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DOES DELAWARE COMPETE?

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Abstract

After a century of academic thinking that states compete for corporate chartering revenues, a revisionist perspective has emerged in which states do not compete for chartering revenues, leaving Delaware alone in the interstate charter market. Firms either stay incorporated in their home state or reincorporate to Delaware, but rarely go elsewhere. Delaware has a monopoly, one that goes unchallenged.

I here use industrial organization concepts to better illuminate this competitive setting. Even if no other state challenges Delaware for the reincorporation business, it still must operate in three key competitive arenas. First, it must attract firms to reincorporate away from their home states. The dynamism of American business interacts with even a lackluster state-based corporate chartering market to create a broad avenue of chartering competition. Second, a once-and-for-all exit of corporate America to another state or the awakening of a dormant competitor is not impossible. I outline what might motivate one or the other. The one instance we have of serious state-to-state competition — New Jersey's demise as the corporate capital at the beginning of the 20th century — was just that. Similarly, and third, Delaware has reason to fear federalization of core elements of its corporate law even if no other state actively competes for charters. A reputation for bad decisionmaking (or bad decisionmakers) could impel Congress to displace Delaware, in whole or in part, perhaps as an excuse during an economic downturn. While the odds of full displacement are low, Sarbanes-Oxley shows us that the odds of substantial partial displacement are not.

These ideas have parallels in the industrial organization, antitrust literature on contestable markets: a single producer can dominate a market, but, depending on the nature of its technology and its market, it could lose its market share overnight or suddenly face a new entrant if the incumbent missteps badly. Hence, it has incentives to act like a competitor on some issues, or knows it must provide a package that overall is attractive to its primary customers. Delaware could face this kind of catastrophic loss in two dimensions: the traditional horizontal one of a competing state, and the vertical one of federal displacement.

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INTRODUCTION

After a century of academic thinking that states compete with one another for corporate chartering revenues, with Delaware having emerged as today's winner, a revisionist perspective has arisen that the other states don't compete and that Delaware is alone in the interstate charter market. A firm typically decides either to stay incorporated in the state where it arose or to reincorporate to Delaware, rarely reincorporating elsewhere. What's more, other states don't try hard to sell corporations the services Delaware so ably provides. Delaware has a monopoly. In an important article, Marcel Kahan and Ehud Kamar showed that no state other than Delaware actively seeks chartering revenues.[1] Any state-to-state competition isn't the Economics 101 competition of close effort to undercut a competitor's pricing, improve on its services, or make and market a better product.

Here I explore the nature of the competition that there is. Although Delaware indeed need not fear day-to-day erosion of the corporate charters it has, just as the new thinking runs, three competitive dimensions still remain — and, even if they're not tight, they are real. First, Delaware must continually provide enough value to new firms (and controlling decisionmakers) to induce them to reincorporate into Delaware. American business is dynamic, turnover substantial. Firms arise, prosper, and merge; firms arise, fail, and disappear. For Delaware to stay important over the decades, it must convince new and growing firms to reincorporate away from their home state. Data from the Delaware Secretary of State's office shows that flow and turnover are quite substantial. Delaware must continually provide value to new corporate players to maintain the flow of reincorporations into Delaware. Even if state-to-state competition for chartering revenues is somnolent, as Kahan and Kamar have shown, competition in American business — *in the real economy* — is not. The dynamism of the real economy interacts with the structure of the chartering market to create a substantial arena where Delaware must compete to persist.

Second, Delaware faces competition, albeit at a weak level, to retain its installed base of firms currently incorporated in Delaware. It's not that another state or two will pick off a few Delaware firms. No one hungrily waits in the wings, *actively* looking to capitalize on a Delaware misstep. It's rather that Delaware must be wary of making a big mistake, one that would induce a new entrant to enter, conceivably even irreversibly eroding its existing base of charters or arresting the flow of firms that reincorporate into Delaware. The major historical instance we have of serious state-to-

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[1] Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

state competition — New Jersey's demise as the corporate capital at the beginning of the 20th century — was just that: rapid exit and a new winner, not long-term hand-to-hand combat. Although no state now vies actively and successfully with Delaware for corporate business, the primary beneficiaries of Delaware's corporate industry — managers, firms, and their shareholders — *could*, if unhappy, turn to another state, offer it the $500 million annual franchise tax bonanza, and show it how to build a viable corporate law industry. Even states not actively seeking charters in this limited sense do "compete" with Delaware. Moreover, many states are actively seeking to charter alternative business entities, such as limited partnerships and business trusts; success in a collateral field could be the springboard to competition in the corporate chartering arena. Although potential competition is not the tight rivalry of a market of many producers, it is pale but perceptible competition, of a type that often works passably well in industry. The question isn't whether this effect from potential competition is real — it must be — but how much slack it really takes away from Delaware. Perhaps the competitive restraint it imposes does not amount to much. But not much is not the same as none at all.

The third challenge to Delaware is from Washington. Sustained and serious error by Delaware (or sustained serious offense to popular opinion or influential interests) could induce Washington to take corporate lawmaking, or a large fraction of it, away from Delaware. Even if no other state actively competes with it for charters, Delaware is not free from restraints.

These ideas have parallels in the industrial literature on contestable markets: a single producer can putatively dominate a market, but could lose its market share overnight. Hence, it acts like a competitor on some matters, or knows it must provide an overall package that is attractive to its primary customers. It has slack, but that slack is not unlimited, because its market, like Delaware's, is contestable. Another state could enter if Delaware slips. Or, Washington could step in. On some matters, it already has.

Delaware's status in American corporate life is contestable horizontally, as its position is susceptible to challenge from another state, and it's contestable vertically, as its position is susceptible to challenge from Washington. Its position is more precarious than the current academic consensus sees it, as contestability limits the breadth of Delaware's discretion.

That Delaware competes in some albeit weak sense seems indisputable: its principal lawmakers are active, involved and energetic. A simple conversation with a Delaware judge or corporate lawyer, or an hour spent reading recent court opinions, would disabuse one of the notion that Delaware players are sloppy monopolists unconcerned about the professionalism of their product. Inside, astute commentators tell us that even if Delaware has won some race or another "no one in Delaware is willing to play hare while some other state tortoise gains ground."[2] Moreover, there are other dimensions of competition, such as professionalism and yardstick competition, which I address after considering the core financial incentives.

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[2] Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1765 (2006).

Delaware players worry. The task I set to accomplish in this article is to better understand what they have to be worried about.

I. DELAWARE'S MONOPOLY

The number that illustrates Delaware's dominance is the oft-recited fact that more than half of American public firms have Delaware charters.[3] Moreover, recent incisive analyses show that of those firms reincorporating, most move to Delaware, not elsewhere.[4] But behind these numbers, there's more to see. The first key feature we need to see is the importance to Delaware of flow. An American business is founded in, say, a garage in California. It grows and incorporates, with the local lawyer getting a California charter for the founders. Most of those small firms eventually fail and close, but some survive and grow. Meanwhile, older, established Delaware-incorporated firms decline and disappear, sometimes in mergers, sometimes otherwise. For Delaware to make money in the chartering business, it must continually capture an inflow of firms from other states to compensate for the regular erosion of its market. It must do so even if *no* other state actively tries to attract reincorporations by selling charters to enhance their own tax revenue. Hence, Delaware must compete, even if no other state does.

American business is dynamic, even if state competition is not. Delaware must deal with both the potential threat of competition from other states and the dynamism of American business. The two interact.

A. The Numbers: Incorporations, Reincorporations, and Tax Dollars

Recent analyses tell us that 97% of America's public firms are incorporated in either Delaware or their home state.[5] Eighty-five per cent of the firms reincorporating away from their home state go to Delaware.[6] Firms either stay put in their home state or move to Delaware. There's no third state that corporate players regularly consider.

Marcel Kahan's recent investigation of 3,800 firms going public in the past dozen years showed that 2,600, or about 70%, moved their state of incorporation from their home state. Of those that moved, 94% chose to go to Delaware.[7] And it's common to recite the tax revenue that Delaware generates: more than $500 million in chartering fees annually. No other state is close.[8]

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[3] E.g., http://www.state.de.us/corp/default.html.

[4] Lucian A. Bebchuk and Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J. LAW & ECON. 383 (2003).

[5] Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1562 (2002); see also Bebchuk and Cohen, supra note 4, at 396).

[6] Lucian Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 588 (2002).

[7] Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 340, 352 tbl. 2 (2006).

[8] Kahan & Kamar, supra note 1, at 687-93.

B. The Classical Interpretations

For quite some time, these results — Delaware as home to the corporate charters and its tax revenues — were seen as Delaware having won a race among the states, either one to the top, or one to the bottom. Those seeing the race as one to the top emphasized that Delaware had to provide a corporate law with which the shareholders would be happy;[9] those who thought the race more one to the bottom argued that, as managers were the prime actors in the reincorporation decision,[10] Delaware won by catering more to them than to the shareholders.

C. The Current Interpretation

1. Delaware as a monopoly. New analysis is more nuanced. Professors Kahan and Kamar showed that other states just aren't really trying to garner franchise tax revenue.[11] They haven't invested in building up good business courts, they don't make the corporate law that managers and shareholders want, and they don't even charge enough in franchise fees for the result to be interesting financially if they attracted more incorporations. Delaware is alone in competing day-to-day for corporate charters and the franchise tax.[12] Roughly contemporaneously, Lucian Bebchuk and Assaf Hamdani came to a similar conclusion through a complementary route.[13] Melvin Eisenberg made a quite similar observation about fifteen years ago.[14]

2. The other states. States don't persistently compete with Delaware for internal political reasons: For a state to set up a dedicated court, someone in-state would lose, as litigation would move from one locale to another. But often those who'd lose due to the litigation displacement have the political clout to stymie the effort. And, for large states like California or Pennsylvania, the revenue from the incorporation business isn't enough to justify a determined effort that would take years before it became effective.[15] Only the smaller states are potential competitors and there are few enough of them that internal politics could stymie them from emerging as effective competitors.[16]

Moreover, economic reasons can explain why other states do not compete. For a state to start competing, it would incur noticeable start-up costs of getting a good

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[9] Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 21 (1993); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U.L. REV. 913 (1982).

[10] Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437 (1992); William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 701 (1974).

[11] Kahan & Kamar, supra note 1, at 724-35.

[12] Id.

[13] Bebchuk & Hamdani, supra note 6, at 585-95 (economic and structural barriers).

[14] Melvin Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1511-12 (1989).

[15] Bebchuk & Hamdani, supra note 5, at 584.

[16] Id.

corporate law passed, staffing good courts (which need a flow of cases to work with, to be at the top of their game), and so on. Since only small states are likely to play, even modest costs could stymie them from starting up. And a state that began to compete despite these barriers would have reason to fear it'd just serve as a stalking horse: if it started taking corporate chartering business away from Delaware, then Delaware could react by matching their advantage and thereby stopping the erosion. As Bebchuk and Hamdani show, potential upstart states, anticipating that Delaware would strike back, have reason to never incur the costs of starting up.[17]

Moreover, although the current analyses do not point the following feature out, start-up costs interact with political time horizons to further dampen state-to-state competitive effort. The time horizon most vivid for a typical politician extends to the next election, often via a 2-year or 4-year cycle. While the start-up costs for the state to compete would be incurred before the next election, any benefits that might be derived if the effort succeeds would come further in the future. Hence, politicians, wary that the unrealized state profits of the effort will be unrecognized by their constituents when the next election rolls around, will hesitate from supporting start up endeavors.

Whatever the underlying explanation — local politics or stalking horse economics — the bottom-line is clear: no state *has* a tax structure that would make it profitable to take a slice of Delaware's chartering business, few if any states *try* to get it, and no state other than Delaware *gets* a big tax boost from a corporate chartering business.

3. The federal presence. In a complementary analysis, I indicated that during the past century the threat to Delaware in making corporate law came as much, or more, from Washington as from the other states. When a big corporate business issue arises, Washington either takes the issue over, or threatens to do so. Delaware sometimes reacts. Sometimes it watches as the lawmaking flows to Washington. (Sometimes it could prefer that Washington take over a divisive issue, one on which the state might stumble or, if differing firms have differing interests, lose some of its incorporation business.) Washington intermittently threatened to take away the entire chartering business from Delaware and the other states in the twentieth century; more often it has taken over aspects of corporate law, or considered doing so.[18]

Thus Delaware competes with Washington — not in issuing charters, but in making the law governing America's corporations — and that fact is underscored by the new analyses that conclude the other states just aren't tough competitors for

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[17] Bebchuk & Hamdani, supra note 6, at 594-95.

[18] See Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003). Others have tempered the race by pointing to federal authority, although often dismissing its strength and persistence, or limiting its scope to one area of corporate law-making. William W. Bratton, *Corporate Law's Race to Nowhere in Particular*, 44 U. TORONTO L.J. 401, 419 (1994) ("[Federal influence] could be more hypothetical than real… . Certainly, … intensity varies from period to period."); 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, 768 (1987); Eisenberg, supra note 14, at 1512; Arthur Fleischer, Jr., *"Federal Corporation Law": An Assessment*, 78 HARV. L. REV. 1146 (1965) (federal disclosure rules control fiduciary behavior); Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE 321, 340–47 (Margaret Blair ed., 1993) (federal influence on Delaware in making takeover law); Renee M. Jones, *Does Federalism Matter? Its Perplexing Role in the Corporate Governance Debate*, 41 WAKE FOREST L. REV. 879 (2006).

corporate charters. Even if Washington were a weak competitor (or just an intermittent one), its relative importance increases when we see the limits of state-to-state chartering competition.

II. COMPETITION I: TURNOVER

But is there nevertheless an important stream of interjurisdictional chartering competition today? There is, although it's not the intense competition of a basic economics textbook.

A. Inflow and Expiration

1. The incorporation rate. Consider the flow of corporate chartering business into Delaware. The year 2005 began and ended for Delaware with about 300,000 companies chartered there. But intra-year turnover was substantial. More than 35,000 firms incorporated in Delaware during the year 2005 — about 10% of its installed base.[19] And, obviously about the same number left, closed up, or were absorbed into other firms. New firms arise and move into Delaware. Other firms merge, go bankrupt, or close. A handful of firms move back to their home state. Very few firms move to a third state. These numbers — a 10% annual turnover rate — are about what Delaware experienced during each year of the prior decade, as Table 1 shows.

2. Data on changing rates of reincorporation. Table 1 shows the chartering rate in Delaware during the period 1997-2005. For the decade, there's a steady entry and then exit of about one-tenth or more of Delaware's firms.

Table 1. Exit and Entry in Delaware[20]

	1997	1998	1999	2000	2001	2002	2003	2004	2005
Charters on January 1		291,511	297,714	308,492	322,971	318,684	307,907	304,321	299,662
Entry	53,030	48,885	54,585	59,949	40,043	37,160	33,023	33,865	35,245
Entry percentage*		**14.36%**	**15.49%**	**16.27%**	**11.03%**	**10.44%**	**9.69%**	**10.01%**	**10.52%**
Exit		42,682	43,807	45,470	44,330	47,937	36,609	38,524	36,406
Exit percentage**		**12.54%**	**12.44%**	**12.34%**	**12.21%**	**13.47%**	**10.74%**	**11.39%**	**10.87%**
Charters at year-end	291,511	297,714	308,492	322,971	318,684	307,907	304,321	299,662	298,501

* (New charters issued during the year / (Delaware charters at start of year + New charters issued))
** (Charters cancelled during the year / (Delaware charters at start of year + New charters issued))

[19] International Association of Commercial Administrators, Annual Report of the Jurisdictions 2006 (2006) (annual report of Delaware, at 1), available at www.iaca.org/node/80.

[20] Source: International Association of Commercial Administrators, Annual Report of the Jurisdictions 1997-2005 (1997-2005) (Delaware entry). Entry includes all firms receiving a Delaware charter, whether by reincorporation, spin-offs, or new formation.

Inflow of firms going public is similarly dynamic: More than 65% of the firms that went public in the past dozen years reincorporated into Delaware,[21] amounting to 2600 firms, about two-thirds of the total number of Delaware-chartered *public* firms. Overall, Delaware firms are younger and riskier than their counterparts incorporated elsewhere,[22] further suggesting that flow into Delaware is important to the state's tax base and its corporate structural interests (such as the Delaware law firms and governmental agencies that service its corporations).

In the summer of 2006 there were 292,000 active Delaware firms. Of these, about 10% had incorporated in Delaware in the prior year. More interesting are the five-year and ten-year cumulative numbers: 47% of Delaware's active firms had incorporated in Delaware within the prior five years and 70% had incorporated in Delaware in the prior ten years.[23]

Table 2 illustrates flow, showing several well-known companies that moved to Delaware during the past two decades or so. Delaware must be attractive enough to induce them to move from California, Colorado, and Washington, and then pay Delaware more in franchise fees than they were paying in those states.

Table 2. Examples of Major Reincorporations into Delaware[24]

Company	Year company moved to Delaware	State from which firm reincorporated
Northrup	1985	California
Sun Microsystems	1986	California
The Gap	1988	California
Intel	1989	California
Amazon.com	1996	Washington
Ebay	1998	California
Google	2003	California
Coors	2003	Colorado

Tables 3 and 4 show key tax information. In 2006, Delaware's total franchise tax revenue was $534 million. Of that $534 million, $289 million, or 54%, came from

[21] Kahan, supra note 7, at 352 tbl. 2. Delaware charters approximately 3700 publicly traded companies. Lucian A. Bebchuk & Alma Cohen, supra note 4, at 391 tbl. 2.

[22] Feng Chen, Kenton K. Yee, and Yong Keun Yoo, Are Delaware Firms Oranges? Fundamental Attributes and the Delaware Effect (SSRN working Paper, 2006).

[23] Delaware Secretary of State's Office, Spreadsheet calculations, Aug. 10, 2006.

[24] Sources:

http://quotes.nasdaq.com/asp/SummaryQuote.asp?symbol=INTC&selected=INTC;
http://sec.edgar-online.com/2005/03/28/0001193125-05-061097/Section2.asp;
http://www.secinfo.com/d14D5a.148c8.html;
http://money.cnn.com/quote/snapshot/snapshot.html?symb=EBAY;
http://www.sun.com/aboutsun/investor/faq/index.html#12;
http://money.cnn.com/quote/snapshot/snapshot.html?symb=AMZN;
http://sec.edgar-online.com/2003/03/24/0000898430-03-002012/Section2.asp;
http://www.sec.gov/divisions/corpfin/cf-noaction/adolph082503.html.

firms that had incorporated in Delaware in the prior ten years, and $428 million, or 80%, from firms incorporating in Delaware within the prior twenty years. In 1996, the distribution was substantially similar: total franchise revenue was $333 million, with $180 million, or 54%, coming from firms that came to Delaware in the prior ten years.

Table 3. Franchise tax payments in Delaware in 2006, by year incorporated into Delaware

Year of Delaware incorporation	Number of firms	Franchise fee paid		Year of Delaware incorporation	Number of firms	Franchise fee paid
pre-1983	47,764	82,337,153		1994	7,480	15,452,807
1983	2,271	8,319,126		1995	8,397	16,845,342
1984	2,415	5,802,460		1996	9,855	27,319,725
1985	2,870	8,279,260		1997	11,193	28,732,643
1986	3,708	17,295,188		1998	12,316	29,123,604
1987	3,905	16,438,563		1999	14,095	34,630,501
1988	4,115	11,295,576		2000	15,785	34,414,457
1989	4,327	10,540,559		2001	13,473	21,649,052
1990	4,354	7,951,477		2002	14,307	21,369,217
1991	4,518	13,032,348		2003	15,508	24,411,394
1992	5,194	13,135,022		2004	18,283	29,906,781
1993	6,432	17,789,264		2005	21,840	37,584,828

	Total 2006 fees		533,656,346
2006 revenue coming from entrants in prior 20, 15, and 10 years:	20-year total	0.80	428,918,347
	15-year total	0.68	365,396,984
	10-year total	**0.54**	**289,142,201**

Table 4. Franchise tax payments in Delaware in 1996, by year incorporated into Delaware

Year of Delaware incorporation	Number of firms	Franchise fee paid		Year of Delaware incorporation	Number of firms	Franchise fee paid
pre-1983	41,631	97,802,636		1990	10,511	11,260,250
1983	4,688	10,813,562		1991	11,448	16,228,944
1984	5,091	8,362,813		1992	14,321	15,709,549
1985	5,947	11,123,523		1993	19,173	24,225,987
1986	7,994	24,049,635		1994	24,383	20,778,753
1987	8,631	23,569,823		1995	31,013	22,492,417
1988	9,457	16,626,021		1996	39,931	13,919,047
1989	10,215	15,598,866				

	Total 1996 fees		332,563,069
1996 revenue coming from entrants in prior 10 years:	**10-year total**	**0.54**	**180,409,655**

A similar effect can be seen by examining the structure of the maximum payers in Delaware in 2006. As Table 5 shows, 1,639 firms paid the maximum franchise fee

in 2006, providing about one-half of Delaware's $534 million total franchise fee. Of those, half had incorporated in Delaware in the prior ten years.

Table 5. Aging of Delaware's 1,639 maximum franchise tax payers in 2006

Number of maximum payers that incorporated in Delaware *after* the beginning of year	Year	Percentage that incorporated in Delaware *after* the beginning of year
86	2005	0.05
164	2004	0.10
215	2003	0.13
269	2002	0.16
327	2001	0.20
394	2000	0.24
488	1999	0.30
575	1998	0.35
670	1997	0.41
761	1996	0.46
814	**1995**	**0.50**
1059	1990	0.65
1307	1985	0.80
1401	1980	0.85
1478	1970	0.90
1543	1960	0.94
1566	1950	0.96
1581	1940	0.96
1597	1930	0.97
1628	1920	0.99
1638	1910	1.00
1639	1900	1

Note: Of the 1,639 firms paying the maximum franchise tax in 2006, 814 (approximately half) incorporated in Delaware after January 1, 1995.

These figures indicate a previously overlooked financial pressure on Delaware. True, it's not the powerful one of a hungry competitor seeking charter revenues. But, even if no firm leaves Delaware for another state and even if no state actively competes for the reincorporation flow, Delaware still must keep itself attractive enough to keep reincorporations flowing from the home states. Otherwise, the tax base will erode.

Now, if the qualitative gap between the home states' corporate law and Delaware's were huge, such that home states just couldn't service the large public firm, then the pressure on Delaware to maintain an ongoing inflow would be negligible. Firms would move to Delaware because firms in such a setting have no real choice: once they got big enough, they'd have to move, even if Delaware didn't keep

polishing its corporate law. (In technical terms, the question is whether the reincorporation decision is a marginal one or not.) But the flip side of the refrain that Delaware has about half of the big company charters is that the *other* 49 states *have the other half*. Most states now *do* provide a serviceable even if imperfect corporate law for large firms. For example, one of Delaware's prime advantages is its well-praised courts. One reason to incorporate in Delaware is to get better access to the courts when there's a corporate law dispute. However, the evidence is that there's relative exit from Delaware of firms in merger agreements, as Delaware firms often choose another state to be the forum for any resulting litigation. Hence, firms seem to have a real choice even in this dimension. Delaware must draw firms out from their home states; other states provide a usable, satisfactory corporate law structure for the public firm.[25]

Table 6 shows the "half-life" pattern for the prior quarter century for Delaware's maximum franchise fee payers. (I use the maximum franchise fee payers because that's the data available from the Delaware Secretary of State's office. Similarly, I use a 1983 cut-off because that's the earliest date for which the Delaware authorities can readily assemble the data.)

Table 6. The shortening half-life of Delaware's franchise tax base

Year	Number of Maximum Franchise Tax Payers	Maximum Franchise Tax	Total Franchise Tax	Percentage of Total Paid by Maximum Payers	Half of Maximum Payers Became Delaware Corporations within How Many Years?
2006	1639	$165,000	$534,000,000	0.51	11 (after January 1, 1995)
2001	1507	$150,000	$475,000,000	0.48	9 (after January 1, 1992)
1996	951	$150,000	$333,000,000	0.43	10 (after January 1, 1986)
1991	640	$150,000	$231,000,000	0.42	13 (after January 1, 1978)
1986	364	$130,000	$130,000,000	0.36	18 (after January 1, 1968)
1983	246	$110,000	$80,000,000	0.34	25 (after January 1, 1958)

The portion of the revenue provided by maximum payers is steady but rising. In 2006, the maximum payers provided half of the revenue; in 1983, they provided one-third. But the half-life is much shorter in the 21st century (about ten years) than it was in 1983, when it was about a quarter of a century. Some shortening is probably due to the dot.com boom and bubble of the late 1990s, some must be due to the accelerating pace of change in American business. (These two causes may well be opposite sides of the same coin.) Whatever the source, the competitive pressure on Delaware in this dimension seems to have increased in the past quarter-century, not decreased.

[25] Theodore Eisenberg and Geoffrey P. Miller, Ex ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements (NYU School of Law working paper No. 06-31, 2006), at 6, available at http://ssrn.com/abstract=918735:

> The outflow [of merger contract choice of forum] from Delaware is not trivial. Delaware was the place of incorporation for 189 merger contracts; it was the choice of law for 132. With respect to forum selection, 115 contracts that designated a forum had Delaware corporate acquirers. Yet only 64 contracts specified Delaware as the litigation forum. In contrast, New York had eight corporate acquirers and 70 contracts selecting New York law and 45 selecting New York as the litigation forum.

3. Mergers as a source of flow. A related dimension for competitive pressure exists. When firms merge, one firm survives. If a Delaware firm merges with a non-Delaware firm, the firms must decide whether the Delaware or the non-Delaware firm survives. In that moment of decision, Delaware competes to get the business. Even if both firms are Delaware corporations, the merger is a moment for the parties and their attorneys to assess whether they want the survivor to be a Delaware corporation or not.[26] Since most mergers require the approval of shareholders of one or the other (or both) of the constituent corporations, shareholders can turn down the merger if deeply unhappy with the state in which the survivor would be incorporated.[27]

During the 1990s, xx% of the Standard & Poor's 500 disappeared in mergers, making this arena for competition not small.[28] (Whether the decision-upon-merger should be classified as inflow — as the survivor becomes a Delaware company — or as the potential for outflow, could be further analyzed.)[29]

The overall pressure here on Delaware results from the accelerating pace of business change. In 1938 the average life of a Standard & Poor's 500 company was about a century. By 2007, it was only twenty years. Of ten largest American companies by market capitalization in 1965, only on non-oil company was on that list in 2006.[30]

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[26] The merger of two Delaware firms paying the maximum franchise tax rate reduces Delaware's revenue, creating an interesting incentive to the Delaware state corporate apparatus.

[27] The Delaware Secretary of State's office codes each company in the data underlying Tables 3, 4, 5, and 6 with a unique number when there's a new incorporation. If there's a merger of Delaware firms and a Delaware firm is the survivor, the office does not record the firm as a new Delaware entity. Similarly, a name change for a corporation does not yield a new entity for tax-data tracking purposes, as the identification number remains constant. Hence, the data underlying the tables should not be picking up simple mergers of Delaware firms.

[I should confirm that this is true for triangular mergers as well, i.e., that it's not the new company's date that counts for measuring the tax base, but one of the constituent companies' original tax entry date. Even if the triangular mergers are coded by the new date, the merger transaction is an opportunity for firms to re-visit the question of where they'd like to be incorporated.]

[28] Cf. Gerald Davis & Suzanne Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980-1990*, 37 ADMIN. SCI. Q. 605, 608 (1992) (about one-third of Fortune 500 firms received takeover bids during the decade); John C. Coates, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?,* J. CORP. L., Sum. 1989, at 837, 851.

[29] To get a better sense of the composition of Delaware's recently-acquired tax base, we did the following: First, we identified the firms paying Delaware's maximum franchise fee in 2006 that first appeared on Delaware's franchise tax roll ten years previously, in 1996. There were 91 such firms. (Remember, Delaware's maximum franchise fee is reached by not-very-large companies; they are not all the largest firms in America.) We then identified the reason for their entry into Delaware, typically from the firms' 10-Ks, although sometimes from the firms' web-sites or news reports. (No information or only ambiguous information was available for 7 of the 91, yielding 84 whose reason for Delaware incorporation could be obtained.) Nearly half of the firms were new companies (38/84). Reincorporations from another jurisdiction and companies going public accounted for 19 of the entrants (19/84); mergers, reorganizations, and spin-offs accounted for 27/84.

[30] DROR FUTTER & CURTIS L. MO, ADVANCED VENTURE CAPITAL 4 (2007). [Find ultimate source. There may be better indicators of the accelerating pace of change in Delaware's client base.]

B. Structural Implications of Flow vs. Installed Base

The structural importance to the public firm of flow vs. installed base is the following: As the approval of both managers and shareholders is necessary to the reincorporation decision under typical corporate law, to the extent that Delaware does compete for inflow, it must appeal to both managers and shareholders. However, to the extent Delaware need only retain its installed base, it must only persuade one or the other — managers or shareholders — that the firm should stay put in Delaware. Since the board, which has been traditionally and historically tied to managers, must move first for reincorporation away from Delaware, managers have conventionally held the upper hand for incorporation outflow.[31]

Examining flow vs. installed base could help us understand the forces acting on Delaware. If Delaware focuses on obtaining inflow more than on retaining its installed base, then the race-to-the-top story would be stronger than otherwise (or at least the race-to-the-bottom would have more hurdles to overcome). That's because Delaware must provide enough value to a firm deciding whether to reincorporate from Ohio to Delaware that both managers and shareholders expect to be better off by moving.[32] But if Delaware were solely interested in keeping its installed base happy, then it could favor managers over shareholders (or vice versa) because either could veto a mass exodus of firms from Delaware. When protecting its installed base, Delaware can choose whether to please one side more than the other; in inducing inflow, it must keep both deciding parties happy.

To be sure here, this contrast is not as severe as the prior paragraph states it to be: if the firms reincorporating to Delaware typically have a controlling shareholder, they are indifferent as to whether Delaware law favors managers or not for the period when the controlling shareholder remains.[33] But the relative incentive position is clearer: inflow is more likely to involve both parties signing on, while blocking outflow can be done by just one. Analogously — for muddying the contrast here — if organized institutional investors could now stymie outflow as easily as managers, Delaware might cater to them more than before, since they could affect flow. The differences deserve further analysis.

The empirical difficulty in assessing whether inflow and installed base might steer Delaware's race to the bottom or the top lies not only in the ambiguity of whether their effects sharply differ, but in that they *both* vitally affect Delaware's revenue base. Ten per cent of Delaware's firms disappear every year and are replaced. Over ten years, about half of its tax base in the final year comes from the new entrants.[34] That turnover rate *is* fast enough for Delaware to know that it cannot sit on its corporate

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[31] Bebchuk forcefully makes this point. Bebchuk, supra note 10, at 1458.

[32] Some secondary stories could undermine this: if no state protects shareholders, then Delaware only has to provide shareholders a little extra value — from, say, network advantages — to win reincorporation business. Cf. Michal Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 129, 133, 135-36 (2004). (Whether this should be interpreted as a race to the top or to the bottom could be analyzed.) If shareholders are scattered and confused, they might approve a reincorporation that's against their interests.

[33] Bebchuk, supra note 10, at 1476-78.

[34] Based on 1996 and 2006 data. See Tables 3 and 4.

laurels, but slow enough that it knows that with its installed base of larger firms, it can be profitable for several years even if attracts no new entry.

This indeterminacy of flow vs. installed base helps to explain why the bottom vs. top race has proven so inconclusive to many of the debate's observers. Delaware faces two structural pushes here, one to favor managers and shareholders jointly, and another that could lead it to favor one over the other. (Traditionally it's been thought ─ accurately in my estimation ─ that this dimension would tilt toward managers. But this tilt could flip: all Delaware has to do here is to satisfy one side of the jointly determined decision. If authority in the firm otherwise shifted to shareholders, it might be pressured to further favor shareholders, not managers.)

C. The Tax Rate

The structure of Delaware's franchise tax increases the importance of flow, compared to what its importance would be within other imaginable rate structures. The annual rate tops out fairly quickly, at about $165,000 annually, for a corporation with assets of $660 million (or at least 26.4 million authorized shares).[35] General Motors, for many decades America's largest industrial corporation, pays the same franchise tax as, say, Datameg, a relative newcomer.[36]

Consequently, the total number of Delaware's good-sized firms is more important to its total tax revenues than the total market capitalization of its firms. One $660 million firm is as good as any other and, in 2001, 1,559 firms paid the maximum franchise fee. They provided half of Delaware's franchise fees.[37]

Perhaps this results from inertia. Perhaps Delaware doesn't want corporate players to vividly see the rate card, an occasion that might call attention to whether firms really need Delaware so badly. Perhaps the rate structure has an efficiency explanation — it forces Delaware to focus more on inflow than on exploiting its installed base, while another rate configuration might not. Or perhaps once Delaware took on its truncated tax strategy, its tax agents became reluctant, as a matter of agent-style risk aversion, to try something new, fearing they'd suffer serious consequences if a new rate misfired, but garner few benefits if it succeeded. Or perhaps the Delaware players controlling the tax rate are Delaware lawyers, as Jonathan Macey and Geoffrey Miller have emphasized, who maximize their own revenues by encouraging Delaware to employ lower franchise fees in order to attract more corporations, which need more work from corporate attorneys.[38] Or perhaps Delaware — like a shopping mall needing big, name-brand stores that attract smaller tenants — employs this strategy to retain "anchor tenants" like General Motors and Exxon whose presence warranties to smaller tax-paying firms that Delaware's corporate law is appealing.

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[35] Barzuza, supra note 32, at 186.

[36] Cf. id. at 187-88 (although the larger firms would likely be willing to pay more, Delaware retains this taxing formula because of a trade-off between prices charged and the quantity of firms willing to incorporate in Delaware). For Datameg, see http://www.secinfo.com/d11A75.1Aa.d.htm.

[37] [Consider whether the tax rate has been increasing via "bracket creep", pushing more and more firms into the maximum, making Delaware more dependent today than before on mid-cap firms.]

[38] Jonathan R. Macey and Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 503-04 (1987).

Whatever the underlying explanation, the result is that Delaware has reason to focus not just on exploiting (or servicing) its installed base but also on inflow. Density of firms, not just density of capital, is the essential character of Delaware's revenue base.

III. COMPETITION II: CHARTERING COMPETITION AS A CONTESTABLE MARKET

Thus, that no state competes closely with Delaware day-to-day over chartering revenues doesn't mean that Delaware doesn't have to compete over making corporate law. Day-to-day, though, its installed base won't move. (That is, its installed base won't reincorporate. Firms that disappear, go bankrupt, otherwise fail, or merge with an out-of-state survivor do "move" and thereby do erode the state's installed base.)

But over the long-run it's not just the inflow that's important: Delaware's installed base conceivably *could* move en masse, or a dormant state could enter the chartering market. True, contestable market competition is not a day-to-day concern for those guarding the state's tax coffers. It's not something Delaware's lawyers need to stay awake worrying about night, because it's not easy for the installed base to move, it'd take several years before weak inflow would seriously erode the tax base, and there's no evidence of repeated restlessness indicating any risk of an imminent move or even one seriously considered in, say, the last decade. But that the idea isn't in the air doesn't mean the base couldn't move. The chances that I'll die in a car accident are slim. A seat belt has never helped me avoid even minor injury. Yet, I still wear a seatbelt. So does Delaware.

A. What Is a Contestable Market?

The industrial organization concept of a contestable market, which William Baumol analyzed, is relevant here.[39] As Scherer summarizes:

> When potential entrants have access to the same technology as incumbents, when there are no sunk costs, and when a firm can enter and exit the market before incumbents can respond, the market is said by Baumol et al. to be perfectly contestable. The only sustainable price available to incumbents under these conditions is one that just covers average cost.[40]

True, Delaware does not face a perfectly contestable market. Although all states have access to the same technology of making corporate law, none is actively waiting

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[39] WILLIAM J. BAUMOL, THE FREE-MARKET INNOVATION MACHINE 163-65 (2002); WILLIAM J. BAUMOL, JOHN C. PANZAR & ROBERT D. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE 5 (rev. ed. 1988); ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 82-83 (2002).

[40] F.M SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 375-76 (3d ed. 1990).

in the wings, and Delaware could respond to a new entrant quickly.[41] By responding, Delaware would devalue a competing state's investment. Because the potential competitor knows that Delaware could react, the potential competitor has reason not to compete.[42]

But the market structure for state competition is more complex. Consider one key dimension along which Delaware has gained ascendancy: an efficient court system, staffed with high-quality judges familiar with business practice. If Delaware fell short here, a state could set up a corporate court to compete, yes, but when Delaware recovered, the new entrant's investments in superior courts would be devalued. A stalking horse analysis though understates the risks to Delaware: other states could enter a more textured market of providing upgraded commercial courts. The upgraded commercial courts would serve in-state commerce, as well as provide a base for reincorporation competition, diminishing the marginal cost to the state of setting up the competing courts. No state has done so yet successfully, but it wouldn't be so expensive for a state to try, and it could keep its newly-installed commercial judges busy with local business litigation, as they waited for corporate charters to flow their way.

This general point — that Delaware's lock on the chartering market is contestable — is one that Roberta Romano made[43] and it should be expanded. It's not just that another state could contest Delaware's supremacy, but that Delaware's primary interest groups could motivate another state to enter the market for Delaware's installed base. And there's also a vertical dimension to contestability: just as the risks of a state entering are low but real, the chances of Washington acting further in corporate governance in a contestable-markets-manner are low but real. It does do so about every decade. Moreover, the federal presence limits horizontal contestability in an important way that we need to understand. Those limits become apparent as soon as we examine the mechanism that could make Delaware's dominance contestable.

B. Delaware's Installed Base

Delaware does have an installed base of firms that have been paying tax in Delaware for quite some time. It would be a flawed analysis to focus solely on the installed base to bolster a pure noncompetition view, though, because this installed long-term tax base is not the entire tax base: as much as half of the major firms and half of the revenue is "new," brought into Delaware during the previous decade. This we established in Part II. But, at any specific time, Delaware has a large installed base — $500 million worth in 2006, for example — and that base gives the state a core that it could exploit in the short-run.[44] If the past decade is prologue, although the base will

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[41] Delaware's response capability corresponds to the stalking horse impediment to state competition that Bebchuk and Hamdani emphasize. Bebchuk & Hamdani, supra note 6, at 593-95.

[42] See id. at 595.

[43] ROMANO, supra note 39, at 82-83.

[44] See, e.g., Daines, supra note 5, at 1602-03.

erode at a rate of 50% over the subsequent decade or two;[45] Delaware could milk the installed base, but it could not do so for very long.

C. Sleeping Competitors

The no-competition perspective relies on the fact that Rhode Island, South Dakota, and Nevada are ineffective today as ongoing competitors of Delaware for reincorporation chartering revenue. Although Delaware might fumble, no state is close, ready to pick up the ball and run with it. When Delaware stumbles it has time to react, pick itself up, and fix the problem.

Yet, even if no other state's corporate law apparatus is structured so that it could quickly capitalize on, say, a Delaware offense to corporate managers, maybe Delaware is still competing to keep its installed base, albeit in another weakened form. The first competitive channel we've seen: Delaware wants new California firms to reincorporate into Delaware. For firms to do so, Delaware must be seen as providing value to shareholders and managers. We now see a second channel of competition: contestable-market-type competition for Delaware's existing installed base.

1. Who would instigate? Imagine that Delaware fumbled, but didn't recover. Both managers and shareholders are, let's posit, outraged at Delaware's *Van Gorkom* decision, or another line of decisions, or some statutory misfeasance. And they're annoyed and disappointed that Rhode Island, South Dakota, and Nevada have done nothing to improve the situation. No state is waiting in the wings, as Kahan & Kamar have quite effectively shown, watching whether Delaware fumbles so that it can rush to pick up the ball.[46]

But that doesn't mean competition even for Delaware's installed base is absent. It's weak, but weak does not mean nonexistent. State competition might then start up — after the incumbent missteps — if a sleeping competitor sees an opportunity and acts before Delaware recovers. Delaware might recover, and that's one reason, as Bebchuk and Hamdani have said,[47] why other states don't have much of an interest in being a stalking horse that would just induce Delaware to change its law over the long run, rather than yield the new competitor much in the way of corporate chartering revenue.

But there's more. The offended players in Delaware could go to Rhode Island or South Dakota or Nevada and make them an offer. Give us, they say, good chancery-court-style judges (and we can provide a few from our law firms to you), give us Delaware law (but without the offending provisions), and then we'll give you Delaware's tax revenues, $500 million per year.

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[45] E-mail, dated Jan. 17, 2007, from Delaware Secretary of State's Office, using year 2001 data.

[46] Or imagine something more threatening to Delaware's corporation business. Consider the possibility that business changes in some way that half of the firms prefer rule X, and the other half not X, and there's no good way to compromise. Delaware, no matter what it does in the competency arena, could find itself facing unrest from half of its installed base. [This should be in the text, but elsewhere, in another paragraph, maybe in discussion of when and why Delaware would sometimes prefer federal intervention.]

[47] Bebchuk & Hamdani, supra note 6, at 594-95.

That is, the fact that states aren't actively competing for chartering revenue doesn't mean that they couldn't compete, doesn't mean that if Delaware fumbled and didn't recover another state wouldn't pick up the ball, and doesn't mean that the offended players in Delaware wouldn't and couldn't act themselves to create a competitive state. Nor does current absence of an active competing state mean that Delaware is unaware that if it stumbled, a viable competitor could emerge. Moreover, the offended *interest groups* have reason to devote resources to starting up a competitor — *even* a stalking horse competitor that Delaware would co-opt. The interest groups that benefit from changing corporate law win either way: either Delaware changes, or a new more favorable competitor arises. They have reason — if they can overcome their own collective action problem — to instigate a state to compete, even if the state has little reason to invest its own resources. Chambers of Commerce, the American Bar Association, and Business Roundtable committees, some financed by the relevant corporations, could provide much of the start-up costs.

That is, when one adds in the interest groups that could want another state to act, the stalking horse problem, albeit real, becomes less severe. If the state bore most of the corporate start-up costs, it might be reluctant to stalk and enter, knowing that Delaware might in the end match it. But if the interests groups bore those costs — e.g., the Business Roundtable or the Chamber of Commerce commissioned a law firm study group of a City Bar Association to draft a model code, etc. — they might mitigate the stalking horse problem enough to get another state started. Even if a state has reason to be wary of incurring up-front costs in starting up its chartering capacity, the corporate players could sensibly incur the costs themselves and start up state competition.

With no state shadowing Delaware now to compete closely, Delaware obviously has freedom to maneuver, but contestable markets theory tells us that that band of freedom may be wide but is not unlimited.

2. Alternative business entities. Collateral business entities are relevant as toeholds from which other states could, if they succeeded in dominating the chartering of the alternative entity, expand into corporate chartering. Here's what I mean: in recent years, there has been an explosion in alternative business entities such as limited partnerships, business trusts, and other non-corporate business forms.[48] Similarly, courts that serve as the forum for business litigation other than core corporate litigation could become the springboard asset for eroding one of Delaware's assets ─ it's judiciary.[49] A state that finds itself with a strong presence in commercial litigation or in chartering alternative business entities, would find itself well-positioned as an entrant if Delaware stumbled.

Table 7. Alternative entities: density in Delaware.

Table 8. Jurisdictional distribution of alternative business entities.

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[48] Possibly: Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183-232 (2004).

[49] Theodore Eisenberg and Geoffrey P. Miller, supra note 25; Theodore Eisenberg and Geoffrey Miller, The Market for Contracts (NYU Law and Economics Research Paper No. 06-45, 2007), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=938557.

3. How Delaware displaced New Jersey. That's how — via a contestable market — it happened once in America. New Jersey had the chartering business, it changed its corporate law, and corporate America fled to Delaware. It happened fast. The corporate chartering market was contested and one state quickly replaced another.[50]

States — or two of them — vied for the corporate charter business. And then all-at-once (from the long perspective of a century of reincorporation movement), one state won. The chartering market was then a contestable market in theory and in fact. There was a contest, and one state displaced another.

4. Martin Lipton's threat. Fast forward to nearly a century later. The hostile takeover was the overarching corporate transaction of the 1980s. It seemed at the time to be an issue that could move corporations in their state chartering decisions. Many states responded to their local corporations' and their managers' goals, by passing tough anti-takeover laws. Yet, Delaware did little in the mid-1980s. It didn't do much because it was undecided — takeover policy was controversial — because its primary interest groups did not agree, and because it wanted to head off the threat of federal action, which Delaware might have set off if it acted sharply.[51]

When its Chancery Court wrote a strong pro-takeover opinion[52] and its legislature ignored calls to pass antitakeover laws, Delaware faced the threat of exit, as evidenced by Martin Lipton's famous public proposal for firms to reincorporate out of Delaware. The demands of the race were as plain as could be for Delaware. In Lipton's words:

> The Interco case and the failure of Delaware to enact an effective takeover statute, raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.[53]

How much of this was threat and how much was bluff — both managers and shareholders would have had to approve firms going through the reincorporation exit — is hard to assess. Whether Lipton and, say, the Business Roundtable would have geared up to show Rhode Island — or New Jersey again — how to make corporate law is hard to say. Keep in mind that law firms frequently undertake such public service ventures, some of which coincide with their clients' interests. [Provide examples:

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[50] I recount the New Jersey to Delaware history in *Delaware's Competition*, supra note 18, at 607-10. Others have done so as well.

[51] Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE 321, 340–47 (Margaret Blair ed., 1993); Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003).

[52] City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 797 (Del. Ch. 1988).

[53] Martin Lipton, To Our Clients: The Interco Case (Nov. 3, 1988) ("private" mailing available to corporate America); Tim Smart, *For Managers, Delaware Isn't the Haven It Used To Be*, BUS. WK., Dec. 19, 1988, at 33 ("[L]egal advisers to worried managers already are suggesting that companies should consider playing elsewhere… ."); Charles Storch, *As Company, Time Focusing on 1 Newsmaker*, CHI. TRIB., July 9, 1989, at 8 (reporting that Delaware's blocking Interco management from using the pill "so enraged Martin Lipton, the lawyer … credited with inventing the … pill … , that he urged his … clients to consider reincorporating elsewhere"); Stephen Labaton, *The "Poison Pill" Takes a Beating*, N.Y. TIMES, Nov. 14, 1988, at D2; Roger Parloff, *The Outlook of Poison Pills: After* Interco *and* Pillsbury*, What Next?*, MANHATTAN LAW., Jan. 24–30, 1989, at 31.

ABA committees, Principles of Corporate Governance; litigation; Business roundtable funding.]

They had the resources to do so. And for a time, they had the motivation. Then Delaware passed an antitakeover law, its Supreme Court wrote antitakeover decisions, most prominently that in *Time-Warner*,[54] which explicitly rejected *Interco*, hostile takeovers declined in frequency perhaps because of economic reasons, and talk of firms exiting Delaware stopped.

Lipton's threat suggests why contestable market competition is plausible: even if other states do not pursue the opportunity, there are corporate interests that could and, if their ox was being gored, would. Two analogous examples are available, both from the Dakotas.

4. South Dakota and North Dakota: credit cards and corporate charters. When Citibank didn't want its credit card operation subject to local interest rate limits, it sought out South Dakota, then with a high limit. South Dakota then totally repealed its limit, to make it even more attractive to the top the credit-card issuing banks.[55] If corporate America showed up on the steps of the statehouse in South Dakota, one imagines that the state lawmakers would be even more solicitous, when they saw that $500,000,000 franchise fee dangling in front of them. Again, to be explicit, even if no state has an interest in, or the resources to, compete with Delaware, corporate players do. They can incur the up-front costs and organize a response.

Lawyers associated with activist investors asked North Dakota in 2007 to pass a corporate law attuned to institutional investors' current agenda. It did. No firm has yet taken up North Dakota's offer, but its passage of a competing corporate law shows how state-to-state competition is still there, albeit weak. It is also an event that seems much more vivid in Delaware than it is in the corporate world generally.[56] This is how competition would arise: the relevant interest groups would instigate a state to act. It can happen without a motivated, competing state administration starting the action.[57]

IV. COMPETITION III: IT'S NOT JUST STATES THAT CAN CONTEST DELAWARE'S MARKET

So, first, Delaware must maintain inflow. Second, Delaware's installed base is contestable. Another state could gear up to enter the market. That no one has geared up since the beginning of the 20th century to do such a thing means that the threat isn't imminent. But lack of imminence is not impossibility. It's possible, and there are actors with the motivation — and the resources — in common-enough circumstances to promote such a switch. Glimmers of such events (Lipton's memo, North Dakota's

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[54] Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140, 1142 (Del. 1989).

[55] LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 53-54 (2005).

[56] Citations.

[57] Elsewhere I analyze the complex interaction between contestability and the federal presence: the very features — vividness, economic importance, and controversy — that could allow an issue to create contestability would raise the chance that the issue gets onto the federal agenda. See Mark J. Roe, *Is Delaware's Corporate Law Too Big to Fail?*, __ BROOKLYN L. REV. __ (2008).

new corporate law) suggest that it's real. It's a weak form of competition, but it is competition.

Third, the circumstances that create a state-to-state contestable market *also* create a federal vs. state contestable market. American corporate law could be made in Washington. Much already is. This threat is not only possible, it's probably as likely as, or more likely than, another state taking away Delaware's installed base. After all, over the past century every decade has seen the threat or the reality of large batches of American corporate law moving from Delaware to Washington.

But to argue that state-to-state competition is a contestable market that would heat up if a sleeping competitor awakes is only half of what we need to understand Delaware's contestability. There's another potential entrant, one that (a) often has the motivation to act, (b) is potentially quite powerful, capable of displacing big pieces of state-made corporate law in one swoop, and (c) from time-to-time has acted, taking away swathes of previously-state-made law from Delaware and the other states.

The big potential competitor who could contest Delaware's dominance is Washington, D.C. and its potential here is still under-recognized in the academic literature. The contest isn't that Washington would take away the right to charter corporations (that's possible but unlikely) but that if Washington makes all that's important to corporate law, there's no reason for firms to move to Delaware, since it wouldn't be able to provide any distinctive value.

A. Delaware's Biggest Threat: Washington, D.C.

Federal authorities — Congress, the SEC, the Second Circuit Court of Appeals, the New York Stock Exchange acting after SEC prodding — have often made corporate rules that displaced Delaware's rules. At one level, they check Delaware. At another level they just displace it. If all corporate law were made at the federal level, then even if the chartering were local, the franchise tax couldn't be very high, because no state — not even Delaware — would have much to sell corporate America.

1. Regulatory competence. What worries Delaware the most — or what should worry it the most — are two types of actions: One type would be to display incompetence in regulating corporate America. If persistent and widespread, they'd face not just a Sarbanes-Oxley-style incursion into parts of corporate lawmaking, but ouster from controlling wide areas of corporate law.[58]

2. Actions that annoy its two major interest groups. Second, Delaware cannot offend both its two major interest groups, managers and institutional shareholders, simultaneously. If it did so, it would risk the major erosion of reincorporation into a newly found corporate-friendly state. As one observant Delaware player said recently, when the two primary groups agree, Delaware has an easy time making corporate

[58] Cf. Roberta S. Karmel, *Realizing the Dream of William O. Douglas — The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79 (2005) (Sarbanes-Oxley).

law.[59] If it annoyed both of its primary interest group simultaneously, the two would have reason to ask Washington to step in.

3. Not actions that are already in the zone of federal authority. There is though a zone in which Delaware doesn't have to worry too much. Some actions are in the zone where the federal authorities "play." When there, Delaware can feel assured that the federal authorities will act (or be blamed if something goes wrong), so they need not worry.

B. Contestable from Two Directions

Thus, properly understood, Delaware's chartering monopoly is potentially contestable in two dimensions: Horizontally, if Delaware stumbles, then another state could enter, take away market share, and displace Delaware. It once happened that way, as Romano has noted. [60] True, this is a weaker form of competition than ongoing competition for the marginal corporate charter, but contestable market theory provides some lid on the noncompetition, Delaware-as-a-monopoly view.

V. COMPETITION IV: YARDSTICK COMPETITION AMONG CORPORATE LAWMAKERS

A. What Is It?

Yardstick competition among corporate lawmakers constrains Delaware, although surely not tightly. As Albert Hirschman famously wrote in *Exit, Voice, and Loyalty*,[61] when customers cannot exit, they can raise their voice to complain. Delaware constituents if disgruntled can complain. At the limit, if highly dissatisfied with the Delaware product, they could engage in state politics to try to turn out the incumbents. Their basis for complaint would presumably be stronger if they saw other corporate lawmakers doing things differently and thought Delaware wasn't keeping up.

More intuitively, people use benchmarks and yardsticks to see how they are doing. Officials who take their positions seriously look at how others handle similar problems. If another jurisdiction, or another regulator or court, is doing better, officials can look to the others as a model to emulate. Delaware's constituents can point out discrepancies in performance and results. Delaware officials presumably keep their eyes open to innovations in other jurisdictions.

Pierre Salmon describes elements of yardstick competition among governments. Even when voters have no intention of moving, Tiebout-like, to another jurisdiction, they still see what other jurisdictions are doing. Their officials also see what's happening in other jurisdictions. In a democracy, both voters and officials suffer from

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[59] Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough*, 86 CORNELL L. REV. 1257, 1268-70 (2001). Leo Strine is a sitting Vice Chancellor of the Delaware Chancery Court.

[60] ROMANO, supra note 39, at 82-83.

[61] ALBERT HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 30 (1970).

information constraints: voters cannot readily know whether officials are doing a good job and officials cannot always know what constituents want. Each can glance at results in other jurisdictions to help close the information gap.[62] (Even in communist Europe, television viewers in Poland who watched German programming saw consumers doing better there. Disgruntled Polish television viewers could press Polish government officials who themselves had reason to reconsider their policies if they saw better results in other countries.[63]) Even among vertically organized governmental units, if responsibilities overlap, the two should look at one another to gauge their performance.[64]

B. Several Yardsticks

I have thus far focused on chartering revenue as a core consideration for state-to-state competition, as is common in this academic literature. Other dimensions though exist for interjurisdictional competition. Ancillary business to state incorporation — lawyers' fees for example — have been identified before[65] and other dimensions can be identified. Basic professionalism can be a source of competitive pride, as office-holders (judges, regulators, legislators) want to do a good job, for its own sake. Similarly, governmental, Weberian bureaucracies simply seek to be relevant.[66] In both the professionalism and the Weberian relevance dimensions, federal authorities can play a role, and not just via their power to displace Delaware, but because professionals want to be seen to be competent in the eyes of other professionals. True, this goal could simply be competition for chartering revenue, disguised, with even the actors sometimes unaware that competitive competence is a veneer for the franchise tax, but professionalism need not be a veneer and could be a separate dimension. It could also be political competition on another level: office-holders want re-election, re-appointment, or success at reaching a higher office;[67] these

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[62] Pierre Salmon, *L'apport informative des rapports Doing Business est précieux mais attention aux effets pervers*, DROIT & ECONOMIE, May 2004, at 109, 115; Pierre Salmon, Political yardstick competition and corporate governance in the European Union (paper presented at a conference at Harvard Law School, March 2004) (MS at 3); Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 25 (1995); Jack L. Walker, *The Diffusion of Innovations Among the American States*, 63 AM. POL. SCI. REV. 880 (1969); cf. Andrei Shleifer, *A Theory of Yardstick Competition,* 16 RAND J. ECON. 319 (1985).

[63] Pierre Salmon, *Assigning Powers in the European Union in the Light of Yardstick Competition among Governments*, *in* EUROPEAN GOVERNANCE, JAHRBUCH FÜR NEUE POLITISCHE ÖKONOMIE 197, 200 (2003).

[64] Albert Breton, *Towards a theory of competitive federalism*, 3 EUR. J. POL. ECON. 263 (1987); Albert Breton, COMPETITIVE GOVERNMENTS: AN ECONOMIC THEORY OF POLITICS AND PUBLIC FINANCE (1996); Pierre Salmon, *Vertical competition in a unitary state*, *in* COMPETITION AND STRUCTURE: THE POLITICAL ECONOMY OF COLLECTIVE DECISIONS: ESSAYS IN HONOR OF ALBERT BRETON 239, 253 (Gianluigi Galeoti et al. eds. 2000).

[65] Macey and Miller, supra note 38, at __.

[66] WILLIAM NISKANEN, BUREAUCRACY AND REPRESENTATIVE GOVERNMENT __ (1971).

[67] Cf. Pierre Salmon, *How can a country like Canada be inhospitable to an influence of yardstick competition on regulation?*, *in* POLITICAL COMPETITION AND ECONOMIC REGULATION 103, 104 (Peter Bernholz and Roland Vaubel, eds. 2007); Peter Bernholz and Roland Vaubel, *The effect of inter-jurisdictional competition on regulation: Theory and overview*, *in* POLITICAL COMPETITION AND ECONOMIC REGULATION 1, 2-3 (Peter Bernholz and Roland Vaubel, eds. 2007).

goals provide a competitive impetus to office-holders to innovate, or at least keep up. Lynn LoPucki found bankruptcy courts competing for the big, prestigious cases. Yet bankruptcy courts' competition cannot be propelled by a franchise fee motivation[68] — there is none for bankruptcy — and this dimension can well be in play for basic corporate law too, obscured by analyses of competition for chartering revenues.

C. Delaware's Benchmarks

1. Other jurisdictions. Delaware players have plenty of opportunities to benchmark their decisions. There's a Model Business Corporation Act against which to check their work. Major states reconsider corporate lawmaking from time to time. The American Law Institute studied corporate law for about a decade and produced its Principles of Corporate Governance, against which Delaware players could measure their rules. Law professors and student law reviews are always ready to lend a helping, often-critical hand in reviewing any new Delaware action. The *Business Lawyer* provides Delaware players with practicing lawyers' views. Delaware players can often be found on PLI and ABA panels: they're not just marketing Delaware, but gaining feedback, observing current practice, and learning about current problems.

Indeed, one could imagine cross-national checking for innovation and competency. (And as Donald Langevoort pointed out when commenting on an earlier draft, London now provides securities market competition to U.S. firms, as a haven from, say, Sarbanes-Oxley regulation.[69] If London decided, they might seek to provide a total package of listing, trading, *and* chartering.)

2. Interjurisdictional learning. Analysis of Delaware's lawmaking focuses on competition, or its absence. A focus on competition is a natural one for the economics-oriented academics, like myself, who analyze the structural setting of Delaware's corporate lawmaking. But there are other academic reference points. Political scientists have models of interjurisdictional learning, as policymakers observe what others do and, if what they observe looks plausible, adapt it to their own environment.[70] This

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[68] LOPUCKI, supra note 55, at ___. There's been an analogous competition for trust business, which franchise fees cannot drive, since the tax rate there is zero. Robert H. Sitkoff and Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 416 (2005). True, lawyers' and processors' fee-based goals (instead of office-holders' professionalism or bureaucracies' drive for relevance) could drive that competition.

[69] Cf. Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, 1 REV. L. & ECON. 97, 128 (2005) (Ribstein though focuses on loss of business, not just feedback from voice).

[70] See Katerina Linos, Social Learning and the Development of Corporate Law (Harvard Law School student paper, Apr. 24, 2006); William D. Berry & Brady Baybeck, *Using Geographic Information Systems to Study Interstate Competition*, 99 AM. POL. SCI. REV. 505 (2005); cf. Gerald F. Davis & Henrich R. Greve, *Corporate Elite Networks and Governance Changes in the 1980s*, 103 AM. J. SOC. 1 (1997) (inter-firm learning); Chang Kil Lee & David Strang, *The International Diffusion of Public-Sector Downsizing: Network Emulation and Theory-Driven Learning*, 60 INT'L ORG. 883 (2006) (international governmental imitation); Kurt Weyland, *Theories of Policy Diffusion*, 57 WORLD POLITICS 262 (2005) ("waves of diffusion that sometimes sweep across important regions of the world (or across the states of a federal country, such as the United States)"). Romano describes the S-shaped diffusion that's consistent with a yardstick model, but she attributes the motivating mechanism to state competition, principally for chartering revenues. ROMANO, supra note 9, at 16. Linos notes that S-shaped diffusion is consistent both with competition and with imitatative social learning.

isn't competition in the classic economic, incentive-based sense, but it is diffusion of innovation. And there's no reason to think Delaware doesn't keep an eye on what others do, with information and technique flowing into (and from) the jurisdiction.

CONCLUSION: DELAWARE'S CONTESTABILITY

Today only Delaware actively seeks chartering revenues. But that doesn't mean that it isn't competing on other, although weak, levels. The dynamism and turnover of American business interact with even the static nature of government to prod Delaware. Even if Delaware had all of the *current* incorporation business in America, business firms fail, merge, and go out of business. Products erode and new technologies bring forth new firms. Delaware must attract these new firms. Hence, it must compete. It must convince enough of the new winners that it's worth their while to pay Delaware's highest-in-the-nation franchise fee and reincorporate away from their home state into Delaware.

Not only must it pull new firms away from their home states, but contestable market theory tells us that in some markets although one competitor does all the business, it can lose its market dominance overnight. Aware of the risk, it could even be forced to act (if contestable market conditions are strongly in play) as if it faced an immediate competitor. That isn't the classic competition of many producers, but it's still competition, albeit in a weakened form.

The market for corporate charters resembles such a contestable market, albeit imperfectly. If Delaware offended its two central players — managers and shareholders — simultaneously, that would provide an instantaneous competitive opportunity for another small state. Either a state could gear up to compete, or the offended players could go to the state to show it what it needed to do to gain the chartering revenue bonanza. That's about how it happened when New Jersey lost to Delaware at the beginning of the 20th century. And we've seen similar opportunities that states, not then competing head-to-head, rise up and grab when the relevant inside players show them that the state can gain by changing its regulation.

Moreover, the nature of state competition here — a contestable market, with punctuated, possibly even once-and-for-all results — resembles how federal authorities interact with Delaware. It's possible that if Delaware were to offend its primary interest groups, or offend federal lawmakers, larger swathes of corporate law could go national. Delaware has reason to be on its toes, even if no other state is now looking for chartering revenues. It needs to be on its toes because its primary interest groups have the capacity to set up a new state competitor. And it needs to be on its toes because it cannot afford to instigate federal actors who could displace Delaware corporate law, in whole or in part.

Thus when we analyze the structure of state-to-state competition with Delaware, and realize the relative weakness of ongoing competition for chartering revenue, we are driven to see the importance of Delaware as competing in a contestable market. To the extent the market is contestable, Delaware competes. And, once we see Delaware as in a contestable market with other states, we see that Washington could erode Delaware's dominance just as another state can.

Once again, to fully understand the structure of American corporate lawmaking, we must see the importance of the Delaware-Washington interaction, actual and potential.