

Not-So-Fierce Rivalry

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One of the central defining features of American corporate law is the presence of regulatory competition. Corporations are free to choose their state of incorporation, and they are subject to the corporate law of the state they choose. The key role of state law in corporate governance is widely accepted; while there recently has been much debate on reforming corporate governance, there has been little reconsideration of the key role of state law in this area.

Most scholars of corporate law have long believed that competition by states for corporate charters works to the benefit of public investors. State competition, so the argument goes, strongly pushes states to "race toward the top" in enhancing shareholder value. This view is based on two propositions: that states compete vigorously for incorporations, and that incorporations would flow to the state that provides the best rules for shareholders.

A recent empirical study we have conducted, however, indicates each of these two propositions is more subject to doubt than has been commonly recognized.

To begin with the second proposition, our findings indicate that the incorporation market rewards states that amass antitakeover statutes. Such statutes are viewed by most legal scholars, supported by empirical work, as undesirable for shareholders.

Supporters of state competition have therefore argued that it has not encouraged the proliferation of such statutes. They believe some states have adopted them because of lobbying by managers, even though such adoption discourages incorporations.

In our study, we tested this view and found it inconsistent with the evidence.

At one end of the spectrum, states with no antitakeover statutes, such as California, do poorly and retain a relatively small fraction of the companies located in them. At the other end of the spectrum, states that amass most or all standard antitakeover statutes are the ones most successful both in retaining in-state companies and in attracting out-of-state companies.

More generally, antitakeover protections are correlated with success in the incorporation market; adding antitakeover statutes significantly increases the ability of states to retain their local companies, as well as their ability to attract out-of-state incorporations.

The effect we identify is not only statistically significant but also large in magnitude. Controlling for other company and state characteristics, we estimated that had states that currently have all standard antitakeover statutes not adopted them, they would have lost more than half of the incorporations of local companies they currently have (dropping from 49% of all companies located in these states to 23% of these companies).

Conversely, adoption of all standard antitakeover statutes by states that currently have none would have more than doubled the percentage of local companies retained by them (from 23% to 50%).

We pay special attention to two types of statutes: the "recapture" or "disgorgement" statute adopted by Pennsylvania and Ohio, and the mandatory staggered-boards statute adopted by Massachusetts. These measures have been widely criticized as detrimental to shareholder value, and supporters of state competition have blacklisted them as extreme. However, we find that, in contrast to the beliefs of state competition supporters, there is no evidence passage of these statutes has hurt the states in the incorporation market.

Our findings indicate it is no longer possible to maintain, as the dominant view among corporate scholars has it, that state antitakeover statutes largely do not serve shareholders, and that competition provides states with strong incentives to provide rules that are optimal for shareholders. One or both of these propositions needs to be revised.

Our study has also produced findings that cast substantial doubt on the proposition that there is a vigorous competition among states over corporate charters.

Delaware's dominance turns out to be far stronger and more secure than usually recognized. More than 40% of the companies are not incorporated in Delaware, but other states are not actively competing with it for out-of-state incorporations. The overwhelming majority of non-Delaware companies are simply incorporated in the states where their headquarters are based.

The fact that no other state is making a serious attempt to capture a significant share of the out-of-state incorporation market is especially interesting in light of the returns Delaware makes. Delaware's annual revenues from franchise taxes are on the order of \$3,000 for each household of four in the state, and they constitute about 30% of the state's budget.

The absence of any serious challenge to Delaware's dominance likely results from barriers to entry. Among other things, this is not a market where hit-and-run entry is possible. Any challenge would take much time to develop, enabling Delaware to match whatever benefit the challenger might offer.

Be that as it may, the absence of vigorous competition casts doubt on the strength of incentives that the current state of affairs provides to states.

How can this state of affairs be improved? In articles written with Allen Ferrell and Assaf Hamdani of the Harvard Law School, one of us argues that improvement can be made without imposing mandatory federal rules and forgoing the benefits of competition.

First, to invigorate competition a federal incorporation option should be provided. Such an option has been offered in Canada with considerable success.

Second, it would be desirable for the federal government to provide a mandatory switching rule under which shareholders would be able to initiate and approve, even over the objection of management, a reincorporation to another jurisdiction. Such a measure would tie success in the incorporation market more closely to the provision of rules that serve shareholders.

Each of these two measures would enhance shareholder choice and operate to the benefit of investors.

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