.* 54, 73-75 (praising the unpredictability of the proportionality test).

24. See *Guth v. Loft, Inc.*, 5 A.2d 503, 511 (Del. 1939).

only “provide guidelines to be considered by a reviewing court in balancing the equities of an individual case. No one factor is dispositive and all factors must be taken into account insofar as they are applicable.”²⁵ In the opinion of prominent commentators, such tests are intolerably ambiguous and uncertain in application.²⁶

Consider last the test used by the court for reviewing a decision of a special board committee to seek a derivative suit’s dismissal. Under Delaware law, the court will apply a two-step test to the motion to dismiss the suit.²⁷ First, the court will “inquire into the independence and good faith of the committee and the bases supporting its conclusions.”²⁸ If the court is satisfied “that the committee was independent and showed reasonable bases for good faith findings and recommendations,” the court [*1917] “may proceed, in its discretion,” to the next step of determining, by “applying its own independent business judgement, whether the motion should be granted.”²⁹ This second step “is intended to thwart instances where corporate actions meet the criteria of step one, but the result does not appear to satisfy its spirit, or where corporate actions would simply prematurely terminate a stockholder grievance deserving of further consideration in the corporation’s interest.”³⁰ The court must “carefully consider and weigh how compelling the corporate interest in dismissal is when faced with a non-frivolous lawsuit.”³¹ When doing so, the court may give consideration to such broad matters as “law and public policy in addition to the corporation’s best interests.”³² In other words, the court is entrusted not only with applying open-ended standards to the case at bar, but also with determining which standards it will apply. In both decisions, the court is guided by little more than experience and common sense.³³

25. Broz v. Cellular Info. Sys., Inc., 673 A.2d 148, 155 (Del. 1996).

26. See Robert Charles Clark, Corporate Law § 7.6.2, at 244-45 (1986) (advocating a clearer test); Victor Brudney & Robert Charles Clark, A New Look at Corporate Opportunities, 94 Harv. L. Rev. 997, 1024, 1030 (1981). For another test designed to clarify the law, see American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 5.05(b), at 284, 293-94, 298 (1994) [hereinafter ALI, Principles of Corporate Governance].

27. See Zapata Corp. v. Maldonado, 430 A.2d 779, 788 (Del. 1981).

28. Id.

29. Id. at 789.

30. Id.

31. Id.

32. Id. Subsequent case law has added to the list of relevant considerations “ethical, commercial, promotional, public relations, employee relations and fiscal factors.” Kaplan v. Wyatt, 484 A.2d 501, 509 (Del. Ch. 1984), aff’d, 499 A.2d 1184 (Del. 1985).

33. See Dennis J. Block & H. Adam Prussin, The Business Judgement Rule and Shareholder Derivative Actions: Viva *Zapata*?, 37 Bus. Law. 27, 61-62 (1981); John C. Coffee, Jr. & Donald E. Schwartz, The Survival of the Derivative Suit: An Evaluation and a Proposal for Legislative Reform, 81 Colum. L. Rev. 261, 327-30 (1981); Daniel R. Fischel, The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law, 76 Nw. U.

These examples illustrate the general trend in Delaware corporate law.³⁴ One can never be confident that a certain corporate action will be upheld in court, given that a litany of factors, which are neither conclusive, nor cumulative, nor prioritized, can come into play.³⁵ Even under [*1918] standing past decisions in and of themselves can be puzzling, since fact-specific decisions often do not square with each other. Determinative facts in one case may be less consequential in another, creating the impression of inconsistency.

A brief look at two landmark takeover cases, *Paramount v. Time*³⁶ and *Paramount v. QVC*³⁷ demonstrates this point. Both cases involved corporations that were close to consummating a negotiated merger and rejected a last-minute tender offer that attempted to derail the merger. In the first case, the court approved the rejection. In the second case, it reached the opposite conclusion.³⁸ The key to explaining the different outcomes, without dismissing them as inconsistent, is a close reading of factual nuances that color management's behavior differently in the two cases.³⁹ This, however, can only be done in hindsight. Predicting the second decision on the basis of the first was much more difficult. This example is not unique, but rather

L. Rev. 913, 935-41 (1982); Jonathan R. Macey & Geoffrey P. Miller, The Plaintiffs' Attorney's Role in Class Action and Derivative Litigation: Economic Analysis and Recommendations for Reform, 58 U. Chi. L. Rev. 1, 39 (1991); Marcel Kahan, A Comment on Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work? (Apr. 1996) (unpublished manuscript, presented at the University of Pennsylvania School of Law Roundtable) (on file with the *Columbia Law Review*).

34. See William T. Allen, Ambiguity in Corporation Law, 22 Del. J. Corp. L. 894, 900 (1997) (describing Delaware cases as highly fact-specific applications of grand principles that are difficult to generalize). For open-ended tests applied by courts in other corporate contexts, see, e.g., *Gonsalves v. Straight Arrow Publishers, Inc.*, 701 A.2d 357, 361-62 (Del. 1997) (appraisal rights); *Mills Acquisition Co. v. Macmillan, Inc.*, 559 A.2d 1261, 1282 n.29 (Del. 1989) (firm auction); *Aronson v. Lewis*, 473 A.2d 805, 814-15 (Del. 1984) (demand futility); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (entire fairness). For decisions emphasizing fact-specificity, see, e.g., *Singer v. Magnavox Co.*, 380 A.2d 969, 976-77 (Del. 1977) (freezeout mergers); *In re Tri-Star Pictures, Inc. Litig.*, 20 Del. J. Corp. L. 854, 862-63 (Del. Ch. 1995) (board domination).

35. The inability to predict from Delaware cases how the courts will rule in the future explains why stock prices do not react to unexpected court decisions. See Elliott J. Weiss & Lawrence J. White, Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law, 75 Cal. L. Rev. 551, 593-601 (1987).

36. *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1990).

37. *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34 (Del. 1994).

38. For criticism leveled at the court for creating confusion by deciding these cases differently, see Peter Blackman, Move Over Delaware! Making New York Incorporation-Friendly, N.Y. L.J., Dec. 16, 1993, at 5.

39. For a detailed analysis of these nuances, see Edward B. Rock, Saints and Sinners: How Does Delaware Corporate Law Work?, 44 UCLA L. Rev. 1009, 1080-81 (1997); see also Lawrence A. Cunningham & Charles M. Yablon, Delaware Fiduciary Duty Law After QVC and *Technicolor*: A Unified Standard (And the End of *Revlon* Duties?), 49 Bus. Law. 1593, 1625-26 (1994) (arguing that doctrinal distinctions have little explanatory power in Delaware law).

illustrates a common pattern in Delaware case law.⁴⁰ In many cases, the impression of inconsistency can be avoided only if the holdings are read together with their underlying facts. Such a reading, however, is of limited value in business planning, as it does not always predict what facts will be deemed material by the next court.⁴¹ [*1919]

B. *Suboptimal Indeterminacy*

It is hard to prove that Delaware's legal indeterminacy is suboptimal. Theoretically, it is possible that Delaware law does strike an optimal balance between determinacy and flexibility. In the following paragraphs I address this difficulty. My argument is that, while some indeterminacy in corporate law may be inevitable, the degree of indeterminacy in Delaware law appears too high. Optimal determinacy is a function of the legal context in question. In corporate law, business planning needs render legal determinacy vital. Since legal standards are indeterminate in comparison to legal rules, an optimal law would limit their role, and when they were unavoidable, use them in a way that minimized uncertainty. The observed structure of Delaware law is very different from this model. It relies heavily on open-ended legal standards that admit myriad factual criteria as relevant.

Business planners often stress the importance of being able to carry out transactions with minimal risk of liability.⁴² Yet open-ended standards lead to greater legal exposure. Instead of delineating what can and what cannot be done, they leave this question open to ex post judicial determination. Such indeterminacy imposes high costs on individuals who try to plan their behavior so that it will meet legal requirements. As the law becomes more

40. The cases that have received the most attention in this regard are takeover cases. See Suzanne S. Dawson et al., *Poison Pill Defensive Measures*, 42 *Bus. Law.* 423, 438 (1987); Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 *Colum. L. Rev.* 1931, 1934-48 (1991); Roe, supra note 4, at 341; Skeel, supra note 14, at 152 & n.75. For a careful analysis of inconsistencies among management buyout decisions as a result of fact-intensiveness, see Rock, supra note 39, at 1028-63. For a recent example of inconsistency that can be resolved only by close attention to factual nuances between cases, compare *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 142 (Del. 1997) (holding that there is no per se rule of damages for breach of the duty of disclosure), with *In re Tri-Star Pictures, Inc. Litig.*, 634 A.2d 319, 333 (Del. 1993) (holding that there is a per se rule of damages for breach of the duty of disclosure).

41. See Branson, supra note 17, at 523 (criticizing the subjectivity of the equitableness standard in Delaware law); Cunningham & Yablon, supra note 39, at 1594-95 (reducing Delaware law to a "smell test"); Robert H. Mundheim & Dennis J. Block, *The Business-Judgment Rule*, in *Twentieth Annual Institute on Securities Regulation* 173, 180 (Charles M. Nathan et al. eds., 1989) (same); E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 *Del. J. Corp. L.* 503, 512 (1986) (same).

42. See Romano, *Law as a Product*, supra note 4, at 250-51. Indeed, empirical studies show that the management of uncertainty is a key element of corporate lawyering. See John Flood, *Doing Business: The Management of Uncertainty in Lawyers' Work*, 25 *L. & Soc'y Rev.* 41 (1991).

uncertain, they face higher costs of legal advice, and a greater risk of litigation.⁴³

Corporate managers and directors fall squarely into this category. Having invested their entire human capital in the firm, they are highly averse to the risk of being sued by shareholders. While litigation is unlikely to cost them their jobs, liability can damage their reputations and future careers.⁴⁴ In addition to reputational effects, legal exposure also entails a risk of personal liability for damages in amounts that far exceed their personal wealth. All these costs of legal indeterminacy are passed on to the firm, which may pay dearly for legal services, liability insurance, and missed business opportunities.⁴⁵

[*1920] The obvious way of avoiding the indeterminacy associated with open-ended standards is the employment of rules. Not all rules are so rigid as to preclude their use in the relational context of corporate law. For instance, procedural and structural rules that stipulate how decisions should be made in the firm without dictating their content can be both determinate and flexible.⁴⁶ The same is true of rules that limit directorial ability to interfere with shareholder choice in defined situations. Such rules may stipulate, for instance, that boards must allow shareholders to decide whether to accept or reject noncoercive takeover bids.⁴⁷ Even rules that prescribe a binding course of action for a firm may be desirable, despite their rigidity, if their

43. See Kaplow, *supra* note 16, at 574.

44. See Rock, *supra* note 39, at 1103-04 (emphasizing the centrality of reputation in the business community). Managers and directors can also be genuinely interested in abiding by the law irrespective of reputational considerations. For this reason, the risk that legal determinacy will facilitate evasion of the law is not high. See Allen, *supra* note 34, at 900 n.10.

45. See Kaplow, *supra* note 16, at 602-05 (arguing that standards are particularly problematic when private and social costs of legal advice diverge, and when individuals are risk averse). For the impact of legal uncertainty on the cost of liability insurance, see Roberta Romano, *What Went Wrong with Directors' and Officers' Liability Insurance?*, 14 *Del. J. Corp. L.* 1, 24 (1989). For the planning, litigation, and opportunity costs associated with legal uncertainty, see Klausner, *Networks of Contracts*, *supra* note 4, at 777. Elsewhere, I analyze the costs of legal uncertainty more closely. See Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 *U. Chi. L. Rev.* (forthcoming 1999).

46. For a complete model of corporate law based on procedural and structural rules, see Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 *Harv. L. Rev.* 1911 (1996).

47. This rule was rejected in Delaware. See *supra* text accompanying note 22. Alternative rules are also possible, and have been proposed in the wake of the takeover tide of the 1980s. See, e.g., Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 *Harv. L. Rev.* 1028, 1050-56 (1982); John C. Coffee, Jr., *Regulating the Market for Corporate Control: A Critical Assessment of the Tender Offer's Role in Corporate Governance*, 84 *Colum. L. Rev.* 1145, 1250-94 (1984); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 *Harv. L. Rev.* 1161, 1201-04 (1981); Louis Lowenstein, *Pruning Deadwood in Hostile Takeovers: A Proposal for Legislation*, 83 *Colum. L. Rev.* 249, 317-34 (1983). While the rules differ markedly in their substantive content, they are all more determinate than the proportionality test.

benefits outweigh their costs. An example of such a rule is the proposal to ban full-time executives in public corporations from taking any other active business positions.⁴⁸

Notwithstanding the preference for bright-line rules, some issues in corporate law are best governed by flexible standards. This does not imply, however, that a high level of indeterminacy must follow. Standards can reduce indeterminacy by limiting and prioritizing the criteria relevant to their application, adopting presumptions, or ruling certain options in or out.⁴⁹ Delaware law makes little use of such techniques. Rather, as the courts often hold, many factors can bear on the outcome of a case.⁵⁰ No single factor is dispositive, and factors other than those enumerated by the court may prove to be relevant in other circumstances.⁵¹ Delaware law also fails to employ presumptions to reduce uncertainty. For instance, it subjects to fiduciary duties any shareholder that holds at least half of the voting power in a firm or otherwise exercises [*1921] actual control over its business decisions.⁵² What amounts to actual control is never defined.⁵³ But it could be. The proposal advanced by the American Law Institute, for example, provides more determinacy without compromising flexibility. It adopts a presumption that holding one quarter of the voting power confers control over the firm.⁵⁴ Finally, Delaware law offers no safe harbors, compliance with which would preclude judicial review and reduce uncertainty.⁵⁵ It is instruc-

48. See Clark, *supra* note 26, § 7.6, at 243-48; Brudney & Clark, *supra* note 26, at 1022-32. For another example, see Victor Brudney & Marvin A. Chirelstein, A Restatement of Corporate Freezeouts, 87 *Yale L.J.* 1354, 1365-70 (1978) (proposing a flat rule against management buyouts).

49. See Kaplow, *supra* note 16, at 600.

50. For examples, see *supra* Part I.A.

51. See, e.g., *supra* note 32 and accompanying text.

52. See *Citron v. Fairchild Camera and Instrument Corp.*, 569 A.2d 53, 70 (Del. 1989).

53. See *id.* Even 43.3% and 47% shareholders in widely held corporations are not *ipso facto* dominating shareholders. See *Kahn v. Lynch Communication Sys., Inc.*, 638 A.2d 1110, 1114 (Del. 1994); *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984).

54. See ALI, *Principles of Corporate Governance*, *supra* note 26, §1.10(b); cf. *Investment Company Act of 1940*, 15 U.S.C. § 80a-2(a)(9) (1994); American Law Institute, *Federal Securities Code* § 202(29)(B) (1980). While this example illustrates one way of reducing indeterminacy, it does not suggest that the American Law Institute proposal as a whole is more determinate than Delaware law. Indeed, this proposal was criticized precisely on the grounds that it exacerbates the indeterminacy and reliance on judicial discretion in Delaware law. See William J. Carney, *The ALI's Corporate Governance Project: The Death of Property Rights?*, 61 *Geo. Wash. L. Rev.* 898, 925 (1993).

55. See *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). Even what may seem to constitute a safe harbor is not entirely safe. For instance, a special committee of disinterested directors shifts the burden of proof with regard to the fairness of a transaction with a controlling shareholder only when the committee effectively negotiated the transaction. See, e.g., *Kahn v. Tremont Corp.*, 694 A.2d 422, 429 (Del. 1997); *Lynch Communications Sys.*, 638 A.2d at 1120-21; *Rabkin v. Phillip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1106 (Del. 1985). The elu-

tive in this regard to compare Delaware law with federal securities law, which, in addition to being rule-based, makes use of safe harbors to accompany standards where rules cannot readily be devised.⁵⁶

The preceding paragraphs do not prove that the level of legal indeterminacy in Delaware is excessive. It is doubtful that such a claim could be proved at all. Nonetheless, by contrasting the importance of legal determinacy to business planning with the low level of determinacy in Delaware law, they present strong circumstantial evidence pointing in that direction. Some indeterminacy in corporate law is probably inescapable, but Delaware's extensive reliance on loosely defined standards seems to go far beyond what is necessary. This conclusion is consistent with similar sentiments expressed by academics and practitioners alike. To the practical mind, the existence of such sentiments may be the ultimate proof of the claim.⁵⁷

The tension between the primacy of legal certainty in business planning and the high level of indeterminacy in the leading incorporation state presents a puzzle. How can Delaware offer overly indeterminate law without being dethroned by another state offering a better alternative? This Article argues that the observed structure of the market for corporate chartering

siveness of this test is demonstrated by the fact that in all three cases it led the trial court and the appellate court to opposite conclusions.

56. See, e.g., Rule 144 Under the Securities Act of 1933, 17 C.F.R. § 230.144 (1998) (persons deemed not to be engaged in a distribution and therefore not underwriters); Regulation D Under the Securities Act of 1933, 17 C.F.R. §§ 230.501-508 (1998) (rules governing the limited offer and sale of securities without registration); Regulation S Under the Securities Act of 1933, 17 C.F.R. §§ 230.901-904 (1998) (rules governing offers and sales made outside the United States without registration). Safe harbor rules can similarly be used in corporate law. For example, compare Delaware General Corporation Law, Del. Code Ann. tit. 8, § 271(a) (1991) (requiring shareholder approval for sale of "all or substantially all" assets of the firm), with Georgia Business Corporation Code, Ga. Code Ann. § 14-2-1201(b) (1994) (waiving the requirement of shareholder approval for sale of assets that do not constitute more than two-thirds of the value of all corporate assets, and do not generate more than two-thirds of gross revenues). See also William J. Carney, *The Production of Corporate Law*, 71 S. Cal. L. Rev. 715, 727 n.51 (1998) (contrasting the two provisions).

57. See, e.g., John C. Coates IV, "Fair Value" as an Avoidable Rule of Corporate Law: Minority Discounts in Conflict Transactions, 147 U. Pa. L. Rev. (forthcoming 1999) (Oct. 29, 1998 manuscript at 60, on file with the *Columbia Law Review*) (challenging Delaware law on minority discounts for being obscure and unpredictable); Ronald J. Gilson & Reinier Kraakman, *What Triggers Revlon?*, 25 Wake Forest L. Rev. 37, 56 (1990) (arguing that the scope of the duty to auction the firm is not sufficiently defined); Leo Herzl et al., *Sales and Acquisitions of Divisions*, 5 Corp. L. Rev. 3, 25-26 (1982) (pointing to uncertainty concerning the meaning of "a sale of substantially all of the assets of a corporation" for the purpose of shareholder consent); John F. Olson & Patricia M. Hynes, *Defensive Techniques and Avoiding Problems*, in 23rd Annual Institute on Securities Regulation 357, 360 (Harvey L. Pitt et al. eds., 1992) (suggesting to corporate counsels that they trust their instincts when advising clients about the legitimacy of anti-takeover defenses); Larry E. Ribstein, *Takeover Defenses and the Corporate Contract*, 78 Geo. L.J. 71, 116-17 (1989) (arguing that indeterminate fiduciary duties deter takeover bidders and are costly to contract around).

provides little assurance that Delaware leads by selling an optimal product, either to shareholders or to managers. The disproportionate market share that Delaware has held for a prolonged period of time suggests that the chartering market is not perfectly competitive. Delaware enjoys various competitive advantages that protect its market share and allow it to engage in uncompetitive behavior without losing business. Delaware can take advantage of its competitive position by charging a higher franchise tax than other states, as well as by offering corporate law that is overly indeterminate, but that still enhances its competitive position in the market.

Since even suboptimal indeterminacy may assist Delaware in maintaining its lead, there is no reason to interpret the survival of indeterminacy as proof of its optimality.⁵⁸ The frequently voiced criticism of excessive indeterminacy in Delaware law may thus be well-founded. On the other hand, showing that suboptimal indeterminacy can benefit Delaware does not prove that Delaware's indeterminate law is in fact suboptimal. This Article therefore does not definitively conclude that Delaware law is [*1923] suboptimally indeterminate. Rather, it argues that Delaware law may well be so.

II. DELAWARE'S COMPETITIVE ADVANTAGES

The debate over the desirability of interstate competition in corporate chartering has become a staple of corporate legal scholarship in the United States. It centers on whether Delaware law, the clear winner in the competition, attracts firms by protecting investors or by protecting managers.⁵⁹ But any such favoritism cannot in itself explain the preeminence of Delaware. Other states clearly could adopt laws that protect either shareholders or managers, just as Delaware does.⁶⁰ Nevada, for instance, followed the Delaware model closely, and yet failed to lure significant incorporation.⁶¹ Something other than the tilt of Delaware law must therefore account for its lead. Below I analyze three competitive advantages that commentators recognize as supporting Delaware's lead. These advantages include the ease of using an already popular law; the proficiency of the Delaware judiciary in corpo-

58. The claim that even suboptimal indeterminacy may assist Delaware in maintaining its lead is developed *infra* Part III. Needless to say, indeterminacy may also assist Delaware if it is optimal. Thus, whether or not indeterminacy is optimal, it bestows on Delaware market power that allows the state to charge a supracompetitive price. This practice in and of itself is socially costly. If indeterminacy is suboptimal, then the social cost is even higher.

59. See *supra* note 1.

60. For instance, the perception that California law is more protective of shareholders than Delaware law is consistent with the fact that, being a large state that benefits little from corporate chartering, California does not compete with Delaware. See Melvin Aron Eisenberg, *The Modernization of Corporate Law: An Essay for Bill Cary*, 37 U. Miami L. Rev. 187, 188-89 (1983) (arguing that only a state with a small fiscal base can be motivated to compete in the market for corporate law).

61. See Cary, *supra* note 1, at 665; Macey & Miller, *supra* note 3, at 488. For the limited incorporation that Nevada did attract, see Romano, *Law as a Product*, *supra* note 4, at 246-47.

rate adjudication; and the state's commitment to corporate needs that results from its dependence on chartering. All of these are first-mover advantages. Ever since Delaware established its dominant position in the market for corporate law, these advantages have made competition with Delaware difficult.

A. *Network and Learning Externalities*

One advantage that Delaware has over its rivals is the lure of network and learning externalities that accrue to firms incorporated in the state. Network externalities are the increasing returns to users of a product as the total number of users grows. The telephone is a classic example. The greater the number of telephone users, the more extensive the telephone network becomes, and the higher its value for each user. The car is another example. As the number of car owners increases, the supply of roads, gas stations, and garages increases, and the more valuable each car becomes.

Corporate law can also be viewed as a product whose value increases with the number of corporations using it.⁶² First, as more corporations [*1924] are governed by the same law, court decisions begin to accumulate that apply that law to various factual settings and increase legal certainty. Moreover, the law sometimes refers to a common practice as a benchmark for appropriate conduct. The more firms that are subject to the same law, the more common is the practice, and the more certain is the benchmark. Second, a commonly used law is likely to be better serviced by lawyers. As the number of firms needing legal counseling and representation in connection with a certain law increases, lawyers gain expertise in providing these services. Lawyers can also refer to the legal commentary, reference tools, and professional symposia that proliferate around a commonly used law. Legal services improve in quality and timeliness, while legal costs fall. Third, the marketability of securities improves as the network grows. Legal uniformity facilitates securities pricing by making comparison with other securities on the market easier. When a security is subject to the same legal regime as many other securities, it can be priced more accurately and cheaply.

62. The discussion below is based on Kahan & Klausner, *Economics of Boilerplate*, supra note 4, at 718-29, and Klausner, *Networks of Contracts*, supra note 4, at 772-89; see also David Charny, *Competition Among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities*, 32 *Harv. Int'l L.J.* 423, 442-46 (1991); Kenneth B. Davis, Jr., *Judicial Review of Fiduciary Decisionmaking—Some Theoretical Perspectives*, 80 *Nw. U. L. Rev.* 1, 22 (1985); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 *Colum. L. Rev.* 1549, 1567-68 (1989); Jason Scott Johnston, *The Influence of *The Nature of the Firm* on the Theory of Corporate Law*, 18 *J. Corp. L.* 213, 242 (1993); Roe, supra note 4, at 351; Romano, *Law as a Product*, supra note 4, at 277-78. But see Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 *Cal. L. Rev.* 479, 562-86 (1998) (downplaying the importance of network externalities in corporate contracting).

Network externalities are forward-looking. They reflect the value added by the wide use of the product at present. In corporate law, this means that contemporaneous use of a law by many firms adds to its value, because this use will produce the benefits discussed above in the future. A product may also have an added value because of its wide use in the past, which mirrors these network externalities. For example, past use may have generated comprehensive case law and first-rate legal services. These benefits, termed “learning externalities,” are different from network externalities, as they do not depend on the number of firms using the law at present. They are nonetheless related to network externalities, in that a product widely used in the past is often still widely used in the present.

Delaware law, being the most widely used corporate law, offers greater network and learning externalities to corporations than do rival laws. It boasts comprehensive case law, superb legal services, and improved marketability of securities, resulting from its extensive present use, as well as similar benefits resulting from its past use. In order to lure corporations away from Delaware, rival laws must be sufficiently superior to offset these benefits.⁶³ [*1925]

B. *Judicial Proficiency*

Another important source of Delaware’s attractiveness is its experienced judiciary.⁶⁴ The preeminence of the Delaware judiciary stems from its unique history. Delaware initially replaced New Jersey as the leader in corporate chartering early in this century, following changes in New Jersey law that were unfavorable to business.⁶⁵ Delaware has never lost its lead, and its courts, particularly the Court of Chancery, have gained experience in corpo-

63. Firms may prefer incorporating in a popular state even in the absence of network and learning externalities. They are inclined to do so because corporate lawyers, as well as corporate managers, follow trends to avoid being blamed for mistakes. See Marcel Kahan & Michael Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases, 74 Wash. U. L. Q. 347, 353-56 (1996) [hereinafter Kahan & Klausner, Path Dependence] (drawing on David Scharfstein & Jeremy Stein, Herd Behavior and Investment, 80 Am. Econ. Rev. 465 (1990)). Firms are also inclined to incorporate in a popular state because shareholders themselves do not know—in view of the complexity and similarity of states’ laws—which law is best. Given the popularity of Delaware law, corporate decisionmakers may rationally infer that the probability that it is worse than other laws is low. See Abhijit V. Banerjee, A Simple Model of Herd Behavior, 107 Q.J. Econ. 797 (1992) (discussing herd behavior in general). Whatever the source of herding, it stifles competition in a manner similar to network and learning externalities. It bestows on Delaware, because of its past advantage, a current advantage not shared by other states.

64. See Black, *supra* note 5, at 589-90; Bayless Manning, State Competition: Panel Response, 8 Cardozo L. Rev. 779, 784-85 (1987); Romano, Law as a Product, *supra* note 4, at 276-77.

65. See Christopher Grandy, New Jersey Corporate Chartermongering, 1875-1929, 49 J. Econ. Hist. 677, 689 (1989); Joel Seligman, A Brief History of Delaware’s General Corporation Law of 1899, 1 Del. J. Corp. L. 249, 272 (1976).

rate adjudication and earned a reputation for proficiency. The courts were ideally suited to do so due to their small size, low caseload, selected judges, and a concentration of corporate cases.⁶⁶ Once established, their qualitative advantage became self-perpetuating, as it attracted still more high-stake corporate cases, prominent corporate lawyers, and talented judges.

The advantage of Delaware's courts is twofold. First, they are experienced in deciding corporate matters. Over the years, Delaware courts have adapted to this task in a way that is difficult for other courts to emulate. Delaware judges possess experience as a group that would take time to amass.⁶⁷ Moreover, they continuously hone their superior skills [*1926] through hearing cases. Frequent exposure to corporate disputes is a key element in the quality of corporate adjudicators. Not only does it keep judges current, but it also enables them to compare cases they hear and distinguish the meritorious from the frivolous. Even if other states were to recruit experienced corporate jurists to their courts, those courts would subsequently lose their initial advantage if few cases were filed in them.⁶⁸

Second, over the years, Delaware courts have earned a unique reputation for quality adjudication. This reputation is particularly meaningful since the quality of courts can be ascertained only through the use of their services.⁶⁹ Even if a rival state recruited judges proficient in corporate law—

66. See Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 *Brook. L. Rev.* 1, 5-8 (1995); William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 *Bus. Law.* 351 (1992). The main subject of this high esteem is the Delaware Court of Chancery. Nonetheless, part of the credit is shared also by the Delaware Supreme Court. See Dreyfuss, *supra*, at 28-29; Jeffrey W. Stempel, *Two Cheers for Specialization*, 61 *Brook. L. Rev.* 67, 77-79 (1995). But see Ronald J. Gilson, *The Fine Art of Judging: William T. Allen*, 22 *Del. J. Corp. L.* 914, 918-20 (1997) (opining that the Delaware Supreme Court is "less sophisticated" than the Court of Chancery). In any event, the impact of the Court of Chancery on the outcome of corporate cases is high, because of its responsibility for fact finding and because most cases never reach appellate review.

67. Like other joint enterprises, courts and judges develop over time an organizational language that streamlines and improves functionality. See Harold Demsetz, *The Theory of the Firm Revisited*, 4 *J.L. Econ. & Org.* 141, 157 (1988); Bruce Kogut & Udo Zander, *Knowledge of the Firm, Combinative Capabilities, and the Replication of Technology*, 3 *Org. Sci.* 383 (1992); cf. Romano, *The Genius of American Corporate Law*, *supra* note 6, at 40 (arguing that considerable time is needed to develop legal expertise in other states).

68. Corporate matters comprise more than 70% of the docket of the Delaware Court of Chancery. See Appendix B; see also Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 *Del. J. Corp. L.* 885, 903 (1990) (providing an estimate of 75% for both the percentage of corporate cases among pending cases, and the percentage of judicial time spent on corporate cases). The need for a steady flow of cases to the court to preserve judicial quality thus links Delaware's judicial advantage to its network externalities. Only Delaware, by virtue of its large number of chartered firms, is guaranteed sufficient litigation to keep its judges current. See Klausner, *Networks of Contracts*, *supra* note 4, at 845-46.

69. Judicial services thus fall into the category of an experience good, as defined in Philip Nelson, *Information and Consumer Behavior*, 78 *J. Pol. Econ.* 311, 312 (1970).

a difficult task in itself, when that state's judiciary has no prior reputation⁷⁰—the market would react slowly to this new recruitment.⁷¹

The significance of the judicial advantage is not merely theoretical. It is demonstrated by the fact that the bulk of suits pursuant to Delaware corporate law are filed in the Delaware Court of Chancery, although they could be brought in federal or other state courts.⁷² A likely explanation [*1927] is that plaintiffs consider Delaware's judiciary to be better than those of other states.⁷³

C. *Credible Commitment*

A third advantage supporting Delaware is its credible commitment to the needs of corporations. Delaware is the only state that has grown dependent on income generated by corporate chartering, and is therefore the only state that must constantly ensure that its law meets corporate needs. In a direct sense, Delaware depends on revenues from its franchise tax.⁷⁴ More indirectly, its sunk investments in legal capital are valuable only if it can retain the chartering business. This legal capital includes comprehensive case

70. See E. Norman Veasey, *Professionalism and Pragmatism —The Future: A Message from the Chief Justice of Delaware*, *Del. Law.*, Winter 1993, at 13, 13 (stressing that Delaware's national prominence has been pertinent to attracting quality judges); see also Klausner, *Networks of Contracts*, *supra* note 4, at 845 (same). Another difficulty that rival states may face in overcoming the reputation advantage of Delaware is that part of this reputation is associated with the Delaware courts as an institution. While rival states can, perhaps, match the reputation of Delaware judges by recruiting prominent corporate lawyers to their courts, they cannot match the institutional reputation of the Delaware courts themselves. For a discussion of institutional reputation in general, see Jean Tirole, *A Theory of Collective Reputations (With Applications to the Persistence of Corruption and to Firm Quality)*, 63 *Rev. Econ. Stud.* 1 (1996).

71. See Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks*, 43 *U. Kan. L. Rev.* 541, 548 (1995) (drawing on Richard Schmalensee, *Product Differentiation Advantages of Pioneering Brands*, 72 *Am. Econ. Rev.* 349 (1982)); cf. Rochelle Cooper Dreyfuss, *The Federal Circuit: A Case Study in Specialized Courts*, 64 *N.Y.U. L. Rev.* 1, 60-64 (1989) (arguing that stature cannot be manufactured overnight).

72. See Romano, *The Genius of American Corporate Law*, *supra* note 6, at 41 (out of a sample of 35 shareholder suits involving Delaware firms, 29 were brought in Delaware).

73. This explanation does not preclude other explanations, such as that Delaware eases procedural hurdles that deter plaintiffs, and awards generous fees to plaintiffs' attorneys. See Macey & Miller, *supra* note 3, at 496-97.

74. Over the past thirty years, franchise tax revenue has averaged 16.7% of Delaware's total tax revenue. See Romano, *Empowering Investors*, *supra* note 9, at 2388. In 1990, for example, franchise tax revenue constituted 17.7% of the taxes collected in Delaware. In every other state, franchise tax revenue for that year constituted no more than 4.6% of total tax revenues. See Romano, *The Genius of American Corporate Law*, *supra* note 6, at 10-11. Delaware lawmakers are well aware that the state's dependence on franchise tax revenue commits it to the chartering business. See, e.g., Richard F. Corroon, *The Proposed New Delaware Corporation Statute*, 20 *J. Legal Educ.* 522, 522 (1968).

law, judicial expertise in corporation law, administrative expertise in the processing of corporate filings, and a specialized bar.⁷⁵

This advantage for Delaware is a disadvantage for other states. Since only Delaware is credibly committed to corporate needs, investors discount any other state law by the risk of adverse future changes in that law.⁷⁶ A rival state may not be able to monger chartering business away from Delaware simply by offering better law. Charging a lower franchise tax to attract incorporation may not help either, because it will make the rival's own commitment to corporations even less credible compared to Delaware's commitment.

III. ENHANCEMENT OF COMPETITIVENESS THROUGH INDETERMINACY

This Part suggests an explanation for the indeterminacy of Delaware law. Indeterminate law enhances Delaware's competitive advantages—network externalities, judicial advantage, and credible commitment—and thus reinforces its market power. Indeterminacy makes Delaware law [*1928] incompatible with other laws, thereby excluding non-Delaware firms from network benefits. As long as this exclusion reduces the value of rival laws by more than indeterminacy reduces the value of Delaware law, the competitive edge that Delaware has over its rivals is heightened. The differential effect of indeterminacy on the respective values of Delaware law and rival laws is bolstered by two additional effects that mitigate, only for Delaware, the costs of legal indeterminacy. First, the centrality of courts under indeterminate law accentuates the judicial advantage that Delaware enjoys over other states. Second, legal indeterminacy strengthens Delaware's commitment to corporate needs by making its versatile system of corporate adjudication more valuable for the state. Finally, incompatibility with other states' laws raises the cost to Delaware corporations of reincorporating elsewhere, cementing Delaware's large market share. To secure these competitive advantages, it is worthwhile for Delaware to adopt even overly indeterminate law.

Previous scholarship has recognized that legal indeterminacy may benefit the Delaware bar by generating demand for legal services.⁷⁷ This scholarship acknowledges that Delaware's competitive advantages allow it to

75 . See Romano, *The Genius of American Corporate Law*, supra note 6, at 39; Romano, *Law as a Product*, supra note 4, at 240-41. The analytical framework for the credible commitment construct is set in Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 *Am. Econ. Rev.* 519 (1983). The specialized bar effectively commits Delaware to the chartering business through its political influence in the state. The effect of the local bar as a bonding device that keeps Delaware responsive to corporations was recognized as early as 1940. See E. Merrick Dodd, Jr. & Ralph J. Baker, *1 Cases on Business Associations: Corporations* 42-43 n.7 (1940).

76 . See Black, supra note 5, at 588-89; Roe, supra note 4, at 349.

77 . See Macey & Miller, supra note 3, at 491-98.

raise the cost of incorporation in Delaware above the cost of incorporation elsewhere. A straightforward way to exploit this advantage is to charge a higher franchise tax. While Delaware does in fact charge a higher franchise tax than other states, the tax is lower than it could be because the state's indeterminate law invites excessive litigation. Firms regard the high exposure to litigation as part of the price they pay for incorporation in Delaware and reduce the amount of franchise tax they are willing to pay accordingly. Delaware accepts the loss of potential tax revenue because its lawmaking apparatus is captured by the bar. The explanation I advance below for legal indeterminacy in Delaware is not at odds with the claim that indeterminacy benefits the corporate bar. But, I argue, indeterminacy may also benefit the state as a whole by enhancing its competitive position in the market for corporate law and entrenching its lead.

A. *Network Externalities*

Under imperfect competition, a producer can gain by taking anticompetitive measures that increase its competitive advantage over other market participants. In particular, a producer whose product confers network benefits on consumers gains if it can exclude rival products from the network. As long as rival products are incompatible, they cannot offer similar network benefits, and both old and new consumers will prefer the dominant product in order to avoid being stranded from the network.⁷⁸

[*1929] Legal indeterminacy allows Delaware to exclude other states from its unparalleled network externalities.⁷⁹ To be sure, if Delaware had determinate law, it would still offer network externalities to chartered corporations. But other states would quickly emulate this law in order to link up with the network and offer comparable externalities. The value of Delaware law would increase by the value of determinacy. The value of other states'

78. See Stanley M. Besen & Joseph Farrell, *Choosing How to Compete: Strategies and Tactics in Standardization*, *J. Econ. Persp.*, Spring 1994, at 117, 126-29; Paul A. David & Shane Greenstein, *The Economics of Compatibility Standards: An Introduction to Recent Research*, 1 *Econ. Innovation & New Tech.* 3, 14-15 (1990); Joseph Farrell & Garth Saloner, *Converters, Compatibility, and the Control of Interfaces*, 40 *J. Indus. Econ.* 9, 33 (1992); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 *Am. Econ. Rev.* 424, 425, 436 (1985) [hereinafter Katz & Shapiro, *Network Externalities*]; Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, *J. Econ. Persp.*, Spring 1994, at 93, 110 [hereinafter Katz & Shapiro, *Systems Competition*]; Garth Saloner, *Economic Issues in Computer Interface Standardization*, 1 *Econ. Innovation & New Tech.* 135, 140-42 (1990).

79. Although networks of corporate laws other than Delaware law do exist, Delaware's network is far larger than any other, and its value is accordingly greater. The most important other network is the Model Business Corporation Act, which is used as a standard in many states. This network, however, offers significantly lower network externalities, since it is not entirely uniform. See Carney, *supra* note 56, at 731-34 (documenting selective adoption of Model Business Corporation Act provisions by states). Additionally, even uniformly adopted provisions are bound to be applied differently by different states' courts.

laws, however, would increase not only by the value of determinacy but also by the value of Delaware's otherwise exclusive network externalities. The loss of its competitive advantage would cost Delaware more than its gain from product improvement.⁸⁰

When Delaware law is indeterminate, its content cannot be captured in a firm set of rules, and the courts must give it meaning piecemeal. Other states may well adopt Delaware's current law wholesale.⁸¹ But states cannot adopt future Delaware law as well. Blindly committing themselves to future statutes and court decisions of another state is politically unthinkable and fraught with practical difficulties.⁸²

In fact, even if importation of future Delaware law were feasible, it would not be enough to secure compatibility with the Delaware practice. The importing state would also need to have Delaware judges apply the [*1930] law. Other judges, no matter how skilled and experienced, could not divine how a Delaware judge would decide a given case. While Delaware cases would automatically be binding in other jurisdictions, non-Delaware cases would not be binding in Delaware, and the laws of Delaware and other states would gradually diverge. Thus, for example, a lawyer specializing in Delaware law could not advise a non-Delaware corporation without first consulting the case law of the relevant state, and investors comparing that firm to Delaware firms could not assume that they are subject to the same law. To the extent that such network externalities are valuable, the only way for firms to benefit from them would be by incorporating in Delaware.

The exclusion of other states from network externalities can benefit Delaware even if this advantage is achieved through the adoption of an overly indeterminate law.⁸³ While such law is worth less than determinate

80. For the sake of clarity, the discussion here refers solely to network benefits. It is, however, equally applicable to learning benefits. As Part II.A supra suggested, today's learning benefits are yesterday's network benefits. When Delaware law is indeterminate, other states are excluded from learning benefits resulting from the popularity of Delaware law in the past, as well as from network benefits resulting from the popularity of Delaware law today. In the future, these forward-looking network benefits will have become learning benefits.

81. In fact, Delaware originally adopted the corporate legal precedents of New Jersey. See *Wilmington City Ry. Co. v. People's Ry. Co.*, 47 A. 245, 251, 254 (Del. Ch. 1900).

82. These difficulties include "constitutional delegation problems, problems concerning the parties' rights of appeal, and problems in the coherency of case law, as well as the issue of granting retroactive relief when a state court decision is subsequently adjudicated differently by a Delaware court." Romano, *Law as a Product*, supra note 4, at 277 n.76.

83. Even when Delaware law is overly indeterminate, its popularity ensures availability of quality legal services and ready comparability of many firms' securities. These benefits do not accrue to firms using a different law. Moreover, the widespread use of Delaware law also guarantees abundant precedents, which may render it more predictable than more determinate, but less frequently used, rival laws. While more determinate than Delaware law, these laws are unlikely to achieve perfect determinacy, which would obviate the need for precedents. Since these rival laws are different from Delaware law, firms using them are unable to benefit from Delaware's precedents. Delaware law thus becomes more predictable than the laws of states

law to corporations, it forestalls compatibility and secures exclusive network externalities to Delaware.⁸⁴ As long as exclusion from network externalities reduces the value of rival laws by more than indeterminacy reduces that of Delaware law, the demand for Delaware law will increase. The reason for this is that corporations compare the value of Delaware law to that of rival laws. Since the value of Delaware law *relative* to rival laws is higher when Delaware law is indeterminate, the demand for Delaware law will increase notwithstanding any decline in its *absolute* value.

[*1931] A simple model, included in Appendix A, illustrates this point.⁸⁵ It assumes that the number of corporations in the market for corporate chartering is fixed. According to the model, corporations decide where to incorporate based on the respective values and prices of alternative states' laws. Firms that assign high value to the quality of corporate law will be willing to pay more for the advantages that Delaware law offers. Firms that assign low value to the quality of the law will be willing to pay less. Delaware can thus raise the price it charges to chartered firms above the price its rivals charge, and still attract the firms that assign high value to the quality of the law.⁸⁶ By adopting indeterminate law, Delaware reduces the value of its law

with fewer precedents, but less predictable than it could be if it offered both determinacy and rich case law. Previous commentary has noted that network externalities in corporate law are related to the open-ended nature of the law, which makes judicial interpretation valuable. See Klausner, *Networks of Contracts*, supra note 4, at 775-76. My argument is broader in two respects. First, the open-ended nature of the law not only intensifies network externalities, but also excludes from them firms chartered outside Delaware. Legal indeterminacy is thus a necessary condition for Delaware's dominance. Second, legal indeterminacy can help Delaware in maintaining its dominant position even if corporate law could optimally be more determinate.

84. In this spirit, it was argued that Delaware might be induced to frequently change its statutory law in innocuous ways, making it hard for rivals to copy, as Delaware corporations would rather bear the cost of change than emigrate. See Ayres, supra note 71, at 556-60. The argument was not tied to any particular statutory amendment in Delaware law. See *id.* at 559. Indeed, such amendments are rare. My argument relates incompatibility to the discretionary nature of Delaware case law, rather than to statutory amendments and, more importantly, applies to all corporations, rather than those already chartered in Delaware.

85. The framework I use is a linear location model of a market with products of different quality. See Jean Tirole, *The Theory of Industrial Organization* 296-98 (1988) (applying the model to quality competition); Harold Hotelling, *Stability in Competition*, 39 *Econ. J.* 41 (1929) (describing a model of a market with differentiated products). I then examine how changing the respective qualities of the product affects market equilibrium. For the idea that a producer may benefit from harming its rivals while harming itself less, see Steven C. Salop & David T. Scheffman, *Raising Rivals' Costs*, 73 *Am. Econ. Rev. Papers & Proc.* 267 (1983). An accessible description of this work is provided in Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 407-11 (2d ed. 1994). The model I use centers on reducing the quality of rivals' products, rather than raising their production cost. The two strategies are related, however. See Steven C. Salop & David T. Scheffman, *Cost-Raising Strategies*, 36 *J. Indus. Econ.* 19, 19 (1987) (treating the adoption of incompatible technologies as a cost-raising strategy).

86. This is consistent with empirical evidence showing that only corporations that value these advantages highly enough choose to incorporate in Delaware and incur the higher cost that this entails. See Black, supra note 5, at 585-91; Romano, *Law as a Product*, supra note 4, at

but simultaneously reduces the value of rival laws by a greater amount. As long as the relative value of Delaware law rises, Delaware's equilibrium price and market share—and hence its profit—increase.⁸⁷

Consider the following numerical example. Assume that the value of determinate corporate law is 8, and the value of indeterminate corporate law is 7.⁸⁸ Assume also that each of these values increases by 2 when the [*1932] law is widely used and generates network externalities. When Delaware adopts determinate law, other states follow suit and adopt identical laws. They do so both because compatibility with Delaware confers on them network benefits and because determinate law is better than indeterminate law. The value of their law is thus the sum of 8 and 2. The value of Delaware law may be higher, due to competitive advantages other than network benefits, but the value of network benefits will not be exclusive to Delaware law and therefore will not add to its advantage.⁸⁹

Contrast this with the case where Delaware adopts indeterminate law. The value of Delaware law drops by 1. Delaware's rivals, however, lose even more. They must choose between adopting determinate law, thereby sacrificing their compatibility with Delaware, and adopting indeterminate law, thereby sacrificing the higher value of determinate law. Their choice depends on how close they can get to Delaware by emulating its indeterminate law and, consequently, the extent to which they can capture network exter-

250-51. For a discussion of the higher costs of incorporation in Delaware, see Macey & Miller, *supra* note 3, at 492; Romano, *Law as a Product*, *supra* note 4, at 257-58. Corporations that choose to incur the higher cost of incorporation in Delaware typically are anticipating initial public offerings and control transactions, which are associated with a high rate of subsequent litigation. Being exposed to a greater likelihood of legal dispute, such corporations place a high value on advantages such as network externalities, a proficient judiciary, and a credible commitment, and are willing to pay more for them.

87. Note that this result is specific to the simple model used in Appendix A to illustrate that Delaware can profit from devaluing rival laws even if it devalues its own law. In reality, stronger conditions may need to be met for Delaware's profit to increase. That is, the value of rival laws may need to decline by, say, twice as much as the decline in the value of Delaware law. While I do not specify in this Article the exact conditions that would make the strategy profitable, my general argument is that it *can* be profitable. As a practical matter, one can only speculate about the exact values of determinate law, indeterminate law, network externalities, judicial proficiency, and a credible commitment.

88. I assume that despite the difference in clarity between the laws, both balance the interests of shareholders and managers in the same manner. For instance, if the determinate law has a tilt toward corporate management, then the indeterminate law has the same tilt. Without this assumption, corporate decisionmakers may value the determinate law more than the indeterminate one simply because the determinate law favors them more.

89. For example, if there are 10,000 firms in the market, the production of corporate law requires an investment of 100 in legal capital, and Delaware has competitive advantages (other than network externalities) that firms value between 0 and 3, then Delaware's profit is 13,233, and its rivals' profit is 3233. See Equations (12) and (13) in Appendix A.

nalities.⁹⁰ No matter what choice they make, they lose more than 1 unit in value, while Delaware law loses only 1. Consequently, the demand for Delaware law increases, and so does Delaware's profit. Both the number of Delaware firms and the price they pay are higher than when Delaware law was determinate.⁹¹

B. *Judicial Proficiency*

In addition to excluding rival states from network externalities, legal indeterminacy accentuates Delaware's judicial advantage over other states. It does so by inducing litigation,⁹² and at the same time leaving [*1933] more discretion to the courts in applying the law. The value of determinate law may also increase when it is applied by a proficient court, but the increase in the value of indeterminate law is greater still. Compare, for example, New York law and Delaware law concerning judicial review of a litigation committee's motion to dismiss a derivative suit. New York law requires that the court examine only the disinterestedness of the committee members and the adequacy of the investigative procedures they pursued.⁹³ Delaware law requires that the court, in addition to conducting this examination, also use its own business judgement to assess the committee's decision on its merits.⁹⁴ While both laws can benefit from application by proficient courts, it is clear that a court applying Delaware law has a greater impact on the outcome.

90. Since indeterminate law cannot be copied with perfection, see *supra* text accompanying notes 79-82, states emulating Delaware's indeterminate law can at most attain partial compatibility, which confers network externalities worth less than the maximum of 2. When network externalities due to partial compatibility are between 0 and 1, the combined value for rival states of adopting indeterminate law is less than 8, and so they adopt determinate law. Conversely, when partial network externalities are worth between 1 and 2, rival states adopt indeterminate law. When partial network externalities are worth exactly 1, rival states are otherwise indifferent, but emulate Delaware law in order to save the costs of drafting determinate law.

91. For example, in the scenario described above, *supra* note 89, even if the value of rival laws decreases by only 1.1 (while the value of Delaware law decreases by 1), Delaware's profit climbs to 13,681, and its rivals' profit drops to 3015. Larger decreases in the value of rival laws will of course lead to more dramatic changes in the profits of Delaware and its rivals.

92. See George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 *J. Legal Stud.* 1, 9, 17 (1984) (arguing that legal uncertainty increases disagreement among disputants, thus inducing litigation); cf. Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 *J. Legal Stud.* 399, 423-26 (1973) (arguing that uncertainty concerning trial outcomes induces litigation); Steven Shavell, *Suit, Settlement and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 *J. Legal Stud.* 55, 63 n.36 (1982).

93. See *Auerbach v. Bennett*, 393 N.E.2d 994, 1001-03 (N.Y. 1979); cf. *Cuker v. Mkalaukas*, 692 A.2d 1042, 1048 (Pa. 1997) (holding that only the propriety of the committee's decisionmaking process is subject to judicial review).

94. See *supra* notes 27-32 and accompanying text.

Corporate law is transferable, as the convergence of other states' laws to the Delaware model demonstrates.⁹⁵ Judicial quality, by contrast, is relatively fixed. If Delaware courts formulate tests that are most valuable when applied by them, legal plagiarism becomes infeasible. By adopting indeterminate law, Delaware may be reducing the intrinsic value of its law, but this reduction is partially offset by a more pronounced judicial advantage. By contrast, states with less proficient judiciaries are not similarly compensated for adopting indeterminate law. In fact, by expanding the role of their less proficient judiciaries, they increase their disadvantage.

The previous Section demonstrated how Delaware can gain from reducing the value of rival laws even at the cost of reducing the value of its own law.⁹⁶ Firms incorporate in Delaware based on the value of Delaware law relative to that of rival laws. While excessive indeterminacy reduces the value of Delaware law, it also reduces the value of rival laws by excluding them from network externalities. Delaware's proficient judiciary mitigates the reduction in the value of Delaware law, thereby further increasing its value relative to rival laws. In the previous Section's numerical example, the value of Delaware law decreased by 1 when it was indeterminate, while the value of rival laws decreased by more than 1. The judicial advantage mitigates the reduction in the value of Delaware law, so that it will be less than 1. Although Delaware law is still worth less than a determinate law, its relative value increases.⁹⁷

At the margin, it may be that this judicial advantage would tip the scales toward adopting indeterminate law, where network externalities alone would not be enough. Suppose that the value of determinacy equaled the value of network externalities. The reduction in the value of Delaware law as a result of being indeterminate would then equal the reduction in the value of rival laws as a result of being excluded from network externalities. Without its additional judicial advantage, Delaware would derive no benefit from adopting indeterminate law in this scenario. Or suppose that the value of

95. See Romano, *Law as a Product*, supra note 4, at 233-35. Convergence is incomplete, as is demonstrated, for instance, in variations among states in takeover legislation. But these variations are due to political choice, rather than technical difficulty in transferring the law. See Gordon, supra note 40, at 1963-65; Romano, *The Genius of American Corporate Law*, supra note 6, at 59-60 (arguing that Delaware's political circumstances account for its uniqueness in takeover legislation); see also Charles W. Murdock, *Why Illinois? A Comparison of Illinois and Delaware Corporate Jurisprudence*, 19 S. Ill. U. L.J. 1, 3 (1994) (recounting that Illinois initially did not follow Delaware in adopting a director exculpation statute due to local politics).

96. See supra text accompanying notes 83-91.

97. In the model described in Appendix A, Delaware's profit increases in $y - x$, where x is the decline in the value of Delaware law and y is the decline in the value of the rival law as a result of Delaware's legal indeterminacy. Since Delaware courts add more value to indeterminate law than to determinate law, x is smaller than it would be if Delaware courts added the same value to indeterminate law as to determinate law. Consequently, Delaware's profit increases.

determinacy were less than the value of network externalities but that other states could achieve full compatibility with Delaware's indeterminate law—and hence fully benefit from network externalities. Again Delaware would not benefit from adopting indeterminate law, as it would reduce the value of incorporation in Delaware and elsewhere by the same amount. The balance in both scenarios changes with the introduction of Delaware's judicial advantage, which adds more value to indeterminate law than to determinate law. The value of Delaware law would thus decrease by less than the decrease in the value of rival laws. This might make it worthwhile for Delaware to adopt indeterminate law.⁹⁸

In a similar vein, the combination of network externalities and judicial advantage can make legal indeterminacy beneficial to Delaware, when the judicial advantage alone would not suffice. In the absence of network externalities, Delaware should not adopt indeterminate law unless the attendant loss in value is compensated for by its proficient judiciary.⁹⁹ Indeterminate law would worsen its competitive position versus rival states, which would adopt determinate law regardless of the law chosen by Delaware. The introduction of network externalities changes this equilibrium, since it requires Delaware's rivals either to follow [*1935] Delaware and reveal their judicial disadvantage or to forgo the benefit of network externalities.

Legal indeterminacy also serves to maintain the judicial advantage over time. Delaware's judiciary specializes in corporate adjudication by virtue of the high volume of cases handled by a small core of judges. Indeterminate law heightens this effect by eliciting further litigation. As a result, Delaware courts hear more corporate cases than other courts and so substantiate their experience and reputation.¹⁰⁰ Economic theory recognizes that, when experience improves production and is not readily transferable, the first producer to obtain such experience may perpetuate its first-mover advantage simply through continued production. Indeed, it may intentionally reduce price to stimulate demand for its product in order to produce more and gain valuable experience.¹⁰¹ Given the strategic benefits of legal indeterminacy, Delaware may not need to reduce its price to stimulate demand. In fact,

98. In terms of the model described in Appendix A, the increase in Delaware's judicial advantage under indeterminate law guarantees that x (the decline in the value of Delaware law) is smaller than y (the decline in the value of rival laws), even if x and y would otherwise be equal (either because the value of determinacy equals the value of network externalities, or because rival states can emulate Delaware law despite its indeterminacy).

99. This should considerably limit indeterminacy in Delaware law. See Black, *supra* note 5, at 590 (arguing that the value of a proficient judiciary ought not be exaggerated).

100. Recall that experience and reputation are distinct advantages. Experience relates to the actual aptitude of a court at a given time, while reputation relates to the way the court is perceived at that time based on its past performance. See *supra* text accompanying notes 65-71.

101. See F.M. Scherer & David Ross, *Industrial Market Structure and Economic Performance* 372 (3d ed. 1990).

Delaware courts can engage in learning-by-doing while the state is increasing, rather than decreasing, prices.

The increased volume of litigation associated with legal indeterminacy allows Delaware courts not only to practice their corporate adjudication skills (thereby gaining experience), but also to publicly demonstrate them (thereby earning reputation). Since judicial quality is only observable by corporations when demonstrated in actual adjudication, it is important for courts to communicate their skills continuously to the public. The reputation of Delaware courts depends upon constant adjudication. Indeterminacy ensures that the necessary cases come up continually.

C. *Credible Commitment*

Indeterminacy, in addition to excluding other states from network externalities and allowing Delaware full exploitation of its judicial advantage, may also benefit Delaware by reinforcing its commitment to corporate needs. Delaware is said to have made a credible commitment to maintain the quality of its law by making itself economically dependent on corporate chartering.¹⁰² To the extent that this dependence results from reliance on franchise tax revenues, it is not affected by Delaware's adoption of either determinate or indeterminate law. Reliance on revenues from the franchise tax adds the same value to Delaware law when it is determinate as when it is indeterminate.¹⁰³

[*1936] But Delaware's commitment is based on more than its reliance on revenues from the franchise tax. It is also based on sunk investments that Delaware has made in expert judges, comprehensive case law, and administrative expertise in processing corporate litigation.¹⁰⁴ Moreover, Delaware has established local legal services as well as office and accommodation facilities to support litigation activity to an extent unusual for a state of its size. All these legal assets are closely linked to the indeterminate and litigation-oriented nature of Delaware law. It was legal indeterminacy that historically required Delaware to invest in these assets, and it continues to make them valuable today. Legal indeterminacy may thus strengthen Delaware's commitment to leadership in corporate chartering and render this commitment more valuable. This effect is similar to that of the enhancement of the judicial advantage discussed earlier. The benefit that Delaware derives from increasing the value of its credible commitment may not in itself be enough to induce legal indeterminacy, but may mitigate the reduction

102 . See Romano, *The Genius of American Corporate Law*, supra note 6, at 39.

103 . In the model described in Appendix A, corporations assign a higher value to Delaware law than to the rival law. Part of this advantage is due to a credible commitment.

104 . See Romano, *The Genius of American Corporate Law*, supra note 6, at 39.

in the value of Delaware law due to indeterminacy, thus making the exclusion of rival states from network externalities more profitable.¹⁰⁵

D. *Switching Costs*

There is no consensus in legal scholarship on the magnitude of the costs that firms incur when migrating between states. Some commentators believe that these costs influence migration decisions; others down-play their significance.¹⁰⁶ Whatever the costs of migration, indeterminacy raises them by making Delaware law incompatible with other laws, thus further benefiting Delaware.

When laws are incompatible, reincorporation in a new state requires learning and adapting to a new law.¹⁰⁷ This is clear with respect to the learning and adaptation that would be necessary for in-house counsel, directors, and officers, all of whom remain with the firm after reincorporation.¹⁰⁸ But such switching costs also apply to any learning and adaptation done by outside counsel. While a migrating firm can re- [*1937] place its outside counsel with a new one specializing in the new law, that firm still incurs switching costs associated with the time and effort needed to establish a working relationship with its new counsel.¹⁰⁹

The incompatibility of Delaware law with other laws as a result of its indeterminacy increases the costs of immigration just as it increases the costs of emigration.¹¹⁰ In both cases, the migrating firm must adjust to the law of the destination state, a need that would be obviated if the laws were

105 . See supra text accompanying notes 96-99 .

106 . Compare Romano, *Law as a Product*, supra note 4, at 246-49 (arguing that migration costs can tie firms to their domicile), with Black, supra note 5, at 586-88 (arguing that migration costs are negligible).

107 . The relevance of learning and adaptation costs can be inferred from the original migration of New Jersey firms to Delaware in response to amendments in the law of the former. Migration to Delaware, whose law mimicked the pre-amendment New Jersey law, not only enabled firms to use a hospitable legal regime they had already tested, but also posed minimal learning and adaptation costs. See Russell Carpenter Larcom, *The Delaware Corporation* 25-26 (1937); Grandy, supra note 65, at 685, 689; Seligman, supra note 65, at 271-72.

108 . Cf. Kahan & Klausner, *Economics of Boilerplate*, supra note 4, at 728 (noting that firms take into account the familiarity of their in-house legal counsel with contract terms they currently use when considering whether to switch to other terms).

109 . See Romano, *The Genius of American Corporate Law*, supra note 6, at 30 (arguing that corporate attorneys develop expertise about their clients that enables them to provide legal services more cheaply than competitors).

110 . The analysis here ignores the fact that, due to network externalities, learning Delaware law upon immigration is less costly than learning a rival law upon emigration. Even if both costs are assumed to be the same, they benefit Delaware for the reason discussed in the text below.

compatible.¹¹¹ The symmetric increase in the costs of both types of migration is worthwhile for Delaware, however, because it dominates the market, and would stand to lose more firms than other states if their laws were compatible.¹¹²

E. *Convergence of States' Laws*

The analysis thus far has not made any predictions about how other states are likely to respond to Delaware's legal indeterminacy. Indeed, existing empirical evidence does not indicate whether or not other states' laws mimic Delaware's indeterminacy. While commentators point to similarities between the substantive content of Delaware's and other states' laws, they do not compare their respective levels of determinacy.¹¹³ As a practical matter, it would be difficult to do so because of the scarcity of [*1938] non-Delaware cases. This Section addresses the possible convergence of other states' laws to the Delaware model of legal indeterminacy, and suggests several reasons why other states might wish to adopt indeterminate laws despite their lower value. Ironically, insofar as these reasons induce legal indeterminacy among Delaware's rivals, Delaware's competitive position may be enhanced.

One such reason is that states may follow Delaware's indeterminate law if partial compatibility with Delaware confers at least some network externalities, which would compensate for the lower value of indeterminate law. It is not clear, however, that anything less than perfect compatibility with Delaware law would generate network benefits, let alone benefits high

111. Incompatibility cannot be avoided even if rival states import Delaware law wholesale, because new Delaware case law and statutory law will not be part of the importing states' law. Nor can rival states overcome this problem by automatically incorporating new Delaware law into their laws. For one thing, automatic importation of future Delaware law may well not be feasible, and in practice does not occur. For another, even if it were feasible, it would not avoid incompatibility resulting from the existence of precedents created by the courts of the importing state. See *supra* text accompanying notes 81-82.

112. See Paul Klemperer, *The Competitiveness of Markets with Switching Costs*, 18 *RAND J. Econ.* 138, 142 (1987) (arguing that dominant producers are more interested in exploiting current customers and less interested in attracting new ones than are their smaller rivals); Carl Shapiro, *Aftermarkets and Consumer Welfare: Making Sense of Kodak*, 63 *Anti-trust L.J.* 483, 490 (1995) (arguing that switching costs allow producers to exploit current customers). Delaware should also value keeping old consumers more than it values gaining new consumers because of its dependence on the chartering business. Even a temporary shrinkage in Delaware's base of consumers may destabilize its budget, make its commitment to consumers less credible, and trigger a cascade of emigration.

113. See Romano, *The Genius of American Corporate Law*, *supra* note 6, at 47-48; Black, *supra* note 5, at 586; Romano, *Law as a Product*, *supra* note 4, at 233-35. But see Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 *J.L. & Econ.* 179 (1985) (describing differentiation among state laws); Carney, *supra* note 56, at 731-34 (finding convergence of states' laws to the Model Business Corporation Act, rather than the Delaware General Corporation Law).

enough to justify the loss of value brought on by indeterminacy. Network benefits may stem only from standardization; near-standardization may not be enough. Furthermore, even if partial compatibility confers some network benefits on other states, the adoption of indeterminate laws may underscore their judicial disadvantage.

Another possible reason to adopt Delaware's indeterminate law is rational herding.¹¹⁴ Just as herding among firms may partially account for the popularity of Delaware as an incorporation state, herding among states may account for their emulation of Delaware law.¹¹⁵ If state officials are not certain what makes for optimal law, they may follow a popular trend of mimicking Delaware. There is likely to be a high propensity for state herding in corporate law, where the complexity of the law and the fragile balance that must be struck in satisfying managers, lawyers, shareholders, and federal agencies make information about optimal law costly. States may find following others to be a convenient alternative to incurring these search costs. They may be particularly inclined to follow Delaware because it is assumed to be better informed about the optimal formulation of the law due to its prolonged preeminence.¹¹⁶ In fact, even if states acknowledge that legal indeterminacy may be beneficial to Delaware while being detrimental to them, they may nonetheless be reluctant to invest in formulating an optimally determinate law, knowing that success is uncertain and a successful formulation may be subject to freeriding by other states.¹¹⁷

Although Delaware may gain from adopting indeterminate law irrespective of the law adopted by its rivals, the gain can be greater if rival states adopt indeterminate law too. Adoption of indeterminate law deprives these states of their only mitigating advantage—clarity. When states adopt indeterminate law to gain partial compatibility with Delaware or to save search costs, they take the loss of clarity into account. Their adoption of indeterminate law does not affect Delaware's gain from its own indeterminate law. But if states are induced to adopt indeterminate law only because they fear freeriding by other states or are herding, Delaware's gain may increase. In this case, each state would adopt determinate law if it were the only state competing with Delaware. It chooses to adopt indeterminate

114. Herding here means following Delaware's indeterminacy by adopting open-ended standards similar to those adopted by Delaware. While herding produces indeterminate laws in other states, these laws diverge from Delaware law since they are applied by non-Delaware courts.

115. See *supra* note 63.

116. See Banerjee, *supra* note 63, at 816 (arguing that when information is costly, herding is intensified).

117. See Ayres, *supra* note 71, at 545-50 (arguing that regulators do not innovate when they can be copied by rivals); Ronald J. Daniels, Should Provinces Compete? The Case for a Competitive Corporate Law Market, 36 *McGill L.J.* 130, 182 (1991) (same).

law, which exacerbates its disadvantage vis-à-vis Delaware, only because it takes into consideration the behavior of other states as well.

IV. THE POLITICAL ECONOMY OF DELAWARE'S INDETERMINACY

While indeterminacy may enhance the competitive position of Delaware, it is unlikely that anyone designed Delaware law to this end. To be sure, interpreting legal indeterminacy as a strategy would be in line with state competition commentary, which assumes strategic formulation of Delaware law to attract corporations.¹¹⁸ Nonetheless, as this Part will argue, a more plausible explanation links the indeterminacy of Delaware law to the influence of the corporate bar, judicial preferences, and a court-centered legal culture. Although these forces had little to do with a calculated plan to use indeterminacy to secure market power, they were able to bring about this result. Thus, the competitive advantage that Delaware derives from legal indeterminacy may have shaped its law indirectly. It was the absence of constraining market forces that allowed Delaware to develop indeterminate law while retaining its preeminence. Had it not been profitable, Delaware would have been less likely to yield to the influences that made its law indeterminate; and if it had yielded, its dominance would have been eroded.

A. *Lawyers as an Interest Group*

Interest group theorists describe the corporate bar, and particularly the Delaware corporate bar, as an influential interest group that, through its involvement in legislation and judicial appointments, has made Delaware law indeterminate and litigation-oriented in order to generate demand for legal services.¹¹⁹ According to this view, firms view exposure [*1940] to liti-

118. It would be naive to assume that Delaware judges are blind to the competition among states in the chartering business, the economic gains to Delaware from its lead, and the contribution of the judicial branch to that lead. See E. Norman Veasey, "I Have the Best Job in America," *Del. Law.*, Winter 1995, at 21, 21-22. State competition theorists make this point more explicit. See Romano, *The Genius of American Corporate Law*, supra note 6, at 40 (arguing that Delaware judges' lack of life tenure leads them to accommodate a political consensus that favors incorporation-friendly law); Cary, supra note 1, at 692.

119. See Douglas M. Branson, *Indeterminacy: The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 *Vand. L. Rev.* 85, 111 (1990); Macey & Miller, supra note 3, at 505; see also John C. Coffee, Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Federal Minimum Standards*, 8 *Cardozo L. Rev.* 759, 762-66 (1987) (arguing that Delaware law serves the bar by inducing litigation). For the impact of the corporate bar outside Delaware in this regard, see Sidney B. Silverman, *An Outsider Looks at Chancery*, *Del. Law.*, Summer 1995, at 17, 20-21 (noting the Delaware Court of Chancery's uniquely courteous treatment of out-of-state lawyers, who are often influential in the selection of Delaware as the state of incorporation). The recognition of lawyers' preference for law that increases demand for their services dates back to Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 *J. Legal Stud.* 257, 271, 274 (1974). For recent discussions of lawyers' preference for legal indeterminacy, see Kaplow, supra note 16, at 620; Michelle J. White, *Legal Complexity and Lawyers' Benefit from Litigation*, 12 *Int'l Rev. L. & Econ.* 381,

gation as a cost they incur along with a state's franchise tax. Delaware could raise its franchise tax if it reduced firms' exposure to litigation by making its law more determinate. It does not do so because of the bar's political clout.¹²⁰

This Article suggests that indeterminate and litigation-oriented law is not necessarily inimical to the interests of Delaware, and indeed may enhance its competitiveness.¹²¹ Relations between the bar and the state may therefore be symbiotic rather than confrontational.¹²² This alignment of interest sheds new light on the interest group theory of Delaware law. First, greater indeterminacy is possible when it supports, rather than merely exploits, market power. Second, less political clout is needed than was previously believed to induce Delaware lawmakers to develop indeterminate law. This is not to say that the bar's interest in legal indeterminacy is irrelevant. Rather, the bar has been one of the visible driving forces that have made Delaware law indeterminate. This confluence of forces is important, since it is implausible that legal indeterminacy was intentionally designed as an anticompetitive strategy.

B. *Judicial Preferences*

Delaware's judges may also be inclined toward legal indeterminacy as a consequence of their own preference for wide judicial discretion. Judges generally give up a successful and lucrative legal career to assume a judgeship. In doing so, they are motivated mainly by nonpecuniary rewards, such as prestige, challenge, and a sense of serving society.¹²³ The intangible rewards of judging are most pronounced under indeterminate cor-

393 (1992). Of course, there is a limit as to how indeterminate the law can be and still benefit lawyers. While indeterminacy generally increases the need for lawyers, extreme indeterminacy renders their services less useful as the law verges on being arbitrary. Cf. Richard Craswell & John E. Calfee, Deterrence and Uncertain Legal Standards, 2 J.L. Econ. & Org. 279 (1986) (arguing that highly uncertain legal standards have only a small impact on behavior).

120. See Macey & Miller, *supra* note 3, at 502 (noting that Delaware judges often come from the ranks of the corporate bar).

121. See *supra* Part III.

122. The symbiotic relations are further tightened by the fact that the dependence of the bar on Delaware's preeminence as a venue for corporate litigation adds to the state's credible commitment. See *supra* note 75.

123. See generally Richard A. Posner, What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does), 3 Sup. Ct. Econ. Rev. 1 (1993); see also Janet Cooper Alexander, Judges' Self-Interest and Procedural Rules: Comment on Macey, 23 J. Legal Stud. 647, 663 n.59 (1994) (quoting Judge Bork's statement during his confirmation hearing that judging is "an intellectual feast"); Frank H. Easterbrook, What's So Special About Judges?, 61 U. Colo. L. Rev. 773, 775-76 (1990) (noting that judges value the office independent of their salary).

porate law, which places judges at the center of the business arena.¹²⁴ This incentive is particularly powerful when the usual judicial aversion to increased workload is absent.¹²⁵ Since dockets in Delaware are not congested, and judges are already specialized in corporate law when appointed, they may encourage corporate litigation and develop intricate corporate jurisprudence.¹²⁶ Indeterminacy in Delaware law may thus feed on itself by inviting more litigation, which may in turn produce more indeterminacy.

Judge Posner once said that judicial activity has an element of monotony, which may be unfulfilling for many people, especially educated and intelligent ones.¹²⁷ Without speculating about the professional gratification of deciding ordinary cases in a small state court, it is clear that deciding large corporate cases has a certain appeal.¹²⁸ These cases involve sophisticated transactions, large stakes, and high-profile lawyers and clients. They are also the focus of extensive academic and journalistic commentary. There can hardly be a doubt that deciding such cases on a regular basis can be particularly satisfying for judges.¹²⁹

124. See Roe, *supra* note 4, at 345-46 (arguing that doctrinal uncertainty in the takeover jurisprudence induces frequent litigation, thereby drawing power and attention to Delaware judges).

125. Congested generalist courts typically develop procedural rules that facilitate disposal of cases without deciding them on their merits. See Jonathan R. Macey, *Judicial Preferences, Public Choice, and the Rules of Procedure*, 23 *J. Legal Stud.* 627, 632-33 (1994).

126. See Dreyfuss, *supra* note 66, at 30-31 (arguing that specialized lawyers and judges tend to develop a jurisprudence of fine distinctions in their areas of expertise).

127. See Richard A. Posner, *Will the Federal Courts of Appeals Survive until 1984? An Essay on Delegation and Specialization of the Judicial Function*, 56 *S. Cal. L. Rev.* 761, 779-80 (1983).

128. For quotes of judges expressing preference for significant, rather than routine, cases, see Marc Galanter, *The Life and Times of the Big Six; or, the Federal Courts since the Good Old Days*, 1988 *Wis. L. Rev.* 921, 921-22 (quoting Justice Antonin Scalia describing a deterioration in the role of federal courts over the years from handling “by and large . . . cases of major importance” to hearing “minor’ and ‘routine’ cases about ‘mundane’ matters ‘of less import’ or even ‘overwhelming triviality’” (footnote omitted)); Jon O. Newman, *Are 1,000 Federal Judges Enough? Yes. More Would Dilute the Quality*, *N.Y. Times*, May 17, 1993, at A17 (advocating limiting the size of the federal judiciary and “using Federal courts only for matters of special importance”).

129. See E. Norman Veasey, *The National Court of Excellence*, 48 *Bus. Law.* 357, 361 (1992) [hereinafter Veasey, *The National Court of Excellence*] (characterizing corporate cases as “fascinating, complex, megadollar disputes”); Cecilia Friend, *Chancery Court: High Stakes in Delaware*, *Nat’l L.J.*, Feb. 13, 1984, at 32 (quoting a Delaware judge and a practitioner describing the lure of the opportunity to hear arguments by prominent lawyers and hand down decisions of a national impact). The prestige of deciding major corporate cases may be particularly important to judges whose expertise has widely been acclaimed. Delaware judges have indeed been explicit on the importance of prestige. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1180 n.34 (Del. 1995) (“The exemplary manner in which this litigation proceeded through the Court of Chancery demonstrates why that institution is held in such high regard.”); *Rabkin v. Phillip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1107 (Del. 1985) (“[O]ur courts are not without a degree of sophistication in [distinguishing meritorious claims].”); William T. Allen, *A Bicen-*

[*1942] I do not claim that parochial interests alone drive judges to develop judge-oriented law. For many, the desire to serve society is the primary motivation. Aware of their position as a national corporate tribunal, Delaware judges have a strong sense of responsibility. In court decisions, they often take a preaching stance toward the business community.¹³⁰ In extrajudicial expressions, they stress their duty to society.¹³¹ Their desire to be the ultimate arbiters of corporate disputes reflects their belief that these issues are important and deserve attention.¹³² They may well perceive the judge-oriented nature of Delaware law as a virtue, rather than a fault.

[*1943] Optimal formulation of corporate law involves a tradeoff between predictability and flexibility. Reaching the best result in an individual case may come at the expense of providing the business community with sufficient guidance for future planning. While surely appreciating the wider implications of their rulings, courts must base each decision on the arguments made by the parties then at the bar. It is therefore only natural that, when judges weigh predictability and flexibility, the latter consideration will

ennial Toast to the Delaware Court of Chancery 1792-1992, 48 Bus. Law. 363, 364 (1992) (“Over most of the twentieth century the Delaware courts, and in the first instance the Court of Chancery, have contributed importantly to the national welfare through their contribution to the development of the Delaware corporation law.”); Maurice A. Hartnett, III, *The History of the Delaware Court of Chancery*, 48 Bus. Law. 367, 370 (1992) (“[T]he Delaware Court of Chancery has emerged as a nationally recognized forum for the trial of corporate litigation.”); Andrew G.T. Moore, II, *State Competition: Panel Response*, 8 Cardozo L. Rev. 779, 782 (1987) (“With the possible exception of the Supreme Court of the United States, which I mention only out of respect, I doubt that there is a more exciting appellate court on which to serve.”); William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery - 1792-1992*, 18 Del. J. Corp. L. 819, 866 (1993) (“As the Court of Chancery enters its third century, its art is a scarce commodity in a coarse, crowded and complex world.”); Veasey, *supra* note 118, at 20 (“[M]ost knowledgeable people in Delaware and around the country know of Delaware’s reputation for excellence in the corporation law. That reputation is driven primarily by the national respect for our Court of Chancery and Supreme Court, as well as the . . . initiatives of the General Assembly and the Governor”); Veasey, *The National Court of Excellence*, *supra*, at 360 (“In [board rooms and law offices around the world] the Court of Chancery consistently is viewed with esteem and often with something approaching reverence.”).

130. For numerous examples from court decisions, see Gilson, *supra* note 66, at 916-18; Rock, *supra* note 39, at 1028-60; Skeel, *supra* note 14, at 163-69.

131. See William T. Allen, *Our Schizophrenic Conception of the Business Corporation*, 14 Cardozo L. Rev. 261, 280 (1992) (“[W]hile [public corporations] are surely economic and financial instruments, they are, as well, institutions of social and political significance.”); Moore, *supra* note 129, at 782 (“I think Delaware corporate law will continue to evolve in order to meet the needs of corporate America. The Delaware courts feel strongly that this is our responsibility. Firms have entrusted their corporate life, in a sense, to Delaware, and it is important that we act responsibly.”).

132. See Easterbrook, *supra* note 123, at 778 (“Judges are ‘interested’ persons, though, when the question is moral. Everyone would like society at large to be governed by his philosophical conclusions, to share his aspirations and concerns.”).

prevail.¹³³ Most relevant in this regard is the fact that corporate cases in Delaware are heard in a court of equity, rather than a court of law. The preference for an incremental and fact-driven creation of law can be traced to the historical roots of equity, which originated as an alternative to the rigidity of common law.¹³⁴ The judges of the Delaware Court of Chancery consciously remain faithful to this tradition.¹³⁵

The observations above have implications for the state competition debate. While the Delaware judiciary has been described as subject to the implicit pressure of the bar and the legislature to encourage litigation, my analysis suggests that the interests of the three are aligned. Each supports the centrality of adjudication in corporate law, and therefore is receptive to legal indeterminacy. Political pressure on the courts thus becomes less necessary. [*1944]

C. *Legal Culture*

Beside being welcomed by lawyers and judges, the development of indeterminate and judge-oriented corporate law has been facilitated by a receptive legal culture.¹³⁶ It is beyond the scope of this Article to survey the

133. See *Blasius Indus., Inc. v. Atlas Corp.*, 564 A.2d 651, 661-62 (Del. Ch. 1988) (rejecting a per se rule against any board interference with the voting mechanism, while acknowledging that such a rule would have the advantage of clarity and predictability); *Facet Enters. v. Prospect Group*, 14 Del. J. Corp. L. 310, 320 (Del. Ch. 1988) (“The rapidly evolving law makes any precise legal formulation in [the] fast moving area [of poison pills] a somewhat hazardous endeavor that is best left for another day.”); Allen, *supra* note 34, at 900 (distinguishing between the case-bound nature of adjudication and the promulgating nature of legislation). The preference for flexibility, even at the cost of predictability, is of course not unique to Delaware judges. See, e.g., *Basic Inc. v. Levinson*, 485 U.S. 224, 236 (1988) (preferring a flexible standard over a bright-line rule for the duty to disclose merger negotiations).

134. Equity has been criticized precisely on the ground that it is too indeterminate. See Letter from Thomas Jefferson to Phillip Mazzei (Nov. 28, 1785), *in* 9 *The Papers of Thomas Jefferson* 67, 71 (Julian P. Boyd ed., 1954) (“Relieve the judges from the rigour of text law, and permit them, with pretorian discretion, to wander into it’s equity, and the whole legal system becomes incertain.”).

135. See *In re Holly Farms Corp. Shareholders Litig.*, 564 A.2d 342, 348 (Del. Ch. 1989) (“The Court of Chancery has historically been vested with considerable discretion in delicately balancing all the equities and, although some might desire a more definite standard, no hard and fast rule is likely or desirable which will apply to all factual circumstances.”); Allen, *supra* note 129, at 365 (“The strong identification of the judges of the Court of Chancery with the historic role of chancery, had, I think, subtle but real effects on the jurisprudence of the court over its long life.”); Hartnett, *supra* note 129, at 369 (“Some of us believe that [the] maxims of equity, although not so often quoted now, are as important today as ever.”); Quillen & Hanrahan, *supra* note 126, at 821-22 (“Equity is the flexible application of broad moral principles (maxims) to fact specific situations for the sake of justice. Delaware has preserved the essence.”).

136. For an incomplete list of references, see Walter K. Olson, *The Litigation Explosion: What Happened When America Unleashed the Lawsuit* (1991) (criticizing the pervasiveness of litigation in American society); Ruggero J. Aldisert, *An American View of the Judicial Function*, *in* *Legal Institutions Today: English and American Institutions Compared* 31, 54 (Harry W.

various political, economic, sociological, and historical origins of this legal culture. It suffices to note that these forces many times have resulted in bright-line rules being supplanted by flexible standards that call for case-by-case adjudication.¹³⁷ The centrality of adjudication that this Article describes as a trait of corporate law is thus not an anomaly in American legal tradition. This should not, however, trivialize the thesis of this Article. Culture cannot shape the law counter to strong economic forces.¹³⁸ Were indeterminate law economically unviable for Delaware, culture alone would not have induced Delaware to develop such law; if it had, Delaware's lead would have been lost.

A brief look overseas illustrates the significance of legal culture in shaping legal doctrine. Britain is a telling example, since its legal tradition formed the basis of American law and its market economy resembles that of the United States. Despite these common attributes, British legal culture differs greatly in the limited role it assigns to the courts, in corporate law as well as elsewhere.¹³⁹ The paucity of litigation in Britain during the takeover tide that swept both countries in the 1980s is indicative; in [*1945] the United States, that period saw an avalanche of lawsuits.¹⁴⁰ In Britain, where shareholder derivative suits were constrained by procedural hurdles, voluntary compliance with codes of business practice performed the disciplinary function that in the United States were the sole province of the judiciary.¹⁴¹

Jones ed., 1977) [hereinafter Jones, *Legal Institutions Today*] (arguing that the court system is "the dominant institution in contemporary American society"); John H. Barton, *Behind the Legal Explosion*, 27 *Stan. L. Rev.* 567, 572-78 (1975) (arguing that the relative absence of a common national ethos triggers reliance on courts); Bayless Manning, *Hyperlexis: Our National Disease*, 71 *Nw. U. L. Rev.* 767, 772 (1977) ("It has always been a peculiarity of Americans to turn to their courts for resolution of difficult problems."); Maurice Rosenberg, *Contemporary Litigation in the United States*, in Jones, *Legal Institutions Today*, supra, at 152, 152 (addressing the proliferation of litigation in America). It has been argued that even academics tend to favor access to courts as a fundamental right. See Steven Shavell, *The Fundamental Divergence Between the Private and the Social Motive to Use the Legal System*, 26 *J. Legal Stud.* 575, 594 (1997).

137. See Edward H. Levi, *An Introduction to Legal Reasoning* 1-40 (1949) (discussing casuistic lawmaking in American common law); Jethro K. Lieberman, *The Litigious Society* 8-25 (1981) (discussing the accommodation of litigation through open-ended legal standards).

138. See, e.g., J. Mark Ramseyer, *Learning to Love Japan: Social Norms and Market Incentives*, 31 *San Diego L. Rev.* 263 (1994) (arguing that economic incentives will override social norms when the two are in tension).

139. See P.S. Atiyah & Robert S. Summers, *Form and Substance in Anglo-American Law* 134-50 (1987). A striking example is the marginality of tort litigation in Britain, compared to its pervasiveness in the United States. See *id.* at 135-37; see also P.S. Atiyah, *Tort Law and the Alternatives: Some Anglo-American Comparisons*, 1987 *Duke L.J.* 1002, 1004-16 (noting a vast difference in the volume of mass tort litigation).

140. See Jeffrey Sheban, *Takeover Game in Britain Is Played With Rules That Would Halt U.S. Deals*, *Wall St. J.*, Nov. 3, 1989, at B5E.

141. For a discussion of the hurdles to shareholder derivative suits in Britain, see Jonathan P. Charkham, *Keeping Good Company: A Study of Corporate Governance in Five Coun-*

The origins of judicial predominance in American law lend context to the preceding discussion of the nature of corporate law. In many respects, corporate law reflects undercurrents present in the general legal culture.¹⁴² In a court-centered legal culture, the efficacy of entrusting ultimate responsibility for corporate governance to the courts has rarely been questioned.¹⁴³

D. *Convergence of States' Laws*

While arguing that legal indeterminacy may secure Delaware's market position by enhancing its competitive advantages, this Article has been less predictive with respect to the laws of other states. Since corporate cases are much less common in other states than they are in Delaware, it is difficult to characterize these laws with accuracy. It was argued above that states may follow Delaware in favoring indeterminacy if, as a result, they become sufficiently compatible with Delaware to compensate for the loss of clarity; if they are subject to herding; or if they fear that a determinate law would be subject to freeriding by other states.¹⁴⁴

Conformity with the Delaware model of indeterminate law may also result from political-economy forces similar to those affecting Delaware. Although other states are not subject to pressure from interest groups as cohesive as the Delaware bar, they are nevertheless subject to direct pressure from their local bars and indirect pressure from the bar at large.¹⁴⁵ Similarly, judges in all states' courts can appreciate the prestige, challenge, and sense of contribution associated with playing a central role in corporate governance. Finally, the tradition heralding courts as a focal point of legal disputes is deep-rooted in all states, as part of a national legal culture.

tries 315 (1994); Geoffrey P. Miller, *Political Structure and Corporate Governance: Some Points of Contrast Between the United States and England*, 1998 *Colum. Bus. L. Rev.* 51, 61-63. For the use of voluntary compliance as an alternative to adjudication, see Brian R. Cheffins, *Company Law: Theory, Structure, and Operation* 364-420 (1997); Alice Belcher, *Regulation by the Market: The Case of the Cadbury Code and Compliance Statement*, 1995 *J. Bus. L.* 321. Although legal determinacy may be an additional reason for the dearth of corporate litigation in Britain, this possibility will not be investigated here. Indeed, against it stand anecdotal accounts suggesting that some areas of corporate law in Britain fall short of being determinate. See Cheffins, *supra*, at 332-39. This is hardly surprising, given the equitable origins of British corporate law. See Paul L. Davies, *Gower's Principles of Modern Company Law* 599 (6th ed. 1997).

142. The cultural background has not escaped the notice of Delaware judges. See Allen, *supra* note 131, at 262 n.2 (noting that in American jurisprudence "the processes of law" means the processes of adjudication, with which we are fascinated").

143. For an exception to the general acquiescence to judicial primacy, see Black & Krakman, *supra* note 46, at 1975 (suggesting that shareholder approval may be preferable to judicial review for regulating conflict transactions).

144. See *supra* Part III.E.

145. See Carney, *supra* note 56, at 737.

These factors, however, may not affect other states with the same intensity with which they affect Delaware. First, lawyers in other states have not grown as dependent on corporate legal services. Although they also can benefit from an increased demand for their services under indeterminate corporate law, this gain constitutes a smaller proportion of their income. Similarly, the professional gratification that judges in other states derive from deciding corporate cases may not equal that of presiding over the country's most celebrated corporate cases on a regular basis. Moreover, the dockets of other states' courts are often more congested than those of Delaware.¹⁴⁶ Consequently, the judges of these courts deal with complex legal issues other than corporate law and can spare the challenge of deciding corporate cases, in which they have no special expertise.

V. IMPLICATIONS

The theory presented above offers an alternative account of Delaware's uninterrupted lead in corporate chartering. It shifts the focus away from the substance of Delaware law toward its form as an explanation for Delaware's success. While substance can be emulated by other states, an indeterminate form is more difficult to copy and serves to accentuate the advantages that Delaware has over its rivals.¹⁴⁷ Several implications follow from this theory. One clear implication is that, whether Delaware law favors managers or shareholders, it may harm both by being too indeterminate. Another implication is that competition among regulators, in the market for corporate law as well as in other markets, is susceptible to anticompetitive behavior that may not breed the law most desired by consumers. Such an outcome is conceivable, for example, in a market for securities law, should such a market be formed. Last, the centrality of adjudication under indeterminate law helps to explain investor fragmentation and passivity in the United States. [*1947]

A. *Social Welfare*

An unfavorable picture emerges on calculation of the possible inefficiencies of Delaware's indeterminate law. First, legal indeterminacy is costly. It obstructs business planning by corporate managers and invites expensive litigation. Delaware firms that wish to avoid these costs have no real alternative. By incorporating elsewhere, they would forgo the benefits of network externalities and a proficient judiciary, and might well not benefit from a clearer law. Second, legal indeterminacy isolates firms incorporated in other states from the Delaware network. The excluded firms then

146. See, e.g., Dreyfuss, *supra* note 66, at 18-19 (comparing the Delaware Court of Chancery with the New York Court of Appeals).

147. The substantive content of the law still matters, but it is a necessary, rather than a sufficient, condition for success. See Herzl & Richman, *supra* note 6, at F-17 ("If a state's corporation statute is inferior, its court system and lawyers never even have a chance.").

miss the network benefits offered by Delaware law. Delaware firms also lose, because their network remains smaller than it could be, and so their network benefits are not maximized. The unrealized potential of a larger network is a cost to them just as it is to firms in other states.¹⁴⁸ Third, Delaware's indeterminacy increases the cost of switching between states, thereby artificially differentiating the market without the benefit of wider product choice.¹⁴⁹ If other states were able to attain compatibility with Delaware, this needless friction would be spared.¹⁵⁰

B. *Theories of the Market for Corporate Law*

At this stage, it is useful to relate the thesis of this Article to the state competition debate. Two diametrically opposed views define the boundaries of that debate. Race-to-the-top adherents contend that incorporation decisions prioritize investor interests, and consequently improve the quality of states' corporate laws.¹⁵¹ Race-to-the-bottom adherents believe that incorporation decisions prioritize management interests, and consequently lower the quality of states' corporate laws.¹⁵² An intermediate [*1948] position is that some managerial decisions are made with a view to shareholder interests, while other decisions serve the interests of managers themselves. State competition is productive with respect to the former decisions and destruc-

148. See Klausner, *Networks of Contracts*, supra note 4, at 778-79 (arguing that network externalities in corporate law continue to grow even when the network is already large because very few firms become involved in litigation that results in a judicial opinion, and many judicial opinions are needed to clarify the law). For the small number of firms involved in litigation relative to the total number of firms, see Rock, supra note 39, at 1090-94; Roberta Romano, *The Shareholder Law Suit: Litigation Without Foundation?*, 7 *J.L. Econ. & Org.* 55, 59, 85 (1991).

149. See Paul Klemperer, *Markets with Consumer Switching Costs*, 102 *Q.J. Econ.* 375, 377 (1987) (arguing that while product differentiation may sometimes be justified as addressing different consumer tastes, switching costs create artificial differentiation that cannot be similarly justified).

150. Legal indeterminacy also allows Delaware to charge a higher tax to its chartered firms, and this cost ultimately is borne by their shareholders. Compared to the other costs of suboptimal indeterminacy, the higher franchise tax charged by Delaware is not substantial. It can also be argued that it is a pure transfer of wealth that does not constitute a deadweight loss. A possible response to the latter argument, however, is that such a wealth transfer from Delaware firms to the state interferes with allocative efficiency.

151. See, e.g., Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 212-27 (1991); Romano, *The Genius of America Corporate Law*, supra note 6; Winter, supra note 1.

152. See, e.g., *Corporate Rights and Responsibilities: Hearings Before the Senate Comm. on Commerce*, 94th Cong., 2d Sess., 241, 244-45 (1976) (Statement of Harvey J. Goldschmid); Cary, supra note 1; Donald E. Schwartz, *A Case for Federal Chartering of Corporations*, 31 *Bus. Law.* 1125 (1976).

tive with respect to the latter.¹⁵³ This Article is consistent with all of these views.

That this Article is consistent with a race-to-the-top theory is clear from the fact that all the advantages accentuated by indeterminacy—network externalities, judicial advantage, and credible commitment—benefit investors and managers alike.¹⁵⁴ The argument that Delaware increases its market power by accentuating these advantages is thus consistent with an alignment between management and shareholders. The argument is also consistent, however, with a lack of such alignment. The race-to-the-bottom theory holds that investor interests are subordinated to management interests only when they are in direct conflict. There is no such conflict with regard to indeterminacy. Exposure to legal risk is undesirable from the standpoint of investors as well as managers.¹⁵⁵ Delaware law attracts firms despite its riskiness because indeterminacy accentuates the competitive advantages that both investors and managers appreciate.

In sum, strategic indeterminacy is consistent with both the race-to-the-top and the race-to-the-bottom theories. In the former case, it undercuts the argument that corporate law is efficient. In the latter case, it adds another level of inefficiency. In both cases, it is detrimental to social welfare.

C. *Agenda for Future Research*

The theory of regulatory competition has been known for more than four decades,¹⁵⁶ and its precursors in the context of corporate law are even older.¹⁵⁷ Throughout this time, the theory limited itself to using [*1949] only a few of the tools provided by industrial organization economics. Tradi-

153. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1435, 1461-70 (1992) (arguing that managers choose value-increasing rules to govern insignificantly redistributive issues, and value-decreasing rules to govern significantly redistributive issues and issues that directly affect market discipline).

154. Switching costs do not benefit shareholders, but neither do they benefit managers. The enhancement of Delaware's competitive position by raising switching costs is thus consistent with management alignment with shareholders.

155. See Business Roundtable, *Statement of the Business Roundtable on the American Law Institute's Proposed "Principles of Corporate Governance and Structure: Restatement and Recommendations"* 37 (1983) (expressing alarm over the perceived effects of the proposal in fostering shareholder litigation); Macey & Miller, *supra* note 3, at 512 (describing managerial aversion to litigation).

156. The original analytical framework is due to Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 *J. Pol. Econ.* 416 (1956).

157. See Harold W. Stoke, *Economic Influences upon the Corporation Laws of New Jersey*, 38 *J. Pol. Econ.* 551, 575-76 (1930) (documenting chartermongering among states at the turn of the century). Early references to state competition in corporate law date back to the nineteenth century. See William W. Cook, *A Treatise on Stock and Stockholders* 1604-05 (3d ed. 1894).

tional theory treats regulatory rivalry as perfect competition in a market for laws, which necessarily yields the law most appealing to consumers. In corporate law, managers are the immediate consumers—through their central role in making incorporation decisions—and their incentives determine the direction of the competition.

The disagreement between proponents and opponents of state competition is not about whether the market is competitive, but whether managers make socially optimal choices.¹⁵⁸ Opponents of state competition argue that managers are not aligned with shareholders.¹⁵⁹ The outcome of state competition, they argue, is indeed the law most desired by managers, which is precisely what makes it socially suboptimal.¹⁶⁰ They therefore advocate federal corporate law, which avoids undesirable competition.¹⁶¹ Unfortunately, federal law may result in monopolistic regulatory behavior, as has arguably happened to federal securities regulation. Monopolistic regulators may charge supracompetitive prices, provide low-quality law, and be captured by interest groups.¹⁶²

This Article suggests imperfect competition as a plausible intermediate regulatory structure between perfect competition and monopoly. Under imperfect competition, regulators may employ various strategies to enhance their market position, even if these strategies are detrimental to consumers of the law. Previous commentary has recognized that regulatory markets are often imperfectly competitive, allowing dominant regulators to price their law higher than the competitive price.¹⁶³ This Article extends the literature by arguing that imperfect competition lends itself to other forms of uncompetitive behavior as well, and in particular to a preference by the dominant regulator for indeterminate and judge-oriented corporate law. By no means does this exhaust the panoply of strategies that regulators may employ to enhance their competitive position and exploit it to maximize profits. Future research may explore other strategies and other legal contexts. [*1950]

D. *A Market for Securities Law*

A natural candidate for the study of imperfect regulatory competition is the area of securities law. Today, securities law is administered exclusively

158. See Bebchuk, *supra* note 153, at 1455-56; Romano, *Law as a Product*, *supra* note 4, at 228-29.

159. See Cary, *supra* note 1, at 699.

160. See *id.* at 668.

161. See *id.* at 668.

162. See generally Romano, *Empowering Investors*, *supra* note 9; see also Susan M. Phillips & J. Richard Zecher, *The SEC and the Public Interest* 22-23 (1981); David Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model with an Application to Insider Trading Regulation*, 30 *J.L. & Econ.* 311, 318-30 (1987).

163. See Macey & Miller, *supra* note 3, at 491.

by the federal government. A thoughtful recent proposal, however, calls for replacing the federal monopoly with regulatory competition in securities law similar to that in corporate law.¹⁶⁴ While full discussion of the proposal is beyond the scope of this Article, it is worth noting that a market for securities law may be subject to the same forces that render the market for corporate law imperfectly competitive. Much like a corporate law, a securities law is worth more when a large number of firms follow it. Such legal uniformity results in availability of case law and commentary, as well as legal and financial services. With greater competition among professionals servicing the law, and higher economies of scale for each of these professionals, their services increase in quality and decrease in price. Economies of scale can also exist in administering a securities regulatory regime, making a single regulator more efficient than numerous regulators. Perhaps the most significant advantage of uniformity in securities law is that it facilitates comparisons of different firms' securities. Investors value the ability to compare firms prior to making their investment decisions. Securities that can be more readily compared with others become more marketable and thus more valuable.¹⁶⁵

In view of the network externalities just mentioned, a market for securities law would be unlikely to remain competitive for long. Sooner or later, a single regulator would come to dominate it, as large market share would make its law more valuable than others. That regulator could then use its market power to engage in uncompetitive behavior. In general, when a new market for a network product forms, it is initially marked by aggressive competition among producers to determine whose network will dominate, followed by weak competition once consumers have made their choice.¹⁶⁶ Competition among states in a new market for securities law could be weak from the outset. One state—Delaware—is already the dominant regulator in the market for corporate law. Even if Delaware corporations could choose any state securities law without having to [*1951] reincorporate, they would probably prefer Delaware law for the following reasons.¹⁶⁷

164. See Romano, *Empowering Investors*, supra note 9 (espousing competition among states in the national arena and among countries in the international arena). For other proposals to establish a market for securities laws, see Choi & Guzman, supra note 11 (espousing competition among countries); Paul G. Mahoney, *The Exchange as Regulator*, 83 Va. L. Rev. 1453 (1997) (espousing competition among exchanges).

165. See Kahan & Klausner, *Economics of Boilerplate*, supra note 4, at 723-24 (arguing that standardization in corporate contracting facilitates comparison of firms by investors and securities analysts); cf. Gerald D. Gay & Joanne T. Medero, *The Economics of Derivatives Documentation: Private Contracting as a Substitute for Government Regulation*, 3 J. Derivatives 78, 81 (1996) (noting that standardization in documentation of derivatives contracts lowers the cost of capital by reducing drafting costs, increasing liquidity, and improving transparency).

166. See Besen & Farrell, supra note 78, at 119.

167. This is also the prediction on which Romano's proposal is based. See Romano, *Empowering Investors*, supra note 9, at 2391-92. The proposal to establish an interstate market

First, there would be no a priori reason for another state to be more attractive.¹⁶⁸ Instead of incurring the cost of identifying the best securities law among fifty states' laws (and being subject to freeriding by other corporations), Delaware corporations would be inclined to choose Delaware.¹⁶⁹ Being a focal point, Delaware securities law would attract corporations even if it were no better—or slightly worse—than other securities laws, simply because corporations would expect it to become the dominant network.¹⁷⁰ Moreover, Delaware would have the advantage of a judiciary proficient in corporate matters, and the advantage of a credible commitment to responsiveness to corporate needs.

Second, Delaware could actively use its power in the market for corporate law to obtain power in the market for securities law, by applying its securities law to its chartered firms.¹⁷¹ Given the various competitive advantages supporting Delaware in the market for corporate law, corporations would be reluctant to respond by reincorporating elsewhere, even if Delaware's securities law were somewhat worse than other securities laws. And once Delaware's securities law were established as the dominant law, it would become a source of market power in itself.

The prediction that Delaware would come to dominate a market for securities law soon after its inception should be qualified if, as the proposal suggests, firms would be allowed to continue using federal law.¹⁷² While Delaware would be likely to defeat other states in a new market for securities law, it would be less likely to defeat the federal government in [*1952] such a market. The federal government could match, and possibly surpass, Delaware's competitive advantages with its own. Currently, federal securities law

for securities law favors letting firms be governed by the state law of their choice over automatic application of a state's securities law to its chartered firms. See *id.* at 2408-10. The arguments I discuss in the text offer an additional reason to reject the latter alternative. Delaware firms confronted with the choice of being subject to Delaware securities law or forgoing the benefits of Delaware incorporation will tend to accept Delaware securities law, even if it is somewhat worse than other securities laws.

168. In fact, at least initially it is possible that states' securities laws will be similar to the current federal securities law. See Carney, *supra* note 56, at 741-45 (describing free-riding by states of the Model Business Corporation Act).

169. This inclination will also be reinforced by cognitive biases discouraging experimentation. See Kahan & Klausner, *Path Dependence*, *supra* note 63, at 359-64.

170. See Katz & Shapiro, *Systems Competition*, *supra* note 78, at 425. The initial establishment of Delaware as a dominant network is likely to be accelerated through herding. After Delaware is chosen by some corporations, subsequent corporations will follow suit for fear of being stranded from the future network. See Jay Pil Choi, *Herd Behavior, the "Penguin Effect," and the Suppression of Informational Diffusion: An Analysis of Informational Externalities and Payoff Interdependency*, 28 *RAND J. Econ.* 407, 408-09 (1997).

171. See generally Louis Kaplow, *Extension of Monopoly Power Through Leverage*, 85 *Colum. L. Rev.* 515 (1985); Joseph Kattan, *Market Power in the Presence of an Installed Base*, 62 *Antitrust L.J.* 1 (1993) (describing leverage of market power).

172. See Romano, *Empowering Investors*, *supra* note 9, at 2365, 2391.

applies to all nonexempt issuers on the market, and so constitutes the largest network possible. It thus offers valuable network externalities that firms may not wish to lose.¹⁷³ Further, federal law allows firms to benefit from no-action letters issued by the Securities and Exchange Commission. Compliance with these letters eliminates the risk of being sued by the government and reduces the risk of private suits.¹⁷⁴ Even if Delaware formed an agency that provides similar services, its lack of experience would put it at a disadvantage. Last, should the Securities and Exchange Commission compete with state regulators, it would be even more committed to corporate needs than Delaware. Its very existence and budget would hinge on its ability to successfully market its law.

While it is hard to predict the exact outcome of permitting competition in securities law, one can expect such competition to become dominated by a single regulator. Whether that regulator is Delaware or the federal government, it will face only loose market constraints and be able to engage in uncompetitive behavior—such as charging an inflated price for its law, or entrenching its dominance through legal indeterminacy.¹⁷⁵ This is not to say that competition in securities law is undesirable. Even imperfect competition would likely be an improvement upon the current federal monopoly, provided that it constituted a race to the top as the proposal suggests. The magnitude of that improvement, however, would likely be more modest than that of perfect competition, and may not justify the cost of implementing the change.¹⁷⁶ [*1953]

173. Related to this point is the incomplete body of securities case law in Delaware. Although Delaware can import federal law to compensate for this disadvantage, this will undermine the objective of the proposal to improve upon current federal law. See *id.* at 2395. It is also doubtful that firms will trade federal law for Delaware law in this event.

174. For an overview of no-action letters and their legal implications, see Donna M. Nagy, *Judicial Reliance on Regulatory Interpretations in SEC No-Action Letters: Current Problems and a Proposed Framework*, 83 *Cornell L. Rev.* 921, 929-87 (1998).

175. While a complete taxonomy of federal securities law is beyond the scope of this Article, it seems fair to describe it as more determinate than Delaware corporate law. To be sure, some areas of securities law demonstrate similar indeterminacy. Compare *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976), with *Rosenblatt v. Getty Oil Co.*, 493 A.2d 929, 944 (Del. 1985) (employing an identical open-ended test of materiality to determine what information should be disclosed to investors). But many areas of federal securities law offer clarity where Delaware corporate law does not. One example is the use of safe harbor rules in federal securities law, which is absent in Delaware corporate law. See *supra* notes 55-56 and accompanying text.

176. In addition to the costs of legislation and operation of state enforcement authorities duplicating the work done today by the Securities and Exchange Commission, implementing the proposal would increase transaction costs. Competition would require investors to become informed about firms' securities domicile choice, and to evaluate that choice. See Romano, *Empowering Investors*, *supra* note 9, at 2396.

E. *Investment Patterns*

Throughout most of this century, the separation of corporate ownership and corporate control was widely believed to have arisen from an economically driven fragmentation of ownership.¹⁷⁷ Recently, this opinion has been giving way to the less deterministic view that the fragmentation of corporate ownership and pacification of investors could be the outcome of path dependence and legislation supported by interest groups and public sentiment.¹⁷⁸ This Article suggests that the active judicial stance in corporate governance may have facilitated this process.

While federal law pacified investor voice by constraining equity accumulation and voting, state courts did the same by broadening the scope of managerial fiat.¹⁷⁹ This created the need for alternative means of protecting investors, which was at least partially met by extensive judicial oversight of corporate governance.¹⁸⁰ The substitutability between investor voice and judicial oversight facilitated the fragmentation of corporate ownership, as judicial activism filled a gap created by shareholder pacification. Today, the discussion of investor passivity focuses on large institutional investors, whose passivity is explained by a combination of legal and economic constraints.¹⁸¹ Whatever the reasons for institutional investor passivity, the complementary activism of the courts only adds to them. This Article suggests that this path-dependent equilibrium may well be inefficient.¹⁸² Nevertheless, to the extent that corporate law has become reliant on judges, and legal and economic institutions have adapted to the centrality of courts, this equilibrium is now difficult to change.

177. See Berle & Means, *supra* note 12, at 47-68, 277-87.

178. See Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* 7-8 (1994).

179. See William Carney, *Fundamental Corporate Changes, Minority Shareholders, and Business Purposes*, 1980 *Am. B. Found. Res. J.* 69, 89 (documenting a gradual shrinkage of shareholder voting rights early in the century).

180. See Black & Kraakman, *supra* note 46, at 1974-75 (arguing that active courts compensate for fragmentation and lack of investor voice); Andrei Shleifer & Robert W. Vishny, *A Survey of Corporate Governance*, 52 *J. Fin.* 737, 755, 771 (1997) (same).

181. See Bernard S. Black & John C. Coffee, Jr., *Hail Britannia?: Institutional Investor Behavior Under Limited Regulation*, 92 *Mich. L. Rev.* 1997, 2055-77 (1994); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 *Mich. L. Rev.* 520, 523 (1990); John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 *Colum. L. Rev.* 1277, 1317-28, 1342-45 (1991); Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 *Geo. L.J.* 445, 453-78 (1991).

182. See Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 *Harv. L. Rev.* 641, 643-44 (1996) (explaining how path dependence may lead to an inefficient outcome).

[*1954] CONCLUSION

Participants in the state competition controversy agree that, to date, Delaware is the undisputed winner. They part company only on why. Whereas race-to-the-bottom adherents argue that Delaware attracts corporate managers to the detriment of investors, race-to-the-top adherents argue that the interests of investors and managers are aligned, rendering Delaware's law advantageous to both. What has thus far received little attention is that, no matter where the race is headed, it may not be a race among equals. That Delaware has commanded the market for corporate chartering for close to a century raises the suspicion that the market for corporate law is not perfectly competitive. What has been missing from the debate is the possibility that Delaware utilizes its market power to enhance its competitive position.

This Article attempts to fill this gap in the state competition story. According to the amended story, Delaware's preeminence is reinforced by the indeterminate nature of its law, which makes it impractical to copy. Although indeterminacy may not be optimal, it secures barriers to entry—such as network externalities, judicial advantage, and credible commitment—that protect Delaware. This strategy need not have been pre-meditated. Judicial tendencies, the interests of the bar, investor apathy, and the general legal culture may have serendipitously combined to encourage it.

This leads to a more general reflection on the nature of corporate law. The centrality of the courts is a unique feature of American corporate law.¹⁸³ The sophistication and reliability of American courts do not explain the stark difference between the American system and those of other developed countries.¹⁸⁴ It has been commonplace to compare corporate governance in the United States with that in other industrialized countries such as Germany, Britain, and Japan. Yet in none of those countries do courts play a role in corporate law similar to that played by courts in the United States.¹⁸⁵ It is implausible that courts in those coun- [*1955] tries are inherently less

183. See Charkham, *supra* note 141, at 357; John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 *Colum. L. Rev.* 1618, 1620-28 (1989).

184. The American uniqueness is readily explicable when comparing corporate law in the United States with the law suitable for countries that have a history of corruption and judicial inexperience. In contrast to their American counterparts, courts in such countries may lack the sophistication and reliability to handle complex corporate disputes. See Black & Kraakman, *supra* note 46, at 1920-29 (contrasting Russia with the United States).

185. See Black & Coffee, *supra* note 181, at 2065 (Britain); Charkham, *supra* note 141, at 315 (same); Curtis J. Milhaupt, *A Relational Theory of Japanese Corporate Governance: Contract, Culture, and the Rule of Law*, 37 *Harv. Int'l L.J.* 3, 34, 54-57 (1996) (documenting the paucity of derivative litigation in Japan until recently); Mark D. West, *The Pricing of Shareholder Derivative Actions in Japan and the United States*, 88 *Nw. U. L. Rev.* 1436, 1436-38, 1493 (1994) (same); Edward B. Rock, *America's Shifting Fascination with Comparative Corporate Governance*, 74 *Wash. U. L.Q.* 367, 390-91 (1996) (Germany).

equipped than their American counterparts to handle corporate disputes. If corporate governance by courts were optimal, then a comparable role for the judiciary might have developed in at least one of those countries as well. That it has not suggests that the American model may not be optimal, but rather an outcome of the peculiar evolution of American corporate law.¹⁸⁶

If there were no reason to question the efficiency of the American model, its uniqueness could be dismissed as an efficient adaptation to the idiosyncratic conditions of this country.¹⁸⁷ This Article offers such reasons, by explaining the centrality of adjudication in American corporate law as a product of state competition. Rather than being a virtue, judicial predominance is what allows one state to maintain its dominance in the market for corporate law. By being judge-oriented, Delaware corporate law becomes a proprietary product of Delaware, one that other states find difficult to match.

186. This point is also demonstrated by comparing the centrality of corporate litigation in the United States to its marginality in Canada. One explanation for the restrictive approach taken by Canadian provinces toward corporate litigation is that provinces do not compete in corporate chartering as American states do. See Romano, *The Genius of American Corporate Law*, *supra* note 6, at 127.

187. See Ronald J. Gilson, *Corporate Governance and Economic Efficiency: When Do Institutions Matter?*, 74 *Wash. U. L.Q.* 327, 334-39 (1996); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function* 7-11 (Dec. 5, 1997) (unpublished manuscript, on file with the *Columbia Law Review*) (explaining different corporate governance systems as a product of the efficient adaptation to different initial conditions of industrial organization).

Consider price competition between Delaware (State 1) and another state (State 2) in a market with a total of Q corporations. The cost to any state i of producing law, c_i , includes a fixed component and a variable component, such that $c_i = aq_i + b$, where q_i is the number of corporations using the state's legal services, and a and b are nonnegative. Although the cost functions of both states in this model are identical for convenience, the comparative static results derived below do not change in the more general case, where $c_i = a_iq_i + b_i$.

Corporations value incorporation outside Delaware at $v_2 - y$, where $v_2 > y = 0$. The special case of $y = 0$ is when Delaware adopts determinate law, which does not exclude the rival law from network externalities. When Delaware adopts indeterminate law, it excludes the rival law from network externalities and so reduces its value by $y > 0$.

Corporations value incorporation at Delaware higher, due to advantages other than network externalities. Corporations vary in the degree to which they benefit from such advantages. The value corporations assign to Delaware law is uniformly distributed between $v_1 - x$ and $v_2 - x$, where $v_1 > v_2$ and $x = 0$. The special case of $x = 0$ is when Delaware adopts determinate law, which is worth more than indeterminate law. When Delaware adopts indeterminate law, the value of the law decreases by $x > 0$. While the value assigned to Delaware law is bounded below by $v_2 - x$ for convenience, the comparative static results derived below do not change in the more general case, where that value is bounded below by any $v - x$, where $v_2 = v < v_1$.

Delaware charges a price of p_1 for its law, and its rival charges a price of p_2 for its law, where $p_1 = v_1 - x$ and $p_2 = v_2 - y$ (lest corporations forgo incorporation altogether). Delaware's profit is thus

$$p_1 = q_1 p_1 - c_1 = q_1 (p_1 - a) - b.$$

Similarly, its rival's profit is

$$p_2 = q_2 (p_2 - a) - b.$$

The difference between the price charged by Delaware and the price charged by its rival ($p_1 - p_2$) determines the number of corporations in each state. If $p_1 - p_2 < y - x$, all corporations choose Delaware, whose law is sufficiently superior as to compensate for its higher price. This hypothetical never occurs, because, assuming that $a + b < v_2 - y$, the rival can reduce p_2 , given p_1 , and stay in the market. If $p_1 - p_2 > (v_1 - x) - (v_2 - y)$, no corporation chooses Delaware, since no corporation values Delaware's advantages by more than $(v_1 - x) - (v_2 - y)$. This hypothetical never occurs either, because if $a + b < v_2 - y$ then also $a + b < v_1 - x$, and so Delaware can reduce p_1 , given p_2 , and stay in the market. If $y - x < p_1 - p_2 < (v_1 - x) - (v_2 - y)$, corporations that value the advantages of Delaware highly enough to com-

pensate for its higher price incorporate in Delaware, and the remainder incorporate in the other state. Specifically, the number of corporations chartered in Delaware is

$$[*1957] \quad q_1 = Q \left(1 - \frac{(p_1 - p_2) - (y - x)}{v_1 - v_2} \right), \quad (1)$$

and the number of corporations chartered in the rival state is

$$q_2 = Q \frac{(p_1 - p_2) - (y - x)}{v_1 - v_2}. \quad (2)$$

Examine now the respective profits of Delaware and its rival. Delaware profits by $p_1 = q_1 (p_1 - a) - b$, which equal

$$p_1 = Q \left(1 - \frac{(p_1 - p_2) - (y - x)}{v_1 - v_2} \right) (p_1 - a) - b. \quad (3)$$

Its rival accordingly profits by $p_2 = q_2 (p_2 - a) - b$, which equals

$$p_2 = Q \frac{(p_1 - p_2) - (y - x)}{v_1 - v_2} (p_2 - a) - b. \quad (4)$$

The price set by Delaware affects the price set by its rival, and vice versa. In Nash equilibrium, neither state profits from changing its price, given the price of its rival.

Lemma. In equilibrium, the price of each state and the number of corporations in each state are given by

$$p_1 = \frac{3a + 2(v_1 - v_2) + (y - x)}{3}; \quad (5)$$

$$p_2 = \frac{3a + (v_1 - v_2) - (y - x)}{3}; \quad (6)$$

$$q_1 = Q \left(1 - \frac{(v_1 - v_2) - (y - x)}{3(v_1 - v_2)} \right); \quad (7)$$

$$q_2 = Q \left(\frac{(v_1 - v_2) - (y - x)}{3(v_1 - v_2)} \right); \quad (8)$$

Proof. From Equation (3), it is clear that Delaware's profit is continuously differentiable and concave in p_1 . Therefore, the first-order condition is sufficient for a maximum. This condition is

$$\frac{\partial p_1}{\partial p_1} = \frac{\partial}{\partial p_1} \left[Q \left(1 - \frac{(p_1 - p_2) - (y - x)}{v_1 - v_2} \right) (p_1 - a) - b \right] = 0.$$

Solving for p_1 , we find

$$p_1 = \frac{1}{2} [a + (v_1 - v_2) + (y - x)] + \frac{p_2}{2} \quad (9)$$

This is Delaware's optimal choice of p_1 , given p_2 . Similarly, the rival state maximizes its profit when

$$\frac{\partial p_2}{\partial p_2} = \frac{\partial}{\partial p_2} \left(Q \frac{(p_1 - p_2) - (y - x)}{v_1 - v_2} (p_2 - a) - b \right) = 0,$$

which yields

$$[*1958] p_2 = \frac{1}{2} [a - (y - x)] + \frac{p_1}{2}. \quad (10)$$

Solving Equations (9) and (10) for p_1 and p_2 gives Equations (5) and (6).

Examine now the number of corporations chartered in each state. For this examination, we must first calculate the price difference between Delaware and its rival. Using the above equilibrium prices, the difference is

$$p_1 - p_2 = \frac{(v_1 - v_2) + 2(y - x)}{3}. \quad (11)$$

Substituting the right-hand side of Equation (11) for $p_1 - p_2$ in Equations (1) and (2) gives Equations (7) and (8). Q.E.D.

Proposition Delaware's profit increases (and its rival's profit decreases) in $y - x$, that is when by adopting indeterminate law it reduces the value of its rival's law more than it reduces the value of its own.

Proof. Given the equilibrium price and quantity in Equations (5) and (7), Delaware's profit, $q_1(p_1 - a) - b$, equals

$$p_1 = Q \left(1 - \frac{(v_1 - v_2) - (y - x)}{3(v_1 - v_2)} \right) \left(\frac{3a + 2(v_1 - v_2) + (y - x)}{3} - a \right) - b,$$

which simplifies to

$$p_1 = \frac{Q}{9(v_1 - v_2)} [2(v_1 - v_2) + (y - x)]^2 - b. \quad (12)$$

Similarly, given the equilibrium price and quantity in Equations (6) and (8), the rival state's profit, $q_2(p_2 - a) - b$, equals

$$p_2 = Q \left(\frac{(v_1 - v_2) - (y - x)}{3(v_1 - v_2)} \right) \left(\frac{3a + (v_1 - v_2) - (y - x)}{3} - a \right) - b,$$

which simplifies to

$$p_2 = \frac{Q}{9(v_1 - v_2)} [(v_1 - v_2) - (y - x)]^2 - b. \quad (13)$$

It is readily apparent that p_1 increases, and p_2 decreases, in $y - x$. This is a direct result of the Lemma, according to which p_1 and q_1 increase, and p_2 and q_2 decrease, in $y - x$. Q.E.D.

[*1959] APPENDIX B

THE PERCENTAGE OF CORPORATE CASES OF THE TOTAL NUMBER OF CASES
FILED IN THE DELAWARE COURT OF CHANCERY*

Year	Corporate Cases	All Cases	% of All Cases
1980	56	116	48.3
1981	122	217	56.2
1982	240	379	63.3
1983	175	357	49.0
1984	326	482	67.6
1985	274	433	63.3
1986	305	462	66.0
1987	569	732	77.7
1988	840	1003	83.7
1989	603	786	76.7
1990	380	580	65.5
1991	313	509	61.5
1992	254	434	58.5
1993	311	479	64.9
1994	476	642	74.1
1995	634	808	78.5
1996	494	683	72.3
1997	542	672	80.7
1998**	495	642	77.1
Total	7409	10,416	71.1

Source: Delaware Court of chancery

* Until 1984, there were three judges sitting on the Delaware Court of Chancery. The number was increased to four judges in 1984, and to five judges in 1989.

** Cases files between January 1, and November 1, 1998.