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**The Myth of State Competition in Corporate Law**  
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**Marcel Kahan and Ehud Kamar**

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# ARTICLES

## The Myth of State Competition in Corporate Law

Marcel Kahan\* & Ehud Kamar\*\*

*This Article challenges the conventional wisdom that states compete for incorporations. Delaware aside, no state stands to gain meaningful tax revenues or legal business from chartering firms, and no state takes significant steps to attract incorporations. The explanation for this apathy lies in a combination of economic entry barriers and political factors. This analysis of the market for incorporations has implications for the present structure of corporate law, for the desirability of federal intervention, and for theories of regulatory competition in general.*

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\* Professor of Law, New York University.

\*\* Assistant Professor of Law, University of Southern California.

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INTRODUCTION.....	681
I. WHAT CAN STATES GAIN FROM COMPETING?.....	687
A. Taxes.....	687
1. Annual franchise taxes.....	688
2. Initial incorporation taxes.....	691
3. Illustration: Nevada's tax revenues.....	693
B. Legal Business .....	694
1. Delaware's legal business.....	694
2. The benefits of additional legal business.....	698
C. Potential Objections.....	699
1. Defensive competition.....	699
2. The correlation between tax revenues and corporate legislation.....	700
II. WHAT DO STATES DO TO COMPETE?.....	701
A. Statutory Law .....	701
1. The Model Business Corporation Act.....	702
2. Antitakeover statutes.....	703
3. Other statutory revisions.....	704
B. Judge-Made Law .....	707
C. The Court System .....	708
D. Potential Objections.....	715
1. Diffusion of statutory innovations.....	715
2. Nevada.....	716
3. Maryland.....	721
4. Promotional activities.....	722
5. Historic competition.....	723
III. WHY DO STATES NOT COMPETE?.....	724
A. Economic Entry Barriers .....	725
B. The Political Contingency of State Competition.....	727
1. States as profit seekers.....	728
2. Political constraints.....	730
IV. IMPLICATIONS.....	735
A. The Laws of Noncompeting States.....	736
1. Shareholder protection.....	736
2. Predictability and innovation.....	738
B. Delaware Law .....	739
1. Shareholder protection.....	739
2. Quality and predictability.....	741
3. Incentives to innovate.....	742
4. The Delaware advantage.....	742
C. The Federalism Debate .....	743
1. Shareholder protection.....	743
2. Predictability.....	746
3. Incentives to innovate.....	747
D. Regulatory Competition Theory.....	747
CONCLUSION .....	748

## Tables

TABLE 1: MARGINAL REVENUES FROM ANNUAL TAXES.....	690
TABLE 2: MARGINAL REVENUES FROM INITIAL INCORPORATION FEES .....	692
TABLE 3: AVERAGE INCOME OF ATTORNEYS BY STATE.....	696
TABLE 4: BUSINESS COURTS.....	711

## INTRODUCTION

That states compete for incorporations of public companies has long been a dominant paradigm in corporate legal scholarship.<sup>1</sup> According to this paradigm, states derive substantial benefits from having corporations domicile in them and accordingly engage in significant efforts to attract incorporations. Since a company can incorporate in any state regardless of where it conducts its operations, the legal domicile affects how corporate disputes between directors and shareholders are resolved—and nothing else. State competition for incorporations is thus viewed as a textbook example of regulatory competition.

The competition paradigm has spawned a long debate about the desirability of federalism in corporate law.<sup>2</sup> Race-to-the-bottom scholars argue that managers control incorporation decisions and that states therefore compete by offering laws that cater to managers' personal interests at the expense of shareholders.<sup>3</sup> Race-to-the-top scholars argue that companies incorporate where their value is the highest and that states accordingly compete by offering laws that afford optimal shareholder protection.<sup>4</sup>

1. Early treatments of the state competition for incorporations date to the nineteenth century. See WILLIAM W. COOK, *A TREATISE ON STOCK AND STOCKHOLDERS* 1604-05 (3d ed. 1894) (noting that federalism in corporate law in the United States is driving some states to liberalize their corporate statutes); Edward Q. Keasbey, *New Jersey and the Great Corporations* (pt. 1), 13 HARV. L. REV. 198, 201-02 (1899) (same). Contemporary scholars claim that states still vie for incorporations today. See, e.g., Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 961 (2001) (arguing that states compete for corporate charters); Jonathan R. Macey, *Smith v. Van Gorkom: Insights About C.E.O.s, Corporate Law Rules, and the Jurisdictional Competition for Corporate Charters*, 96 NW. U. L. REV. 607, 625 (2002) (same).

2. A doctoral dissertation written long before state competition for incorporation became the cause celebre in the legal academy anticipated the main views in this debate. See RUSSELL CARPENTER LARCOM, *THE DELAWARE CORPORATION* v-vi (1937) ("Two points of view may be held concerning the effects of this kind of law making in the competing states. On the one hand it may be maintained that, in the effort to procure revenue, law making is reduced to a competitive basis and that this is undesirable, or at least of questionable social value . . . . The other point of view visualizes this competition, induced perhaps by selfish motives, as leading to progress.").

3. See, e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1441 (1992) (arguing that state competition leads to rules biased towards managerial interests); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974) (arguing that state competition results in a race to the bottom).

4. See, e.g., Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on*

The stakes of the debate are high. Empirical evidence suggests that domicile choices affect the value of companies by several percentage points.<sup>5</sup> With market capitalization of public corporations in the United States in the range of \$16 trillion,<sup>6</sup> the dynamics that shape the laws states offer to govern the internal affairs of companies are of substantial importance.

But the significance of the competition paradigm extends beyond corporate law. Competition theorists in other legal fields regularly derive lessons from the putative competition for incorporations, draw parallels to it, or distinguish between it and competition in other areas.<sup>7</sup> Thus, for example, the proposal to repeal federal securities law and devolve responsibility for regulation on the states is explicitly based on the view that state competition for incorporations is effective and beneficial.<sup>8</sup> Similarly, the debate over how financial institutions should be regulated parallels the debate over state competition for incorporations.<sup>9</sup> By contrast, the premise for the proposal that states should have greater authority over the design of environmental protection is that the competitive dynamics in this area differ from those in corporate law.<sup>10</sup> Other

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*Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 915 (1982) (challenging Cary's analysis); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 280-81 (1985) (adducing evidence that state competition results in a race to the top); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) (arguing that state competition results in a race to the top).

5. See Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001).

6. See SEC. INDUS. ASS'N, 2001 SECURITIES INDUSTRY FACT BOOK 48 (2001), available at [http://www.sia.com/reference\\_materials/pdf/2001FactBook.pdf](http://www.sia.com/reference_materials/pdf/2001FactBook.pdf).

7. For an early analysis of state competition in other areas of law drawing on the lessons of competition in corporate law, see Raymond T. Zillmer, *State Laws: Survival of the Unfit*, 62 U. PA. L. REV. 509 (1914) (arguing that states race to the bottom in insurance law, labor law, family law, tax law, and environmental law just as they do in corporate law).

8. See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2361 (1998) (comparing a proposed system of state competition in securities regulation to the purported state competition for incorporations); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQ. L. 387, 507-13 (2001) [hereinafter Romano, *International Securities Regulation*] (defending a proposal to permit state competition for securities regulation by arguing that states effectively compete for incorporations); see also Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 906 (1998) (analogizing the purported state competition for incorporations to a proposed system of regulatory competition among countries in securities regulation); Frank Partnoy, *Multinational Regulatory Competition and Single-Stock Futures*, 21 NW. J. INT'L L. & BUS. 641, 641 (2001) (analyzing regulatory competition with regard to single-stock futures).

9. See Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 THEORETICAL INQ. L. 649, 654 (2001) (noting parallels); see also Mark David Wallace, *Life in the Boardroom After FIRREA: A Revisionist Approach to Corporate Governance in Insured Depository Institutions*, 46 U. MIAMI L. REV. 1187 (1992) (analyzing the regulation of savings and loans).

10. See Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the*

fields drawing on the notion that states compete for incorporations include bankruptcy law,<sup>11</sup> state tax law,<sup>12</sup> limited liability company law,<sup>13</sup> blue sky law,<sup>14</sup> secured transactions law,<sup>15</sup> corporate law in the European Union,<sup>16</sup>

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*"Race-to-the-Bottom" Rationale for Federal Environmental Regulation*, 67 N.Y.U. L. REV. 1210, 1235 (1992) (arguing that, unlike in corporate law, state regulation of environmental law will not result in a race to the bottom); *see also* Jonathan H. Adler, *Wetlands, Waterfowl, and the Menace of Mr. Wilson: Commerce Clause Jurisprudence and the Limits of Federal Wetland Regulation*, 29 ENVT'L L. 1, 44 (citing state competition for incorporations to support claim that competition in environmental law will not result in a race to the bottom); Daniel C. Esty, *Revitalizing Environmental Federalism*, 95 MICH. L. REV. 570, 633-34 (1996) (arguing that competition in environmental law will work less well than in corporate law); Peter P. Swire, *The Race to Laxity and the Race to Undesirability: Explaining Failures in Competition Among Jurisdictions in Environmental Law*, 14 YALE J. ON REG. 67, 74 (1996) (noting that confusion over the meaning of "race to the top" extends from corporate chartering to environmental legislation).

11. See, e.g., Wells M. Englewood, *Cleaning Up the Pigsty: Approaching a Consensus on Exemption Laws*, 74 AM. BANKR. L.J. 275, 296-97 (2000) (citing competition for incorporations to support the claim that state competition in bankruptcy exemption laws will result in a race to the bottom); Lynn M. LoPucki & Sara D. Kalin, *The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a "Race to the Bottom,"* 54 VAND. L. REV. 231, 232-37 (2001) (comparing state competition for incorporations to bankruptcy venue choices); Robert K. Rasmussen & Randall S. Thomas, *Timing Matters: Promoting Forum Shopping by Insolvent Corporations*, 94 NW. U. L. REV. 1357, 1382-406 (2000) (drawing on the competition-for-incorporations literature to propose reforms in bankruptcy venue rules); David A. Skeel, Jr., *Lockups and Delaware Venue in Corporate Law and Bankruptcy*, 68 U. CIN. L. REV. 1243, 1270-79 (2000) (citing to competition for incorporations to argue against limitations on bankruptcy venue and forum shopping).

12. See Peter D. Enrich, *Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business*, 110 HARV. L. REV. 377, 380 (1996) (citing the corporate race-to-the-bottom literature to support a federal standard to judge the constitutionality of state tax incentives).

13. See Carol R. Goforth, *The Rise of the Limited Liability Company: Evidence of a Race Between the States, but Heading Where?*, 45 SYRACUSE L. REV. 1193, 1193-98 (1995) (drawing on the competition-for-incorporations literature to analyze whether widespread adoption of legislation authorizing the formation of limited liability companies can best be explained as a race to the bottom or a race to the top); Larry Ribstein, *Statutory Forms for Closely-Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L.Q. 369, 396-403 (1995) (comparing the dynamics of competition for incorporations by public companies and competition for incorporations by limited liability companies).

14. See Mark I. Steinberg, *The Emergence of State Securities Laws: Partly Sunny Skies for Investors*, 62 U. CIN. L. REV. 395, 395-98 (1993) (discussing an apparent inconsistency between a race to the bottom in corporate law and states offering investor-protective securities laws).

15. See Edward J. Janger, *Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom*, 83 IOWA L. REV. 569, 588-92 (1998) (drawing on the literature on state competition for incorporations to argue that drafters of uniform law may facilitate the adoption of inefficient rules).

16. See, e.g., 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 (1991) (using the state competition paradigm to analyze whether corporate law in the European Union should be harmonized);

antitrust law,<sup>17</sup> computer law,<sup>18</sup> welfare law,<sup>19</sup> choice of law,<sup>20</sup> trust law,<sup>21</sup> campaign finance law,<sup>22</sup> and legal ethics.<sup>23</sup> In short, the state competition paradigm has profoundly influenced the scholarship on corporate law and several other legal areas.

The thesis of this Article is that the very notion that states compete for incorporations is a myth. Other than Delaware, no state is engaged in significant efforts to attract incorporations of public companies.<sup>24</sup> Modern

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Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350-56 (2001) (discussing possible implications of American-style competition for corporate charters in the European Union); Karsten Engsig Sorenson & Mette Neville, *Corporate Migration in the European Union*, 6 COLUM. J. EUR. L. 181, 186-87 (2000) (noting that European choice-of-law rules for corporations are justified as preventing an American-style race to the bottom).

17. See Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23, 35, 45-49 (1983) (drawing on state competition for charters to advocate a new antitrust state action doctrine).

18. See Brian D. McDonald, *The Uniform Computer Information Transactions Act*, 16 BERKELEY TECH. L.J. 461, 476-84 (2001) (drawing on the corporate state competition literature to analyze whether states will adopt uniform computer information transaction law).

19. See Sheryll D. Cashin, *Federalism, Welfare Reform, and the Minority Poor: Accounting for the Tyranny of State Majorities*, 99 COLUM. L. REV. 552, 557 n.14 (1999) (acknowledging the debate over whether competition leads to a race to the top or a race to the bottom in corporate law, and offering an alternative explanation for federal welfare regulation).

20. See Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 DEL. J. CORP. L. 999 (1994) (comparing the dynamics of state competition in the areas of corporate law and choice of law).

21. See Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 CORNELL L. REV. 1035, 1061-74 (2000) (arguing that, unlike in corporate law, state competition in trust law will result in a race to the bottom).

22. See Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103 (2002) (exploring the relevance of states' stance against corporate political speech for the corporate regulatory competition debate).

23. See H. Geoffrey Moulton, Jr., *Federalism and Choice of Law in the Regulation of Legal Ethics*, 82 MINN. L. REV. 73, 139 (1997) (analyzing whether, as in the corporate chartering field, state regulation of lawyers results in a race to the bottom).

24. We focus on competition for public corporations for two reasons. First, most of the prior literature relates to public corporations. See Bebchuk, *supra* note 3 (posing the argument in terms of public corporations); Romano, *supra* note 4 (analyzing stock price effects of reincorporations by public companies to determine whether state competition results in a race to the top); Winter, *supra* note 4 (arguing that forces emanating from the market for corporate control result in a race to the top). Second, the market for incorporations by public firms is segregated from the market for close corporations. See, e.g., Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 368, 377-78 (1992). The existing market structure is consistent with this segmentation: Half of the public firms in the United States are Delaware corporations, while most private firms incorporate in their respective home states or seek an alternative organizational form, even though Delaware assesses minimal franchise taxes on nonpublic corporations. See Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL

state competition scholars have misconstrued the incentives of states to attract incorporations, misinterpreted their actions, misunderstood the economic and political barriers that states face, and arrived at mistaken conclusions about the market for incorporations.

This is not to say that active competition for incorporations never existed; that none of the participants in state legislation cares about incorporations; that states do nothing that could attract incorporations; or that active competition for incorporations could not develop in the future. As we will discuss, competition may well have existed in the distant past;<sup>25</sup> some local lawyers may profit from incorporations;<sup>26</sup> states may adopt laws that make them more attractive as corporate domiciles;<sup>27</sup> and more serious competition could develop in the future.<sup>28</sup> Rather than make sweeping generalizations, we recognize the incorporation market for what it is. The picture we portray is one where states other than Delaware stand to derive only small benefits from attracting incorporations, and take at most half-hearted steps to that end.

Two contemporaneous works complement our analysis. In one study, Robert Daines presents evidence suggesting that the personal interest of lawyers advising companies, and not only the merits of state corporate laws, determines domicile choices.<sup>29</sup> These findings imply that one needs to reconsider not just the supply side of the incorporation market, but also its demand side. In another study, Lucian Bebchuk and Assaf Hamdani argue that states do not vigorously compete for incorporations.<sup>30</sup> Although Bebchuk and

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L. REV. 1205, 1227 (2001).

25. See *infra* Part II.D.5.

26. See *infra* Parts I.B.2, I.C.1, II.A.3.

27. See *infra* Part II.A.

28. See *infra* Part III.

29. See Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. (forthcoming 2002). Two other articles study incorporation patterns, but focus on why some states are more successful than others in attracting companies headquartered in them. See LUCIAN BEBCHUK & ALMA COHEN, FIRMS' DECISIONS WHERE TO INCORPORATE (Nat'l Bureau of Econ. Research, Working Paper No. 9107, 2002) (examining the effect of antitakeover statutes on incorporation choices), available at <http://papers.nber.org/papers/W9107>; Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2002) (same).

30. See Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Debate on State Competition over Corporate Charters*, 112 YALE L.J. (forthcoming 2002). Most legal scholars have taken the notion that states compete for incorporations as virtual gospel. See, e.g., sources cited *supra* notes 3-4. Prior work that is dubious about the extent of competition includes an article by us, where we expressed doubts about the extent of state competition but left a detailed examination of this issue to this Article, see Kahan & Kamar, *supra* note 24, at 1213-14, 1221 (2001) (noting that the structure of annual franchise taxes "casts doubt on the claim that states actively compete for incorporations," that "[no state] has made a determined effort to compete with Delaware," and that this inaction "may be attributed to political constraints, inattentiveness, or a perception that Delaware's competitive advantages are too formidable to overcome"), and an article by William Carney, which highlights the political aspects of the production of

Hamdani attribute this lack of competition to different causes and draw from it different normative implications than we do, their view that states do little today to compete accords with ours.

Our discussion proceeds as follows. Part I analyzes how much states stand to gain by competing. The most commonly alleged benefit that states derive from incorporations is tax revenues. We show, however, that no state other than Delaware structures its taxes to earn revenues from incorporations. The conventional wisdom that states compete to gain such revenues is just wrong. We also examine whether states would profit from attracting legal business associated with incorporations. We argue that any such profits would be rather modest.

Part II considers whether states engage in activities that reflect an effort to attract incorporations. We address three areas for action: the design of statutory law, the design of judge-made law, and the design of the court system. With respect to both the design of judge-made law and the design of the court system, we find no meaningful state activities. With respect to statutory law, we conclude that the activities of states are not principally directed to the goal of attracting incorporations.

Part III examines why the substantial profits that Delaware reaps from incorporations have not induced any other state to revamp its franchise tax structure and compete. Part of the answer, we argue, lies in the existence of economic entry barriers that protect Delaware. Another part is that Delaware's potential competitors are state bureaucracies that pursue political goals and operate under political constraints.

Part IV explores the implications of our analysis for the present structure of corporate law, for the desirability of federal intervention, and for regulatory competition theory in general. Because political factors shape legislation in noncompeting states, the laws of these states favor managers more than they would if states pursued incorporations. And because Delaware needs to respond to these laws in its own pursuit of incorporations, its law protects shareholders less than it would if other states competed, though more than the laws of noncompeting states. The lack of competition also affects other quality dimensions of corporate law. Among other things, it causes the laws of noncompeting states to be less predictable and less innovative, and Delaware

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corporate law, *see* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998). For passing suggestions that competition is less forceful than is alleged, *see* Mark J. Loewenstein, *Delaware as Demon: Twenty-Five Years After Professor Cary's Polemic*, 71 U. COLO. L. REV. 497, 507 (2000) (suggesting that "only a handful" of other states may be competing with Delaware); Ralph K. Winter, *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526, 1529 (1989) (suggesting that the race to the top "is a leisurely walk"). In addition to the new evidence that this Article offers on the reality of states' lethargy in the chartering arena, it departs from those works in arguing that the present dynamics are closer to a complete absence of competition than to merely imperfect competition, and accordingly draws different normative conclusions about the current legal regime.

law to be less predictable but more innovative, than each would be in the presence of competition. While politics would likely shape a federalized corporate law as well, the political dynamics on the federal level could differ from the dynamics in noncompeting states. It is therefore unclear whether a federal corporate law would offer more or less shareholder protection than current Delaware law. A federal corporate law, however, would likely be less innovative, and judge-made federal corporate law would likely be less predictable, than Delaware law.

### I. WHAT CAN STATES GAIN FROM COMPETING?

The most important component of the theory of state competition for incorporations is the claim that states derive significant benefits from attracting incorporations. According to conventional wisdom, these benefits emanate primarily from franchise taxes assessed on incorporated firms, and secondarily from legal business generated by incorporations. Alas, the conventional wisdom is wrong. Other than Delaware, no state structures its taxes to gain from incorporations or stands to reap substantial benefits from legal business by attracting incorporations. In Part I.A, we examine the tax structures that states employ. In Part I.B, we estimate the gains that states can expect to derive from legal business if they attract incorporations. In Part I.C, we address potential challenges to our analysis.

#### A. Taxes

Commentators regularly assert that franchise tax revenues drive states to compete for incorporations.<sup>31</sup> In all states other than Delaware, however,

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31. See, e.g., ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 15-16 (1993); Bebchuk, *supra* note 3, at 1451; Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 548-49 (1990); Cary, *supra* note 3, at 664; John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 650 (1999); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 841-42 (1995); Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 J. CORP. L. 185, 195 (1993); Romano, *International Securities Regulation*, *supra* note 8, at 511.

A few commentators have been more qualified regarding the claim that franchise taxes drive competition. See William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 306 (1997) ("States compete with each other for chartering business not only because it produces franchise tax revenues for the chartering state but also because interest groups within the state are benefited by this activity."); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1511 (1989) (remarking that legislatures, as public bodies, may also be guided by moral concerns, not just franchise taxes); Loewenstein, *supra* note 30, at 506-07 (noting that, in 33 states, franchise tax revenues presently account for 0.5% or less of total taxes collected); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (arguing that states design their corporate laws primarily to increase

franchise taxes are not structured to raise substantial revenues from incorporations, even if a state succeeded in attracting a substantial fraction of publicly traded companies.<sup>32</sup> The choice that state lawmakers have made in this regard indicates that they do not try to attract incorporations in order to boost tax revenues.

### 1. Annual franchise taxes.

Consider first annual franchise taxes, which provide the bulk of states' franchise tax revenues. Forty-five states, including the states viewed as Delaware's leading competitors, charge companies that are incorporated in them a low flat tax, a tax based on the amount of business conducted in the state, or both.<sup>33</sup> The former can generate only trivial revenues, even if a state attracted a large portion of the 10,000 to 12,000 companies with publicly traded shares.<sup>34</sup> The tax based on business conducted in the state does not generate any revenues from incorporations because a company incorporated in the state pays the same amount of tax as it would if it were incorporated elsewhere.<sup>35</sup> The remaining six states employ a tax structure that can result in higher taxes for domestically incorporated firms than for foreign firms.<sup>36</sup> With the exception of Delaware, however, none of these states would gain substantial amounts from attracting incorporations.

To illustrate this, we calculate in Table 1 the annual franchise taxes that each state would earn from chartering a hypothetical company with 100 million authorized shares with a par value of 0.1¢ per share, 60 million issued and outstanding shares, \$600 million worth of assets, and \$200 million in net worth. Column 2 presents the tax payable by such a company if it conducts no business in the state. Because such a company would pay no tax to the state if it incorporated in a different state, the entire amount represents the marginal tax revenue to the state from the company's incorporation in it. Column 3 presents the tax difference between a domestically incorporated company and an

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the legal business of their corporate bar, and only secondarily to increase franchise tax revenues). None, however, offers the direct evidence presented in this section that, Delaware aside, no state structures its franchise taxes to gain from incorporations.

32. States could be charging only small taxes in order to attract corporations while planning to raise their taxes once they had attracted a significant market share or had proven their worth and reliability as incorporation havens. While this may theoretically be possible, in our considerable research we have found no indication of such plans.

33. Throughout this Article, we will refer to the District of Columbia as a state.

34. See Kahan & Kamar, *supra* note 24, at 1219-22 (noting that flat annual fees generate only trivial marginal revenues).

35. The apportioned tax can generate small marginal revenues to the extent that a minimal tax is imposed even on firms that conduct no business in state. Table 1 takes account of such minimum fees.

36. These states are Delaware, Georgia, Nebraska, Rhode Island, Virginia, and West Virginia. Kahan & Kamar, *supra* note 24, at 1220 (describing the franchise tax structure in these states).

identical foreign company when both conduct business in the state.<sup>37</sup> This difference represents the marginal tax revenue to the state from incorporation by a hypothetical company that does at least some of its business in that state.

As Table 1 shows, other than Delaware, only Georgia would earn marginal revenues in excess of \$1000 from a company that conducted no business in it, and no state would earn marginal revenues in excess of \$20 from a company that did at least some business in it. Even if Georgia were to attract 2000 public companies, including all of the companies headquartered in it (a respectable 20% of the market, and fifteen times its present share), its additional annual revenues would amount to less than \$9 million.<sup>38</sup> Other states would earn much less. For example, Maryland would earn marginal revenues of no more than \$200,000 a year. Even if states currently charge the most they can for incorporations, revenues so low are unlikely to induce them to compete.

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37. The marginal annual tax payable by a domestic company in Alabama, Georgia, and Nebraska, and the marginal initial tax payable by a domestic company in Ohio and Rhode Island, depend on the amount of business the company conducts in the state. For these states, we assume that the hypothetical company conducts 20% of its business in the respective state. In all other cases, the marginal tax payable by a domestic company that conducts business in the state does not depend on the amount of business it conducts in the state.

38. About 200 public companies are headquartered in Georgia, and Georgia would derive no marginal revenues from these companies if they incorporated in-state. See BEBCHUK & COHEN, *supra* note 29, at A-5 (listing the number of public companies located in Georgia as 178). If the other 1800 public companies conducted no business in Georgia, Georgia's marginal revenue would be \$9 million.

TABLE 1: MARGINAL REVENUES FROM ANNUAL TAXES (\$)

State	Hypothetical Company with No Business in the State	Hypothetical Company with Business in the State <sup>*</sup>
Alabama	30	20
Alaska	50	-50
Arizona	45	0
Arkansas	0	0
California	20	0
Colorado	12.5	-37.5
Connecticut	75	-225
Delaware	150,000	149,950
District of Columbia	100	0
Florida	150	0
Georgia	5000	0
Hawaii	25	-100
Idaho	0	0
Illinois	25	0
Indiana	15	0
Iowa	30	0
Kansas	0	0
Kentucky	0	0
Louisiana	25	0
Maine	60	0
Maryland	100	0
Massachusetts	85	0
Michigan	15	0
Minnesota	0	-20
Mississippi	25	0
Missouri	40	0
Montana	10	0
Nebraska	455	-14,545
Nevada	85	0
New Hampshire	100	0
New Jersey	40	0
New Mexico	62.5	0
New York	4.5	0
North Carolina	10	0
North Dakota	25	0
Ohio	5	5
Oklahoma	10	0
Oregon	30	-190
Pennsylvania	300	0
Rhode Island	250	0
South Carolina	25	0
South Dakota	10	0
Tennessee	20	0
Texas	0	0
Utah	10	0
Vermont	15	-85
Virginia	850	0
Washington	50	0
West Virginia	340	-2160
Wisconsin	25	-25
Wyoming	0	0

Source: Compiled by authors.

\* Negative amounts mean that fees are higher for a foreign company doing business in the state than for a domestic company doing business in the state.

2. *Initial incorporation taxes.*

Another source of franchise tax revenues, albeit a less significant one, is initial incorporation fees.<sup>39</sup> Just like annual franchise taxes, initial incorporation fees do not provide a significant impetus to attract incorporations. Most states charge either a low flat fee or a low or capped fee based on the number or the par value of authorized shares. In these states, even public companies with a large number of authorized shares pay little in initial taxes. Moreover, in most states, similar initial fees are payable by foreign companies that do business in the state.

As Table 2 demonstrates, for a company with 100 million shares with a par value of 0.1¢, initial incorporation fees exceed \$10,000 in only six states: Connecticut (\$200,850); Kentucky (\$200,449); Massachusetts (\$100,000); Michigan (\$140,000); Ohio (\$100,000); and Rhode Island (\$200,420). These six states would have earned between \$8 million and \$16 million a year between 1986 and 2000 had they succeeded in attracting a 20% market share of firms going public.<sup>40</sup> A more typical state, such as Maryland, would have earned a trivial \$4800 a year.

While initial incorporation fees could generate modest financial benefits for a handful of states if they attracted a substantial share of incorporations, these fees are ill-designed to do so. Since companies derive benefits from being incorporated in a state only over time, a more effective pricing regime would tax companies over time. Delaware employs just such a regime. Employing a front-loaded franchise tax regime is particularly dubious for a state that is trying to challenge a dominant player like Delaware in the incorporation market. Such a state would presumably want to attract incorporations with low initial charges, rather than hit them with a large bill on day one and stop charging them additional tax thereafter.

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39. Similar fees are payable when domestic companies increase their authorized capital stock.

40. This assumes that the average public firm has 100 million authorized shares and that no firm conducts business in-state. Most companies have fewer authorized shares when they go public. For example, the average number of authorized shares in the 26 companies that incorporated in Nevada between 1996 and 2000 was 66 million.

TABLE 2: MARGINAL REVENUES FROM INITIAL INCORPORATION FEES (\$)

State	Hypothetical Company with No Business in the State	Hypothetical Company with Business in the State*	Fee Type or Base
Alabama	75	-105	Flat
Alaska	150	0	Flat
Arizona	60	-115	Flat
Arkansas	50	0	Flat
California	100	0	Flat
Colorado	50	-125	Flat
Connecticut	200,850	200,625	No. of Shares
Delaware	75	-75	Agg. Par Value
District of Columbia	120	-30	Agg. Par Value
Florida	138.75	0	Flat
Georgia	60	-110	Flat
Hawaii	100	-50	Flat
Idaho	100	0	Flat
Illinois	75	0	Flat
Indiana	90	0	Flat
Iowa	50	-50	Flat
Kansas	75	-20	Flat
Kentucky	200,449	200,366	No. of Shares
Louisiana	70	-30	Flat
Maine	120	-60	Agg. Par Value
Maryland	60	-2	Agg. Par Value
Massachusetts	100,000	99,700	No. of Shares
Michigan	140,000	139,940	No. of Shares
Minnesota	135	-65	Flat
Mississippi	50	-475	Flat
Missouri	83	-72	Agg. Par Value
Montana	1020	900	Agg. Par Value
Nebraska	300	170	Agg. Par Value
Nevada	310	0	Agg. Par Value
New Hampshire	85	0	Flat
New Jersey	125	25	Flat
New Mexico	1020	-5	No. of Shares
New York	175	-60	Agg. Par Value
North Carolina	135	-125	Flat
North Dakota	140	5	Agg. Par Value
Ohio	100,000	49,500	No. of Shares
Oklahoma	100	-200	Agg. Par Value
Oregon	50	-390	Flat
Pennsylvania	100	-80	Flat
Rhode Island	200,420	160,288	No. of Shares
South Carolina	110	0	Flat
South Dakota	110	0	Agg. Par Value
Tennessee	100	-500	Flat
Texas	300	-450	Flat
Utah	50	0	Flat
Vermont	75	-25	Flat
Virginia	2525	-65	No. of Shares
Washington	175	0	Flat
West Virginia	50	-50	Flat
Wisconsin	10,000	9900	No. of Shares
Wyoming	100	0	Flat

Source: Compiled by authors.

\* Negative amounts mean that fees are higher for a foreign company doing business in the state than for a domestic company doing business in the state.

3. *Illustration: Nevada's tax revenues.*

To show that tax revenues do not presently account for active pursuit of incorporations, we estimate the revenues of Nevada. Nevada, sometimes referred to as the Delaware of the West,<sup>41</sup> and by many accounts Delaware's leading competitor,<sup>42</sup> is one of few states that attracts more than a handful of corporations headquartered in other states.<sup>43</sup>

About 250 public companies are incorporated in Nevada, of which about 200 are headquartered outside Nevada.<sup>44</sup> According to Thompson Financial data, twenty-six companies went public as Nevada corporations between 1996 and 2000, of which eighteen companies were headquartered outside of Nevada. How much do these companies contribute to Nevada's till?

Nevada charges domestic companies an annual report fee of \$85 plus an additional annual business license fee that depends on the number of employees they have in Nevada. Both fees are also payable by foreign companies conducting business in Nevada. The marginal annual revenues to Nevada from the report fee are thus at most \$17,000.<sup>45</sup> Since being incorporated in Nevada has no effect on the number of employees in Nevada, incorporation in Nevada generates no marginal revenues from the business license fee.

In addition, Nevada earns one-time fees based on the aggregate par value of authorized capital stock when firms incorporate in the state or increase their capital stock. According to our calculations, the twenty-six companies that went public as Nevada corporations between 1996 and 2000 paid initial incorporation fees that totaled \$60,075. Of this, \$14,075 was paid by companies headquartered in Nevada, which would have paid the state a like amount even if they had incorporated elsewhere. Marginal one-time fees from companies that went public as Nevada corporations thus averaged \$9200 a year, and annual and initial incorporation fees taken together averaged \$26,200 a year.<sup>46</sup> Nevada surely does not compete in order to earn this amount.

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41. See, e.g., Keith Paul Bishop, *The Delaware of the West: Does Nevada Offer Better Treatment for Directors?*, INSIGHTS, Mar. 1993, at 20; Richard C. Reuben, *Step Right Up for Some Nevada Snake Oil*, CAL. LAW., July 1992, at 17.

42. See *infra* Part II.D.2. The two other states conventionally viewed as Delaware's most active competitors are Maryland and Pennsylvania.

43. The only other states that attract incorporations by companies headquartered outside the state are Delaware and Maryland. Maryland, however, mostly attracts real estate investment trusts and close-end mutual funds. See *infra* Part II.D.3.

44. See BEBCHUK & COHEN, *supra* note 29, at A-5 (217 companies, of which 172 are not headquartered in Nevada); Subramanian, *supra* note 29, at 1856 (217 companies, of which 175 are not headquartered in Nevada).

45. This assumes that only companies headquartered in Nevada do business in Nevada. To the extent that companies headquartered elsewhere do business in Nevada, Nevada's marginal revenues are lower.

46. This figure slightly understates Nevada's revenue because Nevada may have earned additional fees from existing public companies that increased their authorized capital stock or made similar filings.

### B. Legal Business

The second reason why states are thought to compete for incorporations is that incorporations increase the demand for the services of local law firms.<sup>47</sup> A company that is incorporated in, say, Minnesota, is presumably more likely than a similar company incorporated elsewhere to hire Minnesota lawyers to advise it on Minnesota corporate law. A Minnesota company is also more likely than a similar company incorporated elsewhere to be sued in Minnesota and employ Minnesota lawyers to represent it in court.<sup>48</sup>

Below we assess the potential gains to states and their lawyers from an increase in legal business flowing from incorporations. We begin by estimating the revenues to Delaware lawyers from Delaware's preeminence. We then argue that revenues do not equal profits, and that Delaware is situated differently from other states. The benefits other states and their lawyers can expect to receive from an increase in legal business are therefore rather small.

#### 1. *Delaware's legal business.*

Delaware residents derive financial gains from providing professional services to public corporations incorporated in the state. The bulk of these gains<sup>49</sup> go to corporate transactional lawyers and corporate litigators.<sup>50</sup> A

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47. See Bebchuk, *supra* note 3, at 1443; Klausner, *supra* note 31, at 771; Romano, *supra* note 4, at 240-41. Another benefit from incorporations is that unclaimed interest, dividend, and principal payments held by financial intermediaries as record owners can escheat to the state of incorporation of the intermediary. See *Delaware v. New York*, 507 U.S. 490 (1993) (holding that unclaimed funds escheat to the state of the last known address of the beneficiary and, if such address cannot be determined, to the state of incorporation of the intermediary holding the funds). In 1995, Delaware received \$220 million in one-time funds and an expected annual revenue stream of \$35 million from unclaimed assets that had accumulated over several years. Martha M. Canan, *Delaware Governor Lists His Priorities for Allocating Money from Settlement*, BOND BUYER, Jan. 20, 1995, at 3. This benefit does not accrue to states that charter other types of corporations.

48. Consistent with this hypothesis, Robert Daines finds that local lawyers recommend that their clients incorporate locally, rather than in Delaware. See Daines, *supra* note 29.

49. Registered agents also gain from incorporations. The Delaware Division of Corporations currently refers incorporators to 114 registered agents who provide registration and administrative services to Delaware corporations. See Delaware Division of Corporations, Registered Agents, at <http://www.state.de.us/corp/agents/agt2.htm> (last modified Jan. 31, 2002). While it is hard to estimate their gains from incorporations, we believe that the profits they derive from public companies are small. See also E-mail from Professor Lawrence A. Hamermesh, Chair of the Corporation Law Council, Delaware Bar Association, to Ehud Kamar (Sept. 19, 2002) (on file with authors) (noting that registered agents' involvement in corporate legislation is limited to statutes directly affecting their work).

50. While shareholder lawsuits involving Delaware corporations can sometimes be brought outside of Delaware, plaintiffs often file their suits in the Delaware chancery court both because of its renowned efficiency and expertise and because it has personal jurisdiction over all of the defendant directors, wherever they reside. Courts in other states

quick look at census data suggests that legal practice in Delaware is indeed lucrative. Even before adjusting for differences in the cost of living, the average income of Delaware lawyers is higher than that of lawyers in any other state, or even any city, in the country.<sup>51</sup>

To derive the amount of *additional* income resulting from Delaware's special position in the incorporation market, we estimate separately the per-lawyer income and the number of Delaware lawyers were Delaware not an incorporation haven. We use this estimate in the next subsection to determine the profits other states would gain by attracting incorporations.

According to 1990 census figures, the most recent data available, Delaware had in that year 1855 lawyers, who earned a total income of \$199 million. To estimate per-lawyer income, we regress per-lawyer income in each state on per-

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may or may not have jurisdiction. *See infra* notes 116-18 and accompanying text. In addition, Delaware law contains relatively favorable rules on attorneys' fees. *See* E-mail from Professor Lawrence A. Hamermesh, *supra* note 49.

In addition to corporate disputes, many patent disputes and bankruptcy petitions are brought in Delaware. *See id.* The benefits that Delaware lawyers derive from such cases, however, are only tangentially related to Delaware's status as domicile of choice for public corporations. Jurisdiction and venue rules in patent cases are liberal, such that "national corporations may be sued in virtually any U.S. district court." Kimberly A. Moore, *Forum Shopping in Patent Cases: Does Geographic Choice Affect Innovation?*, 83 J. PAT. & TRADEMARK OFF. SOC'Y 558, 565 (2001). Similarly, bankruptcy petitions may be brought in any district where the debtor *or any cofiling subsidiary* is either incorporated, headquartered, or otherwise subject to personal jurisdiction. *See* 11 U.S.C.A. § 101(2) (West 2002) (defining an affiliate to include a parent, a subsidiary, or a sibling corporation); 28 U.S.C.A. § 1408(1) (West 2002) (venue for bankruptcy petition includes debtor's residence, domicile, and principal place of business); *id.* § 1408(2) (venue is proper in any district where an affiliate of debtor has a case pending); *id.* § 1391(c) (defining the residence of a corporation for venue purposes as any district in which the corporation is subject to personal jurisdiction). Since public corporations tend to have a large number of subsidiaries and companies are subject to personal jurisdiction wherever they transact business, public corporations can file bankruptcy petitions in virtually any federal district court. *See* 3 DAVID G. EPSTEIN, STEVE H. NICKLES & JAMES J. WHITE, BANKRUPTCY 214-15 (1992) ("[A] large corporation will find venue in any of a large number of districts."). Patent lawyers and bankruptcy lawyers in Delaware generally are not consulted during the process of corporate legislation. *See* E-mail from Professor Lawrence A. Hamermesh, *supra* note 49.

51. *See* GOV'T INFO. SHARING PROJECT, OR. STATE UNIV., EARNINGS BY OCCUPATION AND EDUCATION: 1990 (on file with authors) (compiling data provided by the U.S. Bureau of the Census). The census treats individual incomes of \$999,999 or more as \$999,999. *See id.* But few, if any, Delaware lawyers earned more than \$1 million in 1990. *See* E-mail from Professor Lawrence A. Hamermesh, Chair of the Corporation Law Council, Delaware Bar Association, to Marcel Kahan (Apr. 8, 2002) (on file with authors) (noting that it was rare for a Delaware lawyer to earn more than \$500,000 in 1990); E-mail from Professor William T. Allen, Delaware Chancellor between 1985 and 1997, to Marcel Kahan (Dec. 21, 2001) (on file with authors) (expressing doubt that any Delaware lawyer earned more than \$1 million in 1990). The higher income of Delaware lawyers is probably due to the large percentage of corporate lawyers in Delaware. Entry barriers for Delaware lawyers are not evidently higher than those for lawyers in other jurisdictions. *See* THE LAWYER'S ALMANAC E-330 (2002) (listing the Delaware bar examination passage rate as 63%, compared to 65% nationwide).

capita income, two demographic variables, and a dummy variable that takes the value one for Delaware and zero for any other state. The results of the regression are reported in Table 3. All independent variables are statistically significant, and the regression has an R-square of 0.75. The coefficient estimate for the Delaware dummy indicates that Delaware lawyers earned, per lawyer, \$34,859 more than predicted by Delaware's per-capita income and its demographic characteristics.

TABLE 3: AVERAGE INCOME OF ATTORNEYS BY STATE

The dependent variable is the average attorney income by state as reported in the 1990 census. Independent variables are as follows: "Per-Capita Income" is the per-capita income by state as reported in the 1990 Census; "City" is the 1990 population of the largest metropolitan area in each state, rounded down to the nearest million as reported in Table No. 34 of the Statistical Abstract of the United States (in millions); "Urbanization" is the log of the percentage of each state's population living in urban areas in 1990; and "Delaware" takes the value of 1 for Delaware, and 0 for other states. \* indicates significance at 10%. \*\* indicates significance at 1%.

Variable	Coefficient	t-Statistic
Per-Capita Income*	0.662	1.87
City**	885.0	3.09
Urbanization**	14,016.0	4.59
Delaware**	34,859.0	5.53

To conservatively estimate the number of lawyers that would have practiced in Delaware in 1990 if it had not been a prime corporate domicile, we employ two alternative methodologies. First, we assume that, but for Delaware's special status, all of Delaware's corporate lawyers and half of its litigators would not have practiced in Delaware.<sup>52</sup> Second, we assume that all Delaware lawyers serving public corporations practice in multi-lawyer firms and that, but for Delaware's special status, the ratio of solo practitioners to lawyers practicing in multi-lawyer firms in Delaware would have been the same as the national average.<sup>53</sup> These methodologies yield a range of 240 to

52. To estimate the number of corporate lawyers and litigators, we obtained section membership data for 2000 from the Delaware State Bar Association (1990 data were not available). We eliminated from the list section members who worked for the government, were academics, or had an office address outside of Delaware, and made an adjustment for lawyers who were members of both the corporate law and the litigation sections. To account for changes in the number of lawyers and for lawyers who were not members of the state bar, we divided the result by the total number of bar association members with Delaware addresses in 2000 and multiplied it by the number of Delaware lawyers in 1990.

53. For this calculation, we averaged data from 1988 and 1991 contained in BARBARA A. CURRAN & CLARA N. CARSON, SUPPLEMENT TO THE LAWYER STATISTICAL REPORT: THE U.S. LEGAL PROFESSION IN 1988 (1991) [hereinafter CURRAN & CARSON, 1991 REPORT], and BARBARA A. CURRAN & CLARA N. CARSON, THE LAWYER STATISTICAL REPORT: THE U.S. LEGAL PROFESSION IN THE 1990s (1994). Note that this methodology is likely to overstate the number of additional Delaware lawyers due to the state's status as an incorporation

431 additional Delaware lawyers. Multiplying the estimated average income that each Delaware lawyer would have had in 1990 if Delaware had not been an incorporation magnet by the estimates of the number of lawyers that would have practiced in Delaware under those circumstances and subtracting the product from the actual total income of Delaware lawyers in 1990 yields an estimate of additional lawyer income of \$82 million to \$96 million. Adding to this income an estimated \$100,000 per lawyer for other office expenses yields total additional lawyer revenue of \$106 million to \$139 million for 1990.<sup>54</sup> Several Delaware lawyers we talked to considered the lower range of these figures plausible.<sup>55</sup>

For 2001, we estimate additional lawyer income of \$165 million and additional lawyer revenue of \$227 million by adjusting the average of the 1990 figures for a 35% inflation rate and a 36.8% increase in the total number of active Delaware lawyers practicing in the state between 1990 and 2001.<sup>56</sup> By comparison, in 1990 and 2000, the gross revenues of the New York law firm Davis Polk & Wardwell were, respectively, \$250 million and \$525 million; of the Houston law firm Baker & Botts, \$136.5 million and \$311 million; and of the Cleveland law firm Squire, Sanders & Dempsey, \$125 million and \$230

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haven, since it would lead to the inclusion of Delaware patent and bankruptcy lawyers. *See supra* note 50.

54. Robert I. Weil, *Overhead Up! Incomes Up! The 1990 Survey of Law Firm Economics*, in THE LAWYER'S ALMANAC 217-19 (1990) (listing expense categories which aggregate to about \$95,000 per lawyer).

55. E-mail from Professor William T. Allen, *supra* note 51; E-mail from Professor Lawrence A. Hamermesh, *supra* note 51; Telephone Interview with A. Gilchrist Sparks III, Partner, Morris, Nichols, Arsh & Tunnell, Wilmington, Del. (Apr. 15, 2002). Indeed, the higher estimate of the number of lawyers is almost certainly too high, as it implies that without the additional lawyers, Delaware would have the highest ratio of population to private practitioners of any state in the nation. *See CURRAN & CARSON*, 1991 REPORT, *supra* note 53, at 234.

56. Compare SUPREME COURT OF DELAWARE LAWYER REGISTRATION (1990) (reporting 1478 active, in-state lawyers), with SUPREME COURT OF DELAWARE LAWYER REGISTRATION (2001) (reporting 2022 active, in-state lawyers). By comparison, real gross domestic product grew by 38.9% between 1990 and 2001, *see* INTERNATIONAL FINANCIAL STATISTICS YEARBOOK 1032-33 (2001), and the number of publicly traded companies fell by 25.6% between 1990 and 1999. Compare SEC, DIRECTORY OF COMPANIES REQUIRED TO FILE ANNUAL REPORTS WITH THE SECURITIES AND EXCHANGE COMMISSION (1990) (reporting 16,123 filing companies as of 1990), with SEC, DIRECTORY OF COMPANIES REQUIRED TO FILE ANNUAL REPORTS WITH THE SECURITIES AND EXCHANGE COMMISSION (2000) (reporting 11,998 filing companies as of 1999).

million.<sup>57</sup> All of Delaware's additional legal business is thus equivalent to that of a single large non-New York law firm.<sup>58</sup>

## 2. *The benefits of additional legal business.*

Lawyers in other states may be able to generate revenues proportionate to those of Delaware lawyers to the extent that their states attract incorporations. Since Delaware's market share of roughly 50% of incorporations by public companies yields \$165 million in income and \$227 million in revenue from legal business, lawyers in another state would likely gain about \$3.3 million in income and \$4.5 million in revenue for each percentage increase in their state's market share of public corporations. Thus, if another state attracted a respectable 20% market share in 2001, its lawyers would earn a proportionate \$90 million in additional revenue.

However, neither lawyer revenue nor lawyer income would represent economic profits. Some of the money would not even benefit state residents because it would be used to pay suppliers in other states or federal taxes. More importantly, even money that remained in the state would largely represent compensation for the opportunity costs of the goods and services provided by state residents. Indeed, absent barriers to entry, providers of these goods and services would earn no long-term economic profits.

To be sure, states could still derive some benefits from attracting legal business. First, such business would generate direct and indirect tax revenues for the state. Depending on the state, state and local taxes amount to 9% to

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57. The number of lawyers at these firms in 1990 and 2000, respectively, was 397 and 580 for Davis Polk & Wardwell; 375 and 547 for Baker & Botts; and 390 and 675 for Squire, Sanders & Dempsey. THE LAWYER'S ALMANAC, *supra* note 51, at A-19 to A-36 (2000 lawyer figures); *The AMLAW 100 Ranked by Gross Revenue*, AM. LAW., July/Aug. 1991, at 16-18 (all 1990 figures); *The AMLAW 100 Ranked by Gross Revenue*, AM. LAW., July 2001, at 141-42 (2000 revenue figures).

58. By comparison, a single car plant can generate several thousands of jobs and \$1 billion in new capital investment. See, e.g., Reed Branson, *Mississippi in Line for Nissan Plant, 4000 Jobs*, COMM. APPEAL, Oct. 26, 2000, at A1 (noting that the Nissan plant in Mississippi is expected to generate 4000 jobs and up to \$1 billion of investment). Indeed, states and local governments offer significant tax concessions to attract businesses. See, e.g., Steven Brown, *Kinko's Home: Galleria Tower*, DALLAS MORNING NEWS, Nov. 7, 2001, at 2D (reporting that Dallas Mayor Ron Kirk has offered Kinko's a 90% tax abatement on office property and a 60% tax abatement on real estate to entice the California-based firm to relocate its headquarters to Dallas with the expectation that the firm will generate "500 new jobs and a great corporate profile" for the city); David Greising, *Sky's No Limit as Boeing Wins Illinois Lottery*, CHI. TRIB., May 11, 2001, at 1 (reporting that Illinois and Chicago jointly offered a \$63 million tax break to entice Boeing to move its headquarters from Seattle to Chicago after having estimated that the move would create \$4.5 billion worth of economic benefit for the city and state); Gary Washburn, *Boeing Got a Lot, but It Isn't Alone*, CHI. TRIB., May 13, 2001, at 1 (noting that Mayor Richard Daley's administration "doled out more than \$1 billion to woo or nurture business and promote new development" in a bid to generate economic growth and jobs).

15% of personal income, and taxes paid by high-income professionals such as corporate lawyers might well exceed the state's cost of providing services to them.<sup>59</sup> Second, state residents might derive short-term rents from additional legal business, especially if that business employed resources that were underused.<sup>60</sup> Even in the short-term, however, these rents would likely amount to only a small fraction of the additional income generated.

In sum, the benefits to states and local lawyers from generating legal business through incorporations would be relatively low. Such benefits may provide an impetus for some local lawyers to take low-cost measures to lobby for laws that attract incorporations, and for states to pass such laws if they involve no fiscal outlays and raise no political opposition. But the size of these benefits is unlikely to engender more serious and costly efforts to compete.

### C. *Potential Objections*

This section addresses two potential objections to our analysis. First, we consider the claim that states merely try to keep companies that are already incorporated in them. Second, we examine certain empirical evidence that states that adopt corporate law innovations more promptly earn higher franchise tax revenues.

#### 1. *Defensive competition.*

Even if states do not engage in wholesale competition for incorporations, some scholars suggest that they at least engage in a more limited form of "defensive competition" to retain local firms incorporated in-state.<sup>61</sup> But however modest the incentives for states to engage in wholesale competition, the incentives to retain existing incorporations are even weaker. Most states derive no marginal franchise tax revenues from incorporations by firms that do business in them. For the states that do, franchise tax revenues from the few firms already incorporated in them are trivial. The gains from legal business are likewise small.

If at all, states can be motivated to engage in actions to retain existing incorporations by the gains to local lawyers. Whether such gains will induce a state to compete will depend on the political influence of local lawyers, and the degree to which their interests coincide with maximizing the number of

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59. See JUST THE FACTS 1999-2000, at tbl.16 (providing data on state and local taxes), available at <http://www.ppinys.org/jtf99/table16.htm>.

60. Similarly, Delaware corporate lawyers, who have invested human capital in acquiring expertise on Delaware's corporate law and the operation of its court, could suffer short-term losses if Delaware companies moved to a different state. See Carney, *supra* note 30, at 721 (noting that lawyers with capital invested in local law may collect quasi-rents that could dissipate if clients reincorporated elsewhere).

61. Romano, *supra* note 4, at 226.

domestic incorporations. In Part II.A, we will argue that the political influence of lawyers is limited and that their interests coincide with maximizing incorporations only to a limited extent. Thus, states are unlikely to take measures to retain existing incorporations that generate political opposition or involve material fiscal outlays.

## 2. *The correlation between tax revenues and corporate legislation.*

In her influential study of the incorporation market, Roberta Romano finds a correlation between the percentage of a state's total tax collections coming from franchise tax and the speed with which the state enacted four corporate law innovations.<sup>62</sup> Romano interprets this correlation as evidence of a functioning market for incorporations driven by franchise taxes: States that are quicker to revise their codes attract more incorporations and hence earn more franchise taxes, and the desire to earn franchise taxes induces states to compete in this manner.

Our analysis leads to a different conclusion. Delaware aside, no state gains material franchise tax revenues by attracting incorporations.<sup>63</sup> Since incorporations do not increase franchise taxes, the correlation between franchise taxes and the enactment of corporate law innovations cannot be caused by more responsive states attracting more incorporations. For states other than Delaware, significant franchise tax revenues emanate from companies that conduct business in the state, regardless of where they are incorporated. Thus, the percentage of franchise tax revenues of total state revenues is a function of the type and amount of the tax assessed, and the size of the state's corporate sector.<sup>64</sup>

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62. The statutory innovations include the elaboration of a director and officer indemnification standard, the exemption from shareholder vote of mergers involving a specified percentage of the stock, the elimination of appraisal rights in companies listed on national exchanges, and antitakeover statutes. *See* Romano, *supra* note 4, at 233, 239 (describing the study and reporting regression results).

63. We take no issue with Romano's analysis to the extent that it indicates that Delaware is motivated by a desire to earn franchise taxes. Romano's correlation, however, holds even if one excludes Delaware, and Romano claims that the desire for franchise tax revenues induces states other than Delaware to be responsive. *See* Romano, *supra* note 4, at 241.

64. Any number of other explanations can account for the correlation that Romano finds. Romano, *supra* note 4. For example, states where corporate activity is more important have a larger franchise tax base, which generates larger revenues. Such states may also have a more active local corporate bar, which induces them to keep their corporate codes up to date for the benefit of local corporations. *See infra* note 65 and Part II.A.3 (discussing reasons why states update their corporate laws). Alternatively, first-generation antitakeover statutes—one of the four measures of responsiveness employed by Romano—may drive the correlation. As we discuss below, these laws protected companies that did substantial business in the state, rather than companies that were incorporated in it. As such, these laws may have been passed by states in which public companies conducted a relatively large amount of business (such as industrial, as opposed to rural, states), and thus were a

## II. WHAT DO STATES DO TO COMPETE?

In this Part, we argue that states make no real efforts to attract incorporations. In Parts II.A, II.B, and II.C, we examine states' activities with regard to three aspects of the legal structure governing corporations: statutory corporation law, judge-made corporation law, and the court system. With respect to judge-made law and the court system, we find that states have not taken meaningful actions to attract incorporations. With respect to statutory law, we conclude that the impetus for state action is largely unrelated to the goal of attracting incorporations. Of course, states occasionally take actions, such as revising their corporation codes, that have the incidental effect of making them more attractive as corporate domiciles. But they take these actions largely to satisfy political constituents, such as owners of local close corporations or managers of local public corporations.<sup>65</sup> In Part II.D, we address potential challenges to our analysis.

### A. *Statutory Law*

In this section, we argue that the existence and the design of statutory state corporation law are not evidence that states compete to attract incorporations. We address three different elements of statutory corporate law: the Model Business Corporation Act, antitakeover statutes, and other statutory revisions.

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source of considerable franchise tax revenues. Once antitakeover statutes are omitted from the regression, one is left with only three statutory provisions, and unknown statistical significance. We present these explanations not to suggest that they are the ones accounting for the correlation between franchise tax revenues and the speed of adopting statutory revisions in corporation law, but rather to illustrate how the two can be positively related despite the fact that incorporations do not generate franchise tax revenues.

65. It is true that local firms can incorporate in a different state if their home states do not take such actions. But managers of close corporations may prefer to incorporate in the state in which they conduct their business because obtaining legal advice on its law is cheaper and because incorporating in a different state would expose them to lawsuits in a remote forum and require them to file reports in two states. *See Ayres, supra* note 24, at 374-75 (arguing that out-of-state incorporation involves inconvenience and expense). Similarly, managers of public corporations can profit from state law changes in ways in which they could not by reincorporating: Reincorporation requires shareholder approval, and shareholders may not vote to move into a manager-friendly jurisdiction. *See Roberta Romano, The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 181 (1987) (noting that managers lobbied for antitakeover statutes because they would not have gotten shareholder approval for equivalent charter amendments). Managers of a public corporation may also favor incorporation in the corporation's headquarter state because they have more political clout in that state and can induce the state in the future to pass laws that address a specific need that may arise. They would therefore want the corporation's headquarter state to have a corporate law that is generally of high quality. Enacting laws that benefit local companies or their managers is different from competing for incorporations because lawmakers would act similarly if corporations did not have the option of reincorporating. In fact, state-level lobbying is likely less intense when firms can reincorporate in a state that already offers the desired law.

### 1. *The Model Business Corporation Act.*

Many changes in corporate law statutes are based on the Model Business Corporation Act. The Model Act was devised and is periodically revised by the Committee on Corporate Laws of the Section of Corporation, Banking, and Business Law of the American Bar Association for wholesale or piecemeal adoption by states. As of 1999, twenty-four states largely followed the Model Act.<sup>66</sup>

The significance of the Model Act is hard to reconcile with the notion that states compete for incorporations. Its drafters—members of a committee of a national bar association, most of whom do not even hail from states following the Model Act<sup>67</sup>—can hardly be motivated by a desire to increase incorporations in any particular state. Rather, they are likely to participate in the drafting process because it enhances their reputation and because they find the task personally rewarding and important.<sup>68</sup> That states entrust the design of their corporation laws to such a committee seems more consistent with an effort to simplify the process of devising the law than with competition.<sup>69</sup>

To further examine whether adoptions of Model Act provisions indicate the presence of state competition, we investigated the diffusion pattern reported by William Carney of four provisions that the drafters of the Model Act identified as major.<sup>70</sup> Using Roberta Romano's methodology, we ranked states based on the speed with which they adopted these provisions. We then estimated the Spearman correlation between the resulting ranking and the ranking that Romano reports.<sup>71</sup> The two rankings were negatively related, with no statistical significance.

This finding raises questions for state competition theories. If both Romano and the drafters of the Model Act identify important provisions, the lack of correlation between the rankings suggests that the adoption of important provisions is random or at least that states do not engage in sustained

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66. See MODEL BUS. CORP. ACT ANN. xxvii (3d ed. & 1998/9 supp.).

67. Of 23 members on January 1, 1999, only seven came from states that had substantially adopted the Model Act. Compare *id.* at xl (list of members), with *id.* at xxvii (list of Model Act states).

68. See Carney, *supra* note 30, at 725 (discussing the benefits of participating in a law reform). To the extent that states are motivated to attract incorporations and are more likely to adopt the Model Act if it serves this function, the drafters of the Model Act may build better reputations and have a greater impact if they draft the Model Act accordingly. This, however, would only generate weak incentives for the Model Act drafters.

69. See Carney, *supra* note 30, at 741 (noting that copying the Model Act reduces the cost of devising law). Additional reasons for following the Model Act may be the legitimacy of a work product of a committee of lawyers from different states, the technical competence of such a group, and the reduced risk of unexpected effects or internal inconsistencies.

70. The statutory provisions are the authorization of a share exchange, the substitution of insolvency tests for the legal capital rule, the substitution of a plurality rule for a majority rule in shareholder voting, and the making of dissenters' rights exclusive. See *id.* at 746.

71. Romano, *supra* note 4, at 247.

competition. Conversely, if the provisions identified by the drafters of the Model Act are in fact not important, adoption of the Model Act hardly evidences an effort to attract incorporations.<sup>72</sup>

## 2. *Antitakeover statutes.*

The single most important field for statutory innovation in corporate law, and the one attracting the most attention by commentators, has been statutes designed to assist management in fending off unsolicited takeover bids. Modern state antitakeover statutes come in a number of major categories, with countless variants and additional minor categories. With respect to these statutes, states have clearly been active both in devising new provisions and in adopting them.

Whether modern antitakeover statutes have the effect of attracting incorporations is empirically disputed.<sup>73</sup> But whatever the effect of these statutes on future incorporations, all the commentators who have examined the motive for their adoption concluded that it was to protect local firms against hostile bids. Roberta Romano, William Carney, and Henry Butler, for example, identify a large number of modern antitakeover statutes that were passed to protect a specific local company against an impending or potential bid.<sup>74</sup> Even laws not driven by a specific company or a specific bid were intended to protect local companies from takeovers generally.<sup>75</sup>

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72. It is conceivable that the lack of correlation is due to Delaware law and the Model Act being competing networks, with some states copying Delaware law and others copying the Model Act. There is, however, no evident reason why competing states would confine themselves to copying either Delaware law or the Model Act, rather than copy the best provisions from both sources. Moreover, of the four provisions used by Romano to derive her rankings, one was adopted by Delaware law and the Model Act in the same year; another was adopted by the Model Act soon after it was adopted by Delaware law; and a third was adopted by Delaware law several years after it was developed in the Model Act. With respect to three of the four provisions, therefore, states that copy the Model Act should not have a significantly lower responsiveness ranking than states that copy Delaware law. Thus, the competing-networks hypothesis does not explain the lack of correlation between Romano's and Carney's rankings.

73. Compare BEBCHUK & COHEN, *supra* note 29 (finding that companies tend to be incorporated in states with antitakeover statutes), and Subramanian, *supra* note 29 (same), with Daines, *supra* note 29 (finding no evidence that antitakeover statutes increase incorporations).

74. See Henry N. Butler, *Corporate-Specific Anti-Takeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; Carney, *supra* note 30, at 750-51; Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 n.11 (1988).

75. For example, Maryland's antitakeover statute, which is sometimes cited as a reason to incorporate in the state, see James J. Hanks, Jr., *Maryland Legislation Offers New Benefits for Corporations, REITs, and Investment Companies*, INSIGHTS, May 2000, at 8 (citing takeover law as a reason to incorporate in Maryland); Robert B. Robbins & Dava R. Casoni, *Maryland's "Just Say No" Law*, INSIGHTS, Sept. 1999, at 27 (same), was enacted to protect local companies. See *Anti-Takeover Measure Draws Broad Support*, BALT. SUN, Feb. 17,

That antitakeover statutes were intended to protect local companies, rather than to attract incorporations, is also consistent with the way these statutes have evolved. The precursors to modern statutes were so-called first-generation statutes, which were adopted by thirty-seven states, mostly in the 1970s.<sup>76</sup> Unlike modern statutes, first-generation statutes applied to local companies regardless of where they were incorporated.<sup>77</sup> That design would have been perverse if states had aimed to attract incorporations, but it makes perfect sense given the aim of the statutes to protect local management and operations.

To be sure, modern antitakeover statutes apply only to domestically incorporated firms. But the reason for this is not that states realized that first-generation statutes were ill-designed to attract incorporations. Rather, it is that the United States Supreme Court held that those statutes violated the Commerce Clause by applying to firms incorporated in a different state.<sup>78</sup> The states that had adopted first-generation statutes later turned out to be the ones that adopted modern antitakeover statutes.<sup>79</sup> Their motivation did not change either. It still was to protect local firms.

### 3. Other statutory revisions.

State corporate statutes are not confined to copies of the Model Act and antitakeover statutes. Many states do not follow the Model Act, and even states

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1999, at 1C (quoting state politicians and business executives to that effect); Peter Behr, *Maryland's Hostile-Takeover Defense; Proposal Aims to Fight Corporate Raiders; Shareholder Advocates Unconvinced*, WASH. POST, Feb. 25, 1999, at E1 (same); Telephone Interview with James J. Hanks, Partner, Ballard Spahr Andrews & Ingersoll, Baltimore, Md. (Mar. 22, 2002) (stating that the principal purpose of the antitakeover statute was to protect "existing Maryland corporations from hostile takeovers" rather than to attract incorporations, and that the principal support for those laws came from parties interested in that protection).

76. Romano, *supra* note 74, at 458.

77. See, e.g., Ill. REV. STAT. ch. 121½, § 137.54.A (1979) (repealed 1983). By contrast, these statutes did not apply to firms incorporated in the state unless they were also headquartered in the state and conducted substantial business in it. *Id.* See generally Donald Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 CORNELL L. REV. 213, 219 (1977) (concluding that these statutes applied to any "target company [that was] in some way a 'local enterprise'").

78. *Edgar v. MITE Corp.*, 457 U.S. 624, 645 (1982) (striking down the Illinois antitakeover statute because it applied also to companies not incorporated in Illinois); Romano, *supra* note 65, at 114 (noting that second-generation statutes "have been shaped to circumvent the problems of first-generation statutes struck down in *Edgar*"). It was the limitation of second-generation statutes to domestic corporations that won states constitutional approval. See *CTS Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 82-84 (1987).

79. As of 2000, the 14 states that did not adopt a first-generation statute had on average 1.71 modern statutes. The 37 states that had adopted first-generation statutes had on average 3.05 modern statutes. In a chi-square test, the number of modern statutes adopted by states that had adopted first-generation statutes is significantly different at the 10% level from the number of modern statutes adopted by states that had not adopted first-generation statutes. See also Romano, *supra* note 65, at 114 n.7 (noting a similar correlation as of 1987).

that do sometimes deviate from it.<sup>80</sup> States generally do not explain why specific laws were passed, and an extensive historical analysis of each state's revisions of its corporation code would be beyond the scope of this Article. The political economy and incentive structure underlying corporate law revisions, however, suggest that attracting incorporations is not their main objective.

The driving force behind many corporate statutes is corporate lawyers.<sup>81</sup> Corporate law reforms often require no fiscal outlays and generate no political controversy.<sup>82</sup> The main constraint on the passage of such revisions is that state legislators may not want to devote much time to passing corporate laws. Thus, the corporate bar and advisory committees can expect that, if placed high enough on the legislative agenda, proposed revisions of the corporation code will be enacted.

But lawyers' interest in corporate law reform is multifaceted and in many ways not related to attracting incorporations.<sup>83</sup> To the extent that laws are meant to benefit a particular client or close corporations generally, they are not intended to attract, and may not result in attracting, incorporations by public companies.<sup>84</sup> Similarly, to the extent that bar committee members try to enhance their reputation or serve the public good, they are only tangentially concerned with attracting incorporations.

Even to the extent that lawyers are interested in generating business from public companies, their interest cannot be equated with the goal of attracting incorporations. One can think of a number of reasons why that would be the case. First, local lawyers benefit from increased incorporations only to the extent that they have market power or that the increase occurs at a faster rate than the rate at which new lawyers can enter the relevant market. Thus, for example, local lawyers may not benefit much from laws that will attract incorporations mostly in the long term.

Second, lawyers have an interest in laws that increase the need for their services.<sup>85</sup> Therefore, transactional lawyers can benefit from complex laws

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80. See, e.g., Carney, *supra* note 30, at 748-49 (listing important Georgia departures from the Model Act).

81. See *id.* at 737-49 (noting that lawyers initiate most corporate law changes).

82. But see *infra* Part III.B.2 (discussing instances where political opposition inhibited the passage of corporate law reforms).

83. See generally Larry E. Ribstein, Lawyer Licensing and State Law Efficiency (Apr. 30, 2002) (unpublished manuscript) (discussing lawyers' incentives to promote efficient laws), available at <http://home.law.uiuc.edu/~ribstein>.

84. See Ayres, *supra* note 24, at 372-77 (arguing that states are motivated by concerns over public welfare and private interests, rather than by competitive federalism, in designing laws for close corporations); Carney, *supra* note 30, at 748-49 (noting that many of Georgia's departures from the Model Act were meant to fix a problem that a specific client encountered).

85. See Carney, *supra* note 30, at 721 (noting that lawyers benefit from increased litigation); Macey & Miller, *supra* note 31, at 504-05 (same). Competitive pressures

that generate demand for sophisticated legal advice, and litigators can benefit from standard-based laws that entail litigation to resolve disputes, even if such laws reduce incorporations.<sup>86</sup>

Third, local lawyers may want to limit competition by out-of-state law firms.<sup>87</sup> They may not benefit from, say, copying Delaware law or the law of a large neighboring state, even if doing so would attract incorporations.<sup>88</sup>

Fourth, members of advisory committees that draft revisions may be more interested in generating business for themselves than in benefiting local lawyers generally. As a result, they may favor provisions that are idiosyncratic, arcane, or complex in order to enhance their reputation or increase the value of the human capital they derive from participating in the drafting process with little attention to the effect of these provisions on incorporations.

Finally, even to the extent that lawyers benefit from attracting incorporations, they face collective-action problems. Rather than expending significant resources to attract incorporations, they may try to free-ride on the efforts of others.<sup>89</sup> They will therefore be reluctant to make significant

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constrain, but do not eliminate, this preference. Corporations are immobile in the short-term (due to reincorporation costs and lack of information about the quality of the law), and many close corporations tend to be immobile even in the long-term. Thus, lawyers can generate short-term profits by devising the law in a manner that increases the need for their services. Moreover, as explained in the text, lawyers are predominantly affected by the short-term effect of new laws.

86. For the distinction between complex and simple legal commands on the one hand and between rules-based and standard-based commands on the other hand, see generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992). That trial lawyers may favor laws that leave room for litigation is evidenced by the efforts that trial lawyers in Nevada made to limit the effect of a bill to constrain corporate veil piercing and exculpate directors and officers from liability to shareholders. *See Minutes of the Nev. S. Comm. on Judiciary*, S.B. 577, 2001 Leg., 71st Sess. (May 25, 2001) (testimony of Robert L. Crowell, Lobbyist for Nevada Trial Lawyers Association) & Exhibit E (Amendment to S.B. 577, Presented by the Nevada Trial Lawyers Association), available at <http://www.leg.state.nv.us>; *Minutes of the Nev. Assem. Comm. on Judiciary*, S.B. 577, 2001 Leg., 71st Sess. (May 30, 2001) (testimony of Bob Crowell, Bill Bradley, and Pat Cashill, Lobbyists for Nevada Trial Lawyers Association) & Exhibits M & O (Amendments to S.B. 577, Presented by the Nevada Trial Lawyers Association), available at <http://www.leg.state.nv.us>.

87. *See* Carney, *supra* note 30, at 723 (noting the interest of local lawyers in avoiding potential competition by lawyers who specialize in Delaware law).

88. Experts in local law may not derive offsetting benefits from a greater ability to compete for the business of companies incorporated in Delaware, among other reasons, because they either already specialize in Delaware law or lack the expertise and reputation of others specializing in Delaware law.

89. Cf. Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks*, 43 U. KAN. L. REV. 541, 545-50 (1995) (noting that states lack proper incentives to invest in devising corporate law innovations); Carney, *supra* note 30, at 747 (finding that collective-action problems retard the creation and adoption of innovations). Bar associations overcome this collective-action problem only to some extent. While bar associations organize committees to propose legal reforms, the members of the committee are not compensated for the time they spend on committee

investments in devising attractive corporate law reforms or ensuring that their reforms are passed should those initiatives require fiscal outlays or meet with opposition.<sup>90</sup>

### B. Judge-Made Law

An important element of a state's corporate legal structure is its judge-made law. It is judge-made law, rather than statutory law, that governs such fundamental issues as the fiduciary duties of directors, officers, and controlling shareholders in self-dealing transactions, the scope of corporate opportunities, the obligations of directors in dealing with control challenges, the prerequisites for a derivative suit, directors' disclosure obligations, and the scope of impermissible corporate waste.

To our knowledge, no commentator has claimed that states try to compete with Delaware in their design of judge-made law.<sup>91</sup> Indeed, we would regard such a claim as implausible. Delaware aside, attracting incorporations has not become an important part of any state's stated policy.<sup>92</sup> Most judges would therefore be surprised to learn that their state wanted them to render corporate law decisions that attract incorporations. They would also lack the incentives and skills to render such decisions. Outside of Delaware, corporate law cases represent only a tiny fraction of a judge's caseload. It is unlikely that their outcome would have much of an impact on a judge's career,<sup>93</sup> or that a judge

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business. Moreover, bar associations do not typically fund lobbying efforts.

90. See Carney, *supra* note 30, at 749 (noting that many provisions of Georgia corporate law are designed as "low-cost solutions to problems as they arise").

91. Even with respect to Delaware, only a few commentators have claimed that judges consciously participate in the state's efforts to attract incorporations. See ROMANO, *supra* note 31, at 40 ("[T]his appointment process [of chancery court judges] helps to ensure that members of the chancery court will be sensitive to the state's policy of responsiveness in corporate law, since judges who ignore the political consensus in the state will not be reappointed."); Cary, *supra* note 3, at 670-84 (arguing that Delaware judges aid their state in attracting incorporations).

92. Nevada is the only state besides Delaware that openly tries to attract incorporations. However, even for Nevada, attracting incorporations has not become an important state objective. See *infra* Part II.D.2.

93. Outside of Delaware, many corporate cases are decided by federal courts. See Keith Paul Bishop, *Battle for Control of ITT Corporation Spotlights Nevada (and Delaware) Corporate Law: Did Nevada Law Get Stockholders a Better Deal?*, INSIGHTS, Jan. 1998, at 15, 18 (stating that "nearly every reported decision to date involving takeovers under Nevada law has been rendered by the federal courts"). Federal judges have even weaker incentives than state judges to help states attract incorporations. See *id.* (noting that rulings by federal courts "may frustrate the Nevada Legislature's intent to create alternatives to Delaware law"). A federal judge may be interested in deciding large corporate cases. But as the experience with corporate bankruptcy cases demonstrates, this is more likely to happen in a state that encourages this aspiration. See Marcus Cole, "*Delaware Is Not a State*": Are We Witnessing Jurisdictional Competition in Bankruptcy?, 55 VAND. L. REV. (forthcoming 2002) (arguing that federal judges in Delaware draw encouragement from the community to pursue large bankruptcy cases).

would have the necessary experience to determine how a case should be decided to attract incorporations.<sup>94</sup>

### C. The Court System

A principal attraction of incorporating in Delaware is the high quality of its chancery court.<sup>95</sup> The Delaware chancery court combines several features. First, it has limited jurisdiction, its docket consists mainly of corporate cases, and it hears all cases without a jury.<sup>96</sup> These features result in corporate disputes being decided by judges who have developed expertise in corporate law. Second, Delaware chancery court judges are selected based on merit by a nominating commission,<sup>97</sup> and receive financial support from the state—for law clerks, support staff, office space, courtroom facilities, and the like—that is necessary to dispose of cases expeditiously. Third, the opinions of the court are published in the state and the regional reporter, and are available on commercial databases, creating a body of case law that provides guidance to practitioners.

One would expect states trying to attract incorporations to establish similar courts.<sup>98</sup> But none has. A small number of states have established specialized

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94. Judges in other states often follow Delaware precedent. But this tendency does not indicate that they participate in state competition. First, law that attracts incorporations to a state with an expert corporate judiciary like Delaware may not attract incorporations to a state that lacks such a judiciary. *See Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1932-35 (1998). Second, judges may follow Delaware precedent merely because of the lack of precedent in their own state and the recognized experience of Delaware courts in resolving corporate disputes. Indeed, Delaware corporate cases are widely cited by federal courts as well. *See Curtis Alva, Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 903 n.92 (1990) (noting that four important Delaware cases were cited by federal circuit courts in six circuits, by federal district courts in 12 states, and by state courts in 12 states). Yet no one claims that federal courts are somehow part of a scheme to help the states where they sit to attract incorporations.

95. There is a wide consensus on this point among academics, practitioners, and members of the judiciary. *See, e.g.*, U.S. CHAMBER OF COMMERCE, STATE LIABILITY SYSTEMS RANKING STUDY: FINAL REPORT, STUDY No. 14966 (Jan. 11, 2002) (reporting national survey results that rank the Delaware court system first in each of ten categories), available at [http://www.litigationfairness.org/pdf/liabilities\\_survey.pdf](http://www.litigationfairness.org/pdf/liabilities_survey.pdf); Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 BROOK. L. REV. 1, 5-8 (1995) (praising the chancery court); William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice, Speech at the Bicentennial of the Delaware Court of Chancery*, 48 BUS. LAW. 351, 354-55 (1992) (same).

96. Dreyfuss, *supra* note 95, at 5-8.

97. *See THE LAWYER'S ALMANAC*, *supra* note 51, at J-1. Delaware is one of 18 states where all trial court judges are initially appointed in this fashion and, of this group, one of eight states where they do not face retention elections. *Id.* at J2-J15 (describing the initial and subsequent appointment of judges state by state).

98. *See* William W. Bratton, *Delaware Law as Applied Public Choice Theory: Bill*

judicial tribunals for business disputes. These states include New York, Illinois, North Carolina, Massachusetts, Nevada, and Pennsylvania.<sup>99</sup> In addition, Maryland and Michigan are planning to institute business courts in the near future.<sup>100</sup> But these courts are not designed to attract incorporations.

The first business court comprised the commercial divisions that New York established in 1992.<sup>101</sup> The commercial divisions differ from Delaware's chancery court in several fundamental respects. First, judges on the commercial divisions are elected in partisan elections,<sup>102</sup> and hear corporate cases with a jury.<sup>103</sup> Second, the jurisdiction of the commercial divisions is

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*Cary and the Basic Course After Twenty-Five Years*, 34 GA. L. REV. 447, 470 (2000) ("A potential competitor would have to create courts of experts as knowledgeable as Delaware's existing bench."); *Tougher Shareholder Suit Standards in Pennsylvania Are Outlined*, 1997 ANDREWS DEL. CORP. LIT. REP. 20510 (noting agreement among faculty in a seminar at the Pennsylvania Bar Institute that a court that specializes in corporate governance issues as the Delaware chancery court does is necessary for Pennsylvania to attract incorporations).

99. See *infra* Table 4. Virginia has a State Corporation Commission with jurisdiction over challenges to corporate charters (but not over derivative lawsuits). ABA, AD HOC COMM. ON BUS. COURTS, THE STATUS OF BUSINESS COURTS IN THE UNITED STATES (Nov. 4, 1999), available at <http://www.abanet.org/buslaw/buscts/ctsurvey.html>. New Jersey is sometimes wrongly cited as having a business court. The New Jersey State Bar Association had recommended to the state supreme court the establishment of a special business court for complex commercial matters. The supreme court rejected that recommendation and, instead, added a fourth track to its differentiated case management system. In that track, complex commercial cases are grouped with environmental coverage cases, mass torts, actions under the federal Y2K act, and others. Telephone Interview with Barry D. Epstein, former President, New Jersey State Bar Association (May 24, 2001). The New Jersey Superior Court also maintains a chancery division that has been described as having "developed special expertise and abilities with regard to complex corporate law matters." See ABA, *supra*. The docket of the chancery division, however, consists mostly of noncorporate cases, and corporate cases that involve a damage claim are transferred to the law division for trial. Telephone Interview with Peter D. Hutcheon, Partner, Norris McLaughlin & Marcus, Bridgewater, N.J. (May 16, 2001). In 1996, Wisconsin administratively established a pilot business court in Milwaukee County by designating two judges to hear commercial disputes. ABA, *supra*. The court was subsequently disbanded. Telephone Interview with Beth Bishop Perrigo, Deputy District Court Administrator, Milwaukee County, Wis. (Mar. 31, 2001).

100. Amy Lane, *Lack of Funding Keeps Cyber-Court Offline*, CRAINTECH, July 15, 2002, available at <http://michigan.craintech.com/cgi-bin/article.pl?articleId=2163&a=a&bt=amy+lane> (identifying 2003 as the court's hoped-for starting date); Eric G. Orlinsky, *Maryland Creates First Business and Technology Court Program*, CORP. L. WKLY., Feb. 21, 2001, at 64.

101. See NY ACCA General Counsels' Committee Supports Commercial Division of New York Supreme Court, METRO. CORP. COUNSEL, Feb. 1996, at 20 (relating the history of commercial division).

102. In New York, state trial court judges are elected. THE LAWYER'S ALMANAC, *supra* note 51, at J-11. Judges assigned to the commercial division come from the elected pool. This creates the possibility of assigning judges with business law expertise to the commercial division.

103. Fedoryszyn v. Weiss, 310 N.Y.S.2d 55 (N.Y. Sup. Ct. 1970) (holding that, under New York law, plaintiffs have a right to jury trial in corporate disputes that involve a potential damage remedy, even if the dispute involves an equitable procedure such as a

very broad, so that corporate disputes constitute only a small portion of any judge's caseload.<sup>104</sup> Third, commercial divisions were established only in some counties,<sup>105</sup> and no equivalent division was established in New York's intermediate appellate court, making it difficult to develop a coherent body of corporate law precedents.

While hard to mesh with an effort to attract incorporations, the design of the commercial divisions is consistent with the stated goal behind their establishment: to shorten the long delays in the resolution of commercial disputes in New York's overburdened trial courts.<sup>106</sup> From this perspective, it is sensible that the jurisdiction of the commercial divisions encompasses a wide array of commercial disputes, and that commercial divisions were instituted only in some counties, where delay was a problem. Moreover, since the principal concern was dissatisfaction with the delay in resolving disputes, rather than dissatisfaction with their final resolution, there was no need to tinker with the right to a jury trial or to take steps to increase the cohesiveness of New York's case law.

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derivative suit).

104. *Commercial Division Celebrates First Anniversary*, METRO. COUNSEL, Dec. 1996, at 46 (stating that the commercial divisions' jurisdiction includes cases involving the law of contracts, corporations and insurance, the Uniform Commercial Code, and other commercial matters).

105. Commercial divisions were initially created in New York County (Manhattan) and Monroe County (Rochester). Frederick Gabriel, *New York's Commercial Court Is Where Business Speeds Along: New System Is Model for Other States*, CRAIN'S N.Y. BUS., Apr. 7, 1997, at 11 (noting that only New York and Monroe Counties have commercial divisions). Divisions were later added in three more counties. Robert L. Haig, *Commercial Litigation in New York State Courts: A Current Guide for Commercial Cases*, METRO. COUNSEL, Jan. 2001, at 37 (noting that commercial divisions were added in Westchester, Nassau, and Erie Counties).

106. See Annemarie Franczyk, *State Court System Floats Plan for Unit for Commercial Suits; New York State, Bus. FIRST BUFFALO*, June 19, 1995, at 21 (citing delay as the reason for the establishment of the commercial division); *Pilot Succeeds, Task Force Studies N.Y. State Commercial Court Plans*, COMM. LENDING LITIG. NEWS, May 5, 1995 (same).

TABLE 4: BUSINESS COURTS

	Delaware	New York	Illinois	Massachusetts	Pennsylvania	North Carolina	Nevada	Michigan	Maryland
Established	1792	1992 pilot 1995 permanent	1992	2000 pilot	2000	1995	2000	Approved 2002, but not funded	Awaiting approval by the Court of Appeals
Name	Chancery Court	Commercial Division	Commercial Calendar	Business Litigation Sitting	Commerce Court	Business Court	Business Court	Cyber Court	Business and Technology Case Management Program
Created	Constitution	Administrative	Administrative	Administrative	Administrative	Administrative	Administrative	Legislation	Administrative
Division/ Separate	Separate	Division	Division	Division	Division	Division	Division	Division	Division
Jury Trial for Corporate Cases	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Judges Elected	No	Yes	Yes	No	Yes	No	Yes	Yes	No
Opinions on Lexis/Westlaw	Yes	Yes	No	Yes	No	No	No	No	No
State-Wide	Yes	No	No	No	No	Yes	No	No	Yes
Size Full/Part-Time	5 Judges Full-Time	12 Judges Full-Time	8 Judges Full-Time	2 Judges Part-Time	3 Judges Full-Time	1 Judge Full-Time	3 Judges Part-Time	To be decided	20 Judges
Subject Matter Jurisdiction	Equity (mostly corporate)	Contracts, commercial, corporations, other	Cases involving a commercial relationship	Business, commercial, complex contract cases	Corporate, commercial, trade secrets, business torts, intellectual property, other	Complex business cases assigned	Corporate, trademark, securities, deceptive practices, other	Technology, corporate, contract, commercial, insurance, trade, other	Technology, licensing, corporate, breach of contract, insurance, other

Source: Compiled by authors.

As Table 4 shows, the business courts in the other states largely resemble New York's commercial divisions, rather than Delaware's chancery court. All of these courts are divisions of the regular trial court and none affects the right to a jury trial.<sup>107</sup> All have relatively broad jurisdiction, and thus deal mostly with more common contract and commercial disputes rather than with corporate law disputes,<sup>108</sup> and none is designed to generate a coherent body of corporate law precedents. This is evidenced by the fact that in all states but Maryland some corporate disputes are heard by the regular trial court, and no state but New York and Massachusetts publishes the opinions of its business court in reporters or makes them available on commercial databases.<sup>109</sup> As in the case of New York, the purpose of these courts was to streamline the disposition of commercial cases, not to attract incorporations.<sup>110</sup>

The business courts in North Carolina and Nevada are a partial exception in that attracting incorporations may have been a secondary motive for their creation.<sup>111</sup> But both suffer from the same severe design flaws—broad subject

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107. In Michigan, parties who want their case to be heard in front of the cyber court must waive the right to a jury trial. 2001 Mich. Pub. Acts 262, § 8019 (providing that any action in the cyber court shall be heard by the judge without a jury). Either party can obtain a jury trial by not filing in, or removing the dispute from, the cyber court. *Id.* §§ 8005, 8011 (providing the court only with concurrent jurisdiction over certain disputes, and giving defendants a right to remove any action to a state circuit court).

108. Even North Carolina's business court, the smallest and most selective of the business courts, deals overwhelmingly with commercial, rather than corporate, disputes. Of 11 opinions authored in 2000 available on the court's website, six deal with contract disputes, one with antitrust disputes, two with zoning disputes, and two with corporate law disputes. See Website of the North Carolina Business Court, at <http://www.ncbusinesscourt.net> (last visited Nov. 10, 2002). The two corporate cases involve closely held corporations and thus have limited relevance for public corporations. See Kahan & Kamar, *supra* note 30, at 1226.

109. The only other state-wide court, North Carolina's, hears cases by special assignment. See REPORT ON ACTIVITIES OF THE NORTH CAROLINA BUSINESS COURT 2000 TO 2001, available at <http://www.ncbusinesscourt.net/ref/2001%20General%20Assembly.htm> (last visited Nov. 24, 2002) [hereinafter NORTH CAROLINA BUSINESS COURT REPORT].

110. See Steven Anderson, *Massachusetts Tackles Litigation Backlog with a New Business Court*, CORP. LEGAL TIMES, Apr. 2001, at 74 (citing logjam of litigation and delays as the reasons why a business court was created); *Focus on Business Courts*, METRO. CORP. COUNSEL, Apr. 2000, at 40 (documenting an interview with Paul Dacier, a leading proponent of the business court, who cites the slowness with which Massachusetts courts dispose of intellectual property cases as the reason why he advocates the creation of a business court); William C. Smith, *Md. Panel Urges Biz Court*, NAT'L L.J., Nov. 27, 2000, at B1 (noting praise by a Chicago lawyer for faster disposition of commercial cases); Steven R. Stahler, *Illinois Lobbies Firms to Incorporate Here*, CRAIN'S CHI. BUS., Oct. 9, 1995, at 9 (discussing Illinois features attractive to incorporations, including low franchise taxes and a revised corporation law, but not mentioning the business court); Telephone Interview with William H. Clark, head of Pennsylvania chancery court coalition (June 1999) (stating that the proposal to create a specialized commercial court, unlike an earlier failed effort to establish a "chancery court," is not part of an effort to attract incorporations).

111. Lawrence F. Dickie & John L.W. Garrou, *North Carolina Judge to Hear Complex Business Disputes: Oversight of Cases from Designation to Conclusion*, CORP. LEGAL TIMES,

matter jurisdiction, retention of juries, and unpublished opinions being the most important ones—as the other business courts.<sup>112</sup> Moreover, the judges on Nevada’s business court either rotate every two years or are randomly assigned civil or criminal cases in addition to business matters.<sup>113</sup> And the business court in North Carolina has been suffering from a shortage of funding for chambers and legal and clerical support from the day it was created,<sup>114</sup> leading a local newspaper to headline: “Business Court Pleads Poverty.”<sup>115</sup>

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June 1996, at 32 (noting the concern of North Carolina corporations over the lack of a specialized court); Jack Scis, *Greensboro Lawyer Gets New Business Judgeship*, NEWS & REC. (Greensboro, N.C.), Jan. 16, 1996, at B5 (noting that the court is intended to speed up trials of significant business cases, and quoting a legislative commission study as finding that the “[l]ack of a business court . . . puts North Carolina at a disadvantage when corporations are considering states in which to incorporate to do business”); Email from Steven B. Miller, Managing Editor, Nevada Policy Research Institute, to Marcel Kahan (Mar. 20, 2002) (on file with authors) (noting that business courts are related to the goal of attracting incorporations, but are more relevant to Nevada’s attempt to induce companies to locate operations and upscale professionals in Nevada). Despite these intentions, promoters of Nevada incorporations do not seem to place great significance on the court. The website of Nevada’s secretary of state does not mention the court among the reasons why companies should incorporate in Nevada. See <http://sos.state.nv.us/commrec/whyinc.htm> (last visited Nov. 10, 2002). Even incorporation services specializing in Nevada fail to mention the court as a reason to incorporate in Nevada. See, e.g., Website of Nevada Corporation Services, at <http://www.nevada-incorporations.com/whynevada2.html> (last visited Nov. 10, 2002).

112. In North Carolina, only decisions by the state court of appeals and the state supreme court are published. Doug Campbell, *Home Court*, NEWS & REC. (Greensboro, N.C.), May 3, 1998, at E1. Moreover, the business court’s opinions lack precedential value. See NORTH CAROLINA BUSINESS COURT REPORT, *supra* note 109, at VII.C.

113. Nev. St. 8 Dist. Ct. R. § 1.33 (providing for mandatory rotation of district court judges every two years among the civil or criminal division, business court division, civil only division, drug court or overflow division, and overflow division); Nev. St. 2 Dist. Ct. R. §§ 2.1, 2.1.4, 2.1.5 (providing for appointment of presiding judges of the business court docket for renewable two-year terms and for random assignment to them of other civil or criminal actions as any other district court judge while they preside over the business court docket).

114. *State Business Courts Here to Stay; Concept Gets Entrenched Despite Setbacks*, COMM. LENDING LITIG. NEWS, Sept. 5, 1997 (noting that the judge has been “outspoken concerning the lack of funds for chambers, and legal and clerical support”).

115. Leah Beth Ward, *Business Court Pleads Poverty: Expansion Plan Asks Lawmakers for More Resources, Extra Judges*, CHARLOTTE OBSERVER, Mar. 24, 1998, at 1D (quoting North Carolina’s secretary of state as saying that “[t]he state just hasn’t put a whole lot of resources into [the business court]” and reporting that the judge has no law clerks and no way to publish his opinions); see also Campbell, *supra* note 112, at E1 (reporting that the court lacks a law clerk, an administrator, and up-to-date technology). The five Delaware chancery court judges, by comparison, have a total of seven clerks. Interview with Professor William T. Allen, former Chancellor, Delaware Court of Chancery (May 16, 2001). The North Carolina legislature eventually approved \$118,000 to hire a judicial assistant, buy office equipment, and establish an electronic filing system. Doug Campbell, *Business Court Will Not Come to City: State Officials Hesitated Because Greensboro Wouldn’t Provide Quarters for the Court*, NEWS & REC. (Greensboro, N.C.), Oct. 28, 1998, at B7. But it took a private foundation to donate the funds for a lease to relocate the court from High Point to Greensboro. Doug Campbell, *Foundation Pays Lease for Business Court*, NEWS & REC. (Greensboro, N.C.), Mar. 1, 1999, at B6. The following year, the state decided to pick up the

The flaws of Nevada's business court are even greater. As in Delaware, and unlike any other state, a large percentage of the public companies incorporated in Nevada are headquartered in other states. But Nevada law, unlike Delaware law, does not require directors of domestic corporations to consent to being sued in the state for breaches of their fiduciary duties.<sup>116</sup> It is Delaware's consent statute, rather than the inherent ties between a director and the company's state of incorporation, that permits Delaware courts to exercise personal jurisdiction over director defendants.<sup>117</sup> Since Nevada lacks such a statute, there is doubt as to whether Nevada's business court has personal jurisdiction over directors of companies that are incorporated in Nevada but are headquartered elsewhere.<sup>118</sup>

Finally, all business courts were created after 1992, when New York established the commercial divisions on a trial basis. That no business court had been established until 1992, decades after states had purportedly started to compete for incorporations, poses a quandary for state competition scholars.

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tab. Eric Dyer, *Local Projects Included in Budget*, NEWS & REC. (Greensboro, N.C.), July 2, 1999, at B1. But to this date, the court lacks its own budget, has to rely on private funding to upgrade its technology, and has difficulty in locating a courtroom space to hold hearings. See NORTH CAROLINA BUSINESS COURT REPORT, *supra* note 109, at §§ VI.C (courtroom space), X (budget and technology).

116. Compare DEL. CODE ANN. tit. 10, § 3114 (2002) (Delaware consent statute), with NEV. REV. STAT. ANN. § 14.065 (Michie 2002) (Nevada long-arm statute).

117. See *Shaffer v. Heitner*, 433 U.S. 186 (1977) (holding that directors of a Delaware corporation lack sufficient contacts with Delaware to grant Delaware courts personal jurisdiction over them under Delaware's quasi-in-rem statute). Signifying the importance that Delaware places on its courts having jurisdiction over directors of Delaware corporations, Delaware passed a specific statute deeming such directors to have consented to such jurisdiction 13 days after *Shaffer*. JOHN J. COUND, JACK H. FRIEDENTHAL, ARTHUR R. MILLER & JOHN E. SEXTON, CIVIL PROCEDURE: CASES AND MATERIALS 165 (8th ed. 2001). Similar statutes have been adopted by Alaska, Illinois, Kansas, Maine, Michigan, Montana, North Carolina, North Dakota, Oregon, Pennsylvania, South Dakota, and Wisconsin—but not Nevada. See ROBERT C. CASAD & WILLIAM B. RICHMAN, JURISDICTION IN CIVIL ACTIONS app. E (3d ed. 1998).

118. Nevada's statute grants its courts jurisdiction "on any basis not inconsistent with the constitution of this state or the Constitution of the United States." NEV. REV. STAT. ANN. § 14.065 (Michie 2002). Despite its broad formulation, this statute may reach less far than statutes presuming directors' consent to jurisdiction. See *Kulko v. Superior Court*, 436 U.S. 84, 88 (1978) (noting that the lack of a special jurisdiction statute signifies a lack of particularized interest by the state in obtaining personal jurisdiction over a father of a child residing in the state in a child support dispute); *Shaffer*, 433 U.S. at 216 (explaining that the directors of a Delaware corporation "have simply had nothing to do with the State of Delaware" and pointing out that Delaware "has not enacted a statute that treats acceptance of a directorship as consent to jurisdiction in the State"); *Hanson v. Denckla*, 357 U.S. 235 (1958) (noting the significance of specific statutes conferring on a state personal jurisdiction); see also *Armstrong v. Pomerance*, 423 A.2d 174, 178-79 (Del. 1980) (noting as a reason for upholding the Delaware consent statute that it provided explicit notice to directors that they could be haled into Delaware courts). We are unaware of cases upholding the exercise of jurisdiction over a director of a domestic corporation where the state lacked a specific statute authorizing such jurisdiction and the director did not have other contacts with the state.

Why would states, eager to compete, permit Delaware to build up competitive advantages from case law, accumulated judicial expertise, and reputation? From our perspective, however, this timing is not surprising. It was New York's success in streamlining commercial litigation,<sup>119</sup> rather than Delaware's success in attracting incorporations, that prompted the creation of business courts in other states.<sup>120</sup>

#### D. Potential Objections

We now turn to a number of potential objections to our analysis: the claim that the diffusion pattern of statutory innovations in corporate law is evidence of competition, the suggestion that Nevada and Maryland do compete for incorporations, the argument that states actively promote themselves as incorporation havens, and indications that states competed for incorporations at the close of the nineteenth century.

##### 1. Diffusion of statutory innovations.

In an article that has become a classic, Roberta Romano examines four statutory innovations in corporate law and finds that they quickly diffuse among states, forming an ogive (S-shaped) curve of cumulative adoptions over time. This pattern, Romano observes, resembles the diffusion of innovations in competitive markets.<sup>121</sup>

We agree that competitive forces can give rise to an ogive diffusion pattern. We do not agree, however, that this pattern indicates the presence of competition. Many statutory innovations in areas where states do not compete diffuse among states along ogive curves. These areas include welfare, health, education, conservation, planning, administrative organization, highways, civil rights, corrections and police, labor, taxes, and professional regulation.<sup>122</sup>

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119. *Commercial Division Celebrates First Anniversary*, *supra* note 104, at 46 (noting praise of the commercial divisions by the chair of the business law section of the ABA and the chairman of the board of the directors of the American Corporate Counsel Association); Gabriel, *supra* note 105 (citing a study showing that the commercial divisions have shortened the time to resolution of contract cases by 29% and noting that several states have plans to adopt similar systems).

120. Nevada serves as a useful illustration. According to the chief drafter of the rule that established its business court, "Delaware would be a poor example to follow because Nevada has equity and law combined and Delaware's structure of appointing judges is different from Nevada's." Rather, "the example New York provides would be a good one for Nevada to follow." See *Minutes of the Nev. Legis. Commission's Subcomm. to Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State*, 1999 Leg., 1999-2000 Interim Sess. (Jan. 7, 2000) (testimony of Robert E. Rose, Chief Justice, Supreme Court of Nevada), available at <http://www.leg.state.nv.us>.

121. See Romano, *supra* note 4, at 233-42.

122. See generally Virginia Gray, *Innovation in the States: A Diffusion Study*, 67 AM. POL. SCI. REV. 1174 (1973); Jack L. Walker, *The Diffusion of Innovations Among the*

Even abortion laws exhibit a similar pattern of diffusion.<sup>123</sup> More generally, almost every type of information, be it a statute, a custom, a rumor, or anything else, diffuses. What drives the diffusion in these areas and explains its shape is innocuous information transfer and learning.<sup>124</sup>

Indeed, a closer look at Romano's data suggests that corporate innovations spread for reasons unrelated to state competition for incorporations. One of the provisions that diffuse along an ogive curve is first-generation antitakeover statutes pioneered by Virginia in 1968. However, as explained above, these statutes were designed to protect local firms, not to attract corporations.<sup>125</sup> That these statutes diffuse in an ogive manner demonstrates that ogive diffusion of statutory innovations is consistent with legislative motives other than competition for incorporations.

## 2. Nevada.

Nevada is the poster child for those believing that states compete for incorporations. It is the only state other than Delaware that openly endeavors to attract incorporations, and one of few that attract a substantial number of companies headquartered in other states.<sup>126</sup> Nevada also revises its corporate statute regularly.<sup>127</sup>

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*American States*, 63 AM. POL. SCI. REV. 880 (1969). For more recent studies see, for example, GEORGE W. DOWNS, JR., BUREAUCRACY, INNOVATION, AND PUBLIC POLICY (1976) (juvenile correction); Henry R. Glick & Scott P. Hays, *Innovation and Reinvention in State Policymaking: Theory and the Evolution of Living Will Laws*, 53 J. POL. 835 (1991); Henry R. Glick, *Innovation in State Judicial Administration: Effects on Court Management and Organization*, 9 AM. POL. Q. 49 (1981); Fred W. Grupp, Jr. & Alan R. Richards, *Variations in the Elite Perceptions of American States as Referents for Public Policy Making*, 69 AM. POL. SCI. REV. 850 (1975); James L. Regens, *State Policy Responses to the Energy Issue: An Analysis of Innovation*, 61 SOC. SCI. Q. 44 (1980) (energy); Lee Sigelman et al., *Social Service Innovation in the American States*, 62 SOC. SCI. Q. 503 (1981) (human services).

123. See generally Christopher Z. Mooney & Mei-Hsien Lee, *Legislative Morality in the American States: The Case of Pre-Roe Abortion Regulation Reform*, 39 AM. J. POL. SCI. 599 (1995).

124. See generally EVERETT M. ROGERS, *DIFFUSION OF INNOVATIONS* (4th ed. 1995).

125. See *supra* Part II.A.2.

126. See, e.g., John G. Edwards, *Nevada Joins the Company of Top Incorporation States*, LAS VEGAS REV.J., Feb. 8, 1998, at 1K (noting that new filings in Nevada by corporations, limited liability companies, and partnerships rose to 38,153 in 1997, placing the state (along with Delaware) among the few smaller states in the top ten in the number of new filings).

127. Some of these revisions, however, merely follow the Model Business Corporation Act. See, e.g., *Minutes of the Nev. S. and Assem. Comms. on Judiciary*, A.B. 655, 1991 Leg., 66th Sess. (May 7, 1991) (prepared testimony of John P. Fowler, Partner, Vargas & Bartlett, Reno and Las Vegas, Nev.) and Exhibit 1 (Study of Nevada Corporate Law, July 30, 1990) (identifying the Model Act as the origin of many provisions of a bill to overhaul the Nevada corporation code); *Minutes of the Nev. S. Comm. on Judiciary*, S.B. 433, 462, 1995 Leg., 68th Sess. (May 16, 1995) (statement of John P. Fowler, Chairman, Executive Committee of the Business Law Section, Nevada State Bar) (stating that much of the wording in the

But in stark contrast to Delaware, Nevada's marketing efforts are principally directed at a particular segment of close corporations.<sup>128</sup> Thus, promoters of Nevada brag that it is "the most difficult state in the country in which to pierce the corporate veil,"<sup>129</sup> "the only state in the country that does not exchange information with the IRS,"<sup>130</sup> and "the only state that allows its corporations to use bearer stock certificates . . . to ensure privacy."<sup>131</sup> In addition, the lack of a state corporate income tax attracts to Nevada corporations that hold only intangible assets and conduct no operations, and may thus avoid paying income tax in other states.<sup>132</sup> All of these features are advantageous to close corporations, but are largely irrelevant to public ones.<sup>133</sup>

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existing merger chapter in the Nevada code comes from the Model Act, and that the Model Act was used to draft the new merger bill), *available at* <http://www.leg.state.nv.us>.

128. The website of Delaware's division of corporations lists as reasons for incorporating in Delaware the state's advanced and flexible corporation statute, the quality of Delaware courts, the efforts by the legislature to keep Delaware law current, and the service quality of the office of the secretary of state. *See* Del. Div. of Corps., Frequently Asked Questions, *at* <http://www.state.de.us/corp/q&a.htm> (last modified Nov. 7, 2002). All of these features are important to public corporations. By contrast, the website of Nevada's secretary of state highlights, in addition to low taxes and fees, that Nevada has "No I.R.S. Information Sharing Agreement" and "Minimal Reporting and Disclosure Requirements" and that "Stockholders are not Public Record." *See* Nev. Sec'y of State, Why Incorporate in Nevada?, *at* <http://sos.state.nv.us/commrec/whyinc.htm> (last modified Jan. 1, 2002); *see also* JOHN H.O. LA GATTA, NEVADA ECONOMIC DIVERSIFICATION 17 (July 1999) ("Nevada's promotional material concedes that large corporations might look to Delaware, as Nevada is best suited for smaller, closely-held enterprises.").

129. Website of Nevada Corporation Services (2000), *at* <http://www.nevadaincorporations.com/whynevada2.html>; *see also* Website of Nevada Corporate Planners (2002), *at* <http://www.nvinc.com/piercecorp.htm> (suggesting that veil-piercing law is "the real" reason to incorporate in Nevada); Website of Why Incorporate in Nevada (2002), *at* <http://www.whyincorporateinnevada.com/4advantages.php> (listing veil-piercing law, tax savings, asset protection, and privacy as advantages of incorporating in Nevada). Incorporation services, of course, do not speak for the state and may be prone to exaggerate the virtues of a state's regime. No similar claims, however, are made by Delaware incorporation services. *See, e.g.*, Website of Delaware Intercorp (2002), *at* <http://www.delawareintercorp.com/why.htm> (listing the quality of law and courts, availability of legal advice, service quality of the division of corporations, and ability to connect directly to the division's database as advantages of Delaware).

130. Website of Nevada Corporation Services, *supra* note 129; Website of Nevada's Secretary of State, *supra* note 128; *see also* Website of Nevada's Best Incorporators, *at* <http://www.nevadaincorporate.com> (last visited Nov. 24, 2002) (noting as a reason for incorporating in Nevada that the state does not share information with the Internal Revenue Service).

131. *See* Website of Why Incorporate in Nevada, *supra* note 129; *see also* Website of Nevada's Best Incorporators, *supra* note 130 (noting minimal reporting and disclosure requirements).

132. Since states assess income taxes on companies doing business in them regardless of where they are incorporated, Nevada's lack of an income tax is no reason to incorporate in it for most companies. Only companies that conduct no operations in any state and own no tangible property can avoid taxes on income derived from intangible assets by incorporating in Nevada. But those companies would obtain similar benefits by incorporating in Delaware or in a number of other states charging low or no corporate income taxes. *See* Glenn R.

The attention to close corporations is natural. They generate the bulk of Nevada's tax revenues from incorporations (perhaps \$20 million a year), and many of them are small businesses run by Nevada citizens.<sup>134</sup> They are indeed the reason why Nevada recently decided not to raise its annual report fee above its current flat rate of \$85 a year.<sup>135</sup>

But with regard to public corporations, Nevada has done little, derived minuscule benefits, and had trivial success. Nevada lacks a developed corporate case law,<sup>136</sup> a fact not helped by the state's failure to publish trial

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Simpson, *Diminishing Returns: A Tax Maneuver in Delaware Puts Squeeze on States*, WALL ST. J., Aug. 9, 2002, at A1 (featuring Delaware as the main tax haven for subsidiaries holding intangible assets, and mentioning Nevada and Michigan only secondarily). Wholly owned subsidiaries, of course, make little use of corporate law and the state court system, pay negligible franchise taxes, and do not need the services of local lawyers. *Id.* (noting that wholly owned subsidiaries require minimal legal services).

133. Public corporations are rarely concerned that their corporate veil may be pierced. See Robert B. Thompson, *Piercing the Corporate Veil: An Empirical Study*, 76 CORNELL L. REV. 1036, 1047 (1991) (reporting the absence of decisions holding individual shareholders of a public corporation personally liable for acts of the corporation in a sample of 1600 reported decisions through 1985). Public corporations are also subject to extensive disclosure obligations under the federal securities laws, making the absence of disclosure obligations under state law irrelevant.

134. See John G. Edwards, *Committee Aims to Lure Firms*, LAS VEGAS REV.-J., Nov. 28, 1999, at 1K (stating that Nevada's commercial recordings division generated total revenues of \$26 million in the preceding fiscal year). Some fees payable to the commercial recording division, such as fees for foreign and nonprofit corporations, trademark registration fees, and Uniform Commercial Code filing fees, are unrelated to incorporations. See *Commercial Recording Fee Schedule*, available at [http://sos.state.nv.us/comm\\_rec/fees/index.htm](http://sos.state.nv.us/comm_rec/fees/index.htm) (last visited Nov. 4, 2002).

135. In 2001, the Nevada legislature considered a bill to increase the annual report fee payable by both domestic companies and foreign companies licensed to do business in the state to \$150 plus 0.35% of the company's net worth in Nevada in excess of \$40,000. See *Minutes of the Nev. S. Comm. on Judiciary*, B.D.R. 7-1547 (later introduced as S.B. 577), 2001 Leg., 71st Sess. (May 22, 2001) (statement of Committee Chairman Mark A. James), available at <http://www.leg.state.nv.us>. The proposal was quickly abandoned. See *Minutes of the Nev. S. Comm. on Judiciary*, B.D.R. 7-1547 (later introduced as S.B. 577), 2001 Leg., 71st Sess. (May 24, 2001) [hereinafter May 24 Minutes] (statement of Committee Chairman Mark A. James), available at <http://www.leg.state.nv.us>. Concerns about the effect of fee increases on small businesses shaped the final legislation. See, e.g., May 24 Minutes, *supra*, (statement of Committee Vice Chairman Jon C. Porter) (expressing "a grave concern shared by Senator James and other members of the committee" about "the impact on small businesses"); *Minutes of the Nev. Assem. Comm. on Judiciary*, S.B. 577, 2001 Leg., 71st Sess. (May 30, 2001) (testimony of Derek Rowley, President of Corporate Services Center) (stating, in response to a question about the kind of corporation that would be concerned over a \$50 fee increase, that "the typical 'mom and pop' operation or 'people with a good idea' made up a vast majority of Nevada corporations," and that "[t]hey were very conscientious about costs, running their business on a shoestring"), available at <http://www.leg.state.nv.us>.

136. We conducted a Westlaw Key search in the state court database for Nevada by searching for Corporations key numbers 310, 314, 315, and 316 (relating to fiduciary duties). As of February 25, 2002, there were eight Nevada cases with these key numbers, compared to 197 for Delaware, 53 for Michigan, 27 for Florida, 14 for South Carolina, and six for New

court opinions.<sup>137</sup> Nevada's main draw for public corporations is allegedly its comprehensive corporation statute,<sup>138</sup> yet its legislature meets only every two years—a feature hardly conducive to keeping its law up to date. Nevada's business court is of recent vintage, employs juries to resolve factual disputes, may lack personal jurisdiction over most officers and directors of Nevada's public corporations, and has as its main goal the inducement of companies to locate their operations in Nevada.<sup>139</sup> And Nevada's aspiration to become the Delaware of the West refers less to a targeted effort to attract incorporations than to a general strategy of offering services to businesses from other states.<sup>140</sup>

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Hampshire.

137. David Mace Roberts & Rob Pivnick, *Tale of the Corporate Tape: Delaware, Nevada and Texas*, 52 BAYLOR L. REV. 45, 47 (2000) (noting that publishing only opinions of the Nevada Supreme Court results in sparse corporate case law).

138. See, e.g., CONDOR CAPITAL, INC., PROXY STATEMENT, at 7 (Mar. 28, 2000) (noting comprehensive and flexible law as a main reason to reincorporate from Colorado into Nevada), available at <http://www.sec.gov/Archives/edgar/data/831375/0001093094-00-000049-index.html>.

139. See *supra* Part II.C.

140. See E-mail from Steven B. Miller, Managing Editor, Nevada Policy Research Institute, to Marcel Kahan (Mar. 20, 2002) (on file with authors) (noting that "Delaware of the West" refers to Nevada's overall initiatives to further its economic development, not to a specific effort to become an incorporation haven). A recent plan to pursue this goal was recommended to the Nevada legislature in 2001. See LEGISLATIVE COMM'N'S SUBCOMM. TO ENCOURAGE CORPS. & OTHER BUS. ENTITIES TO ORGANIZE AND CONDUCT BUS. IN THIS STATE, NEV. LEGISLATURE, LEGISLATIVE COUNSEL BUREAU BULLETIN NO. 01-8, (Jan. 2001), available at <http://www.leg.state.nv.us> [hereinafter NEV. LEGISLATIVE COMM'N REPORT]. In addition to some changes in corporate law, *id.* § II.B., the committee report recommended creating a business court which, as explained above, is geared toward general business litigation, *id.* § II.A; updating laws involving intellectual property, electronic commerce, and labor in order to lure the film and high technology industries to the state, *id.* § II.D; auctioning public lands in rural Nevada to developers, and funding a gas pipeline and a power plant project, *id.* § II.E.; and modernizing the commercial recordings division, *id.* § II.F. Although some of these recommendations could relate to an effort to attract public corporations, Nevadans who participated in formulating the plan or followed its preparation regarded the plan primarily as an effort to attract business. See *Minutes of the Nev. Legis. Commission's Subcomm. to Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State*, 1999 Leg., 1999-2000 Interim Sess. (June 30, 2000) (testimony of John H.O. La Gatta) (opining that Nevada should endeavor to attract clean industries rather than focus on incorporations), available at <http://www.leg.state.nv.us>; *Minutes of the Nev. Legis. Commission's Subcomm. to Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State*, 1999 Leg., 1999-2000 Interim Sess. (Nov. 19, 1999) (testimony of John H.O. La Gatta) (describing a vision of Nevada as the Delaware of the West and a financial center based on attracting legal, accounting, banking, financing, investment management, and administration services as well as providing a tax shelter for corporate subsidiaries, rather than merely competing with Delaware in the area of corporate governance and control), available at <http://www.leg.state.nv.us>; *Minutes of the Nev. Legis. Commission's Subcomm. to Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State*, 1999 Leg., 1999-2000 Interim Sess. (Nov. 19, 1999) (testimony of Karen Baggett, Deputy Director, Nevada's Commission on Economic Development) ("To truly become the 'Delaware of the West,' Nevada must revise existing statutes to reflect the needs

Nevada's fee revenues from incorporations by public companies are a meager \$26,200 a year. The additional income and revenues from legal business can be estimated at a modest \$9 million and \$13 million, respectively, and only a small fraction of these represents an economic profit.<sup>141</sup> To put these figures in perspective, Nevada's general fund tax revenues are expected to total over \$3.74 billion in the 2001-2003 biennium, with revenues from sales and use tax and from gaming taxes alone amounting to \$2.74 billion.<sup>142</sup> Relative to these amounts, the gains from public incorporations are a drop in the bucket.

Finally, Nevada's market share in the market for public corporations is tiny<sup>143</sup>—and shrinking. During 1986-1990, about 2% of the companies that conducted initial public offerings in the United States incorporated in Nevada. During 1996-2000, that percentage dropped to 1.1%.<sup>144</sup> In 2000, Nevada attracted two firms at the initial-public-offering stage (one of which was headquartered in it). In 2001, it attracted none. Delaware, by contrast, attracted 325. That Nevada is mentioned as a player in the market for public incorporations illustrates not the vigor of competition, but how tepid that market is.<sup>145</sup>

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of the ‘new economy,’ and encourage more significant intangible investment in this state; modernize and equip the Secretary of State’s Office with the necessary resources to meet the new technologies competitors have in place; and develop a court structure that reflects the entire breadth of corporate, finance, contract, and business law.”), *available at* <http://www.leg.state.nv.us>.

141. These estimates are derived from a 3% market share for Nevada, *see* Subramanian, *supra* note 29, at 1856 (reporting a 2.8% market share for Nevada), and additional lawyers’ income and revenues proportionate to our estimates of Delaware lawyers’ income and revenues. Actual additional income and revenues are probably lower because Nevada courts may lack personal jurisdiction over most individual defendants in shareholder disputes, *see supra* Part II.C, thus reducing the incentive to bring such suits in Nevada, and because Nevada’s public corporations tend to be smaller than Delaware’s. *See* Daines, *supra* note 29.

142. *See* Executive Budget in Brief for the 2001-2003 Biennium (Jan. 22, 2001), *at* <http://www.budget.state.nv.us/budinbrief01.htm#SpendingSummary>.

143. *See* Daines, *supra* note 29 (reporting a Nevada market share of 1.5% of the companies that went public between 1978 and 1997). The irrelevance of Nevada as an incorporation state in the eyes of corporate practitioners is reflected in the lack of demand for professional publications on Nevada corporate law. Thus, for example, the publications catalog of Corporation Service Company for the year 2002 lists compilations of the corporate laws of Delaware (published twice a year and touted as the publisher’s “best-selling publication”), California, Florida, Illinois, Maryland and the District of Columbia, Massachusetts, New Jersey, New York, Ohio, Pennsylvania, and Virginia. CORP. SERV. CO., CATALOG OF BUSINESS, CORPORATION LAW & RELATED STATUTES (2002), *available at* [http://www.incspot.com/public/pub\\_index.html](http://www.incspot.com/public/pub_index.html). The absence of Nevada from the list speaks volumes of its unimportance to corporate practitioners.

144. The respective figures for companies that did not incorporate in their headquarter state are 3.0% and 1.1%.

145. It comes as no surprise that Nevada lawyers are not regular participants in professional conferences on the law of public corporations. For example, of 190 participants in the most recent Corporate Law Institute at Tulane Law School, a national conference on

3. *Maryland.*

A more recent entry into the league of states alleged to compete for incorporations is Maryland.<sup>146</sup> Maryland indeed attracts a fair number of companies headquartered elsewhere, but most of these firms are regulated investment companies.<sup>147</sup> Maryland's attraction for investment funds is based on the fact that Maryland law contains a number of statutory provisions targeted at investment companies, including provisions designed to assure that the investment company satisfies federal tax requirements, a waiver of the requirement to hold annual meetings of shareholders, and a grant of power to the board of an investment company to increase the number of authorized shares without shareholder approval.<sup>148</sup> In addition, like most other states, Maryland assesses only minimal franchise taxes on corporations.

It is unclear to what extent Maryland's status is the product of an active effort by the state to attract investment companies.<sup>149</sup> In any case, the market

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the law of public corporations, none came from Nevada. *See REGISTRANT LIST, 14TH CORP. L. INST.*, Mar. 7-8, 2002 (on file with authors).

146. *See BECHUK & COHEN, supra* note 29, at A-5 (reporting that a relatively large number of publicly traded firms are incorporated in Maryland but headquartered elsewhere); Subramanian, *supra* note 29, at 1816 (noting that Maryland controls a sizeable portion of the out-of-state incorporation market).

147. According to a database maintained by Thompson Financial, between 1986 and 2001, 249 companies incorporated in Maryland when they went public, of which 193 were investment companies (mostly close-end mutual funds and real estate investment trusts). Of these, six companies were headquartered in Maryland and 187 were headquartered elsewhere. Excluding investment companies, Maryland attracted only 56 companies over 15 years, out of a total of over 8000 companies going public and over 100 companies headquartered in Maryland. Maryland is also a popular domicile for open-end mutual funds, which are not included in the Thompson Financial database. Telephone Interview with James R. Bordewick, Jr., Senior Vice President and Associate General Counsel, MFS Investment Management, and Chairman, Investment Company Institute Close-End Fund Committee (Feb. 15, 2002).

148. *See MD. CODE ANN., CORPS. & ASS'NS § 2-105(c) (2002)* (permitting the board to increase number of authorized shares without shareholder approval); *id.* § 2-501(b) (eliminating the requirement of annual meetings for investment companies).

149. Mutual funds originally incorporated in Maryland because Maryland corporate law, unlike the corporate laws of other states, did not restrict the ability of corporations to redeem their common stock. This was historically part of Maryland law, rather than an affirmative attempt by the state to attract mutual funds. *See Telephone Interview with James J. Hanks, supra* note 75. As mutual funds flocked into Maryland, they became a constituency for the state legislature and a source of political influence. In addition, several large mutual fund sponsors—T. Rowe Price, Legg Mason, and Alex. Brown—are located in Maryland. Telephone Interview with Henry Hopkins, General Counsel, T. Rowe Price (Mar. 22, 2002). The monetary benefits that Maryland and its residents derive from investment companies are small. Maryland derives no significant franchise tax revenues from such companies. *See supra* Part I.A. Maryland lawyers derive some modest benefits from providing corporate advice to such companies, though not from litigation. Telephone Interview with James R. Bordewick, Jr., *supra* note 147 (noting that investment companies tend not to be involved in corporate disputes); Telephone Interview with James J. Hanks, *supra* note 75 (noting that mutual funds generate mostly non-litigation business for

for investment companies is rather separate from the market for regular public corporations. Most investment companies are not even organized as corporations. Instead they take the form of a trust.<sup>150</sup> Moreover, the internal affairs of investment companies are largely regulated by the federal Investment Company Act of 1940. The choice of organizational form for such companies does not hinge on the attraction of state law or the quality of state courts, but on minimizing state taxes and avoiding a second layer of state regulation on top of federal regulation.<sup>151</sup> The features of the incorporation product sought by investment companies thus differ markedly from those sought by regular public companies. Even if Maryland does compete for investment companies, that competition is meaningless for regular public corporations.

#### 4. *Promotional activities.*

Another argument suggested to support the claim that states compete to attract incorporations is that states promote their corporate laws as a reason to incorporate in them.<sup>152</sup> We have indeed encountered several articles tooting the horn for one or another state's corporation law. But they were all written by local lawyers praising their own state's law.<sup>153</sup> None of the articles we

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Maryland lawyers who help them to organize and provide them with corporate law advice).

150. John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 171 (1997) (noting that at least half of the American mutual funds are organized as trusts).

151. See TAMAR FRANKEL & ANN TAYLOR SCHWING, THE REGULATION OF MONEY MANAGERS § 9.4 (2d ed. 2001) (discussing Maryland law's harmonizing definition of independence for state law and Investment Company Act purposes); VANGUARD ASSET ALLOCATION FUND ET AL., PROXY STATEMENT 3 (Feb. 13, 1998) (noting that tax savings are the principal reason for changing the structure of the funds from Maryland corporations to Delaware business trusts), available at <http://www.sec.gov/Archives/edgar/data/836906/0000893220-98-000343.txt>; Langbein, *supra* note 150, at 183 (noting the benefit for trusts in avoiding a second layer of regulation); Telephone Interview with James R. Bordewick, Jr., *supra* note 147 (explaining that mutual funds are structured to maximize contractual flexibility and avoid a second layer of regulation).

152. See, e.g., Romano, *International Securities Regulation*, *supra* note 8, at 509-10.

153. See Byron F. Egan & Curtis W. Huff, *Choice of State of Incorporation—Texas Versus Delaware: Is It Now Time to Rethink Traditional Notions?*, 54 SMU L. REV. 249 (2001) (Texas lawyers highlighting benefits of Texas law); James I. Lotstein & Christopher Calio, *Why Choose Connecticut? Advantages of the Connecticut Business Corporation Act over the Delaware General Corporation Law*, 10 CONN. L. 10 (2000) (Connecticut lawyers noting the benefits of Connecticut law); Cyril Moscow, *Michigan or Delaware Incorporation*, 42 WAYNE L. REV. 1897, 1899 (1996) (Michigan lawyer discussing the advantages of a Michigan incorporation); Charles W. Murdock, *Why Illinois? A Comparison of Illinois and Delaware Corporate Jurisprudence*, 19 S. ILL. U. L.J. 1 (1994) (draftsman of Illinois's 1983 Business Corporation Act and author of a two-volume treatise on Illinois law noting benefits of Illinois law); Frederick D. Lipman, *Alternatives to Incorporating in Delaware*, N.Y. L.J., Nov. 6 1997, at 5 (Philadelphia lawyer promoting Pennsylvania law); Telephone Interview with James J. Hanks, *supra* note 75 (Maryland lawyer praising features of Maryland law).

found was written by a state official, and no other major promotional activities targeting public corporations by states other than Delaware have come to our attention.<sup>154</sup>

Articles extolling a state's law may well reflect competition by lawyers for clients. They advertise the author's expertise, may result in referrals, and can be listed on one's resume—regardless of whether they generate additional incorporations. To the extent that locally incorporated companies are more likely than Delaware companies to hire a local lawyer, lawyers may also try to increase local incorporations, although this would benefit local lawyers generally, not just the author. All this suggests that local lawyers may overstate the virtues of the local law, not that states join them in their quest.

##### 5. *Historic competition.*

Historical accounts suggest that states competed for incorporations at the end of the nineteenth century.<sup>155</sup> We make no claim about the extent to which states actively pursued incorporations at that time, and the exact point in time at which that pursuit stopped. We note parenthetically, however, that many corporate law revisions attributed to state competition at the end of the nineteenth century—such as allowing the formation of companies with unlimited life, permitting companies to hold stock of other companies, and removing restrictions on the maximum capital stock that companies can issue—had been introduced into unitary United Kingdom corporate law long before they became part, allegedly as a result of state competition, of the law in the United States.<sup>156</sup> Thus, even for that earlier time period, the significance of state competition may have been exaggerated.

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154. Telephone Interview with Cynthia B. Kane, International Special Projects, Delaware Department of State (June 6, 2002) (stating that, to her knowledge, no state other than Delaware is engaged in serious marketing efforts directed at public corporations). Delaware, by contrast, commits substantial resources to promotional activities. In July 1999, for example, it sent to Israel a high-level delegation to market itself as an incorporation haven. *See* Benjamin Strauss, *Governor Thomas R. Carper Leads Trade Mission to Israel*, CORP. EDGE, Fall 1999, at 1, available at <http://www.state.de.us/corp/fall99.pdf>.

155. *See* Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677, 688 fig.4 (1989) (documenting chartermongering among states during the late 1800s); William E. Kirk, III, *A Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain Corporate Pre-Eminence*, 10 J. CORP. L. 233 (1984) (same); Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249 (1976) (same); Harold W. Stoke, *Economic Influences upon the Corporation Laws of New Jersey*, 38 J. POL. ECON. 551, 575-76 (1930) (same).

156. *See* PALMER'S COMPANY LAW 7.012 (Geoffrey Morse principal ed., 25th ed. 1992) (Eng.) (attributing the principle that companies may own stock in other companies to a 1867 decision); Joint Stock Companies Act of 1856 (Eng.) (making no reference to maximum limits on the amount of capital stock); 8 W.S. HOLDSWORTH, A HISTORY OF ENGLISH LAW 202 (1926) (noting that, already in the seventeenth century, a corporation's existence was perpetual unless it was created for a definite period).

But for purposes of analyzing corporate law today, it suffices that any such competition has long since ended. Corporate law and competitive dynamics are not static. For example, the rules governing takeovers and the rules concerning conflict-of-interest transactions have changed substantially over the last twenty years. Even if state corporate laws were the product of competition for incorporations a hundred years ago, state laws today, and probably the laws that were in force when the modern state competition debate started, no longer reflect that historic competition.

### III. WHY DO STATES NOT COMPETE?

Delaware is presently earning about \$500 million a year in profits from franchise taxes paid by public corporations.<sup>157</sup> Its outlays to generate these profits are minimal. In terms of profit margins, return on capital, and net present value, Delaware's incorporation business is highly lucrative. Why is it, then, that no state seriously competes with Delaware?

In an earlier work, we suggested that the explanation lies in a combination of economic entry barriers and the political contingency of state action.<sup>158</sup> We shall now elaborate on this view. In Part III.A, we discuss the competitive advantages that Delaware enjoys. In Part III.B, we explain how political factors hamper the ability of states to compete effectively. Our analysis suggests that both economic entry barriers and politics account for state inaction. Were Delaware not protected by competitive advantages, political constraints might not be enough to retard entry by other states.<sup>159</sup> Similarly, if the political calculus in a state were to change, economic entry barriers might not suffice to deter entry.

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157. Delaware's budgeted 2002 revenues from the division of corporations are \$576.3 million. See Del. Office of the Budget, Fiscal Year 2003 Governor's Recommended Operating and Capital Budget Information, available at [http://www.state.de.us/budget/fy2003/budget\\_2003.html](http://www.state.de.us/budget/fy2003/budget_2003.html) (last modified Jan. 24, 2002). Profits from franchise taxes payable by public corporations are about 90% of these revenues. See Kahan & Kamar, *supra* note 24, at 1211, 1225, 1251 (providing estimates of revenues from public corporations in relation to total franchise tax revenues and costs).

158. Kahan & Kamar, *supra* note 24, at 1213-14.

159. For examples of successful attempts to lure businesses already installed elsewhere, see sources cited *supra* note 58. While these examples suggest that public officials may go to great lengths to attract business when the potential benefits to the community are of the right magnitude, political considerations may play a more central role in their calculations. See, e.g., GEORGE LEFCOE, REAL ESTATE TRANSACTIONS ch. 29, § I.D (4th ed. forthcoming 2003) (reviewing the literature on the failure of politically driven tax and zoning incentives to achieve economic development); Margaret E. Dewar, *Why State and Local Economic Development Programs Cause So Little Economic Development*, 12 ECON. DEV. Q. 68, 68-69 (1998) (reviewing the literature on programs to attract business and arguing that these programs often suffer from being initiated and run by poorly informed public officials who pursue political goals).

The reasons why states do not compete bear on the stability of the current equilibrium in corporate law as well as the potential for regulatory competition in other fields. Lucian Bebchuk and Assaf Hamdani argue in a contemporaneous work that significant economic entry barriers account for Delaware's market power.<sup>160</sup> This implies that the major risk for Delaware is a change in economic conditions. By contrast, we attribute the lack of competition to a combination of political and economic factors. Even absent a change in economic fundamentals, it is entirely plausible that an enterprising governor will in the future revamp her state's corporate law, establish a specialized court, and go after a portion of Delaware's profits.

#### A. Economic Entry Barriers

It has long been recognized that Delaware enjoys competitive advantages over other states that make it more attractive as a domicile for incorporation. From the perspective of potential competitors, these advantages constitute economic barriers to entry. But while these entry barriers clearly make competition with Delaware more difficult, we do not believe that they make competition so difficult as to be a sufficient explanation for its near absence today.

The main advantage that Delaware possesses is its specialized corporate court. Setting up similar courts, however, would entail only modest budgetary requirements. Judges on Delaware's chancery court earn about \$135,000 a year,<sup>161</sup> and the total outlays for Delaware's five-member court are about \$2 million a year.<sup>162</sup> For a competitor state, which initially would have fewer companies and less corporate litigation, a one-member court would be enough. Granted, a court in a competitor state would lack the pedigree of Delaware's chancery court and, to the extent that it initially failed to attract a sufficient number of corporate cases, its judge might not develop expertise that would match the expertise of Delaware judges.<sup>163</sup> But these deficiencies could be mitigated. For example, the state could appoint a renowned and experienced corporate jurist to the court.

Another important advantage that Delaware offers is its extensive and widely known corporate case law. The extensiveness and familiarity of Delaware case law reduce the cost of planning transactions for Delaware corporations, obtaining legal advice for them, and assessing their value.<sup>164</sup> However, while a competitor state might find it difficult to manufacture comparable advantages overnight, it could nevertheless take steps to narrow the

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160. See Bebchuk & Hamdani, *supra* note 30.

161. THE LAWYER'S ALMANAC, *supra* note 51, at J-21.

162. Kahan & Kamar, *supra* note 24, at 1230 n.109.

163. Kamar, *supra* note 94, at 1935.

164. See Klausner, *supra* note 31, at 842-47.

gap between itself and Delaware. For example, it could enact a more rule-oriented corporate code, which would reduce the significance of legal precedent. It could also attach an elaborate set of examples or comments to its code, increasing its predictability and reducing the costs of learning it. Most simply, a competitor state could keep its corporation code identical to the Delaware General Corporation Law, continually update it to track changes adopted by Delaware, and instruct its court to interpret the code in light of Delaware precedent.<sup>165</sup>

It is true that by emulating Delaware a competitor state would not deliver the same product that Delaware does. Copying Delaware statutory law would not obviate the need for an expert court and, even with such a court, the competitor state would lack Delaware's reputation.<sup>166</sup> Thus, at least initially, that state would have to charge a lower franchise tax than Delaware's.<sup>167</sup> But given the substantial profits that Delaware earns, the strategy of setting up a court modeled after the Delaware court of chancery and copying the Delaware code seems viable. Even if only modestly successful, such a strategy would generate a positive return on the investment. Yet no state has pursued either prong of this strategy.<sup>168</sup>

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165. Cf. Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA L. REV. 713, 750-51, 760-61 (1997) (documenting how contractual provisions are copied, and attributing that copying to learning and network benefits). While the failure of states to copy Delaware law must be puzzling to devotees of state competition, it is consistent with our suggestion that local lawyers may not want to copy Delaware law even if doing so increases incorporations. See *supra* Part II.A.3.

166. See Kamar, *supra* note 94, at 1928-32 (arguing that the structure of Delaware law makes quality courts particularly important).

167. Bebchuk and Hamdani suggest that price-based competition would be futile since a lower price would not compensate for the lower quality of the law of a competing state. See Bebchuk & Hamdani, *supra* note 30, at 130-31. This implies that, at the price Delaware charges, incorporation decisions are highly inelastic. However, several theoretical and empirical factors suggest that companies are price-sensitive. First, a profit-maximizing producer with market power will raise its price to a level at which demand is elastic. Second, companies leaving Delaware regularly cite franchise taxes as a major consideration. See Romano, *supra* note 4, at 256-60. Third, the Delaware corporate bar tends to oppose franchise tax increases because it is concerned that such increases will reduce the number of Delaware incorporations. See E-mail from Professor William T. Allen, Delaware Chancellor between 1985 and 1997, to Marcel Kahan (Oct. 18, 2002) (on file with authors). Fourth, Delaware's practice of charging higher prices to large public corporations than to small ones, see Kahan & Kamar, *supra* note 24, at 1223-32, suggests that public companies are price-sensitive.

168. Despite occasional claims to the contrary, Nevada does not imitate Delaware. See Roberts & Pivnick, *supra* note 137 (cataloguing differences between Delaware law, Nevada law, and Texas law). To assure that a state's case law does not diverge from Delaware law over time, a state would have to accord greater weight to Delaware precedent than to its own. Such a scheme would obviously entail significant political costs. See *infra* Part III.B.2.

### B. *The Political Contingency of State Competition*

Given the ineffectiveness of the strategy that states allegedly follow—revising their corporate codes periodically—why has no state ever experimented with the inexpensive strategy of copying Delaware law or made the small investment required to set up a properly structured corporate court? And if Delaware's present advantages are so formidable, why did allegedly competing states not intervene earlier, when Delaware's competitive edge was less pronounced?<sup>169</sup> Having been portrayed as determined competitors for corporate charters, it seems peculiar that states have failed to act, rather than acted and failed.<sup>170</sup>

Moreover, economic entry barriers did not deter Delaware from challenging New Jersey in 1899 by copying its corporation code and embarking on an aggressive marketing campaign, even though New Jersey was at that time well established as a national incorporation center.<sup>171</sup> Several other states competed as well.<sup>172</sup> The explanation for these puzzles lies in political factors, rather than merely economic ones.

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169. In 1932, Delaware was much less dominant than it is today. Its share of New York Stock Exchange companies was only 34%, followed by New York's 16%, and New Jersey's 14%. *See LARCOM, supra* note 2, at 175.

170. For examples of attempted, and even successful, entries into network markets, see Rajiv Chandrasekaran & Elizabeth Corcoran, *Microsoft's Web Browser Overtakes Netscape's*, WASH. POST, Oct. 1, 1998, at C2 (reporting that Microsoft had overtaken Netscape as the maker of the most widely used web browsing software despite Netscape's initial command of 80% of the market); Richard S. Ginell, *Be Forearmed: New VHS-Beta Battle Afoot*, CHI. TRIB., Oct. 29, 1987, at 13E (reporting that despite a 90% market dominance of the VHS format for video cassette recorders, Sony introduced a new Beta-format video cassette recorder). Admittedly, the switching costs involved in experimenting with different web browsers or video cassette recorders may be lower than the cost of a single shareholder lawsuit that is handled poorly, and so corporate decisionmakers may be more reluctant than consumers of other network products to trade a tried-and-true Delaware incorporation for incorporation in an unfamiliar jurisdiction. Nevertheless, half of the public corporations in the United States are incorporated outside of Delaware.

171. New Jersey built its market share between 1888 and 1896 by liberalizing its corporation code and advertising itself. *See Grandy, supra* note 155, at 681 (discussing statutory revisions); Lincoln Steffens, *New Jersey: A Traitor State*, 25 MCCLURE'S MAG. 41, 44-45 (1905) (describing New Jersey's marketing efforts). As of January 1, 1904, more than 55% of the United States companies with capitalizations over \$1,000,000 were chartered in New Jersey. *See LARCOM, supra* note 2, at 13. In 1899, Delaware adopted its first general corporation code, which drew heavily on the New Jersey code. *See Wilmington City Ry. Co. v. People's Ry. Co.*, 47 A. 245, 251, 254 (Del. Ch. 1900) (finding that the Delaware corporation code largely adopts language from the New Jersey code and concluding that the Delaware legislature intended it to be construed according to New Jersey case law); LARCOM, *supra* note 2, at 15 (noting that Delaware copied many of the features of the New Jersey corporation code because it was the most popular at the time). The adoption of the new code was followed by vigorous marketing efforts. *See Note, Little Delaware Makes a Bid for the Organization of Trusts*, 33 AM. L. REV. 418, 419-22 (1899) (commenting on a circular explaining the advantages of incorporation in Delaware).

172. *See GILBERT HOLLAND MONTAGUE, TRUSTS OF TO-DAY* 98-101 (1904) (noting

1. *States as profit seekers.*

Standard economic theory posits that firms strive to maximize profits. Even for firms this assumption is no more than a first approximation. But whatever its validity for firms, the goal of profit maximization cannot be transposed to states.<sup>173</sup> For that reason, government-run enterprises are generally not paragons of efficiency.<sup>174</sup> Indeed, political science scholars and public-choice economists agree that state lawmakers pursue political and ideological goals, rather than profits.<sup>175</sup>

To be sure, profits earned from franchise taxes may aid state lawmakers in achieving their other goals. But this does not imply that state lawmakers will try to earn such profits whenever possible. First, the amount of profits may just be too small to appear on a state's radar screen. A business proposal to generate profits of, say, \$2 million a year, which would be attractive to a host of business entrepreneurs, may get no attention in any state capital.<sup>176</sup> At a

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West Virginia and Delaware as states that competed with New Jersey for corporations at the end of the nineteenth century); Grandy, *supra* note 155, at 685 (noting West Virginia, Maryland, Maine, and New York); Keasbey, *supra* note 1, at 201-02 (noting West Virginia, Kentucky, Delaware, and New York); Stoke, *supra* note 155, at 575-76 (noting West Virginia, Maryland, and Maine).

173. The literature on this topic is much too vast to be covered here. For representative examples, see BRUCE A. ACKERMAN & WILLIAM T. HASSLER, CLEAN COAL/DIRTY AIR OR HOW THE CLEAN AIR ACT BECAME A MULTIBILLION-DOLLAR BAIL-OUT FOR HIGH-SULFUR COAL PRODUCERS AND WHAT SHOULD BE DONE ABOUT IT 1-3, 88-90 (1981) (describing the Clean Air Act of 1970 as an economically inefficient political compromise driven by the desire not to harm existing coal producers); JOHN A. FEREJOHN, PORK BARREL POLITICS; RIVERS AND HARBORS LEGISLATION 1947-68 (1974) (documenting economically unviable governmental dam projects whose main purpose is to find favor with interest groups); DANIEL B. KLEIN, ADRIAN MOORE & BINYAM REJA, CURB RIGHTS: A FOUNDATION FOR FREE ENTERPRISE IN URBAN TRANSIT 22-29 (1997) (blaming goals unrelated to profitability for the economic failure of public transportation systems); SPORTS, JOBS, AND TAXES: THE ECONOMIC IMPACT OF SPORTS TEAMS AND STADIUMS (Roger G. Noll & Andrew Zimbalist eds., 1997) (collecting studies suggesting that, notwithstanding claims by politicians to the contrary, public sponsorship of sports teams and stadiums is economically unviable).

174. For a survey of numerous studies comparing the efficiency of public and private enterprises, see W. KIP VISCUSI, JOHN M. VERNON & JOSEPH E. HARRINGTON, JR., ECONOMICS OF REGULATION AND ANTITRUST 433-51 (3d ed. 2000).

175. See, e.g., Sam Peltzman, *Towards a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGM'T SCI. 3 (1971); see also Daryl J. Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345, 354-57 (2000) (arguing that the government should not be modeled as a profit-maximizing firm); Sitkoff, *supra* note 22, at 1143-49 (analyzing how the interests of individual legislators in attracting campaign contributions can detract from a state's ability to raise franchise taxes by attracting incorporations).

176. That lawmakers pay little attention to policy choices that yield only minor benefits per voter is hardly a new discovery. See R. DOUGLAS ARNOLD, THE LOGIC OF CONGRESSIONAL ACTION 28 (1990). Of course, given a certain amount of profits, benefits per voter will be higher in less populated states. Thus, other things being equal, less populated states may be more likely to pursue profitable business ventures. Bebchuk and

minimum, the threshold before states will engage in such activities is higher than the one for businesses formed for the express purpose of generating profits.

Second, profits may come too late to be relevant for state lawmakers. A business proposal, say, to invest \$1 million over the next ten years to generate a considerable payoff thereafter may hold little attraction to politicians concerned about the next elections.<sup>177</sup> The timing of the benefit to the state and the timing of political and economic costs that must be incurred in order to achieve that benefit are significant for a number of reasons. For one thing, interest groups and voters at large are more likely to notice the immediate effects of a policy choice and link them to that choice.<sup>178</sup> In addition, voters evaluate politicians on Election Day based on demonstrable achievements rather than promises.<sup>179</sup>

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Hamdani infer from the failure of South Dakota to compete with Delaware that economic entry barriers rather than political factors account for the lack of competition. *See* Bebchuk & Hamdani, *supra* note 30. To our knowledge, however, South Dakota has never taken meaningful measures to compete for incorporations, not even in the middle of the twentieth century, when Delaware's competitive advantages were less pronounced, or at the close of nineteenth century, when Delaware was making its first steps in competing for incorporations. *See supra* note 172 and accompanying text. Accordingly, of 8664 U.S. corporations tallied in 1904, none were organized in South Dakota. *See* JOHN MOODY, THE TRUTH ABOUT THE TRUSTS: A DESCRIPTION AND ANALYSIS OF THE AMERICAN TRUST MOVEMENT 453-77 (1904) (listing corporations).

Moreover, at least when states competed at the end of the nineteenth century, state size did not appear to have been an overriding factor. In 1902, New York had the second largest budget of all states in the United States, with receipts totaling almost \$24 million. It nevertheless reportedly competed with New Jersey, which collected about \$6 million in total receipts. The other states that reportedly competed for incorporations at that time, Delaware, West Virginia, Maine, and Kentucky, had total receipts of about \$0.5 million, \$2.3 million, \$2.5 million, and \$6 million, respectively. But many other states had similar budgets. Only eight states (California, Illinois, Michigan, Minnesota, Ohio, Pennsylvania, Texas, and Wisconsin) had total receipts higher than \$6 million, and sixteen states (Arizona, Arkansas, Florida, Indiana, Montana, Nevada, New Hampshire, North Carolina, North Dakota, Oklahoma, Oregon, Rhode Island, Utah, Vermont, and Wyoming) had total receipts lower than \$2 million. In fact, four of those states had receipts lower than \$1 million. They included Wyoming, Nevada, Arizona, and Oklahoma, which collected about \$0.4 million, \$0.5 million, \$0.7 million, and \$0.9 million, respectively. All figures exclude transfer receipts, most of which were transfers within each state. *See* DIR. OF THE CENSUS, DEP'T OF COMMERCE & LABOR, WEALTH, DEBT, AND TAXATION 998-1003 (1907).

177. In a recent contribution to the incorporation scholarship, Gillian Hadfield and Eric Talley argue that state lawmakers rarely look beyond maximizing their reelection prospects, and so they are more concerned with maintaining the economic condition of the state than with improving it. *See* Gillian Hadfield & Eric Talley, On Public Versus Private Provision of Corporate Law (Oct. 2001) (unpublished manuscript), available at <http://www-rcf.usc.edu/~etalley/hadtall.pdf>. One implication of this view for the incentives to compete is that states will not bother to attract new incorporations, and at most will try to retain existing ones. As we have argued above, the gains to states other than Delaware from retaining their chartered firms are meager. *See supra* Part I.C.1.

178. *See* ARNOLD, *supra* note 176, at 27, 29.

179. Voters evaluate candidates for public office based on what the candidates have already achieved because this motivates elected officials to deliver on their promises,

Finally, state budgets are designed to balance short-term cash flows, rather than long-term present values.<sup>180</sup>

Third, state lawmakers may have more important items on their agenda. Even if they are interested in profit because of its political payoffs, it is not sufficient that a venture generate profits. It must generate profits with payoffs that exceed those from other political initiatives. In this regard, it is noteworthy that New Jersey, the nation's incorporation center before 1913, started its chartering business only after a local lawyer had convinced prominent political figures in the state that the plan would advance their careers.<sup>181</sup> And in West Virginia, another state that pursued incorporations at that time, the secretary of state himself acted as the legal representative of chartered companies for a personal fee.<sup>182</sup>

## 2. Political constraints.

Even to the extent that state policymakers want to derive profits, political constraints can hamper the ability of states to compete for incorporations. These constraints constitute entry barriers of sorts, but barriers that are particular to political entities. In the remainder of this subsection, we relate

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because past outcomes are easier to grasp than projections, and because long-term promises depend on cooperation by future legislators and thus are not credible. See Linda Cohen & Matthew Spitzer, *Term Limits*, 80 GEO. L.J. 477, 486-89 (1992); see also MORRIS P. FIORINA, RETROSPECTIVE VOTING IN AMERICAN NATIONAL ELECTIONS 20-43 (1981) (surveying data suggesting that voters evaluate candidates for president and Congress based on past performance). Evidence suggests that legislators are responsive to this method of evaluation. For example, they offer much stronger support to development projects that are already in place than to projects yet to be implemented. See LINDA R. COHEN & ROGER G. NOLL, THE TECHNOLOGY PORK BARREL 61 (1991) (arguing that citizens engage in retrospective voting, creating a political disadvantage for long-term projects the benefits of which will accrue in the future).

180. See RICHARD BRIFFAULT, BALANCING ACTS: THE REALITY BEHIND STATE BALANCED BUDGET REQUIREMENTS 63 (1996) (finding that states strive to balance their operating budgets). The preoccupation with short-term cash flows characterizes the federal budget as well. See Elizabeth Garrett, *Harnessing Politics: The Dynamics of Offset Requirements in the Tax Legislative Process*, 65 U. CHI. L. REV. 501, 527-30 (1998) (describing accounting gimmicks aimed at balancing short-term cash flows in the federal budget); Michael J. Graetz, *Paint-By-Numbers Tax Lawmaking*, 95 COLUM. L. REV. 609, 672-77 (1995) (describing efforts to accelerate revenue gains and delay revenue costs in the federal budget). The pressure on states to balance their budgets may be even stronger because their smaller economies are less protected from cyclical variations in cash flows. See Michael Wolkoff, *State and Local Government Budgeting: Coping with the Business Cycle*, in HANDBOOK OF GOVERNMENT BUDGETING 178, 179 (Roy T. Meyers ed., 1999).

181. See Steffens, *supra* note 171, at 44 (describing conversations between James B. Dill and Governor Leon Abbott, Secretary of State and Member of the Democratic State House Ring Henry C. Kelsey, Chancery Court Clerk and Chairman of the Democratic State Committee Allan L. McDermott, United States District Attorney and influential Republican Henry S. White, and Secretary of the powerful Pennsylvania Railroad Charles B. Thurston).

182. See MONTAGUE, *supra* note 172, at 99.

several instances in which states, for political reasons, failed to take steps that would have been conducive to increasing incorporations. Some may dismiss these examples as involving states that do not compete. But that is precisely our point. Whether to compete or not is itself a political decision. It is the presence of political obstacles that, together with other considerations, discourages states from competing.

*New Jersey and the Seven Sisters.* A well-known incident of politics interfering with attracting incorporations is New Jersey's passage of the Seven Sisters Acts in 1913. Prior to 1913, New Jersey had one of the most liberal corporate laws in the country, and was the domicile of choice for large corporations, with a market share as large as the one that Delaware has today.<sup>183</sup> New Jersey's liberal regime extended beyond corporate internal affairs to the freedom it afforded to corporations to build and retain market power.<sup>184</sup>

New Jersey's fall from corporate grace is due to the political agenda of then governor and president-elect Woodrow Wilson. In his 1912 presidential election campaign, Wilson made the destruction of business monopolies a keystone of his platform.<sup>185</sup> But as opposing candidate Theodore Roosevelt pointed out, Wilson had done nothing as governor of New Jersey to reform the state's own laws. Wilson reacted by drafting antitrust legislation and personally pushing it through the New Jersey legislature. The Seven Sisters, as the series of Acts was dubbed, effectively outlawed trusts and holding companies.<sup>186</sup> As predicted, they cost New Jersey its lead.<sup>187</sup>

*Illinois and the aftermath of Smith v. Van Gorkom.* One of the major statutory reforms of the 1980s was the enactment by most states of a provision permitting companies to eliminate the liability of directors for breaching the duty of care. These provisions were stimulated by a controversial 1985 Delaware Supreme Court decision that held Jerome Van Gorkom and his fellow directors of Trans Union personally liable for breaching their duty of care in conducting the sale of the company.<sup>188</sup> The decision sent shockwaves through corporate boardrooms. Within a few months, Delaware amended its corporate law to limit directors' personal liability for duty-of-care violations. One might have expected Illinois—home to Trans Union, Van Gorkom and

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183. See Seligman, *supra* note 155, at 265-72 (discussing New Jersey law). As of January 1, 1904, 55% of U.S. trusts were chartered in New Jersey. See LARCOM, *supra* note 2, at 13.

184. See MONTAGUE, *supra* note 172, at 138 (discussing the ineffectiveness of the Sherman Act of 1890 at the turn of the century); MOODY, *supra* note 176, at 497-99 (same).

185. Kirk, *supra* note 155, at 256 (describing Wilson's campaign).

186. Seligman, *supra* note 155, at 270 (discussing the Seven Sisters Acts).

187. Kirk, *supra* note 155, at 257 (discussing the effect of the Acts on New Jersey incorporations). New Jersey repealed the Seven Sisters Acts in 1917. *Id.* at 257-58.

188. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985).

each of the other Trans Union directors<sup>189</sup>—to be next. Not so. While forty other states followed Delaware's lead within two years,<sup>190</sup> it took Illinois seven years to enact a provision limiting director liability.<sup>191</sup> Illinois's tardiness was not mere neglect. Bills to amend the Illinois Business Corporation Act were introduced as early as 1987.<sup>192</sup> Yet the bills failed to pass “because the savings and loan fiasco was engendering widespread publicity about the competence of boards of directors.”<sup>193</sup> Political opposition, rather than economic factors, thus prevented Illinois from adopting a measure that would have made it more attractive as a corporate domicile.

*Unlimited liability for wage claims in New York.* Under section 630 of New York's Business Corporation Law, the ten largest shareholders of a company are personally liable for wages and salaries payable to the company's employees.<sup>194</sup> Section 630 is widely regarded as a major reason why many New York-based companies do not incorporate in New York.<sup>195</sup> Yet repeated efforts by the local bar to have section 630 repealed failed because of political opposition by organized labor.<sup>196</sup> Again, political forces forestalled a change that would have been conducive to increasing incorporations.<sup>197</sup>

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189. Trans Union had five insider directors, who were presumably residents of Illinois. Trans Union's five outside directors included the dean of the University of Chicago business school and four chief executive officers of large Chicago-based companies. *See id.* at 894.

190. *See* Roberta Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L.J. 1155, 1160 (1990) (noting that 41 states, including Delaware, adopted provisions reducing directors' liability exposure within two years); *see also* Carney, *supra* note 30, at 753 (presenting a chart showing adoptions of director liability statutes over time).

191. *See* 1993 ILL. LAWS P.A. 88-43.

192. Lynne A. Whited, *Corporate Directors—An Endangered Species? A More Reasonable Standard for Director and Officer Liability in Illinois*, 1987 U. ILL. L. REV. 495, 509 n.96 (noting the introduction of the bills).

193. Charles W. Murdock, *Why Illinois? A Comparison of Illinois and Delaware Corporate Jurisprudence*, 19 S. ILL. U. L.J. 1, 3 (1994).

194. N.Y. BUS. CORP. LAW § 630 (McKinney 2002). Companies with stock listed on an exchange or regularly quoted in an over-the-counter market are exempt from section 630. *Id.* But public companies are routinely delisted when they become insolvent. *See, e.g.*, Drew DeSilver, *Yearlong Rough Ride for Market*, SEATTLE TIMES, Dec. 31, 2001, at A1 (noting that in 2001 “384 Nasdaq companies had been delisted for failure to meet listing requirements, bankruptcy or other reasons”). Thus, the exemption from section 630 may vanish exactly when it is needed. Moreover, when a company goes public, it often remains in the state where it was incorporated as a private company. By discouraging private companies from incorporating in New York, section 630 therefore also reduces the number of public companies incorporated in New York.

195. *See, e.g.*, Frederick Attea, *State Has Hard Time Following a Lead*, BUS. FIRST IN BUFFALO, Apr. 17, 2000, at 30 (describing section 630 as “the single most important reason why New York shareholders decide to incorporate in Delaware”); Michael M. Membrado & Christopher J. Gulotta, *Navigating the Formation of Start-Up Companies*, N.Y. L.J., Sept. 18, 2000, at S6 (noting that New York-based companies incorporate in Delaware to evade section 630).

196. *See* Attea, *supra* note 195 (noting that section 630 has been preserved “for political purposes” despite 40 years of attack); Dominic Bencivenga, *At Long Last, a Bill*, N.Y. L.J., July 31, 1997, at 5 (“[L]abor groups were adamant about retaining [section 630]

*The failure of states to establish corporate courts.* One of the most significant political constraints presently impeding the ability of states to compete relates to the establishment of corporate courts. As discussed above, such a court should be staffed with a renowned and experienced jurist and should dispose of corporate cases without juries.

Political norms, however, tie the hands of states in their search for suitable judges by requiring judges to be longtime state residents and by limiting their compensation.<sup>198</sup> These norms would preclude a competitor state from inducing a Delaware judge to move to its court and would impede a state from recruiting other qualified candidates.

Political factors also impede the ability to set up corporate courts without juries and with judges selected based on merit.<sup>199</sup> Local interest groups benefit from jury trials and judicial elections. Though perhaps not concerned about corporate disputes, these groups may fear that, once the jinni is out of the bottle, the concepts of judicial appointments and trial without a jury could expand to a broader set of cases. Moreover, political concerns over equal access to justice may hamper efforts to set up corporate courts.

Indeed, labor unions and public interest lawyers in Pennsylvania successfully opposed a bill to establish a chancery court with appointed judges and without the right to a jury trial for exactly these reasons.<sup>200</sup> Their success

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and corporate attorneys reluctantly acceded."); Richard Siegler, *Impact of Business Corporation Law Amendments*, N.Y. L.J., Oct. 29, 1997, at 3 (noting that section 630, "the strongest deterrent to incorporating in New York," was not repealed due to "strong opposition from labor unions").

197. New York was active in its efforts to attract incorporations at the end of the nineteenth century. *See supra* note 172 and accompanying text. At that time, however, it had an even less attractive statutory provision on its books, which made *all* shareholders liable for wages and salaries payable to employees. *See* Act of June 7, 1890, ch. 564, 1890 N.Y. Laws 1066, § 57.

198. Other political constraints affect even Delaware. The five judges on the Delaware chancery court are selected from long-term state residents—not from a national pool. At least one judge comes from each of the three Delaware counties—including the counties of Sussex and Kent, each of which accounts for less than seven percent of Delaware's lawyers. *See SUPREME COURT OF DELAWARE LAWYER REGISTRATION* 2001 (noting that 104 and 103 active private practice lawyers out of a total of 1518 come, respectively, from Kent and Sussex counties); Interview with Professor William T. Allen, *supra* note 115 (describing the composition of the chancery court). It is evident that these rules are not designed to produce the most qualified judiciary, but rather to satisfy traditions and legal requirements that would be politically costly to change. Because of the lack of active competition by other states, Delaware can, to some extent, indulge in such political luxuries without jeopardizing its market position.

199. Delaware never had to face equivalent political opposition in the design of its chancery court. The main features of the court—limited subject matter jurisdiction, lack of jury trial in corporate law disputes, and appointed judges—were present in Delaware by historical accident long before its entry into the market for corporate charters. *See generally* William T. Quillen & Michael Hanahan, *A Short History of the Delaware Court of Chancery—1792-1992*, 18 DEL. J. CORP. L. 819 (1993).

200. *See* John L. Kennedy, *Chancery Ct. Plan Sent to Senate*, *LEGAL INTELLIGENCER*,

in derailing Pennsylvania's chancery-court initiative illustrates the stickiness of the status quo in government politics. The potential losers from any proposed policy change will often be better positioned and more motivated to influence policymakers than will the potential winners.<sup>201</sup> Resistance to change by beneficiaries of the exiting policy is much less of an issue in hierarchical business firms, where coalition building is not necessary.

Even if there is political support for a corporate court, court structure is often entrenched in a state's constitution. Nevada, for example, considered the establishment of a separate business court by constitutional amendment. But a constitutional amendment would have resulted in a five-year delay and required approval by two consecutive legislatures and the state citizenry.<sup>202</sup> Nevada thus decided to form a business court by court rule. Its court is accordingly subject to the constitutional requirement that judges rotate, limiting the ability of judges to develop expertise in business disputes, as envisioned by the court's proponents.<sup>203</sup>

*The difficulty of following Delaware case law.* In order to fully emulate Delaware and tap its network benefits, a state would have to adopt both present and future Delaware case law. But no state does. It is hard enough for a state legislature to instruct the judiciary to follow existing case law of another state,

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May 17, 1993, at 1 (noting an opposition to merit selection by “[p]owerful labor unions”); Mark A. Tarasiewicz, *Chancery Ct. Opposed by Bar Ass’n, Resolution Is Withdrawn*, LEGAL INTELLIGENCER, June 1, 1992, at 1 (noting the opposition of the executive director of Community Legal Services to the chancery court due to concern over “the potential for low-income individuals to be swept into the Chancery Court without the ability to exercise their right to a jury trial”). Pennsylvania’s original chancery court proposal was designed to attract incorporations into Pennsylvania. *See id.* Ultimately, however, a commerce court was administratively established. Unlike the original proposal, judges assigned to that court are elected, the right to a jury trial is unaffected, and the court’s purpose is to speed up commercial litigation, rather than to attract incorporations. *See supra* Table 4, note 110.

201. *See, e.g.*, Matthew D. McCubbins, Roger G. Noll & Barry R. Weingast, *Structure and Process, Politics and Policy: Administrative Arrangements and the Political Control of Agencies*, 75 VA. L. REV. 431, 434-40, 466-68 (1989) (using the Clean Air Act of 1970 to illustrate the difficulty of overcoming objections to policy changes).

202. *See* NEV. CONST. art. XVI, § 1 (setting the procedure for amending the constitution upon a Senate or Assembly proposal); *Minutes of the Nev. Legis. Commission’s Subcomm. to Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State*, 1999 Leg., 1999-2000 Interim Sess. (Jan. 7, 2000) (statement of John Fowler, Chairman of the Executive Committee, Business Law Section, State Bar of Nevada), available at <http://www.leg.state.nv.us> (noting the convenience of creating a business court by court rule rather than by constitutional amendment).

203. *See* NEV. LEGISLATIVE COMM’N REPORT, *supra* note 140, §§ I.A, II.A (describing the two methods of establishing a business court and choosing to form, by court rule, a business court with rotating judges); *Minutes of the Nev. Legis. Commission’s Subcomm. to Encourage Corporations and Other Business Entities to Organize and Conduct Business in This State*, 1999 Leg., 1999-2000 Interim Sess. (May 30, 2000) (testimony of A. William Maupin, Associate Justice, Supreme Court of Nevada) (explaining that creating a business court with judges who do not rotate would require a constitutional amendment similar to the one that was necessary to create a family court in the state), available at <http://www.leg.state.nv.us>.

hook, line, and sinker.<sup>204</sup> To commit to adopt all future statutory revisions from another state and instruct the courts to follow its future case law is politically even harder.<sup>205</sup> None of these difficulties would prevent a business firm from imitating a popular product.

#### IV. IMPLICATIONS

Despite the many twists and turns that the state-competition debate has taken in the last three decades, the core areas of agreement and disagreement have not changed. Commentators agree that states compete, but disagree about the desirability of competition.<sup>206</sup> By contrast, we have argued that only Delaware takes significant steps to appeal to incorporators. Politics, rather than competitive motives, shape the laws of other states, and *firm choice*, rather than *state competition*, is therefore the proper paradigm to analyze corporate law.

In this Part, we discuss the implications of the firm-choice paradigm. These implications differ from those posited by state-competition scholars, including those who have considered the effect of political factors on the design of corporate law.<sup>207</sup> Several of our conclusions also differ from those of Lucian Bebchuk and Assaf Hamdani, who in a contemporaneous work analyze the implications of states' failure to compete vigorously. Most significantly, unlike Bebchuk and Hamdani, we conclude that Delaware tends to offer more protection to shareholders than noncompeting states and we do not share the

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204. Courts sometimes voluntarily follow the legal precedents of another state, but are rarely instructed to do so by the legislature. *See, e.g.*, *Wilmington City Ry. Co. v. People's Ry. Co.*, 47 A. 245, 254 (Del. Ch. 1900) (drawing on New Jersey case law to interpret language in the Delaware corporation code).

205. *See Kamar, supra* note 94, at 1929 (arguing that “[b]lindly committing . . . to future statutes and court decisions of another state is politically unthinkable and fraught with practical difficulties”); Romano, *supra* note 4, at 277 n.76 (arguing that a commitment to follow Delaware case law as binding precedent raises constitutional delegation problems, problems concerning the right of appeal, problems in the coherency of case law, and problems related to granting retroactive relief when a state court is subsequently adjudicated differently by a Delaware court).

206. *See supra* notes 3-4 and accompanying text. Lucian Bebchuk, a leading race-to-the-bottom theorist, has recently changed his view and now takes the view that states other than Delaware do not vigorously compete for incorporations. Compare Bebchuk & Hamdani, *supra* note 30 (arguing that states do not compete vigorously), with Lucian A. Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 130, 158 (2001) (arguing that competition has induced states to restrict takeovers).

207. *See Bebchuk, supra* note 3, at 1502-07 (discussing how interest-group lobbying would affect federal law); Carney, *supra* note 30 (discussing the influence and interests of the corporate bar); Macey & Miller, *supra* note 31 (discussing the influence of lawyers on Delaware law); Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 854-57 (1993) (noting political reasons for the enactment of antitakeover statutes).

assessment that the virtual lack of competition strengthens the case for a mandatory federal corporate law.<sup>208</sup>

In Parts IV.A and IV.B, we examine the implications of the firm-choice paradigm for evaluating the laws of noncompeting states and Delaware law. In Part IV.C, we consider the implications for the desirability of federalizing corporate law. In Part IV.D, we sketch the implications for regulatory competition in general.

#### A. *The Laws of Noncompeting States*

While Delaware has deservedly attracted the attention of corporate-law commentators, about half of the public companies in the United States are incorporated in states other than Delaware. Assessing the factors that influence their laws is thus important in its own right. Moreover, as we discuss in the next section, the laws of noncompeting states affect the way Delaware designs its own law.

The state-competition paradigm is ill-suited to evaluate the laws of states other than Delaware. Those states have little regard for attracting incorporations, and do not balance the interests of shareholders and managers to that end. A more appropriate theoretical tool to evaluate their laws is an analysis of the political forces at play. These forces include the corporate bar, managers of local public corporations, legislative inertia, and occasionally other interests.<sup>209</sup>

##### 1. *Shareholder protection.*

The aspect of corporate law that is most hotly debated in state-competition commentary is whether the law that competition produces affords adequate protection to shareholders. The firm-choice paradigm suggests that noncompeting states, driven by politics, are likely to favor the interests of managers more than is optimal and, importantly, more than they would if they were driven by competition. This is so because in noncompeting states, lobbying by managers (directly or through the corporate bar) weighs most heavily in the political calculus,<sup>210</sup> and, along with the interests of corporate

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208. See Bebchuk & Hamdani, *supra* note 30.

209. Because incorporations have little effect on noncompeting states, there is no natural selection process that replicates competition. And to the extent that corporate lobbying and participation of the corporate bar in the legislative process eliminate such laws, it is a process that has little to do with state competition.

210. Since the political influence of managers tends to be strongest in the state where a company is headquartered, a company may be inclined to incorporate in its home state. Similarly, local lawyers tend to participate more in the legislative process. See Daines, *supra* note 29 (finding that companies tend to incorporate either in Delaware or in their home state, and that the use of local lawyers increases the probability of home-state incorporation).

lawyers, shapes the law.<sup>211</sup> Shareholders have little influence over, and often lack information about, managerial lobbying activities. On issues where the interests of managers and shareholders differ, managerial lobbying therefore tends to induce noncompeting states to pass laws that cater to managers.<sup>212</sup>

This promanagement bias would be weaker if states competed for incorporations. The reason is that shareholders have at least some influence over incorporation decisions. They can veto reincorporation proposals put before them by the board, and discount the stock price of companies that go public while being incorporated in states whose laws shareholders dislike. Competition theorists debate the extent to which such shareholder power can keep states from offering laws that overly favor managers.<sup>213</sup> But however effective this power might be as a check on the laws of states that compete for incorporations, it has little effect on the laws of states that do not. The laws of noncompeting states therefore tend to be more favorable to managers than they would be if they competed for incorporations.<sup>214</sup>

As others have noted, the promanagement bias of noncompeting states is exemplified in the area of antitakeover legislation, where the interests of shareholders and managers have historically conflicted.<sup>215</sup> Antitakeover legislation has been a response to lobbying by local businesses, rather than an

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211. See Carney, *supra* note 30, at 717-28 (noting that lawyers and managers are the strongest interest groups shaping corporate law). For purposes of this argument, we need not resolve the extent to which lawyers will lobby for laws that increase incorporations. See *supra* Part II.A.3.

212. See Carney, *supra* note 31, at 309 (noting that legislators of states unconcerned about attracting incorporations will be more responsive to the interests of local labor, management, and creditors); Romano, *supra* note 207, at 860 (noting the lobbying advantages of management).

213. Compare Bebchuk, *supra* note 3, at 1470-75 (arguing that collective-action problems and coercion may lead shareholders to approve wealth-reducing decisions), and Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-85 (1989) (same), with Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1606-13 (1989) (responding to that argument).

214. But see Bebchuk, *supra* note 3, at 1500-04 (suggesting that the promanagement incentives created by efforts to attract incorporations are stronger than the promanagement incentives created by managerial lobbying). The inattentiveness of states not intent on attracting new incorporations to shareholder interests also casts doubt on the possibility that defensive competition will create a race to the top, as some scholars contend. See *supra* Part I.C.1. These scholars define defensive competition as a scenario in which states try to retain their chartered firms without attracting new ones. But all that is needed in order to keep chartered firms from reincorporating into another state is to appease managers.

215. Even proponents of state regulation of corporate law do not endorse antitakeover statutes of states other than Delaware. See ROMANO, *supra* note 31, at 60-75 (finding that many antitakeover statutes reduce shareholder wealth); Winter, *supra* note 4, at 287-89 (excepting takeover impediments from the general thesis that states race to the top).

attempt to attract incorporations.<sup>216</sup> It was only natural for noncompeting states to favor incumbent managers more than Delaware did.<sup>217</sup>

## 2. *Predictability and innovation.*

Because noncompeting states are largely oblivious to the effect of their laws on the number of companies incorporated in them, they tend to have corporate laws that lack predictability, to be slow to copy innovations, and to invest little in developing innovations on their own.

First, noncompeting states tend to have a lower market share, and correspondingly fewer corporate lawsuits filed in their courts, than they would if they actively competed for incorporations. The paucity of case law in noncompeting states in turn makes their laws less predictable.<sup>218</sup> As members of the judiciary like to point out, trial judges do not choose the cases they decide. They are like clams in the sea, taking whatever the water brings them. And the shallow waters outside Delaware do not bring a whole lot.

Second, the inattentiveness in state capitals to the chartering market means that statutory law often provides less guidance than one would wish. Noncompeting states are impeded by legislative inertia. Even when they revise their laws, the revisions may be influenced by lawyers who benefit from excessively complex or vague rules because such rules increase the demand for their services.<sup>219</sup>

Similar factors influence another aspect of corporate law—the rate at which corporate laws are updated—which according to some competition theorists benefits from state competition.<sup>220</sup> Because few cases are filed in the courts of noncompeting states, doctrinal innovations in those states are sporadic. And because lawmakers in noncompeting states do not make much effort to attract incorporations, their incentives to copy innovations or develop innovations on their own are weaker than proponents of state competition believe.<sup>221</sup>

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216. *See supra* Part II.A.2.

217. ROMANO, *supra* note 31, at 57-60 (discussing differences between antitakeover statutes in Delaware and in other states).

218. *See* Kamar, *supra* note 94, at 1923-25 (noting that court decisions increase legal certainty); Klausner, *supra* note 31, at 775-79 (discussing interpretive network externalities).

219. *See supra* Part II.A.3 (noting that litigators may prefer standard-based laws while transactional lawyers may prefer complex laws).

220. Romano, *supra* note 4, at 233-42 (arguing that competition leads states to update corporate statutes).

221. *See* Carney, *supra* note 30, at 720 (drawing similar conclusions).

## B. Delaware Law

Because of the absence of effective competition, Delaware enjoys substantial market power.<sup>222</sup> Since its profits from incorporations depend on the number of public firms incorporated in it, Delaware designs its law to attract and retain these incorporations. At the same time, as a producer with market power, it may benefit from offering law that protects and exploits its market power.<sup>223</sup> And as a political entity, it is also influenced by political considerations.<sup>224</sup>

### 1. Shareholder protection.

Since Delaware aims to attract incorporations, the degree to which its law caters to managers depends on the relative influence of managers and shareholders over incorporation decisions and the extent to which their interests are aligned. While a thorough discussion of these issues is beyond the scope of this Article, some remarks are in order to frame the analysis.

First, forces rooted outside of state law do not eliminate all managerial agency costs.<sup>225</sup> Thus, there remain areas of conflict between shareholders and managers, and a potential for managerial actions that advance the interests of managers at the expense of shareholders. This potential is the very reason for corporate law. Second, the degree of shareholder and management influence over incorporation decisions depends both on the context of the decision (an initial public offering, a decision to reincorporate, or a decision not to reincorporate) and firm-specific factors (such as the existence of a controlling shareholder, or the amount of stock held by institutional investors). Different firms, in different contexts, may thus be attracted to laws that strike different balances between the interests of shareholders and managers.

Because both managers and shareholders influence incorporation decisions, Delaware can benefit from designing its product to be attractive, if not equally

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222. Delaware is not a dominant producer of corporate law surrounded by a competitive fringe because other states are not intent on competing with it. This is also the reason why Delaware should not be expected to conduct itself as if other states did compete. While other states can enter the market and discipline Delaware at any time, the probability of entry is low due to the combination of economic entry barriers and political impediments that other states face. The large profits that Delaware earns from incorporations, which would not be possible if entry by other states was imminent, reflect the relative security that Delaware enjoys.

223. See generally Kahan & Kamar, *supra* note 24, at 1217-50 (discussing how Delaware engages in price discrimination); Kamar, *supra* note 94, at 1927-39 (discussing how Delaware raises entry barriers for potential competitors).

224. See generally Macey & Miller, *supra* note 31 (discussing the influence of the Delaware bar).

225. See, e.g., Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 U. CHI. L. REV. 917 (2002) (arguing that corporate contracts cannot eliminate all agency costs within firms).

so, to both shareholders and managers of as many corporations as possible.<sup>226</sup> To do so, Delaware has to position its corporate law optimally relative to the corporate laws of other states.<sup>227</sup> Because these laws tend to favor managers, they drive Delaware to favor managers more than it would otherwise. In other words, the firm-choice paradigm we put forth predicts that, albeit for different reasons and to different degrees, both the laws of noncompeting states and Delaware law will be more favorable to managers than they would be with state competition.

This analysis is consistent with the history of Delaware's antitakeover statute. It was not until after most states had passed antitakeover statutes driven by noncompetitive motives that Delaware followed suit.<sup>228</sup> Delaware's actions can be understood by its interest in positioning its product optimally relative to those of other states. Because many noncompeting states had adopted antitakeover statutes, Delaware had to follow in order not to antagonize managers. But because, unlike noncompeting states, Delaware also had an interest in not antagonizing shareholders of companies that it might attract from other states or from the pool of companies that would go public, it passed a milder statute.<sup>229</sup>

There is yet another reason to believe that Delaware lawmakers will seek a middle ground. Because Delaware earns substantial profits from incorporations, its lawmakers want to avoid federal intervention.<sup>230</sup> Since they

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226. The empirical evidence adduced by race-to-the-top theories about the positive effect of reincorporations into Delaware and the higher Tobin's Q of Delaware firms, *see* Romano, *International Securities Regulation*, *supra* note 8, at 494-507, is equally consistent with this conclusion.

227. Producers design their products with a view to the preferences of consumers and the products that other producers offer. All else equal, a producer would like her product to be closer than rival products to the preferences of as many consumers as possible. *See JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION* 296-98 (1988); Harold Hotelling, *Stability in Competition*, 39 ECON. J. 41 (1929). The same principle applies to producers with market power. They too must take into account the other products in the market. In the case of Delaware, as one of us has argued, the fact that firms compare Delaware law to the alternatives that other states offer allows Delaware to profitably degrade the law it offers if by doing so it lowers the quality of other states' laws more. *See Kamar, supra* note 94, at 1928-32.

228. Romano, *supra* note 207, at 855-56 (discussing Delaware's antitakeover statute).

229. *See INVESTOR RESPONSIBILITY RESEARCH CTR., INC., STATE TAKEOVER LAWS*, at Delaware-3 (2001) (citing Delaware Secretary of State Michael Harkins as saying in the bill hearings that many Delaware companies threatened to leave Delaware if it did not enact an antitakeover statute); Carney, *supra* note 30, at 754-55 (concluding that Delaware's antitakeover statute represents a concession to incumbent managers constrained by concerns over investor reactions).

230. *See 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, 764 (1987) (noting that Delaware may forgo opportunities to increase the attractiveness of its corporate law to corporate decisionmakers due to fear of federal intervention); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1511-13 (1989) (attributing the shift in Delaware fiduciary duty law towards shareholders in the late 1970s to

cannot be sure which political wind will prevail in Washington, their safest course is to ensure that neither shareholders nor managers are highly dissatisfied with Delaware law. Since, however, the likelihood of federal intervention is usually remote, Delaware retains substantial discretion to shape its law to pursue its other economic and political goals.

## 2. *Quality and predictability.*

Even as a producer with market power, Delaware can generally benefit from increasing the quality of its product in the eyes of corporate decisionmakers. By offering a higher quality, it can increase the number of public firms that incorporate in the state or raise the price it charges for incorporations. But Delaware can also benefit from offering a lower quality when doing so exploits or furthers its market power. Thus, as we have argued in an earlier work, Delaware law may benefit from offering law that is overly indeterminate and thus litigation-intensive because litigation intensiveness effectively price discriminates among chartered firms.<sup>231</sup> In addition, as one of us has argued elsewhere, indeterminacy raises the barriers for other states to enter the market for incorporations and thereby strengthens Delaware's market power.<sup>232</sup>

The anticompetitive effect of indeterminacy can benefit Delaware despite the present lack of serious competition because its law would be vulnerable to emulation at low costs if it were more determinate.<sup>233</sup> In particular, a less litigation-intensive law would reduce the importance of corporate courts, which currently serve as an important political hurdle for potential competitors. Moreover, even though no state seriously competes with Delaware at present, the potential for competition exists. The litigation-intensive nature of Delaware

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concerns about federal intervention); Mark J. Roe, *Takeover Politics*, in THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE 321, 340-42 (Margaret M. Blair ed., 1993) (arguing that the fear of federal intervention was one of the reasons for judicial zigzagging between advancing the interests of shareholders and advancing the interests of managers in Delaware takeover jurisprudence in the 1980s). The fear of federal preemption was also one of the factors that shaped Delaware's antitakeover statute. See Audiotape: *Hearing on H.B. 396 Before the Del. H.R.*, 134th Gen. Assem., held by the Delaware House of Representatives (Jan. 26, 1988) (testimony of A. Gilchrist Sparks III, Chairman of the Corporation Law Council, Delaware Bar Association) (on file with authors) ("And you say, why do we want to [regulate takeovers] in a moderate way? Why don't we want to pass the most restrictive thing that we can pass? And the reason for that is that to the extent that our legislation is viewed either in the short run or the long run as unbalanced and unreasonable, we all know that ultimately somewhere down the road we might have to pay the price for that in the context of the federal government coming in and taking some portion of that privilege from us.").

231. Kahan & Kamar, *supra* note 24, at 1232-50.

232. See Kamar, *supra* note 94, at 1910-12 (arguing that indeterminacy prevents other states from emulating Delaware law and tapping the learning and network benefits accruing to firms that use it).

233. *Id.*

law makes it less likely that another state would challenge Delaware, and less detrimental to Delaware if one did.

### 3. *Incentives to innovate.*

A separate dimension on which corporate law can be evaluated is the rate of legal innovation. Along with the claim that competition pulls corporate laws toward optimal shareholder protection, race-to-the-top scholars argue that much of the innovativeness we see today in corporation statutes would be lost if a single federal regulator were to replace states.

Indeed, Delaware has strong incentives to copy useful innovations developed by other states.<sup>234</sup> With respect to Delaware's incentives to develop innovations on its own, however, the firm-choice paradigm offers an interesting twist: These incentives are *higher* than under the state competition paradigm. Because monopolists reap the full benefit of their innovative efforts without sharing it with imitators, they innovate more than producers in a competitive market. It is thus precisely the absence of significant competition that allows Delaware to capitalize on its legislative innovations.<sup>235</sup>

### 4. *The Delaware advantage.*

In a recent contribution to the state competition literature, Robert Daines reports that shareholders value Delaware firms as much as five percent higher than firms incorporated in other states.<sup>236</sup> Proponents of competition embrace these findings as proof that states race to the top and that Delaware wins by offering the best corporate law.<sup>237</sup> Opponents of competition both dispute the economic significance of these findings and dismiss them as merely measuring the network benefits that Delaware offers to firms even as it races along with other states to the bottom.<sup>238</sup>

Our thesis suggests an alternative explanation for the Delaware advantage. First, wherever Delaware is headed, in areas where shareholders and managers are not in conflict it will offer better law than states that are indifferent to corporate chartering.<sup>239</sup> Even in areas where shareholders and managers are in

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234. Romano, *supra* note 4, at 240 (noting that Delaware is quick to copy statutory innovations).

235. Other states can, and occasionally do, follow the spirit and letter of Delaware statutes. But because they are slower to adopt these innovations than they would be if they actively competed, and because the value of statutory innovations depends on the existence of quality courts, which they lack, Delaware retains incentives to develop innovations.

236. See Daines, *supra* note 29.

237. See Romano, *International Securities Regulation*, *supra* note 8, at 505-07.

238. See Lucian Arye Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 Bus. L.W. 1047, 1059-63 (2002).

239. For example, consider the legislation that Delaware adopted in 2000 to

conflict, Delaware will offer better law than other states by choosing legal rules that confer the same benefit upon one side while minimizing the cost to the other.

Second, noncompeting states respond mostly to the lobbying efforts of local managers and lawyers. By contrast, Delaware caters also to shareholders in an attempt to attract new incorporations. To those skeptical of the importance of the network benefits that incorporation in Delaware entails,<sup>240</sup> the lack of competition can thus explain—in a manner consistent both with the view that Delaware optimally protects shareholders and the view that it plays to managers—why shareholders value Delaware firms higher than other firms.

### C. *The Federalism Debate*

Our analysis of the firm-choice paradigm also offers new insights into the shape that corporate law would take if it were part of federal law. First, we consider how a federal corporation law would compare to existing laws in protecting shareholders. Second, we consider how such a law would compare to existing laws in innovation and predictability.

#### 1. *Shareholder protection.*

A federal regulator, just like noncompeting states today, would be influenced by political factors, rather than economic ones.<sup>241</sup> Like noncompeting states, Congress would likely be amenable to lobbying by campaign contributors.<sup>242</sup> As a result, it would likely play to corporate

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accommodate online shareholder meetings. DEL. CODE ANN. tit. 8, §§ 211, 232 (2002); Michael P. Dooley & Michael D. Goldman, *Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law*, 56 BUS. LAW. 737, 756-58 (2001) (pointing out that Delaware is the first jurisdiction to provide for shareholder meetings in cyberspace and noting shortcomings of the Model Business Corporation Act in that regard); Jed Graham, *Annual Meetings Need No Walls, Can Be Held via the Internet*, INVESTOR'S BUS. DAILY, Nov. 7, 2001, at A9 (noting that only companies incorporated in Delaware can hold electronic stockholder meetings). Other states may in time follow suit. See Ross Kerber, *The Momentum Builds for Online-Only Annual Meetings*, BOSTON GLOBE, July 22, 2002, at C1 (reporting that Massachusetts lawmakers “are considering rule changes to permit online-only meetings, a year after the idea was postponed in the face of criticism”). But this will not take away from Delaware the advantage of having modernized its law before others.

240. *See generally* Black, *supra* note 31, 589-91 (arguing that the benefit of access to the Delaware judiciary is modest); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479 (1998) (downplaying the importance of network benefits in corporate law).

241. Cf. Bebchuk, *supra* note 3, at 1500-01, 1503 (noting that federal lawmakers would lack incentives to attract incorporations).

242. Unlike shareholders, corporate managers regularly use personal and corporate funds for political contributions and lobbying for laws favorable to them. *See* Adam Winkler, “Other People’s Money”: Corporate Contribution Bans and the Separation of

managers, subject to occasional corrective legislation following financial debacles.<sup>243</sup> In the past, for example, members of Congress opposed by an overwhelming margin a proposal by the Financial Accounting Standards Board to require companies to account for stock options as an expense<sup>244</sup>—until, that is, a series of major financial scandals changed the political calculus somewhat.<sup>245</sup>

However, for several reasons, one cannot draw firm conclusions about the likely shape of a federal corporation law. First, the political forces shaping the law may play out differently on the federal level than on the state level. On the one hand, shareholder groups may be more effective on the federal level because most shareholders can vote in federal elections, while only a fraction can vote in the elections of any given state.<sup>246</sup> Moreover, federal policymakers may be more concerned and better informed about the long-term economic impact of corporate laws than state policymakers.<sup>247</sup> On the other hand, federal policymakers may also be more responsive to lobbying by managers than state legislators because they rely more heavily on campaign contributions, and they may be more prone to legislative inertia because other issues occupy their agenda.<sup>248</sup>

Second, Congress may well entrust the regulation of public corporations to the SEC, which already regulates corporate disclosures.<sup>249</sup> The forces that

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Ownership and Control (Oct. 2001) (unpublished manuscript, on file with authors). For the argument that federal lawmakers would be more responsive than Delaware lawmakers to political campaign contributions in the design of corporate law, see Sitkoff, *supra* note 22, at 1163-64.

243. ROMANO, *supra* note 31, at 75-84 (arguing that management's lobbying advantages would lead to promanagement federal law); *see, e.g.*, Michael Schroeder, *The Economy: House, in Bipartisan Vote, Backs Moderate Accounting Overhaul*, WALL ST. J., Apr. 25, 2002, at A2 (reporting an overwhelming approval by the House of a moderate bill aimed at overhauling accounting oversight and corporate financial reporting in the wake of the financial collapse of Enron).

244. *See* Floyd Norris, *Accounting Board Yields on Stock Options*, N.Y. TIMES, Dec. 15, 1994, at D1 (noting that the Financial Accounting Standards Board dropped the proposal to require companies to account for stock options as expense after the Senate voted 88 to 9 to oppose such treatment).

245. *See Fortified Sarbanes Accounting Bill Subject to Debate Limit, on Fast Track*, 34 SEC. REG. & L. REP. (BNA) 1164, 1165 (2002) (noting post-Enron support by some politicians for expensing stock options). *But see* Tom Hamburger & Christine B. Whelan, *Stock-Options Foe Tries to Ride Momentum*, WALL ST. J., Aug. 6, 2002, at A4 ("Despite this year's cascade of accounting and corporate scandals, neither the House nor the Senate so far has voted on any stock-options proposals, largely because high-technology companies have vociferously opposed legislation.").

246. Carney, *supra* note 30, at 721 (noting that the fact that shareholders reside outside the state of incorporation reduces their political influence).

247. *See* Romano, *supra* note 65, at 133, 145 (noting that a lobbyist may have greater influence when legislators face resource or staffing constraints).

248. *See* Sitkoff, *supra* note 22, at 1157-64 (discussing the possible impact of contributions on the shape of federal corporate law).

249. *See, e.g.*, Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 303, 116 Stat. 745,

would affect rulemaking by the SEC would differ from the forces that would affect congressional legislation.<sup>250</sup> On the one hand, the impact of campaign contributions would be significantly less than in a scenario in which Congress alone were responsible for corporate law, if only because agency officials cannot accept money donations. And although agencies are subject to regulatory capture, it does not appear that the SEC has so far been captured by the managers of public corporations.<sup>251</sup> Rather, it has traditionally taken a pro-shareholder-rights stance in areas such as insider trading, dual-class stock recapitalization, and executive compensation.<sup>252</sup> Then again, the incentives for managers to invest resources in capturing the SEC would increase with its regulatory powers over matters near and dear to their hearts. And even if the SEC resisted capture, Congress would retain ultimate regulatory authority and could exert pressure on the SEC.<sup>253</sup> Thus, as in the case of congressional legislation, one cannot reliably predict the shape of regulation by the SEC.

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778 (2002) (delegating authority to the SEC to adopt rules regarding improper influence on the conduct of audits).

250. Some commentators argue that the United Kingdom's more shareholder-friendly approach towards takeovers stems from its unitary system. *See* Geoffrey P. Miller, *Takeovers: English and American*, 6 EUR. FIN. MGMT 533, 541 (2000). However, the forces shaping regulation by the Corporate Takeover Panel in the United Kingdom differ from those that would shape regulation by Congress or the SEC.

251. Other interest groups, however, may have captured the SEC to some extent. *See* SUSAN M. PHILIPS & J. RICHARD ZECHER, THE SEC AND THE PUBLIC INTEREST 22-23 (1981) (arguing that regulatory monopoly enables the SEC to favor financial-market professionals over investors); David D. Haddock & Jonathan R. Macey, *Regulation on Demand: A Private Interest Model, with an Application to Insider Trading Regulation*, 30 J.L. & ECON. 311 (1987) (arguing that the SEC has shaped insider-trading law with an eye to protecting the interests of securities analysts); Roberta S. Karmel, *Do the Capital Markets Need So Many Regulators?*, N.Y. L.J., Oct. 18, 1990, at 3 (attributing the SEC's support of takeovers to the fees that takeovers generate for the securities industry).

252. *See, e.g.*, SEC Final Voting Rights Rule, Securities Exchange Act Release No. 34-25891, 20 Sec. Reg. & L. Rep. (BNA) 1124 (July 7, 1988) (imposing a one-share, one-vote rule on securities exchanges); Jonn R. Beeson, *Rounding the Peg to Fit the Hole: A Proposed Regulatory Reform of the Misappropriation Theory*, 144 U. PA. L. REV. 1077, 1100-01 (1996) ("Although it is not entirely clear whether insider trading is harmful, it seems clear, under today's securities laws, that the regulation of insider trading in the securities markets will be vigorously pursued by the SEC and the Justice Department for some time to come."); David S. Hilzenrath, *Shareholder Rights Expand; SEC Rules Could Help Curb Executive Pay*, WASH. POST, Oct. 16, 1992, at A1 (discussing the SEC's efforts to increase shareholder rights and information regarding executive pay).

253. In the past, corporate lobbyists drove Congress to force the Financial Accounting Standards Board into what some observers called "a timid retreat" from a proposal to require companies to recognize the cost of executive stock options and, within a few years, embarked on a new campaign aimed at getting Congress to pressure the Financial Accounting Standards Board to back down from its proposal that companies be required to recognize derivatives on their balance sheets at market value. *See* Roger Lowenstein, *Corporate America Bullies FASB, Part II*, WALL ST. J., Sept. 11, 1997, at C1.

## 2. Predictability.

Consider next how the level of predictability under a federal regime would differ from the present levels in noncompeting states and in Delaware. With regard to statutory law, there is no determinate answer.<sup>254</sup> However, with regard to case law, federal law is likely to be less predictable than Delaware law, and more predictable than the laws of noncompeting states.

Delaware currently offers a single corporate tribunal that regularly hears corporate cases with expert judges and without juries. While a federal law applicable to corporations nationwide could increase the number of corporate cases interpreting the same body of law, these cases would be heard in many different, nonspecialized courts.<sup>255</sup> Taken together with the fact that the number of cases decided in Delaware today is already large and the fact that the United States Supreme Court would likely hear fewer corporate law cases than the Delaware Supreme Court hears today, the predictability of federal case law would likely be lower than that of Delaware case law.<sup>256</sup>

By contrast, compared to the laws of noncompeting states, a federal law would likely be more predictable. First, while both federal judges and judges of noncompeting states are not specialized, federal judges are commonly regarded as better jurists than state judges.<sup>257</sup> Second, a unitary federal law

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254. The current federal securities code contains both open-ended provisions similar to typical provisions in Delaware law and provisions designed to offer greater predictability. *See Kamar, supra* note 94, at 1952 n.175. While we believe that the overall level of predictability is greater than under Delaware law, reasonable minds can disagree on this question. *See Romano, International Securities Regulation, supra* note 8, at 521 (arguing that federal securities law is no more predictable than Delaware corporate law).

255. It is conceivable that a single federal corporate court could be created to hear all corporate disputes. However, experience with the federal circuit court formed in 1982 to hear appeals on patent issues suggests that it takes an unusual course of political events and a sense of urgency for such a court to be formed. *See Marion T. Bennet, The United States Court of Appeals for the Federal Circuit—Origins, in U.S. JUDICIAL CONFERENCE COMM. ON THE BICENTENNIAL OF THE CONSTITUTION OF THE UNITED STATES, THE UNITED STATES COURT OF APPEALS FOR THE FEDERAL CIRCUIT: A HISTORY 1982-1990 1, 8 (1991).*

256. In prior work, we have argued that Delaware case law may well be excessively indeterminate. *See Kahan & Kamar, supra* note 24 (relating indeterminacy to price discrimination); Kamar, *supra* note 94, at 1927-39 (relating indeterminacy to degrading rival products). The thrust of our argument in those articles was that Delaware's interest in profiting from incorporations provides suboptimal incentives to clarify its law. Since the federal government lacks interest in profiting from incorporations, the arguments in those articles provide no reason to believe that federal law would be superior to Delaware's.

257. *See RICHARD A. POSNER, THE FEDERAL COURTS: CHALLENGE AND REFORM 37-39, 277 (1996)* (opining that the combination of higher salaries and benefits, lighter caseloads and more support staff, lifetime appointment, being appointed rather than elected, and greater prestige makes federal courts more attractive than state courts to judicial candidates of above-average ability and character). Note, however, that the claim that federal courts are in the whole more sophisticated than state courts does not lend itself to simple empirical testing. *See Erwin Chemerinsky, Parity Reconsidered: Defining a Role for the Federal Judiciary, 36 UCLA L. REV. 233 (1988).*

would harmonize corporate case law across states and give corporations access to a richer body of legal precedents than is available to them today.

### 3. *Incentives to innovate.*

One of the alleged advantages of state competition is that it produces incentives for states to innovate. As we have discussed, the firm-choice paradigm predicts that Delaware will have stronger incentives to innovate in corporate law than it would under state competition, while noncompeting states will lack significant incentives.

What one can expect from a federal regulator depends on the identity of that regulator. A federal regulator would likely not behave as a profit-maximizing monopolist. Rather, it would follow the pattern it follows in other areas of law. Congress would likely be slower than the Delaware legislature, and perhaps even slower than the legislatures of noncompeting states, in amending the corporation code. And as in other areas, it would leave much of the development of the law to courts and respond by legislation only to major developments. By contrast, the SEC would likely develop the law more rapidly than noncompeting states, although perhaps no more rapidly than Delaware, as its activity in the area of securities regulation illustrates.<sup>258</sup>

### D. *Regulatory Competition Theory*

The lessons that emerge from our analysis extend beyond the debate on state competition in corporate law. First, the premise that states actively compete for incorporations has been used to argue that other regulatory structures should be changed to permit a similar competitive system to emerge.<sup>259</sup> This argument needs to be rethought. Regulatory competition in other areas may be desirable, but the reason is not that competition in the corporate area has proven its worth.

Second, our investigation points to the importance of a more rigorous, fact-based approach to regulatory competition. Neither theory nor anecdotal evidence is enough to establish the actual existence of competition. Rather than assume that jurisdictional competition exists whenever economic factors

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258. Innovation in case law is different. While a federal corporate law could increase the number of corporate cases interpreting the same law, those cases would be heard in different courts and by judges who are not experts. Because the number of corporate cases decided in Delaware today is already large and because the United States Supreme Court would probably hear fewer corporate law cases than the Delaware Supreme Court hears today, on balance it is likely that both the rate of legal innovation and the quality of adjudication would be lower in a federal system than they are in Delaware. By contrast, because federalizing corporate law would channel all corporate disputes—including those currently heard in Delaware—to a single court system, case law could be expected to develop more rapidly than it does outside of Delaware today.

259. See sources cited *supra* notes 8-23.

dictate that it should, one ought to search for hard evidence of actual competition. Doing so may reveal that competition in practice is far weaker than predicted.

Third, competition among public regulators is different from competition in the private sphere. Regulators are influenced by political factors, which may affect the way they compete, or induce them not to compete at all. The presence of alternative regulators that pursue political payoffs rather than profits in turn affects the strategy chosen by those regulators that do pursue profits. Moreover, because the political-payoff structure is less predictable and more heterogeneous than the economic one, it is often difficult to predict the strategies that different regulators will follow. This suggests that, whatever the theoretical appeal, one should be wary of replacing a regulatory structure that works reasonably well with one that is untried and unproven.

Fourth, probably the most significant difference between a regime with a single regulator and a regime with multiple regulators lies in the choice that the latter regime offers to regulated entities, rather than the ephemeral possibility of competition. This suggests that the firm-choice paradigm that we have developed in this Article in the context of state corporate law may be useful in analyzing the tradeoff between a unitary law and a menu of laws in other areas.

#### CONCLUSION

This Article has challenged the conventional wisdom that states compete for incorporations. Other than Delaware, states do not gain significant financial benefits from competing. Even if they attracted a substantial number of public corporations, they would neither earn meaningful additional franchises taxes under their current tax structures nor profit significantly from an increase in legal business. Accordingly, they do preciously little to attract incorporations. Delaware aside, states have failed to establish specialized corporate courts, and have left the design of large portions of their corporate laws to judges who lack the knowledge and incentives to attract incorporations. And even though states have been quick to adopt antitakeover statutes and periodically revise their corporate statutes in other respects, they do so largely for reasons unrelated to attracting incorporations. The notion that states compete, and that this competition results in a metaphorical race, is a myth.

Why does no state revamp its tax structure and make a serious attempt to get a slice of the \$500 million in profits that Delaware earns annually on minimal outlays? The lack of competition is due in part to economic entry barriers. But that is only part of the story. To an important extent, the lack of competition is also due to factors that are endemic to state competition, to wit that state lawmakers pursue political goals rather than economic profits.

Our analysis warrants a reconsideration of the structure of corporate law. The proper analytical paradigm is one where companies choose where to incorporate, but states other than Delaware do not pursue incorporations. The

firm-choice paradigm has, among others, two implications for the longstanding debate between race-to-the-bottom scholars and race-to-the-top scholars about the merits of federal intervention—one comforting to the former camp, the other comforting to the latter. On the one hand, both Delaware and noncompeting states, albeit for different reasons, skew their laws in favor of managers. On the other hand, Delaware's incentives to attract incorporations make its law more favorable to shareholders than the laws of noncompeting states. More generally, regulatory competition theory should adopt a more rigorous and fact-based approach, focus on the political contingencies of regulation, and distinguish between the demand-side effects of choice by regulated entities and the supply-side effects of lawmaking by regulators.