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VIGOROUS RACE OR LEISURELY WALK: RECONSIDERING THE DEBATE ON STATE COMPETITION OVER CORPORATE CHARTERS

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VIGOROUS RACE OR LEISURELY WALK: RECONSIDERING THE DEBATE ON STATE COMPETITION OVER CORPORATE CHARTERS

Lucian Arye Bebchuk[*] and Assaf Hamdani[**]

Abstract

The long-standing and central debate on state competition in corporate law has been largely premised on a widely held belief that, whether the race is toward the top or the bottom, states vigorously "race" in seeking to attract incorporations. In this paper, we argue that this belief is in fact incorrect and that the competitive threat to Delaware's dominant position in the market for incorporations is quite weak. We present evidence that Delaware's position in this market is far more dominant and secure than has been previously recognized, and we analyze the barriers to entry that can explain this state of affairs. The weak-competition account that we put forward casts substantial doubt on the extent to which state competition can be relied on -- even on the most favorable view of it – to produce optimal corporate rules. Finally, this account strengthens the case for some form of federal intervention; at the minimum, it would be desirable for federal law to invigorate competition by permitting shareholders to initiate and approve reincorporations and by providing a federal incorporation option.

Key words: Delaware, Incorporation, Corporate Charters, Corporate Governance, Regulatory Competition, Managers, Shareholders, Takeovers, Barriers to entry, Network Externalities, Federalism.
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I. INTRODUCTION

A central feature of U.S. Corporate law is that corporations are free to choose where to incorporate and thus which state's corporate law system will govern their affairs. The dominant state in attracting such incorporations is, and for a long time has been, the small state of Delaware.[1] Although Delaware is home to less than one third of a percent of the U.S. population,[2] it is the incorporation jurisdiction of half of the publicly traded companies in the U.S. and of an even greater fraction of the larger publicly trade companies.[3] Delaware thus plays a dominant role in setting corporate governance rules for the nation's publicly traded companies.

Why should this small state play such a critical role in the governance of the nation's corporate sector? At first glance, the existing dominant role might be viewed as inefficient or even illegitimate. The widely accepted justification for the existing state of affairs, however, is that Delaware's dominant role is a product of its winning a competition among states for providing desirable corporate law rules.

Indeed, the dominant view in corporate law scholarship is that allowing Delaware to dominate national corporate law is not a problematic feature, but rather an important virtue, indeed the "genius" of American corporate law.[4] According to the prevailing view among corporate scholars, competition provides powerful incentives for adoption and development of value-enhancing corporate rules.[5] Delaware has won its leading place by offering the best rules, and the competitive pressure it faces can be relied on to ensure that Delaware would continue to provide companies with whatever rules would turn to be best in our dynamic and changing business world.

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[1] Delaware has dominated this market ever since the beginning of the last century when New Jersey, the market leader at the time, adopted rules that put firms incorporated in New Jersey at a disadvantage. *See* Curtis Alva, *Delaware and the Market for Corporate Charters:: History and Agency,* 15 DEL. J. CORP. L. 885 (1990).

[2] At the end of 1999, Delaware had a population of about 740 thousand, whereas the total population of the U.S. was about 270 million.

[3] Delaware is the state of incorporation for 51% of U.S. public companies and for 63% of Fortune 500 companies. *See* Table 2 *infra*.

[4] *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW (1993).

[5] *See generally* Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); Ralph K. Winter, Jr., *The "Race For The Top" Revisited: A Comment On Eisenberg*, 89 COLUM. L. REV. 1526 (1989); FRANK H. EASTERBROOK AND DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW, 1-40 (1991); ROMANO, *id*. *See also* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 842 (1995) (stating that "there is a broad consensus that state competition to produce corporate law is a race to (or at least toward) the top").

The view that state competition works well rests on two propositions: (1) that states actively and vigorously compete for incorporations, and (2) that the ensuing competitive threat provides the dominant state of Delaware, as well as other states, with powerful incentives to provide value-enhancing rules. Those skeptical of state competition have mainly focused on questioning proposition (2). Accepting that states actively compete for incorporations, such critics have argued that the competitive threat might push states in undesirable directions with respect to some important corporate issues.[6]

In contrast, this paper challenges the standard case for state competition by questioning the claim of proposition (1) that states vigorously compete for incorporations. The alleged vigorous race among states vying for incorporations, we argue, simply does not exist. We present evidence that Delaware's dominant position is far stronger, and thus that the competitive threat that it faces is far weaker, than has been previously recognized. We also explain the underlying reasons for the weakness of competition in the market for incorporations. Furthermore, we show that the weakness of competition has major implications both for assessing the performance of state competition and for determining the desirable role of federal law in this area.

Part II of this paper discusses the conventional premise that states compete actively for incorporations. We highlight the key role that this premise plays in the views of supporters of state competition. We also discuss how, at least for the purpose of the debate, critics of state competition have often accepted this premise.

Part III then discusses evidence indicating the absence of active competition among states for corporate charters. We pay close attention in this Part to the patterns of incorporations among states that have been documented in a recent empirical study by Alma Cohen and one of us.[7] Although half of the publicly traded companies are incorporated outside Delaware, Delaware does not face any significant competitors in the business of attracting and serving out-of-state

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[6] *See, e.g.,* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L. J. 663 (1974); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: the Race to Protect Managers from Takeovers,* 99 COLUM. L. REV. 1168 (1999) [hereinafter Bebchuk & Ferrell, *Race to Protect Managers*]; Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001) [hereinafter Bebchuk & Ferrell, *New Approach*]; Oren Bar-Gill, Michal Barzuza, and Lucian Arye Bebchuk, *The Market for Corporate Law* (Working Paper, 2002), *available at* http://papers.ssrn.com/abstract=275452; Lucian Arye Bebchuk, Alma Cohen, and Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law*?, CAL. L. REV. (forthcoming 2002), available at http://papers.ssrn.com/abstract=303417.

[7] Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate,* Harvard Olin Discussion Paper No. 351 (2002), available at http://papers.ssrn.com/abstract=296492.

incorporations. The vast majority of non-Delaware corporations do not incorporate in a state that competes with Delaware over the hearts (or pockets) of firms incorporating out-of-state; rather, these firms simply remain incorporated in their state of headquarters.

In assessing the competitive threat facing Delaware, it is important to consider Delaware's position in the market for out-of-state incorporations. Among firms that do "shop" for out-of-state incorporations, Delaware captures approximately 85% of all incorporations.[8] Delaware is thus a virtual monopoly in the out-of-state incorporations market, and no other state holds a significant position in this market. For example, whereas Delaware captures 216 out-of-state incorporations of Fortune 500 companies, no other state captures even 10 such incorporations, and the five states that follow Delaware's lead capture a total of 27 such out-of-state incorporations. Similarly, whereas Delaware captures about 3,744 out-of-state incorporations of publicly trade companies, each other state attracts less than 180 such incorporations. Furthermore, Delaware's long-standing dominance of the out-of-state incorporation market, and the larger incorporation market, has been growing. Indeed, examination of recent trends indicates that Delaware's dominance can be expected to keep growing even further in the near future.

Its dominant position enables Delaware to make substantial supra-competitive profits. While Delaware's expenses on providing corporate law rules to the nation's firms are exceedingly small, it captures large franchise tax revenues – which on a per capita basis amount to $3,000 for each household of four -- that constitute a large fraction of the state's budget.[9] Still, notwithstanding these supra-competitive returns, other states have not been making any visible efforts to mount a serious challenge to Delaware's dominance. No state, as it were, has been giving Delaware a run for its money.

What explains Delaware's powerful and unchallenged dominance? Some states, especially large states for which such profits would not be of significance, might well be simply indifferent to the prospect of making profits from the incorporation business. However, there are enough small states in the U.S. for which profits such as those Delaware has been making would be quite attractive; such states would have had strong motivation to mount a challenge to Delaware's dominance if such a challenge could have been expected to succeed in enabling them to capture a significant fraction of these profits. That this has not been

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[8] As we explain below, we focus on the incorporation statistics of non-financial firms. *See* text accompanying note 36 *infra*. Focusing on the numbers for all firms, including financial ones, does not materially change the picture..

[9] In 2001, Delaware collected approximately 600 million dollars in franchise fees and had a population of 800,000. *See* UNITED STATES CENSUS BUREAU, 2001 STATE GOVERNMENT TAX COLLECTIONS, *available at http://www.census.gov/govs/statetax/0108destax.html* .

happening, notwithstanding Delaware's persistent supra-competitive returns, indicates in our view that mounting a challenge to Delaware has not been viewed as likely to be profitable.

Part IV analyzes the reasons for the absence of active competition. Drawing on the theory of industrial organization, we identify a number of structural features of the incorporation market that can explain why a challenge to Delaware's dominance by some other small state is unlikely to be profitable for this state. The "product" currently offered by Delaware should be viewed as including not only its rules but also the institutional infrastructure, including Delaware's specialized chancery court, and the network benefits currently enjoyed by Delaware corporations. As a result, a state that would offer the same rules, but charge lower incorporation taxes and fees, would not be able to attract many out-of-state incorporations. Although its current incorporation taxes are in the aggregate meaningful for Delaware, they never exceed $150,000 for any given firm, and reductions in such expenditures are unlikely to lead firms incorporating out-of-state to forgo the benefits from the institutional infrastructure and network externalities provided by Delaware. Similarly, a state that merely offers the same rules as Delaware with some marginal improvements cannot hope that such marginal improvements would by themselves attract many out-of-state incorporations.

The existing rules governing reincorporations further constrain the ability of a challenger to attract quickly a significant number of out-of-state incorporations. Reincorporations must be initiated by the board before being brought to a shareholder vote. Therefore, even if a rival state could identify a set of rules that could make shareholders substantially better off, this state would be unable to attract quickly many out-of-state incorporations unless the rules are also preferable for managers. This significantly narrows, of course, the scope of improvements in substantive rules on which potential challenge could be based.

Finally, even if a rival were to identify some substantial set of changes that could substantially benefit shareholders and be preferable by managers as well, and even if the rival were willing to invest up-front in institutional infrastructure, the profitability of a challenge could be undermined by the inability of the rival to launch a swift hit-and-run challenge. The substantial amount of time that would be required for the challenger to adopt changes and for firms to react to them would provide Delaware with ample opportunity to react. Delaware could "match" by adopting the challenger's improved rules; Delaware's out-of-state incorporators might then stick to Delaware due to its initial network benefits, and the challenger would merely serve as a stalking horse pulling Delaware to improve its rules. Furthermore, even if the challenger were somehow able to capture a significant fraction of the out-of-state incorporation markets, price competition between the challenger and Delaware would likely bring prices down; in this case the challenger

would bring down Delaware's current profits without being able to capture a substantial fraction of them.

Part V turns to explore the implications of the weak-competition account we develop for assessing the performance of state competition in corporate law. Our analysis indicates that the incentives of Delaware and of other states are likely to e quite different. Delaware is in the business of attracting and profiting form out-of-state incorporation. Its interests would be best served from policies that maintain its monopoly and undermine possible threat to it and that increase the profits it makes from its position. Other states cannot and do not expect to obtain such a position in the out-of-state incorporation markets, and maximizing revenues from such incorporation is thus irrelevant for such states. Accordingly, we examine separately the implications of our analysis both for Delaware law and for the corporate law of other states.

Among other things, we show that our account of state competition undermines the view that rules produced by state competition should be regarded as presumptively efficient. Neither Delaware nor other states face the type of competitive situation in which a limited slack could gravely hurt a player's interests. We also explain how our account leads to the conclusion that states would tend to provide rules that with respect to some issues, such as takeover protections, are more favorable to managers than would be optimal for shareholders.

Finally, Part VI discusses the implications of the weak-competition account we put forward for the desirable role of federal law in this realm. The absence of strong competition undermines the basis for the view that Delaware's law is the product of its winning a vigorous competition. Thus, the analysis implies that the case for preferring state competition to mandatory federal rules is much weaker than supporters of state competition have assumed.

Furthermore, we argue that, given the weakness of existing competition, state competition, as currently structured, could be in all likelihood improved by using "choice-enhancing" federal intervention. This type of intervention, which has been put forward by Allen Ferrell and one of us in other work, could invigorate state competition.[10] In particular, it would be desirable for federal law to provide a federal incorporation option, as Canada's federal law does, as well as to enable shareholders to initiate and approve via a vote reincorporation to another state.

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[10] Bebchuk and Ferrell, *A New Approach, supra* note 6. For further development and reply to critics of the choice-enhancing approach, see Lucian Arye Bebchuk & Allen Ferrell, *Federal Intervention to Enhance Shareholder Choice,* 87 VA. L. REV. 993 (2001) [hereinafter Bebchuk & Ferrell, Reply to Critics I] (replying to a critical response by Stephen Choi and Andrew Guzman to the choice-enhancing approach); Bebchuk and Ferrell, *On Takeover Law and Regulatory Competition,* BUS. LAW. (forthcoming, 2002) (replying to a critical response by Jonathan Macey) (hereinafter Bebchuk & Ferrell, Reply to Critics II).

Such federal intervention could introduce substantial and healthy competition in this market to the benefit of investors.

Although much of the work on state competition has taken as given the presence of active competition, there has been some prior work on Delaware's dominant position, most importantly by Ehud Kamar and Marcel Kahan, upon which we build.[11] Among other things, earlier work has highlighted the significance of network externalities and legal infrastructure, which is an important premise of our analysis.[12]

In a contemporaneous work, Kahan and Kamar also challenge the vigorous competition account of state competition, offering an analysis that complements ours.[13] Kahan and Kamar persuasively document and show that states other than Delaware have not made a determined effort to attract and profit from out-of-state incorporations; this analysis complements the evidence on which we focus concerning the patterns of incorporation among states. As will be discussed below, in explaining the absence of vigorous competition, Kahan and Kamar take an approach rather different from ours.[14]

Our work differs from earlier and contemporaneous work by others in several important respects. First, we show that the patterns of incorporations indicate that

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[11] Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998) (arguing that Delaware's dominance is strengthened by its granting courts overly broad discretion that prevents other states from free-riding on its network externalities). Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law,* 86 CORNELL L. REV. 1205 (2001) (arguing that Delaware uses its dominance to makes substantial supra-competitive profits and that price discrimination practices increase its profits). This work also observes, at 1213 and 1221, that states other than Delaware have not made a determined effort to compete..

We also build on earlier work discussing how network externalities and Delaware's legal infrastructure provide Delaware with a significant advantage. The presence of network externalities in this market was first highlighted by Klausner, *supra* note 5, at 841-51. The value of Delaware's specialized judiciary has been highlighted by the analysis of Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); Jill Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000).

Finally, our argument with respect to the "stalking horse" problem builds on Bebchuk & Ferrell, *New Approach*, *supra* note 6, at 154-5, which pointed out that this problem might deter rival states from challenging Delaware's dominance.

[12] See Romano, *id.;* Black, *id.;* Klausner, *supra* note 5, at 841-51; Fisch, *id.*.

[13] See Marcel Kahan and Ehud Kamar, *The Myth of State Competition* (partial draft prepared for presentation at the American Law and Economics Annual Association Meeting, May 2002), available at http://hal-law.usc.edu/cleo/ALEA/Kamar.pdf.

[14] See *infra* Section III.F.

Delaware's dominant position in the incorporations market is far stronger and more secure than has been previously recognized. Second, we provide a comprehensive analysis of the structural features of the market for corporate law that make it unprofitable for other small states to challenge Delaware's position and thus enable Delaware to enjoy a secure position and make supra competitive profits. Third, other writers that have discussed the imperfect competition in the market for incorporations have largely remained agnostic or even positive about the current system of state competition (as compared with mandatory rules or choice-enhancing intervention).[15] In contrast, we show that the lack of meaningful competition in the incorporation market undermines the case for the existing system and provides an important basis for supporting a federal role.

Some of the points discussed in this paper are more fully or rigorously developed in two companion pieces. An empirical work by Alma Cohen and one of us provides a comprehensive study of the patterns of incorporations and we build on it in Part III.[16] A theoretical work by Oren Bar-Gill, Michal Barzuza, and one of us develops the first formal model of state competition over incorporations;[17] this model pays close attention to the industrial organization features of the incorporation market and we build on some of its insights in Part IV.

II. THE CONVENTIONAL PREMISE OF VIGOROUS COMPETITION

As stressed in the introduction, the premise that states vigorously compete for incorporations is widely shared in the corporate literature. To begin, this premise is a critical building block of the standard the case for state competition in corporate law. For example, Ralph Winter, an early and prominent supporter of such competition, begins from the premise that "an important mechanism generating change in American corporate law has … been the competition among states for charters," that "Delaware cannot create barriers, " and that "any attempt at monopolization will only drive capital from that state."[18] Daniel Fischel, another earlier supporter, characterized the existing state of affairs as "a system of fifty states

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[15] *See, e.g.,* Kamar, *id.*, at 1948 (stating that his depiction of the strategic indeterminacy of Delaware's corporate law "is consistent with both race-to-the-top and race-to-the-bottom theories"); Kahan & Kamar, *id.* at 1252 (stating that their account of the market is compatible with both the view that state competition is desirable and the view that it is not). Imperfect competition arguments have been used to call for federal intervention, however, in other work by one of us, see Bebchuk & Ferrell, *New Approach*, *supra* note 6, at 154-5 (discussing how the "stalking horse" problem, which we further develop in this paper, deters rival states from challenging Delaware's dominance and strengthens the case for a body of optional federal law).

[16] *See* Bebchuk and Cohen, *supra* note 7.

[17] *See* Bar-Gill, Barzuza, and Bebchuk, *supra* note 6.

[18] *See* Winter, *supra* note 5, at 255-258.

striving to create an attractive climate for private parties to maximize their joint welfare."[19] Roberta Romano, a supporter of state competition who has been most influential writer on state competition in the past decade, stressed that "states *do* compete for chartering business."[20]

From this premise of active competition, supporters of state competition have proceeded to argue that this competition works to the benefit of shareholders. On their view, states that offer the best rules will attract the most incorporations, and competition for incorporations will thus drive states to offer such rules.[21] The competition provides incentives to offer not just rules but also institutions, such as specialized courts, that operate to increase shareholder value. Another benefit of competition in the view of its supporters is "dynamic:" states will have incentives to innovate and develop better arrangements and to adopt quickly those beneficial innovations that will be produced by others.[22] Yet another benefit arises from the heterogeneity among firms: whereas most states might offer arrangements that are commonly beneficial, some states might seek to gain incorporations by developing a niche and providing rules attractive for a certain special type of firms.[23]

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[19] *See* Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 922 (1982) (emphasis added). *See also* EASTERBROOK & FISCHEL, *supra* note 5, at 6 (observing that "states compete to offer – and managers to use – beneficial sets of legal rules.")

[20] *See* ROMANO, *supra* note 4, at 16 (emphasis added). Romano offers a refined account of the competitive process. Under her depiction, which she labels "defensive competition," most states compete to maintain their position and not to enlarge their market share. *See* Roberta Romano, *The Need for Competition in International Securities Regulation*, (Yale ICF Working Paper No. 00-49, June 30, 2001), 99 [hereinafter Romano, *The Need for Competition*]; Roberta Romano, *Law as a Product, supra* note 11, at 236.

[21] *See, e.g.,* Frank H. Easterbrook and Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1416-1417 (1989).

[22] *See* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2392 (1998) [hereinafter, Romano, *Empowering Investors*] (positing that the current regime of corporate federalism facilities successful innovations in the realm of corporate law).

[23] *See* Barry D. Baysinger & Henry Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J. LAW & ECON. 179 (1985) (arguing that variations in corporate codes match divergent capital structures – companies with more concentrated share ownership will tend to prefer codes providing less discretion to managers than Delaware's code); RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION, 11 (1980) (suggesting that Delaware specializes in charters for large public corporations). *But see* ROMANO, *supra* note 4, at 45-48 (questioning the validity of these product-differentiation arguments). In a different context, Professor Coffee argues that global competition among securities markets would lead markets to specialize. *See* John C. Coffee Jr., *The Coming Competition Among Securities Markets: What Strategies Will Dominate?,* (Working Paper No. 192, Columbia Law School Center for Law and Economic Studies, 2001), *available at* www.ssrn.com (predicting the emergence of two types

All this has led supporters of state competition to view it as a powerful mechanism working to benefit shareholders – indeed, in the words of a prominent supporter, the "genius of American corporate law."[24] It is thus not surprising that, concerned that the federal government is not subject to such beneficial competitive pressure, these supporters strongly oppose any federal role in the area of corporate law.[25] Indeed, viewing the competition among states as having worked wonders for corporate law, several scholars have recently called for a regime of unlimited regulatory competition among countries in the area of securities regulation.[26]

Turning from supporters of state competition to critics, it is important to observe that the latter have generally not sought to challenge the premise of the supporters of state competition that states actively compete for incorporations. Rather, taking as given this premise for the purpose of their analysis, they have questioned the implications that supporters of state competition drew from this premise. In particular, critics have questioned whether competitive pressure on states would generally push them to adopt desirable rules. Competitive pressure, they argued, might have counter-productive effects with respect to certain important issues.

Critics, for example, have argued that competition for incorporations might induce states to offer freezeout rules that are excessively favorable to controlling shareholders.[27] Similarly, critics have argued that competitive pressure might lead states to adopt rules that are excessively favorable to managers and controlling shareholders with respect to issues that (i) have a major effect on private benefits of control (are "significantly re-distributive"), or (ii) directly affect the strength of market discipline.[28] Recent evidence that states that have amassed anti-takeover

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of specialized markets for securities: one for companies with dispersed ownership and one for companies with concentrated ownership).

[24] ROMANO, *supra* note 4.

[25] *See, e.g.,* RICHARD A. POSNER, LAW AND ECONOMICS 458-59 (5th ed. 1998) (arguing that "Competition among states to attract corporations should result in optimal rules of corporate law. A preemptive federal corporation law would carry no similar presumption of optimality").

[26] *See* Romano, *The Need for Competition*, *supra* note 20; Romano, *Empowering Investors, supra* note 22; Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 901 (1998). But see Merritt T. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335 (1999) (opposing proposals for international competition of securities regulation); Robert Bloomfield and Maureen O'Hara, *Can Transparent Markets Survive*?, 55 J. FIN. ECON. 425 (2000) (predicting that international competition in securities regulation will result in a "race to the bottom").

[27] *See* Cary, *supra* note 6, at 665-6 (describing the erosion of shareholder rights produced by the competition among states over incorporations and coining the term "race to the bottom" to describe this phenomenon).

[28] *See* Bebchuk, *supra* note 6.

statutes have been more successful in attracting incorporation is consistent with this critique of state competition. [29]

Whereas this line of work has been skeptical of the virtues of subjecting the providers of corporate rules to competitive pressures (at least as currently structured), it has not questioned the premise that there is an active and vigorous competition. Rather, the presence of competition is a premise of this line of work. Indeed, the stronger the competitive pressure, the more severe the adverse effects suggested by this work. For this reason, accounts of the debate on state competition have often observed that, notwithstanding the substantial disagreements about the consequences of competition, participants in the debate all still accept that states actively compete to attract incorporations.[30]

As we now turn to show, however, there is another basis for questioning the case for state competition. The evidence we put forward in the next Part indicates that the vigorous race among states, this key premise of the case for state competition, does not in fact exist.

III. THE ABSENCE OF VIGOROUS COMPETITION: EVIDENCE

A. Where Do Firms Incorporate?

The question of state competition has produced a voluminous literature in the last there decades. Nevertheless, surprisingly little effort has been taken to examine the actual patterns of incorporations. Although there has been substantial empirical work on the general subject of state competition, this work has largely focused on studying the effects of shareholder wealth of incorporation in, or reincorporation to, Delaware.[31] In terms of the distribution of incorporations, this literature has

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[29] Bebchuk & Cohen, *supra* note 7; Bebchuk, Cohen, and Ferrell, supra note 6; Guhan Subramanian, "The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the 'Race' Debate and Antitakeover Overreaching," U. PA. L. REV. _ (2002).

[30] *See also* Mark J. Loewenstein, *Delaware as Demon: Twenty-Five Years after Professor Cary's Polemic*, 71 U. COLO. L. REV. 497, 502 (2000) (observing that "it is the accepted wisdom that states do compete" in the market for corporate incorporations); Romano, *Law as a Product, supra* note 11, at 227-29 (reviewing the common assumptions shared by the two scholarly camps).

[31] *See* Jianghong Wang, *Performance of Reincorporating Firms*, (unpublished manuscript, on file with authors) (Yale School of Management 1995); Jeffrey Netter & Annette Poulson, *State Corporation Laws and Shareholders: The Recent Experience*, 18 FIN. MGMT. 29 (1989); Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989); Pamela Peterson, *Reincorporation: Motives and Shareholder Wealth*, 23 FIN. REV. 151 (1988); Romano, *Law as a Product*, *supra* note 11; Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" vs. Federal Regulation* 53 J. BUS. 259 (1980); and Allen Hyman, *The Delaware Controversy – The Legal Debate*, 4 J. CORP. L. 259 (1980).

generally only observed Delaware's large market position.[32] In this context, studies either refer to the official data provided by the state of Delaware, which indicate that Delaware is the incorporation venue for roughly 50% of publicly traded firms,[33] or note similar figures for Delaware incorporation among the firms in their database.[34]

What has been largely missing is an account of where the large fraction of firms that do not incorporate in Delaware choose to have their state of incorporation. The full division of the market is, of course, necessary for assessing whether any states are presently posing a competitive challenge, offering Delaware a "run for it money," and, if so, which are those states. Similarly needed is evidence on the segments of the market in which Delaware does better and worse, and how Delaware's share in these segments, and as a result in the market as a whole, has been developing. As students of industrial organization know, such evidence would be useful for assessing the strength of the competitive threat confronting Delaware.

A recent study by Alma Cohen and one of us has documented the patterns of incorporations in a way that enables assessing the structure of the incorporations market, and we discuss the findings of this study below.[35] This study is based on

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For a recent survey and critique of the empirical work on the wealth effects of Delaware incorporation, see Bebchuk, Cohen, and Ferrell, supra note 6.

[32] *See, e.g.*, Jill Fisch, *supra* note 11 (seeking to explain Delaware's dominant position based on the unique role of its judiciary); Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512-13 (1989) (noting that Delaware has market power).

[33] *See* Delaware Division of Corporations Web site, available at http://www.state.de.us/corp/index.htm (last visited August 20, 2001) (stating that 50% of the companies listed on the New York Stock Exchange, and 60% of the Fortune 500 companies, are incorporated in Delaware). For representative examples of commentators relying on such data, see Kahan & Kamar, *supra* note 11, at 1210 (noting, in reliance on Delaware's web site, that about half of U.S. public corporations are incorporated in Delaware); Roberta Romano, *Competition for Corporate Charters and The Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 845 (1993) [hereinafter Romano, *Takeover Statutes*] (roughly half of the largest industrial firms are incorporated in Delaware).

In addition, several studies have noted the fraction of companies re-incorporating in Delaware. *See* Demetrios G. Kaouris, *Is Delaware Still a Haven for Incorporation?*, 20 DEL. J. CORP. L. 965, 999-1003 (1995) (reporting that out of 255 surveyed companies that changed domicile between 1982 and 1994, 89% reincorporated in Delaware); Romano, *Law as a Product, supra* note 11, at 244 (finding that between 1960-1983 over 82% of re-incorporations were in Delaware); Dodd & Leftwich, *supra* note 31, at 263 (finding that between 1927-1977, 90% of re-incorporations were in Delaware).

[34] *See* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 225, 538 (2001) (reporting Delaware has a share of 55.8% of public companies in his sample).

[35] *See* Bebchuk and Cohen, *supra* note 7. All the Tables displayed below are adapted from this study, which includes a detailed discussion of the procedures used for reaching its findings.

A recent study by Subramanian, supra note 29, also reports the distribution of firms among states of incorporation, but he does not document the patterns of home-state advantage,

examining the data available in Compustat, a widely used database, on all exchange-traded firms that were both headquartered and incorporated in the United States. The identified patterns we report below exclude financial firms, following Robert Daines, and focus on the set of all non-financial firms.[36] At the end of 1999, there were 6,530 publicly traded non-financial firms that were both incorporated and headquartered in the United States.

Table 1 (all tables are currently at the end of the paper) presents the distribution of U.S. companies by state of location. By state of location we shall mean throughout the state where the firm's headquarters are located (which is the information included in Compustat). The table presents (as do subsequent tables) the distribution of companies not only for all publicly traded companies, but also for all Fortune 500 companies and all companies going public in the five-year period 1996-2000.

[Insert Table 1 here]

Not surprisingly, a large number of firms are located in states with large populations and big economies. California, for example, with the biggest population and economy, is home to 19.2% of all companies. Texas comes second, with approximately 9% of all companies. California's share is especially large (27.3%) among companies that went public in 1996-2000, presumably because of the large incidence of Silicon Valley companies going public in those years.

Table 2 displays the distribution of U.S. companies by their state of incorporation.

[Insert Table 2 here]

As expected, Delaware has by far the largest stake of incorporations: 57.75% of all public companies. Delaware's share is even larger with respect to Fortune 500 companies (59%), and companies that went public in 1996-2000 (68%). These figures are generally consistent with the literature's estimates of Delaware's large market

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and the growing dominance of Delaware over time, findings on which we focus below. Daines, "How Firms Choose Corporate Law Rules: Some Evidence on Law, Lawyers, and the Market for IPO charters," presented at the May 2002 ALEA meeting, is studying firms' incorporation choices at the IPO stage (rather than firms' incorporations current incorporations). He documents a similar home-state advantage to the one documented by Bebchuk and Cohen for the existing stock of all firms.

[36] *See* Daines, *supra* note 34 at 530 (excluding financial firms for several reasons, including the different regime governing the takeovers of these firms).

share. As we shall argue below, however, focusing on these figures leads to underestimation of Delaware's actual dominance of the incorporation market.

Comparing Tables 1 and 2 reveals that the distributions of corporations by state of location and state of incorporation are quite different. California, for example, is the state of location for 27.3% of public companies, but only 4% of public companies choose California as their state of incorporation. In contrast, Delaware, where approximately 58% of public companies incorporate, is the state of location for less than 0.9% of publicly traded companies.

B. Home-State Bias and Its Implications

1. Presence

The evidence presented thus far does not tell us where the large fraction of non-Delaware firms incorporate. Do these firms incorporate in states that, like Delaware but on a smaller scale, are active and somewhat successful in the business of attracting out-of-state incorporations? Might it be that, in addition to Delaware with 58% of the market, there are other substantial players with, say, 15% of the market each? Such smaller but still substantial competitors could provide Delaware with a competitive threat. As we shall now see, this is far from being the case.

Table 3 presents a matrix displaying the web of company migrations. The table indicates for each state how the firms located in it divide their incorporations between this state and all other states.

[Insert Table 3 here]

A noticeable feature of Table 3 is the large numbers in the boxes along the diagonal, which contain the numbers of in-state incorporations for each and every state. The large concentration of firms along this diagonal suggests the possible presence of a significant "home-state advantage" or a "home-state bias." Even states that are hardly able to attract out-of-state companies (i.e., whose corporate law system is rarely "purchased" by out-of-state "buyers") generally succeed in retaining a significant fraction of their in-state companies. [37]

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[37] That location might affect choices in this way was observed by Robert Daines who noted in an early version of his study on the effects of Delaware incorporation on share value that the majority of companies incorporate either in their home state or in Delaware. Daines, supra note 35, studies firms' home-state preferences at the time of the IPO. His results are consistent with those of Bebchuk and Cohen, supra note 7, on which we rely and which are based on Compustat data on the stock of all firms existing at the end of 1999.

Overall, there is an enormous difference between states' attractiveness to in-state and out-of-state companies. For example, California, which does relatively poorly on both dimensions, still performs far better for in-state firms, retaining 22% of them, than for out-of-state firms, attracting only 0.2% of them.[38] Altogether, California is the incorporation choice of 273 firms located in California but only 10 firms located elsewhere. A regression analysis confirms that being located in California hugely increases, in a statistically significant way, the likelihood that a company will incorporate in California.[39] It is worth noting that this home-state advantage is not unique to any particular subset of the states, but rather characterizes states across the board.

Table 4 presents overall figures indicating the importance of in-state incorporations. The table displays the total number and percentage of firms incorporated in their home state – among all firms, firms that went public during 1991-1995 and during 1996-2000, Fortune 500 firms, and Fortune 100 firms. The table indicates that there is a substantial percentage of in-state incorporation in all groups. Roughly 33% of all public companies incorporate in their home state. The fraction of in-state incorporations is smaller – but still substantial – for firms that went public in the 90's and for large firms.

[Insert Table 4 here]

2. Possible Sources

The pattern documented above indicates that firms' incorporation choices are characterized by substantial home-state bias in favor of incorporating in the state of headquarters. What explains the preference given by firms to incorporating in their home state?

One possible factor that might contribute to a home-state bias is firms' desire to avoid the extra costs that might be involved in incorporating outside their home state. Incorporation in Delaware involves a franchise tax that is non-negligible, though not substantial for most publicly traded firms. Perhaps more importantly, incorporating out-of-state might involve some additional transaction costs resulting from the need to retain additional law firms or to conduct legal business at a distance.[40] Because the extra costs of going out of state are unlikely to rise

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[38] *See* Bebchuk and Cohen, *supra* note 7, Table 5.
[39] *See* Bebchuk and Cohen, *supra* note 7, Table 6.
[40] *See* Douglas J. Cummings & Jeffrey G. MacIntosh, *The Rationales Underlying Reincorporation and Implications for Canadian Corporations*, (Working Paper, 2001), available at www.ssrn.com (reporting survey results indicating that the costs associated with incorporation play a role in the decision of Canadian companies to incorporate outside their jurisdiction).

proportionately with firm size, this story is consistent with the fact that larger firms display weaker tendencies to incorporate in-state.[41] Note that, because these extra costs are likely to be trivial for firms that are very large, and because home-state bias is still present to some extent for Fortune 500 and Fortune 100 firms, the extra-cost account cannot provide a full explanation for the observed home-state bias.

Another factor that might lead some firms to give preference to in-state incorporation is the hope of getting favorable treatment. Although a state should treat all firms incorporated in it in the same way regardless of where they are located, a firm located in a state – especially a large firm located in a small state – might hope that its stature and clout in the state would lead judges or public officials to give it a favorable treatment with respect to some corporate law issues that might arise. The power of political clout in a firm's home state has been reflected in the ability of some local firms confronting a takeover threat to get antitakeover legislation enacted to aid them in their antitakeover efforts.[42] Similarly, a firm located in a state might expect that, if it displays "loyal citizenship" by incorporating in the state, it would increase its chances of getting favorable treatment from public officials on issues unrelated to corporate law that might arise in the firm's dealings with the state.

The study by Alma Cohen and one of us finds evidence consistent with the above role of "local favoritism" considerations.[43] This study finds that large firms located in a small state are more likely to remain in-state than are similarly sized firms in a large state. Location in a small state makes it more likely for a large firm to benefit from local favoritism; a big fish in a small pond, such a firm might have substantial clout.

Yet another factor that might pull some firms in the direction of in-state incorporation is that of agency costs in the market for legal services. Recent work by Coates has forcefully pointed out that agency problems between lawyers and owners-managers might shape choices made at the IPO stage.[44] In particular, it has shown how the identity and location of the IPO law firm substantially affect the antitakeover charter provisions chosen by firms going public. Similarly, the identity of the law firm involved in a firm's IPO and the firm's subsequent corporate

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[41] See Bebchuk and Cohen, supra note 7 (finding that small firm size significantly increases the likelihood of remaining in-state
and interpreting this finding as consistent with the influence of transaction costs).

[42] *See* Henry Butler, *Corporation-Specific Antitakeover Statutes and the Market for Corporate Charters*, 1988 WIS. L. REV. 365; Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111 (1987).

[43] See Bebchuk and Cohen, supra note 7, at_.

[44] *See* John C. Coates IV, *Explaining Variation in Takeover Defenses*, 89 CAL. L. REV. 1301 (2001).

governance – and, in particular, whether the law firm is based in the firm's state of location or elsewhere – might significantly affect the choice of incorporation state.[45]

An in-state law firm might be inclined to keep the firm in-state because such in-state incorporation would enable the law firm to handle fully the firm's corporate affairs, avoiding the inconvenience and fees-sharing involved in having to use counsel from another state. Furthermore, in-state incorporation would provide the local law firm with an advantage over out-of-state law firms that might compete for the firm's business, as the local law firm would be likely to have greater familiarity with the home state's corporate law and better connections in this state.[46]

In any event, a full analysis of the sources of home-state bias is beyond the scope of this paper. What is important for our purposes is to explore the implications of the existence of home-state bias for the strength of competition in the incorporation market.

3. Implications for Assessing Competition

Under the conventional picture of state competition for incorporations, the incorporation choice of publicly traded firms is regarded as a "stand-alone" choice, a "pure" choice of a legal regime, that depends only on judgment as to which state's corporate law system would be best. The corporate law rules that would best fit any given firm might depend on various features of the firm, its shareholders, or its managers, but there is no good reason to expect them to depend on the particular location of the firm's headquarters. Under the conventional view, therefore, all states are viewed as "selling" their corporate law system to all publicly traded firms, and not especially to the firms located within their boundaries.

This view – that all states are potential competitors for each company – is an important element of the vigorous competition picture. If this element were indeed present, we could still expect some states to be more successful than others in attracting a given type of firm, but we would not expect a state to be more successful in attracting local firms than out-of-state firms. As shown above, however, this is what in fact takes place.

Thus, the existing situation should not be understood as one in which fifty-one "sellers" of corporate law rules compete in a "national" market over any given firm. Rather, the existing situation might be better understood as one in which there are

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[45] Investigating the role of legal counsel on incorporation decisions is a main focus of Daines' work, see supra note 37, which finds strong support for such a role. Bebchuk and Cohen, supra note 7, also find that the evidence is consistent with the hypothesis that law firms play such a role.

[46] For a discussion of the incentives of local counsel to attract incorporation to their state, see William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 722-8 (1998).

fifty-one local markets, with the firms located in each of them making a choice between incorporating in their home state or out of it. Furthermore, as we shall see before too long, the vast majority of firms that opt for out-of-state incorporation go to Delaware, and firms in each local market are currently making a choice that is effectively between incorporating in their home state or in Delaware.

The presence of home-state bias is quite important for assessing the incentives facing Delaware and its potential competitors. There is no reason to think that all of the firms incorporated in-state are exactly on the fence – that is, that they prefer to incorporate in their home state rather than in Delaware by only a very small margin. Some of the companies currently incorporated in their home state might be close to the margin in the sense that even slight improvements in the corporate law of other states would make them change the venue of their incorporation. The home bias of other companies, however, might be so strong that even significant improvements in the corporate law offered by other jurisdictions would be insufficient to make them incorporate outside their home state.

The above implies that, in assessing Delaware's competitive situation, it would be important not only to look at the division of the general incorporations market but also to look at the sub-market made of out-of-state incorporations. In any study of imperfect competition, defining the relevant market for examination is a necessary first step in assessing market power.[47] A key factor in defining the relevant market is the degree of substitution across products.[48] The presence of a significant home-bias effect suggests that, at least for some public companies, the corporate laws of their home state and of other states are not perfectly interchangeable. Hence, it is important to examine Delaware's market power with respect to out-of-state incorporations. Examining this market can provide us with a sense of the extent to which states competing with Delaware over the out-of-state incorporation business have made inroads into this market.

Furthermore, examination of the division of the out-of-state incorporations market is necessary for assessing the possibility of mounting a challenge to Delaware's dominance. Consider a state that is contemplating an all-out effort to unseat Delaware as the dominant provider of corporate law. To lure companies already incorporated outside their home state, i.e., companies that do not need to overcome their home bias, it would be sufficient for the rival state to offer a product

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[47] *See, e.g.*, HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY 82-3 (1994) (in antitrust cases that require the proof of market power the court will first determine what is the relevant market).

[48] *See* U.S. v. Microsoft Corp., 253 F.3rd 34, 51-2 (C.A.D.C. 2001) (stating that "the relevant market must include all products reasonably interchangeable by consumers for the same purposes."); Daniel L. Rubinfeld, *Market Definition with Differentiated Products: The Post/Nabisco Cereal Merger*, 68 ANTITRUST L.J. 163, 165-6 (2000) (noting the importance of the elasticity of demand in defining the relevant market).

that is only slightly better overall than Delaware's. Slightly improving upon Delaware's law, however, might be insufficient to attract companies still incorporated in their home state to the extent these companies have a significant preference for incorporating in their home state.49

C. Delaware's Dominant Position

1. Delaware's Monopolistic Position

Having concluded that it is useful to consider not only Delaware's fraction of the national incorporation market as a whole but also its fraction of out-of-state incorporations, we now turn to examine the latter. As mentioned earlier, the common picture of Delaware's market share, based on data pertaining to the overall U.S. incorporation market, is roughly 50%.50 Though this market share is large, it is also indicative of substantial competition by other states.51 In the previous section, we have suggested that the presence of a home-bias effect makes it important to examine Delaware's share not only of all U.S. incorporations, but also of the segment of out-of-state incorporations. As we show in this section, Delaware's share of out-of-state incorporations is substantially larger – and the share of states other than Delaware is substantially smaller -- than the respective shares among incorporations in general.

Table 5 presents the distribution of companies by state of incorporation, but only for public companies incorporated outside their home state. This table presents data for all public companies, for Fortune 500 companies, and for all companies that went public between the years 1996 and 2000.

[Insert Table 5 here]

Table 5 shows that Delaware's share of the out-of-state incorporation market is significantly larger than its share of the overall incorporation market. While 58% of

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[49] Also, as we show below, focusing on the market for out-of-state incorporation enables us to identify incorporation trends and predict an increase in Delaware's share of the overall market. *See infra* text accompanying notes 55-56.

[50] Under the study we rely upon, which excludes financial firms, Delaware's share of the overall incorporation market is approximately 58%. *See* Part III.B (2) *supra*.

[51] In antitrust cases, for instance, a market share of 50% would be insufficient to infer monopoly power. *See also* United States v. Paramount Pictures, Inc., 334 U.S. 131 (1948) (suggesting that a 70% market share is sufficient to establish market power); HERBERT HOVENKAMP, FEDERAL ANTITRUST POLICY: THE LAW OF COMPETITION AND ITS PRACTICE, 270 (2nd ed. 1999) (finding that courts will be reluctant to find monopoly power when defendant's market share is lower than 70%).

U.S. public companies are incorporated in Delaware, 85% of the companies that choose to incorporate outside their home state incorporate in Delaware. Likewise, 59% of Fortune 500 companies are incorporated in Delaware, whereas 83% of Fortune 500 companies incorporating outside their home state are incorporated in Delaware. This degree of market concentration is considered to be very large.[52] Indeed, the value of the Herfindahl index, commonly used by economists to measure market concentration, in the market for out-of-state incorporation for all public companies is 7,287; and, with respect to Fortune 500 companies, the value of this index is 6,929.[53] For illustrative purposes, we would like to note that, under the Department of Justice 1992 Horizontal Merger Guidelines, markets where the value of the post-merger Herfindahl index is above 1,800 are regarded as highly concentrated.[54]

2. Current Trends

To assess the strength of Delaware's dominance, it would be worthwhile to examine not only Delaware's current share of total incorporations and total out-of-state incorporations but also to consider how these shares have been evolving over time. To identify recent trends in the out-of-state incorporation market, Table 6 shows Delaware's fraction of companies going public over three different periods – prior to the year 1991, between the years 1991 and 1995, and between the years 1996 and 2000.

[Insert Table 6 here]

Table 6 shows that Delaware's has a dominant share of the market for out-of-state incorporation and that this dominance has been growing in the last decade. Delaware's share of the overall U.S. incorporation market has been growing in recent years.[55] This increase in Delaware market share has been viewed as indicating

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[52] *See id.*

[53] *See* Bebchuk & Cohen, *supra* note 7, at 23. For a formulation of this index, see JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION, 221-2 (1988).

[54] *See* 1992 Horizontal Merger Guidelines, § 1.51, 57 Fed. Reg. 41552 (Sep. 10, 1992); HOVENKAMP, *supra* note 47, at 516-7.

[55] Table 2 indicates a growth of Delaware share of the overall incorporation market. While 58% of public companies are incorporated in Delaware, 68% of companies that went public during the years 1996-2000 have chosen to incorporate in Delaware. *See also* Daines, *supra* note 34, at 539 (reporting an increase in Delaware's share of the overall incorporation market from 44.3% in 1981 to 55.8% in 1996).

that the recognition of the superiority of Delaware law is growing.[56] The evidence presented in Tables 4 and 6 above, however, casts doubt on this explanation.

Table 4 shows that the home-bias effect is weaker for younger companies. While 62.7% of companies that went public before 1991 incorporated outside their home state, 74.8% of the companies that went public between the years 1996 and 2000 incorporated outside their home state. This pattern suggests that the recent increase in Delaware's overall market share might be the result of the decline in the magnitude of the home-bias effect rather than an increase in the attractiveness of Delaware corporate law.

More importantly, the pattern emerging from Table 4 suggests that Delaware's current large fraction of total incorporations can be expected to increase further in the future. Assuming that firms going public in the future continue to display the weaker tendency to incorporate in-state that firms going public recently have been displaying, Delaware's total market share can be expected to increase significantly before too long.

D. The Absence of Challenges by Other States

As we have seen, Delaware captures a great majority of out-of-state incorporations. Furthermore, as we shall explain in the next section, Delaware derives large profits from its market share. Markets in which super-competitive profits are made often attract effort by rivals to capture some or all of these profits. Thus, one might think that the presence of these supra-competitive profits might induce other states to make efforts to capture some of Delaware's incorporations and profits. However, as Kahan and Kamar have shown, other states are not making significant active efforts to attract out-of-state incorporations. [57]

In particular, states have made no effort to develop the infrastructure necessary for attracting out-of-state incorporations. The corporate law system offered by Delaware includes not only the substantive corporate-law rules, but also the institutional infrastructure provided by Delaware for applying and implementing these rules. Among other things, this infrastructure includes Delaware's specialized corporate court, the chancery court, with its expert judiciary and ability to resolve quickly complex business disputes, as well as the surrounding infrastructure of professionals and providers of incorporation and legal services.[58] The presence of

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[56] *See* Daines *id.*

[57] Kahan and Kamar document this pattern in a detailed and compelling way. See Kahan & Kamar, *supra* note 13, at 42-53.

[58] *See, e.g.,* William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice,* 48 BUS. LAW. 351, 354-55 (1992); Klausner, *supra* note 4, at 845.

this institutional infrastructure is an important component of the quality of the system offered by Delaware. Thus, a state wishing to lure out-of-state incorporations will be expected to put the necessary resources into developing such institutional infrastructure.[59] Thus far, however, no state other than Delaware has made a serious effort to design its court system in a way that would be attractive for corporations.[60]

Indeed, states have not even structured their incorporation taxes and fees in a way that would provide them with meaningful benefits if they were to attract many out-of-state incorporations. Under the conventional premise of active competition among states, states are motivated to attract incorporations by their interest in maximizing their franchise tax revenues.[61] This premise implies that states capture additional franchise tax revenues when companies choose them as their state of incorporation. Indeed, the dominant state, Delaware, derives a significant fraction of its total revenues from incorporation-related taxes.[62]

As Kahan and Kamar have recently documented, however, Delaware is the only state that structures its tax system to derive substantial additional revenues from incorporations.[63] All other states employ one of two taxing methods: (i) imposing taxes on corporations only to the extent they conduct business within the state, regardless of their state of incorporation; or (ii) imposing only trivial fees on corporations incorporated in the state. This prevalent structure of the tax system therefore suggests that states are not attempting to make any profits from increasing the number of out-of-state incorporations.

It might be argued that the failure to create a significant scheme of incorporation-related taxes cannot be explained by the absence of competition for out-of-state incorporations. After all, the argument goes, as long as some corporations, whether out-of-state or local, incorporate in a given state, the state

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[59] On the effect of the need to invest in infrastructure on the likelihood of successful entry into the market for incorporations, see our discussion in Part IV.B. *infra*.

[60] *See* Kahan and Kamar, *supra* note 13 at 60-75.

[61] *See, e.g.,* Winter, *supra* note 5, at 255; Cary, *supra* note 6, at 668-69; Romano, *Empowering Investors, supra* note 22, at 2388 ("In the corporate law setting, the benefit is financial: States collect franchise tax revenues from locally incorporated firms"). *But see* Loewenstein, *supra* note 30, at 501-02 (arguing that state legislators are motivated to produce corporate law by public policy concerns, and not by a desire to attract incorporations in order to maximize tax revenues).

[62] In 2001, franchise tax revenues constituted roughly 27% of Delaware's total tax revenues. *See* UNITED STATES CENSUS BUREAU, 2001 STATE GOVERNMENT TAX COLLECTIONS, *available at* www.census.gov/govs/statetax/0118destax.html (revenues from franchise taxes were $600,593,000 while total tax revenues were $2,174,440,000). Delaware obtained an additional 3% of its tax revenues from documentary and stock transfer taxes, which are at least partly attributable to the incorporation business. *Id*.

[63] *See* Kahan & Kamar, *supra* note 11, at 1218-1222.

would have an incentive to increase its incorporation revenues by charging a tax for its incorporation services. This argument, however, is unpersuasive.

While states do not charge local companies directly and separately for incorporations services, states do derive substantial revenues from such companies through income and other taxes. Indeed, incorporation services are not unique in this respect; states also do not charge local companies directly and separately for many other services and benefits. Administrative considerations might make it more efficient to charge local companies using, say, income and property taxes, rather than numerous separate charges and fees. In short, local companies pay for incorporations services, so to speak, through the other taxes they are already paying to their state. In contrast, when out-of-state firms that have no other link to a state incorporate in it, the only way for the state to benefit from these firms would be to charge them incorporation taxes and fees.

If states are not making any direct profits from incorporations, it might be asked why they nonetheless offer corporate laws. One main reason is that states might offer such rules as a service to their local firms. States after all offer various services to local firms without charging them separately for each such service. The fact that all states, regardless of the structure of their franchise tax system, supply corporate codes suggests that states do have some incentives to engage in the production of corporate laws. Out-of-state incorporation involves transaction costs that local corporations might be reluctant to bear, and local lawyers have an interest in having their clients incorporate in their home state. These reasons might be sufficient to induce states to offer their local corporations the option to incorporate at a nominal fee.

For our purposes, however, the important point is that the manner in which states have chosen to design their franchise tax systems indicates that states other than Delaware are not aiming at, and are not harboring hopes of, making profits from attracting a significant number of incorporations. Why is this the case? One possible explanation that is worth considering upfront is that, while it indeed captures a significant amount of revenues, Delaware makes no supra-competitive profits, thus leaving other states with no incentives to challenge its lead. As the next section will show, however, Delaware does make such profits.

E. Monopoly Profits

The fact that Delaware has such a dominant position does not by itself imply that Delaware does not face – and is not very much influenced by – a very strong competitive threat. When a monopolist operates in a market that is perfectly contestable, with no barriers to entry whatsoever, the mere threat of entry and

replacement is very powerful and would prevent a monopolist from making any supra-competitive returns.[64] In such a perfectly contestable market, given that the monopolist is not making such profits, rivals would have no reason to enter, but their potential competition would be very much at work.

Delaware's tax revenues constitute a large fraction of its annual budget. In 2001, these tax revenues amounted to $600 million. In our view, the significance of these taxes can be best appreciated from a per capita perspective. Dividing the tax revenues by the number of Delaware's residents, we find that each Delaware household of four gains $3,000 annually.

As Kahan and Kamar have observed, Delaware's franchise tax revenues represent super-competitive returns, reflecting profit margins of several thousand percent.[65] Specifically, over the past thirty-five years, Delaware has commonly devoted less than three percent of its franchise tax revenues to cover the costs of operating its incorporation business..[66]

Furthermore, in addition to the substantial franchise tax revenues, Delaware derives additional benefits from its incorporation business. These benefits include the fees paid by companies to local providers of services, especially lawyers and local corporate service companies.[67] For example, Kahan and Kamar estimate that, in the year 1990, the incorporation business increased the total revenues derived by Delaware lawyers by an amount between $89 million to $95 million.[68] These revenues, and the profits derived from them, further augment Delaware's return on its incorporations business.

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[64] *See* WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982).

[65] *See* Kahan & Kamar, *supra* note 11, at 1211.

[66] For example, in 1996, Delaware's expenditures were $9.5 million, whereas its franchise tax revenues were $350 million. *See* Romano, *Empowering Investors, supra* note 22, at 2429 table. 1.

[67] *See* John C. Coffee Jr., *The Future of Corporate Federalism: State Competition and the New Trend Toward De Facto Minimum Standards,* 8 CARDOZO L. REV. 759, 762 (1987); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 492-3 (1987). Companies may be indirectly required to bear the cost of incorporation-related revenues by their state of incorporation. Delaware law, for example, requires all chartered firms to be represented in the state by a local registered agent. *See* DEL. CODE. ANN. Tit. 8, § 102(a) (2) (1991). This requirement generates incorporation-related revenues to these local agents, and, indirectly, to Delaware itself.

[68] *See* Kahan & Kamar, *supra* note 13, at 16. Kahan and Kamar also estimate that Delaware's dominance of the incorporation market increased the per-lawyer annual income of lawyers practicing in Delaware by $34,859. *Id.* at 14.

F. What Needs to Be Explained

In the previous sections of this Part, we have shown that (i) Delaware has a monopoly position in the market for out-of-state incorporations, (ii) Delaware makes substantial supra-competitive returns on the business of out-of-state incorporations, and (iii) other states have not been making efforts to make themselves attractive for out-of-state incorporations. Why has Delaware's dominance gone unchallenged for so long?

One possible reason that needs to be considered is that Delaware's objective function is different and that other states are simply not interested in making profits from such a business. Kahan and Kamar argue that Delaware's potential competitors "are not business organizations motivated solely by profits" but rather "are state bureaucracies seeking other goals as well."[69] We very much agree that the magnitude of the profits made by Delaware is likely to provide little motivation for some large states. The prospect of making such profits might well be insufficient to make much of an impression on a large state such as California. Large states are unlikely to be much moved, and are unlikely to be guided in designing their corporate laws and institutional infrastructure, by this amount of money.

However, in our view, this "different-objectives" explanation cannot fully account for the behavior of all small states. In our view, there are likely to be some other small states for which the amounts now made by Delaware would be quite substantial and attractive and which, if they could act to capture such profits, would indeed do so. To illustrate, South Dakota has a population slightly lower than Delaware and a much smaller state budget; Delaware's 2001 franchise tax revenues constitute 61% of South Dakota's total revenues from taxes in 2001. [70] If South Dakota could capture Delaware's current revenues, it would be able to reduce its taxes by 61% -- a strong motivation indeed.

Kahan and Kamar also suggest that, even if Delaware's profits could be sufficiently attractive to some pother states, the minimal franchise tax rates used by other states imply that, even if such a state could obtain a large number of out-of-state incorporations, it would not make the kind of profits that Delaware now makes from such incorporations.[71] The question, however, is why states other than Delaware use such minimal franchise tax rates. In the analysis below we will take other states' minimal franchise tax rates not as given but rather as an *endogenous*

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[69] See Kahan and Kamar, *supra* note 13, at 7.

[70] In 2001, South Dakota's tax revenues in 2001 were approximately $977 million, and its population was 757,000. *See* UNITED STATES CENSUS BUREAU, 2001 STATE GOVERNMENT TAX COLLECTIONS, *available at* http://www.census.gov/govs/statetax/0142sdstax.html. Delaware's revenues from franchise taxes for 2001 were approximately $600 million. *See supra* note 62.

[71] *See* Kahan and Kamar, *supra* note 13, at 12-19.

feature, which needs to be explained, of the existing state of affairs. Rather than viewing the minimal tax rates used by states as making them indifferent to attracting out-of-state incorporations, we view the choice of such rates as a result of the fact that such states do not harbor much hope of attracting a significant number of such incorporations.

Thus, our question is why, even though capturing Delaware's current profits would be attractive at least to some small states, no such state has been making an effort to attract out-of-state incorporations or has bothered to adopt a franchise tax system that would provide it with significant revenues if it were to attract a substantial number of such incorporations. What discourages other states from attempting to capture all or some of Delaware's current profits? This is the question that the next Part will seek to answer.

IV. THE ABSENCE OF VIGOROUS COMPETITION: EXPLANATIONS

This Part analyzes several structural features of the market for incorporations that discourage rival states from mounting a challenge to Delaware and that can explain Delaware' secure dominance. Sections A and B set the basis for the analysis by discussing the importance in this market of network externalities and institutional infrastructure respectively. Section C discusses the futility of challenges based on price-undercutting or on limited local changes. Section D discusses the difficulty facing challenges that are not supported by managers. Finally, Section E discusses how Delaware's ability to respond and match or improve upon what challengers offer, which is facilitated by the long time that would be required for a challenger to obtain a large market position, further discourages challenges to Delaware's dominance.

A. Network Externalities

The market for incorporations is characterized by network and learning externalities that produce barriers to entry. Network externalities exist where purchasers find a good more valuable as additional purchasers buy the same good.[72] According to Michael Klausner, who was the first to stress the importance of network externalities in the incorporation market, this market is characterized by both "interpretative externalities" and "legal service" externalities.

Interpretative externalities refer to the net present value of future judicial decisions interpreting the state's corporate law. The quality of a future case law

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[72] *See* Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CAL. L. REV. 479, 483 (1998); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424, 424 (1985).

depends on the number and diversity of lawsuits brought before the courts. These factors in turn depend on the number of firms incorporated in the state. As long as a large number of firms remain incorporated in Delaware, its courts will produce a steady stream of case law that addresses cutting-edge issues in a timely fashion.[73] Thus, the decision where to incorporate will be based not only on the inherent value of corporate law offered by the competing states but also on the number of firms incorporated in each state.

Legal services externalities refer to the benefit to firms from having a large number of providers of legal services apply the state's corporate law. The larger is the number of such providers, the larger will be the number of capital market participants and their advisers that can know the rules applicable to a company without additional investment in information acquisition. Thus, the value of these benefits also increases with the number of firms incorporated in a particular state.

The presence of network externalities commonly makes competition more imperfect. Competition in markets with substantial network effects is usually for the dominant market position, i.e., competition will be "for the field" rather than "within the field."[74] The early leader, offering the largest network benefits, will successfully attract additional consumers and have good chances for dominating the market. Moreover, once a monopoly is achieved, network effects reinforce its position and produce substantial barriers to entry.[75] Since consumers switching to a new entrant will lose the network benefits offered by the dominant firm, a new entrant will successfully attract consumers only if it can quickly attain a critical mass of consumers, or develop a sufficiently superior product that will compensate consumers switching to the new entrant for their loss of network benefits.[76] Indeed,

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[73] *See* Klausner, *supra* note 5, at 843-6. *See also* Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997). *But see* Romano, *The Need for Competition*, *supra* note 20, at 103-106 (casting doubt on the existence of network effects in the market for corporate law and arguing that corporate law will be efficient despite the existence of these effects); Mark A. Lemley & David McGowan, *id.*, at 566-76 (questioning the extent to which the market for incorporations exhibits network externalities).

[74] *See* Microsoft decision at 49; Howard A. Shelanski & J. Gregory Sidak, *Antitrust Divestiture in Network Industries*, 68 U. CHI. L. REV. 1, 6 (2001) (stating that "[c]ompetition in network markets can therefore take on a winner-take-all dynamic with competitive strategies geared towards gaining an early lead in market penetration.")

[75] *See* Steven C. Salop &, R. Craig Romaine, *Preserving Monopoly: Economic Analysis, Legal Standards, and Microsoft*, 7 GEO. MASON L. REV. 617, 620 (1999); Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 J. ECON. PERSP. 93, 109-13 (1994).

[76] *See* Shelanski & Sidak, *supra* note 74, at 9.

in the recent *Microsoft* case, the network effects characterizing the market for PC operating systems has been found to constitute a substantial entry barrier.[77]

Delaware, with a market share of approximately 85% of out-of-state incorporations, enjoys a clear incumbency advantage over other states. In order to challenge Delaware successfully, other states must either attract a mass of incorporations that would produce sufficient network benefits or offer corporate laws that would be substantively far superior to Delaware's to compensate for the loss of network benefits offered by Delaware. As our analysis below will show, either route is expected to be rather difficult for potential rivals.

B. Investment in Institutional Infrastructure

In addition to the network benefits associated with incorporating in Delaware, there is another type of benefit Delaware offers – the quality of its legal infrastructure. As explained earlier,[78] a system of corporate law includes not only the substantive rules of corporate law, but also the institutional infrastructure provided by the state for applying and implementing these rules. This infrastructure should be also viewed as an aspect of the product offered by Delaware.

To offer network benefits, a challenger would have to attract many incorporations. To offer an institutional infrastructure, the challenger would have first to make some necessary investments. For one thing, it would have to set up a specialized, expert business court. Developing such legal infrastructure would be costly and time-consuming.[79] The costs would come not only from out-of-pocket expenditures but, more importantly, from the institutional resources, attention and determination needed for adapting the state's judicial system to include a specialized court and for the state's legislature to have a mechanism for close and immediate attention to legislative changes if they become needed.

Note that such an up-front investment will become sunk: If the state fails to grab a significant market share from Delaware, the resources it invested in developing this infrastructure will be of no alternative use. [80] Up-front sunk investments are important for our analysis because they are generally recognized to

[77] *See* Microsoft decision at 55 (discussing the "applications" barrier to entry that arises because (1) most consumers prefer operating systems for which a large number of applications have already been written; and (2) most developers prefer to write for operating systems that already have a substantial consumer base).

[78] *See supra*, text accompanying footnote 58.

[79] On the critical importance of time in this context see our discussion of Delaware's likely response to a challenge by a rival state in Part IV.E. *infra*.

[80] *See also* Bebchuk & Ferrell, *New Approach*, *supra* note 6, at 154-55 (pointing to the sunk costs involved in mounting a challenge to Delaware).

produce barriers to entry.[81] In our context, a state would be willing to make the necessary up-front investment only if it can expect to make a sufficient return on it. As we shall show below, the need of the state to recoup the up-front investment in infrastructure intensifies the barrier to entry produced by Delaware's network benefits.

Although the literature has focused on the institutional infrastructure offered by the state itself, especially its court system, there is another important element which has not received notice, namely, the presence of an appropriate system of legal and other professional service firms. For one thing, Delaware has law firms with established practices and expertise to serve smoothly as a liaison between out-of-state firms and their advisers and Delaware's court system. Such a system does not at present exist in other small states whose chances of becoming a challenger we are assessing.

Again, the presence of such legal service providers requires up-front investments, but this time by private actors. For North Dakota to offer an infrastructure similar to Delaware's North Dakota law firms would have to do certain expansions and hiring. These investments, again, would be made only if the law firms can expect to recoup them. Although we will below focus for simplicity on the absence of sufficient incentives for states to make needed up-front investments, our discussion will largely apply to the needed investments by private actors which would be thus worthwhile keeping in mind.

C. The Futility of Price-Based and Local Challenges

We have seen that Delaware offers a multi-dimensional product that includes, in addition to certain legal rules, network benefits and the value of a sophisticated infrastructure. As we now turn to show, recognizing this nature of the Delaware product by itself indicates that rivals will not be able to make major inroads into the market by offering the same rules and undercutting Delaware's prices or by offering rules that marginally improve on Delaware's rules.

1. The Futility of Challenge Based on Undercutting Prices

The presence of network externalities and the value of institutional infrastructure imply that it would be futile for a state to seek to oust Delaware from its dominant position by competing mainly on price. In fact, Delaware has been able to maintain its dominance even though incorporation in states other than Delaware

[81] *See generally* TIROLE, *supra* note 53, at 307-11 (discussing barriers to entry created by the need to bear fixed and sunk costs).

– but not in Delaware – involves only negligible costs in terms of franchise taxes and fees.[82]

It is natural to start considering competition in terms of price competition. In some markets, rivals can hope to capture a substantial market share or even a dominant position by under-cutting prevailing prices. In theory, if another state were to offer exactly the same corporate-law product as the one Delaware offers but at a lower price, then it would become more attractive than Delaware for out-of-state incorporations. Note, however, that this proposition necessarily holds only if the good the rival state offers was identical in quality to the good Delaware offers. This in turn implies that the rival state cannot offer merely the same rules as Delaware, as these rules constitute only one element of Delaware's corporate-law product.

Assume that a rival state simply adopts all of Delaware's corporate code and past precedents concerning corporate issues but does not offer a legal infrastructure of similar value to Delaware's. Assume further that this state offers incorporation at a lower price than Delaware's. This under-cutting would still be unlikely to attract many out-of-state incorporations. Not offering a legal infrastructure and (at least not initially) network benefits, the overall quality of the product this state would offers would be lower than the quality of Delaware's competing product. Charging lower incorporation taxes and fees would be insufficient to overcome this quality deficiency and attract many out-of-state incorporations.

At first sight, it might be argued that a rival state could always attract incorporations to an inferior product by undercutting its franchise taxes by an amount sufficient to compensate companies for the loss of the benefits associated with Delaware's network and infrastructure. In theory, buyers should be willing to purchase a product of somewhat inferior quality provided they are given a sufficient reduction. In the incorporation market, however, the necessary reduction would likely result in a "negative" price, meaning that the considered rival state would need to offer an incorporation "subsidy" to out-of-state firms to attract many of them.

The reason for this is that, in the incorporations market, the considered differences in product quality are likely to be more important for buyers than reductions in the franchise taxes and fees charged by Delaware. Although the revenues from incorporation taxes are in the aggregate quite meaningful for

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[82] The assumption that competition is not about prices is implicit in much of the existing literature *See, e.g.*, ROMANO, *supra* note 4, at 15 (observing that under both Cary's and Winter's positions, the goal of maximizing revenues leads state corporation laws to offer the arrangements that firms desire); EASTERBROOK & FISCEHL, *supra* note 5, at 6 (stating that states compete to offer "beneficial sets of legal rules"). No writer, however, has provided an explicit explanation for the absence of price competition in the market for incorporations.

Delaware and its citizens, they are hardly burdensome for each publicly traded companies. While franchise taxes and related fees are quite meaningful in the aggregate to a small state like Delaware, the cost to each public company incorporated in Delaware is relatively small. Whereas the average franchise tax paid in 1999 by NYSE companies was 134 thousand dollars,[83] the median value of publicly traded companies incorporated in Delaware was 237 million dollars. Thus, a reduction in the franchise tax bill appears unlikely to lead a firm that finds network benefits and institutional infrastructure to move to forgo them. In sum, a challenge based on merely offering the same rule but at a lower price is highly unlikely to succeed in attracting a large number of out-of-state incorporations.

2. The Futility of "Limited" Challenge

In some competitive markets, if there is a good that has various dimensions, a player can hope to gain advantage by offering a product that has advantage in one dimension. For this reason, scholars have argued that the competition in the incorporation market would ensure that any given rule would be efficient. If the prevailing rule were in any way inefficient, maintained Easterbrook and Fischel, then some state would be able to offer an improvement in terms of this rule and thereby attract incorporations.[84]

In the incorporation market, however, the importance of network externalities and institutional infrastructure implies that it would be futile to challenge Delaware by offering an improvement in corporate governance that is not central or substantial in magnitude. Offering a somewhat better rule on a single issue would not be sufficient to attract companies that otherwise would be incorporated in Delaware. The only challenge that could conceivably threaten Delaware would arise from a "global " challenge – a major effort by a state that would make a commitment to this effort, develop the needed accompanying institutional infrastructure, and offer a sufficient improvement to overcome the network benefits advantage of the incumbent Delaware.

D. The Futility of Challenge Unsupported by Managers

A challenge would likely be successful only if it were to attract a large number of out-of-state incorporations. To begin, only such a challenge would likely generate significant profits. Furthermore, attracting any significant number of out-of-state incorporations would be much facilitated if the challenger were able to offer firms network benefits. As explained below, the need to attract a large number of out-of-

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[83] *See* Kahan & Kamar, *supra* note 11, at 1225.
[84] See sources cites in infra note 101.

state incorporations imposes significant limits on the type of rule improvements that could provide a basis for a successful challenge. In particular, it would be quite difficult for a challenge to succeed unless the challenger offers not only a corporate law system more favorable to shareholders than Delaware's but also one that would be as (or more) favorable to managers as Delaware's.

Potential incorporations in a rival's jurisdiction might come from two sources – first, from companies that will go public in the future and, second, from companies that went public in the past and are presently incorporated in Delaware (or in another state) and might choose to reincorporate in the rival state.[85] The rival state therefore will have a strong interest in luring exiting public companies because, at any given point in time, the number of existing public companies is significantly larger than the number of companies expected to go public in the near future. A rival state would thus be able to obtain a substantial number of incorporations with a reasonable period only if it is able to attract not only future public companies but also a considerable number of existing public companies.

The rival state, however, would find it difficult to attract existing public firms by offering rules that would be value-enhancing for shareholders but not attractive for managers. Under prevailing law, management has veto power over reincorporations.[86] Thus, offering a corporate law system that is better for shareholders but not for managers, say one that would offer managers fewer protections from takeovers, will be unable to attract existing companies. Without drawing existing companies, the rival would not be able to capture a large fraction of the market for quite a while, which would preclude the rival from being able to offer network benefits and from being able to recoup its up-front investment.[87]

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[85] On the importance of reincorporating companies and the implications of the managerial control over reincorporation decisions for the debate on state competition, see Bebchuk, *supra* note 6, at 1458-59.

[86] There is no explicit procedure under any state statute for reincorporating. A corporation brought to life under one state's statute can only have life as a corporation of that state. But, practically, a reincorporation can be achieved by having the corporation merged into a shell corporation incorporated in another state. The rules for approving mergers require a vote of shareholder approval but only on proposals initiated by the board. *See* Delaware General Corporation Law, §251(a), (b). Our analysis takes the existing allocation of power between managers and shareholders as given. For a proposal to grant shareholders initiative power with respect to certain matters of corporate governance, see Lucian Arye Bebchuk, *The Allocation of Power between Managers and Shareholders* (Working Draft, 2001).

[87] Could this problem be overcome if the rival is sufficiently patient and has a sufficiently long horizon? Problems of credibility and commitment might cause a rival to fail even if it is patient enough (in terms of the amount of time it is willing to wait to recoup its investment) to adopt a strategy targeting only new companies in the hope of eventually getting a large fraction of these companies. To see this, suppose that Delaware currently offers rules that favor managers at the expense of shareholders because its large fraction of existing companies gives it incentive to do

The analysis above indicates that a rival considering a challenge would likely focus on possible moves that would be favored not only by shareholders but also by managers. Reforms aimed at enhancing shareholder wealth by curtailing managers' private benefits are unlikely to be a good basis for a challenge to Delaware's position. This aspect of the existing state of affairs further adds to the difficulty of mounting a successful challenge. It also provides Delaware with incentives to make sure that managers of Delaware companies are content, an issue to which we will return in the next Part.

E. Delaware's Response and the Stalking Horse Problem

Thus far, our analysis of the impediments to a profitable challenge to Delaware's dominance has assumed implicitly that Delaware would not alter its course in response to such a challenge. This assumption, however, is unlikely to hold, which would introduce additional impediments. Confronting a challenge, Delaware is unlikely to sit idle and let its long-standing and profitable dominance disappear. Rather, Delaware will probably make whatever response would best serve its interests and, in particular, would make it most likely that it would be ale to preserve all or most of its revenues from out-of-state incorporations. [88]

The industrial organization literature has noted that rivals' ability to make a profitable entry depends on the incumbent's ability to respond. In some markets, an entrant can engage in a hit-and-run strategy, moving fast and capturing a large market share or at least covering its entry costs swiftly before the incumbent will be able to adapt and develop responses to the new challenge.[89] For this to happen, the response time of the incumbent must exceed the period needed for a rival state to mount a challenge and make some significant inroads.[90]

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so. If that is the case, the market would expect that, if the rival were to succeed in attracting over time a large number of firms going public, then eventually it would also have incentives to act in the same way as Delaware. Unless the rules are enshrined in the state's constitution, it is difficult to make a commitment not to change rules once you are successful.

[88] *See also* TIROLE, *supra* note 53, at 350 ("[B]ecause competition destroys industry profits, an incumbent has more incentive to deter entry than any entrant has to enter.") In fact, it might be the case that Delaware has been engaging in practices to preserve its monopolistic position. *See, e.g.,* Kamar, *supra* note 11 (suggesting that Delaware law might be litigation-biased in order to prevent other states from mimicking its corporate law).

[89] When hit-and-run entry is possible, the threat of entry might be sufficient to discipline an incumbent firm even in a market characterized by economies of scale. *See* WILLIAM J. BAUMOL ET AL., CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982).

[90] *See* TIROLE, *supra* note 53, at 310; Michael Spence, *Contestable Markets and the Theory of Industry Structure: A Review Article*, 21 J. ECON. LIT. 981, 986 (1983) (noting that hit-and-run entry is

This will not be the case, however, with respect to the incorporation market.[91] Until a challenger can attract any significant number of incorporations, a substantial amount of time will likely pass. The adoption of rules by a rival, the development of institutional infrastructure by it, and the movement of companies to incorporate in it, all will take time and will be rather visible to Delaware. Thus, the rival cannot surprise Delaware and attract a substantial number of out-of-state incorporations before Delaware gets a meaningful opportunity to react. Hit-and-run entry is not possible in the market for incorporations.

The fact that Delaware will be able to respond and adapt is important for assessing the profitability of a rival's challenge. A rival seriously considering a challenge to Delaware would have to take into account what Delaware's response to the challenge would likely be.

Suppose that a rival considers challenging Delaware by offering a different set of rules. Suppose also that the rules are sufficiently better than Delaware's so that, if Delaware sat idly, firms would move en masse out of Delaware. The rival will have to take into account that, confronting such a challenge, Delaware might elect to mimic and match the rival's moves, which would be publicly known. The rival would be able to hide neither its intention to challenge Delaware nor the particular steps it contemplates.[92] Moreover, new statutory rules of corporate law are easy to emulate.[93] Hence, knowing what new statutory rules have been put forward by the rival, and recognizing that they have substantial appeal to firms, Delaware will respond to the challenge by matching with the same rules. Given its initial advantage over rival states in terms of network benefits and institutional infrastructure, Delaware will be able to defeat the rival and maintain its dominant position.[94]

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possible only if the time it would take the incumbent to respond is smaller than the period for which the fixed costs of the new entrants are sunk).

[91] The problem discussed in this Section was first noted for this market by Bebchuk and Ferrell, *A New Approach*, *supra* note 6, at 154-55 .

[92] *See* TIROLE , *supra* note 53, at 351 (a monopoly is more likely to persist if the incumbent has access to the rival's technology and sufficient time to preempt the rival because under these conditions the incumbent can duplicate the rival's strategies).

[93] *See* Kamar, *supra* note 11, at 1929 (arguing that Delaware's corporate law is indeterminate to prevent other states from replicating it). *See also* Wilmington City Ry. Co. v. People's Ry. Co., 47 A. 245, 251, 254 (Del. Ch. 1900) (stating that Delaware has adopted the corporate legal precedents of New Jersey). Our analysis assumes that the rival state improves upon Delaware only by providing a superior set of rules and not by improving upon Delaware's legal infrastructure.

[94] Somewhat ironically, supporters of corporate federalism have pointed out that Delaware has adopted this strategy. *See, e.g.,* Carney, *supra* note 46, at 741-42 (finding that Delaware, although not the first mover on most corporate law changes, is a quick follower of successful

Thus, given Delaware's expected response, the rival's investment and effort would not turn out to be worthwhile. To be sure, the rival would have the effect of influencing Delaware to adopt better rules. But the rival itself would not gain. Rather, it would merely serve as a stalking horse, and the investments by the rival would not be recouped.[95] Anticipating such an outcome, the rival would elect not to mount a challenge in the first place. This factor adds to the ones we have discussed in discouraging challenges to Delaware's position, making this position a very secure one.

Moreover, Delaware's ability to respond might well adversely affect a challenger even assuming that it would succeed in attracting a significant number of out-of-state incorporations. Assume that a rival state overcomes all the difficulties we have explored thus far and captures half of the market share currently held by Delaware. At first glance, this would ensure that the successful rival state would enjoy half the monopoly profits currently captured by Delaware. As we shall presently explain, however, this will not necessarily be the case.

A state capturing half of Delaware's current market share would capture half of Delaware's monopoly profits only if the overall level of monopoly profits will remain unchanged notwithstanding the successful entry by this state. Delaware's likely response to a successful challenge, however, makes the constant-level-of-profits assumption unlikely. Once both states are established in the market, with both of them having sunk investments, competition would drive prices and profits down. Thus, a challenger that captured half of the market would not be able to capture half of Delaware's current profits. The price competition following a successful challenge would reduce total profits in the market to lower levels, and this would hurt not only Delaware but also the challenger itself.[96]

This process of price competition and the reduced level of profits will, *ex ante*, reduce the level of profits a rival state can expect to capture following a successful challenge. The prospects of reduced profits, in turn, further discourages states from mounting a serious challenge to Delaware in the market for out-of-state incorporations.

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innovations); Romano, *Takeover Statutes, supra* note _, at 846 (noting that "when Delaware is not the pioneer of a corporate law innovation, it is among the first to imitate"). They argue, however, that this pattern of response by Delaware supports the current regime of corporate federalism because it demonstrates Delaware's commitment to constantly improving its corporate law. *See* Romano, *id.*

[95] *See also* DENNIS W. CARLTON & JEFFREY M PERLOFF, MODERN INDUSTRIAL ORGANIZATION, 79-80 (3rd ed. 2000) (recognizing that the combination of large-scale entry investments and the risk of strategic response of the incumbent provides disincentives for potential entrants because it increases the expected loss).

[96] *See also* TIROLE , *supra* note 53, at 314-16 (analyzing the effect of post-entry price competition on the level of industry profits).

V. IMPLICATIONS FOR ASSESSING THE PERFORMANCE OF STATE COMPETITION

The preceding Parts have shown that Delaware enjoys a monopolistic position in the incorporation market, and that barriers to entry and other structural factors cast substantial doubts over the ability of other states to successfully challenge Delaware's lead. We now turn to assess the implications of the above analysis for evaluating the performance of the current system of federalism. Given the weakness of competition, how well will the incorporation market work? And, if it works imperfectly, in what direction does it push?

Our analysis implies that Delaware and other states are situated quite differently and should not be analyzed in the same way. Delaware is actively in the business of making profits from the incorporation business but, because of the structural features we have analyzed, it faces a limited threat and thereby enjoys a monopoly position. Other states, for which challenging Delaware's position is not a viable option, are not in the same business. Although these two situations are quite different, in both of them states do not face, and are not motivated by, incentives of the type envisioned by supporters of state competition. We shall discuss below each of the situations and the rules that it can be expected to produce. Section A considers Delaware, the market's leader, and Section B discusses other states.

A. Delaware's Incentives and Product

1. The Monopolist's Objectives

Supporters of corporate federalism argue that the competition among states provides Delaware with powerful incentives to offer the most value enhancing set of corporate law rules in order to attract and retain incorporations.[97] Given its monopoly position, however, Delaware might face a set of incentives that differ from the ones that it would confront in the presence of a substantial competitive threat.

Providers in a monopolistic situation do not generally behave in the same way as do ones that face a strong competitive threat. Thus, given its monopoly position, Delaware has incentives to work to (i) maintain its monopoly and (ii) maximize its profits from its monopolistic position.

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[97] *See, e.g.,* Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence,* 9 DEL. J. CORP. L. 540, 564-71 (1984) (arguing that states that make the choice of rules most beneficial to investors will attract incorporations); Frank H. Easterbrook, *Antitrust and the Economics of Federalism,* 26 J. L. & ECON. 23, 34-5 (1983) (competition among states leads them to enact that set of laws most beneficial to the relevant population).

Delaware's motivation for preserving its monopoly is clear. After all, this monopolistic position enables Delaware to obtain substantial revenues both directly, through franchise taxes, and indirectly, through litigation expenses.[98] To be sure, as we have seen earlier, barriers to entry - network effects, large sunk costs, managerial control over re-incorporation decisions, and the risk of strategic response by Delaware - deter rival states from mounting a meaningful challenge to Delaware in the ordinary course of events. Delaware's concern, however, would be to avoid the type of situation that could somehow put its monopoly in doubt. It would have an incentive to avoid the type of circumstances that could make feasible an all-out effort by another state to oust it as the market's leader. Delaware similarly would have an incentive to avoid circumstances that could give rise to a possibility of federal intervention that would take away or undermine its position.[99]

Furthermore, Delaware has an incentive to increase the revenues it can derive from its monopolistic position. After all, what good is a monopoly position unless you can take advantage of it? As the race-to-the-top scholars contend, the profit-maximization objective guiding firms in a competitive market leads to optimal result. In contrast, as the industrial organization literature recognizes, the profit-maximization objective guiding monopolies might produce sub-optimal outcomes.[100]

2. The Monopoly's Slack

Recall the argument made by supporters of state competition, such as Easterbrook and Fischel, according to which state competition would drive states to do the best on each and every rule. On this view, a presumption of efficiency applies

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[98] *See* Kahan & Kamar, *supra* note 11, at 1217. *See also* TIROLE, *supra* note 53, at 350 ("[B]ecause competition destroys industry profits, an incumbent has more incentive to deter entry than any entrant has to enter.")

[99] *See also* William W. Bratton & Joseph E. McCahery, *Regulatory Competition, Regulatory Capture, and Corporate Self-regulation,* 73 N.C. L. REV. 1861, 1899- 1901 (1995) (arguing that the threat of federal intervention affects Delaware's law). Eisenberg, *supra* note 32, at 1512 (threat of federal intervention provides Delaware with an incentive *not* to lead in the adoption of management-biased rules).

[100] Thus, the quality of a good produced by the monopoly might be non-optimal compared to the quality of a good produced by a competitive firm because the monopolist is concerned with the effect of changes in its output on price, whereas a competitive firm is not. A monopolist can thus either under-supply or over-supply quality. *See, e.g.,* TIROLE, *supra* note 53, at 100-101. *See also* Romano, *Empowering Investors*, *supra* note 22, at 2387 (relying on this observation to argue against a mandatory regime of federal securities regulation).

to each and every rule produced by state competition.[101] To be sure, this presumption is not conclusive but rather rebuttable, as states aspiring to adopt value-enhancing arrangements might still make mistakes.[102] But this presumption, so the argument goes, should be used as a starting point for an assessment of a state law rule.

This presumption, however, is not warranted with respect to the rules produced by a state like Delaware that, given the substantial barriers to entry and incumbency effects, enjoys a strong monopoly position. As explained earlier, Delaware is not subject to a meaningful threat of entry or of expansion by rival states. Thus, it is no longer the case that each shortfall in the quality of the corporate law offered by Delaware would trigger an immediate loss of market share. To be sure, the range within which Delaware can move without undermining its position is not unlimited. But Delaware has substantial room to take actions that would not be optimal but would not hurt its leading position. As a result, Delaware does not have an incentive to do the very best on each and every dimension.

In the language of industrial organization, the above argument indicates that Delaware's monopolistic position provides it – as is the case often with monopolies – with slack. The slack reflects the substantial range within which the monopoly might engage in sub-optimal behavior without triggering a loss of market share. For

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[101] *See* POSNER, *supra* note 25, at 458 (arguing that "Competition among states to attract corporations should result in optimal rules of corporate law"); EASTERBROOK & FISCHEL, *supra* note 5, at 81 (arguing, with respect to corporate voting arrangements, that, given the dynamics of state competition, enduring practices of companies "are the best evidence of what constitutes the best allocation of resources on voting procedures") and at 86 (concluding that greater shareholder access to the proxy machinery is undesirable on the grounds that if greater access were beneficial, "it would be adopted by the firms themselves or by state law"); Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J. L. & ECON. 395, 398 (1983) (states provide investors with the sort of voting arrangements they would find desirable if contracts could be arranged and enforced at low cost. "Our conclusions on federal rules are otherwise, reflecting, perhaps, the power of competition among jurisdictions"); Fischel, *supra* note 19, at 919-20 (arguing that Delaware has achieved its prominent position because its corporate law maximizes shareholders' welfare).
But see EASTERBROOK & FISCHEL, *supra* note 5, at 215 (emphasizing they do not argue that "all aspects of Delaware's law are optimal") and 218 ("Delaware can win the race for revenues by being 'best' without being "optimal"). These disclaimers, however, have been made in an attempt to reconcile the inconsistency between Easterbrook and Fischel's general position and the wide adoption of state anti-takeover legislation. On this inconsistency, see Bebchuk & Ferrell, *Race to Protect Managers*, *supra* note 6, 1195-97 (1999); Robert M. Daines & Jon D. Hanson, *The Corporate Law Paradox: The Case for Restructuring Corporate Law,* 102 YALE L.J. 577, 584-89 (1992).

[102] *See, e.g.,* EASTERBROOK & FISCHEL, *supra* note 5, at 218 (explaining that "states no less than managers fish for successful combinations, not knowing what the market really wants").

this reason, as empirical studies confirm, monopolies tend to produce less efficiently than players in a competitive market.[103]

Research in industrial organization has identified several reasons as to why monopolies might operate less efficiently than firms in competitive markets.[104] In our context, the reason that seems to be most important is the weaker incentives of a monopoly to offer optimal product quality.[105] We focus on this reason because it goes to the heart of the claims made by supporters of corporate federalism in support of their highly favorable view of the rules produced by it. With a weak competitive threat, Delaware cannot be relied on to produce generally value-enhancing rules. It might just muddle through and avoid terrible outcomes.

Furthermore, in our context, there are two additional problems beyond the monopolist's limited incentive to exert effort to get it right. The goals of maintaining its monopoly position and increasing profits from it might lead Delaware to bias its laws in favor of managers and in favor of open-ended standards. We shall now turn to discuss each of the problems in turn.

3. Managerial Favoritism

Our earlier analysis indicated the importance of holding a large market share. Because the incorporation market is characterized by economies of scale and network externalities, it would be important for a rival state mounting a challenge to Delaware to attract quickly a sufficiently large number of incorporations. Attracting

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[103] *See, e.g.,* Stephen J. Nickel, *Competition and Corporate Performance,* 104 J. POL. ECON. 724 (1994) (presenting evidence of correlation between degree of market competition and level of productivity growth); Alison Green & David G. Mayes, *Technical Inefficiency in Manufacturing Industries*, 101 ECON. J. 523 (1991) (finding that an increase in market concentration tends to reduce technical efficiency). The phenomenon of monopolistic slack is also known as "X-efficiency." *See generally* Harvey Leibenstein, *Allocative Efficiency vs. 'X-Efficiency'*, 56 AM. ECON. REV. 392 (1966); Roger Frantz, *X-Efficiency and Allocative Efficiency: What Have We Learned?,* 82 AM. ECON. REV. (PAPERS AND PROCEEDINGS) 343 (1992).

[104] *See* DENNIS W. CARLTON & JEFFREY M PERLOFF, MODERN INDUSTRIAL ORGANIZATION 93 (3rd ed. 2000) (discussing reasons why a monopoly might produce less efficiently than a competitive firm).

[105] *See* Leibenstein, *id.* Alternative explanations have been offered for the tendency of monopolies to be less efficient than competitive firms. Some argue that this is because of the absence of yardstick competition - competitors against which to measure performance. *See* TIROLE, *supra* note 53, at 75. Another branch of the economic literature relates the problem to the principal/agent problem, arguing that the more intense the competition, the more opportunity there is for the principal to compare the performance of the agent to the performance of others. *See, e.g.,* David S. Scharfstein, *Product Market Competition and Managerial Slack*, 19 RAND J. ECON. 147 (1988). On the implications of this latter explanation to corporate governance see Mark J. Roe, *Rents and Their Corporate Consequences,* 53 STAN. L. REV. 1463 (2001).

such critical mass of incorporations is necessary for the rival state to offer companies the network benefits currently provided by Delaware. Thus, as long as a rival cannot realistically hope to grab before too long a sufficiently large fraction of the market, the mounting of a challenge to Delaware's dominance is substantially discouraged.

This makes it especially important for Delaware to make sure that the large stock of firms already incorporated in Delaware remain loyal to Delaware even in the presence of a challenge by a rival state. Delaware has a substantial early-lead advantage by starting with the lion's share of the market for out-of-state incorporations. As long as Delaware holds on to its existing companies, a rival cannot realistically expect to attract a large mass of incorporations within a reasonable time frame. Even if the rival succeeds in attracting most of the companies that will go public in the future and incorporate outside their home state, it will take the rival many years to build a large stock of incorporations.

Conversely, if Delaware were somehow to lose much of its existing stock, the cost to it would exceed the direct cost of the revenues that these companies would have produced for Delaware had they stayed. Such a migration out of Delaware would substantially reduce its incumbency advantages, and would make a challenge to its dominance much easier and thus likely.

One useful strategy for retaining existing companies is ensuring that management is sufficiently content. Because a reincorporation must be initiated by the board, existing Delaware companies are bound to stay as long as management is content with staying.[106] Furthermore, when companies incorporated in their home state choose to reincorporate elsewhere, managers can very much influence to which of the out-of-state venues to incorporate.[107]

The existing state of affairs thus provides Delaware with incentives to offer rules that managers favor, even if such rules are not the ones most favorable to shareholders. One area of corporate law in which the tendency of Delaware to favor managers appears to be manifested is the rules governing hostile takeovers. Managers favor rules that make hostile takeovers more difficult because such rules reduce the likelihood of management being ousted in a hostile takeover and enable management to extract some side payments from the acquirer in negotiated transactions.[108]

Delaware's takeover law, especially its judge-made law, has indeed developed substantial barriers to hostile takeovers.[109] Overall, managers have been given

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[106] *See supra* note 86.
[107] *See also* Bar-Gill, Barzuza & Bebchuk, *supra* note 6.
[108] *See* Bebchuk, *supra* note 6, at 1468 (explaining why managers might be interested in rules restricting takeovers even if such rules fail to maximize shareholder value).
[109] For a more elaborate review see Bebchuk & Ferrell, *Race to Protect Managers*, *supra* note 6, at 1177-1191.

substantial power to impede hostile takeovers.[110] Even scholars who are members of the race-to-the-top camp take the view that the developed antitakeover protections go beyond those desirable to shareholders.[111]

Our conclusions in this section complement those of the analysis offered by one of us in earlier work. Proceeding under the assumption of active competition for incorporations, this analysis has concluded that, to the extent that a competitive threat exists, it pushes Delaware to favor managerial interests with respect to an important set of issues.[112] That argument, however, was based on the direct benefits, in the form an increase in the franchise–revenue base, associated with retaining a large number of incorporations. In contrast, dropping the assumption of vigorous competition, as the evidence requires, this paper has shown that, under this assumption as well, the leading state will likely display managerial favoritism.

4. Open-Ended Standards

Delaware corporate law relies on open-ended standards applied by judges in ways that are highly case-specific. Delaware courts avoid providing bright-line guidance to corporate actors, relying instead on a set of loosely defined tests.[113] Such tests govern important corporate issues such as the permissible scope of managerial discretion in adopting and applying defensive tactics against hostile takeovers,[114] the test applied by courts for reviewing the decisions of special board committees when considering motions to dismiss derivative suits,[115] and the corporate opportunity

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[110] *See* Lucian Arye Bebchuk, John C. Coates IV & Guhan Subramanian, *The Antitakeover Power of Classified Boards: Theory, Evidence, and Policy,* 54 STAN. L. REV. _ (2002) (analyzing the entrenching effect of classified boards).

[111] *See* Winter, *supra* note 5, at 288 (stating that a regime that facilitates takeovers maximizes shareholders' profits); Frank Easterbrook and Daniel Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing against the use of defensive tactics by targets' boards); Roberta Romano, *A Guide to Takeovers: Theory, Evidence and Regulation,* 9 YALE J. ON REG. 119 (1992) (finding almost all state antitakeover law is unwarranted and harmful).

[112] *See* Bebchuk & Ferrell, *Race to Protect Managers*, *supra* note 6.

[113] *See* William T. Allen, *Ambiguity in Corporation Law,* 22 DEL. J. CORP. L. 894, 900 (1997) (noting that Delaware cases are fact-specific applications of grand principles that are difficult to generalize).

[114] *See* Ronald J. Gilson & Reinier Kraakman, *Delaware's Indeterminate Standard for Defensive Tactics: Is There Substance to Proportionality Review?,* 44 BUS. LAW. 247 (1989).

[115] *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (setting a vague two-step test for deciding motions to dismiss derivative suits). *See also* Kamar, *supra* note 11, at 1916-7 (arguing that this test is too ambiguous).

doctrine.[116] This indeterminacy creates costly uncertainty. Furthermore, as is suggested by the standard models of trial and settlement, such uncertainty and unpredictability increases the likelihood of litigation.[117]

All this has led observers to conclude that Delaware corporate law is likely overly indeterminate,[118] and that it likely involves an excessive level of litigation.[119] An unpredictable and litigation-intensive body of corporate law produces efficiency costs.[120] First, from an *ex ante* perspective, indeterminate standards undermine the ability of business actors to plan and know how to act to avoid legal liability.[121] Second, the litigation process itself is costly *ex post*, consuming resources and effort on the part of plaintiffs, defendants, lawyers, and courts.

This indeterminacy feature of Delaware corporate law has attracted the attention of corporate law scholars, who have tried to explain it. Of course, increasing the volume of corporate litigation enables Delaware to capture higher revenues from incorporations.[122] But why would Delaware choose to increase its

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[116] *See* Kamar, *supra* note 11, at 1916; ROBERT C. CLARK, CORPORATE LAW § 7.6.2 at 244-45 (1986) (proposing a clearer test).

[117] *See* Bruce L. Hay & Kathryn E. Spier, *Settlement of Litigation*, in 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW (Peter Newman ed. 1998).

[118] *See, e.g.,* Kamar, *supra* note 7; Douglas M. Branson, Indeterminacy: *The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990). *But see* Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough: A Response to Kahan & Kamar's* Price *Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1257 (2001) (positing that Delaware law is not excessively uncertain); Romano, *supra* note **20**, at 109-10 (arguing that Delaware rules of corporate law are not overly indeterminate).

[119] *See, e.g.,* Douglas M. Branson, Indeterminacy: *The Final Ingredient in an Interest Group Analysis of Corporate Law*, 43 VAND. L. REV. 85 (1990).

[120] *See also* Kahan & Kamar, *supra* note 11, at 72 (arguing that unpredictability and excessive litigation are inefficient means of price discrimination because they affect the quality of the underlying product – Delaware corporate law); Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law,* 66 U. CHI. L. REV. 887 (1999) (discussing the costs of indeterminacy in corporate law).

[121] *See* Kamar, *supra* note 11, at 1919.

[122] *See* Kahan & Kamar, *supra* note 11, at 1242-48 (explaining that this feature of Delaware law enables it to engage in the practice of price discrimination); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987) (arguing that increasing the volume of litigation serves the interests of the local bar in increasing their fees). Other scholars, however, have argued that this indeterminacy serves an important function in regulating corporations. *See* Fisch, *supra* note 11 (arguing that indeterminacy increases the value of Delaware corporate law because it enables its judges to exercise law-making powers); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work*?, 44 UCLA L. REV. 1009 (1997) (arguing that the fact-specific nature of Delaware corporate law enables courts to shape social norms governing managerial behavior).

revenues through increasing the level of litigation when it could simply raise franchise taxes instead?[123]

Scholars have advanced several explanations as to why Delaware law has taken such a form. Using a public-choice perspective, Macey and Miller have argued that this feature of Delaware law serves the interests of the Delaware corporate bar, which has substantial influence on Delaware corporate law.[124] Kamar has argued that Delaware's reliance on open-ended standards that are applied in case-specific ways makes it difficult for rival states to duplicate what Delaware does in resolving cases thus excluding these rival states from the network benefits offered by Delaware.[125] Finally, Kahan and Kamar have recently argued that this feature of Delaware law enables Delaware to engage in price discrimination. Whereas raising franchise taxes will affect all companies, regardless of the value they attach to Delaware corporate law, so the argument goes, increasing the amount of litigation will affect only those companies that are more likely to engage in legal disputes over corporate matters, companies which in turn likely assign a higher value to incorporating in Delaware.[126]

Our analysis suggests an alternative, possibly complementary, way in which the indeterminacy feature of Delaware law serves Delaware's interests. The reliance on open-ended, and highly case-specific, judicial decisions benefits Delaware by reducing the threat of federal intervention that presents, as we have explained, the most serious threat to Delaware's dominance. We should stress that we wish merely to note this potential benefit and do not take any view on whether it in fact motivated any Delaware players.

Legal uncertainty serves to make less salient two aspects of the existing state of affairs that might help trigger federal intervention. First, the uncertainty of Delaware law disguises the extent to which Delaware's law favors managers over shareholders.[127] Explicit, bright-line rules favoring managers could conceivably

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[123] *See also* Macey & Miller *id.* at 498 (noting that "[i]f the state were acting as a pure profit maximizer, it would attempt to minimize the indirect costs and maximize the direct costs of Delaware incorporation").

[124] *See Id.*

[125] *See* Kamar, *supra* note 11, at 1929-1932 (exploring how the indeterminacy of its corporate law benefits Delaware by excluding other states from network externalities).

[126] *See* Kamar & Kahan, *supra* note 11, at 1242 (stating that "companies that are involved in litigation or undertake transactions that may result in litigation are the ones assigning the highest value to incorporating in Delaware").

[127] The concept of "camouflage" was introduced to the corporate governance literature by Bebchuk, Fried, and Walker. *See* Lucian Arye Bebchuk, Jesse Fried & David Walker, *Executive Compensation in America: Optimal Contracting or Extraction of Rents*?, U. CHI. L. REV. (forthcoming, 2002). In this paper, we use this concept in a similar way – camouflage is the

encourage shareholder groups to push for federal intervention. In contrast, indeterminate standards applied by courts in case-specific ways make the extent to which Delaware's law favors managers much less salient. The indeterminacy always leaves some chance in most cases that Delaware's chancery court would intervene in favor of shareholders. Even few isolated decisions against managers might be sufficient to disguise and make less conspicuous the managerial favoritism that is actually at work.

Furthermore, reliance on judge-made law reduces the extent to which applying Delaware corporate law for most of the country's large firms is viewed as arbitrary and illegitimate. If Delaware corporate law were largely set by Delaware's legislature – the political representatives of less than one third of a percent of the citizens of the US – Delaware's dominance in setting national corporate law would appear more puzzling. Legislative decisions are viewed as reflecting political choice whose legitimacy is drawn from the fact that the legislators represent those affected by the choices. If Delaware's corporate law were mainly set by the legislature, then the affairs of most investors in U.S. public companies would be decided by the political representatives of a tiny fraction of the citizenry. In contrast, opposition to Delaware's dominance would be weaker if the Delaware arrangements were largely the product of Delaware's apolitical courts, which are quite professional, sophisticated, and respected.

B. States Other than Delaware

1. Limited Innovation and Experimentation

Some early supporters of corporate federalism argued that competition among the states spurs corporate-law innovation,[128] and that it leads states to offer a rich menu of options for companies with varying needs.[129] More recently, however, commentators have shown that the corporate laws offered by the states are in fact very similar.[130] Furthermore, most innovation in the field of corporate law is actually done by Delaware, while other states generally do not attempt to innovate.[131]

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design of arrangements to make it more difficult for outsiders to perceive the extent to which rent is extracted.

[128] *See, e.g.*, Romano, *Takeover Statutes, supra* note 33, at 844.

[129] *See* Baysinger & Butler, *supra* note 23, (arguing that variations in corporate codes match divergent companies with varying capital structures); POSNER & SCOTT, *supra* note 23, at 11 (suggesting that Delaware specializes in charters for large public corporations).

[130] *See* Bebchuk & Ferrell, *New Approach, supra* note 6, at 167 (showing that the takeover laws of the states are rather similar but different as a whole than the British City Code, for example); Carney, *supra* note 46, at 729-734 (1998); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 709 (1987) (finding "substantial uniformity across the

The weak-competition account that we have put forward provides an explanation for the lack of incentives for states to make such investments. We have seen that states other than Delaware generally do not derive revenues from their incorporation business. This is a service they offer essentially for free. For these states, attracting a large number of incorporations by improving their corporate law cannot serve as a motivation for investing in innovation.

It might be argued that the potential benefits to a state from developing arrangements that better serve shareholders are not limited to increasing revenues by attracting more incorporations. Rather, so the argument goes, some of the benefits of a good corporate law would flow directly to the citizens of the state, thus producing an incentive for the state to innovate. Shareholders of publicly traded companies are distributed across the country, and sometimes even the world, and are commonly not concentrated in the state of incorporation. Thus, citizens of the innovating state would not capture all or most of these potential benefits from innovation.

2. Slack and Managerial Favoritism

We have seen that states other than Delaware are generally not guided by the goal of capturing a large fraction of the incorporation market. That is thus not the force influencing their design of their corporate law arrangements. What, then, shapes the content of the corporate law rules adopted by states?

There are probably two groups of actors in each state that play a key role in the design of the state's corporate law system. One group of actors consists of members of the state's bar. The bar usually plays a significant role in choosing and changing the state's corporate law rules. The interests of local law firms lie in having a corporate law system that is sufficiently plausible for incorporation by local firms that they have as clients. These law firms would wish to avoid a system that would force out-of-state incorporation.

The other group consists of firms located in the state and their managers. Local firms are important "citizens" of the state. The firms act through their managers, and the managers are thus the ones that yield whatever political power the firms have. On some issues, where there is no or little divergence of interest between

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states"); John C. Coffee, Jr., *The Future as History; The Prospects for Global Convergence of Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 702 ("the best documented finding in the empirical literature on the U.S. chartering competition is that a high degree of uniformity has emerged in American corporate laws").

[131] *Cf.* Romano, *Law as Product, supra* note 11, at 233-37 (arguing that the patterns of diffusion of corporate-law innovations across states are consistent a dynamics of defensive competition under which, if states "do not follow the leader, they will lose incorporations at the margin").

managers and shareholders, managers would wish to have the state adopt the value-maximizing rules. However, with respect to rules that affect substantially the private benefits of managers, such as takeover rules, managers might have different interests.

What kind of corporate law is likely to be produced by this process? To begin with, like Delaware, though for different reasons, states should not be expected to optimize on each dimension. Some states would not care at all about the number of incorporations. Other states, due to the influence of the local bar, would care about retaining the incorporation of local firms but still would have little incentive to optimize on each possible dimension.

The local firms incorporated in-state are those for which the home advantage is sufficiently significant. There is no reason to expect that they are right on the fence; some deviations from optimality would be consistent with their staying in-state – especially when Delaware's corporate law is also characterized by such deviations. In short, the performance of states other than Delaware is also likely to be characterized by "slack." The presumption suggested by supporters of state competition, according to which rules produced by state competition should be presumed to be efficient, should not be applied also to the rules produced by states other than Delaware.

As to managerial favoritism, like Delaware, other states would also be expected to favor managers to some extent and, in particular, to provide substantial protections from takeovers. Such an approach would be clearly desired by the managers of local firms, and it would be consistent with the interests of the local bar. The empirical evidence indicates that providing more antitakeover protections enables states to retain a larger fraction of their local firms.[132]

Thus, like Delaware, other states can be expected to display managerial favoritism. The tendency of Delaware and the tendency of other states to do so would, of course, reinforce each other. Given the managerial favoritism of other states, which would be partly the effect of direct lobbying of local mangers in such states, Delaware's interest in a large number of incorporations would not be undermined, but rather would be served, by the provision of antitakeover protections.

VI. IMPLICATIONS FOR THE ROLE OF FEDERAL LAW

Having examined the implications of the weak-competition account for the performance of state competition, we turn in this Part to explore its implications for the desirable division of labor between state and federal law in the corporate area. Section A first considers the conventional choice between state law rules and

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[132] *See* Bebchuk and Cohen, *supra* note 7; Subramanian, *supra* note 29.

mandatory federal rules. The weak-competition account casts substantial doubt on the advantages that have been long attributed to state law rules and thus on their superiority to mandatory federal rules. Section B then argues that, at the minimum, the weak-competition account implies that the current situation could be improved by federal intervention that would be "choice-enhancing."[133] Such intervention would introduce stronger and healthier competition than the one currently in place in the market for incorporations.

A. The Uncertain Advantages of State Competition Over Mandatory Federal Rules

The traditional debate between race-to-the-top and race-to-the-bottom scholars has been over the desirability and scope of mandatory federal rules. With the federal securities laws imposing mandatory rules with respect to a certain subset of corporate issues, the debate has been on whether this subset of issues should be expanded or contracted. Supporters of state competition have called for reducing the current scope of federal intervention,[134] and have vigorously opposed any proposal for expanding the role of the federal government.[135] In contrast, critics of state competition argued that mandatory federal rules might be desirable with respect to corporate issues for which competition might pressure states in undesirable directions.

As to the choice between state law rules and mandatory federal rules, our analysis reduces the attractiveness of the former. A recurring theme voiced by supporters of state corporate law is that, because this law is the product of active competition among states, it is likely to be superior to the corporate law produced

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[133] The idea of "choice-enhancing intervention" was first introduced by Bebchuk and Ferrell, *A New Approach*, *supra* note 6, and was subsequently defended and developed by Bebchuk and Ferrell, *Reply to Critics I, supra* note 10; Bebchuk and Ferrell, *Reply to Critics II, supra* note 10. This body of work, however, has grounded the case for such intervention on an analysis that largely accepted the conventional premise that states actively compete for incorporations and showed that, given this assumption, competition might push states in undesirable direction with respect to some areas of corporate law. In contrast, we present below a case for such intervention grounded in skepticism about the existence of active competition. The arguments made by the above earlier work and in this paper are complementary in building the case for choice-enhancing intervention.

[134] *See* Romano, *Empowering Investors, supra* note 22 (proposing to abandon the current regime of mandatory federal securities laws in favor of a regime of regulatory competition); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961 (2001) (same); Easterbrook and Fischel, *supra* note 101 (arguing that states laws should govern corporate voting).

[135] *See supra* note 5.

by a monopolistic federal government. On this view, whatever drawbacks state law rules might have, the discipline of competition provides these rules with a powerful and decisive advantage over mandatory federal rules. Whereas a monopoly federal regulator would not be compelled to produce optimal rules, the forces of competition would compel states to do so.

Our analysis, however, casts doubt on the magnitude of this advantage of state law rules. The competitive pressure on states, including the dominant state of Delaware, is actually much weaker than has been previously recognized. States, we have seen, are hardly compelled by competition to provide optimal rules., and Delaware has market power with respect to firms that seek out-of-state incorporation. With the competition as weak as it is, it cannot provide the powerful and decisive advantage over the monopoly federal regulator as supporters of state law have argued. Thus, the weak-competition account questions the basis for this view.

To be sure, supporters of state law rules might respond and argue that weak competition is still better than a monopoly federal regulator. Weak competition, so the argument would go, is better than no competition; weak competition still provides state law rules with some significant advantage over federal rules. However, concluding that this advantage is smaller than previously recognized implies that it is more likely to be outweighed if federal law rules turn out to have some other advantages.

Mandatory federal law rules do offer some advantages over state rules. To start, managers' control over re-incorporation decisions leads states to develop a managerial bias, which would exist independently of the degree of competition in the incorporation market.[136] This bias would clearly not apply to a single federal regulator. To be sure, a potential bias in favor of managers might emerge even under a mandatory federal regime as a result of successful lobbying efforts by managers.[137] States, however, can also fall prey to managerial lobbying.[138] The key difference between a regime of corporate federalism and a mandatory federal regime is that the managerial bias created by managers' control over re-incorporation decisions requires no lobbying effort on behalf of managers. Stated

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[136] *See supra* text accompanying notes 111-112 (arguing that managerial bias would exist under either perfect or imperfect competition).

[137] *See* Romano, *Empowering Investors, supra* note 22 (positing that the federal government would be subjected to managerial lobbying); Choi & Guzman, *supra* note 134,at 974-76 (raising the concern of managerial lobbying of the federal government).

[138] The relative success of managerial lobbying on the state level can be seen in the context of state anti-takeover legislation. Many such statutes were enacted as a result of lobbying efforts by managers. In several occasions, managers sought protection in the midst of a battle over the control of their corporations. *See* sources cited note 42 *supra.*

differently, managerial control over re-incorporation decisions would produce this bias even if managers do not spend any effort or resources on lobbying.[139]

Second, the dominant state under the current regime of corporate federalism has an interest in making its corporate laws somewhat indeterminate and litigation-intensive.[140] The reasons underlying this bias might be the interest in mitigating the risk of federal intervention, in price discrimination, or in reinforcing the dominant state's position by increasing network effects. Whatever the precise reason turns out to be, a federal regulator would not exhibit this bias.

Thirdly, a federal regulator would have, and be willing to use, more resources to devote to developing and implementing legal rules that would enhance shareholder wealth in publicly traded companies. The resources used for such purposes by the S.E.C. are an order of magnitude larger than those devoted by states for such purposes. As long as Delaware can maintain its dominant position among publicly traded firms, it has no incentive to spend resources on rules that would benefit largely out-of-state shareholders. Other states also do not have an incentive to devote substantial attention to the optimal regulation of publicly traded firms. States are not expected to give direct weight to the interests of out-of-state shareholders, whereas the federal government is expected to take a broader perspective that takes into account the interests of all public shareholders. Accordingly, loyal state officials should be expected to spend less on developing optimal corporate arrangements than would loyal federal officials.

B. Federal Intervention to Invigorate Competition

1. Federal Role without Mandatory Rules

The above analysis indicates that, even if the choice were only between state law rules and mandatory federal rules, the latter would be more attractive than has been recognized. Many corporate scholars, however, might remain reluctant to favor mandatory federal rules. The preceding analysis indicates that the potential advantage of state law rules, compared with mandatory federal rules state rules, is significantly smaller than has been suggested by race-to-the-top scholars. However, this advantage cannot and should not be dismissed. State rules do provide a potentially valuable safety valve that protects against huge deviations of corporate law from optimality. [141]

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[139] *See also* Bebchuk and Ferrell, *Federal Intervention, supra* note 10, at 165.
[140] *See supra* Part V. D.
[141] *See* Romano, *Empowering Investors, supra* note 22, at 2387 (arguing that "[w]ith only a national law, there would be no safety valve offered by a competing jurisdiction…").

To be sure, we have seen that, due to the weakness of competition, state rules might substantially deviate from optimality, say, in favor of managers. However, there is still a limit on how far these deviations can go. If state rules became terribly bad, then at some point, some state might make an effort to provide a better regime, states' limited incentives to do so notwithstanding. If the loss in shareholder value associated with managerial bias became sufficiently large, for example, some state might offer a better regime, and the shareholders of existing companies might overcome their collective action problems and pressure management to re-incorporate elsewhere.[142] Put differently, a regime of corporate federalism establishes a limit to how bad things can go. Mandatory federal rules, in contrast, lack such a corrective mechanism against hugely inefficient rules.

The safety valve advantage of the current regime over mandatory federal rules does not imply that the former is better than the latter. The question still remains whether this advantage outweighs the advantages of mandatory federal rules discussed above. We shall not attempt here to resolve whether the current regime is superior or inferior to mandatory federal rules. The contribution of our analysis has been to show that the advantage of the former over the latter is far more uncertain than has been believed. What we can confidently say, however, is that the problems of the current regime we have identified suggest that, at the minimum, it would be desirable for federal law to play a role that falls short of imposing mandatory substantive arrangements.

In particular, it would be desirable for federal law to play a choice-enhancing role that would invigorate competition.[143] There are two ways in which federal law could serve such a role. First, federal law could establish "switching rules" to govern reincorporation from one state to another that would ensure greater weight to shareholder interests. Second, federal law could provide an incorporation option.

2. Federal Regulation of the Switching Rules

We believe it would be desirable for federal law to adopt a mandatory rule governing the process of corporations' re-incorporation decisions. Specifically, a

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[142] For example, when Pennsylvania enacted an antitakeover statute that was widely perceived as extreme and excessive, pressure from institutional investors led the majority of Pennsylvania companies' boards to opt out of this arrangement. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 68 (1993); Samuel H. Szewczyk & George P. Tsetsekos, *State Intervention in the Market for Corporate Control: The Case of Pennsylvania Senate Bill 1310,* 31 J. FIN. ECON. 3, 18 (1992).

[143] See Bebchuk and Ferrell, *A New Approach, supra* note 6, at _.

federal process rule should enable shareholders to initiate and approve by a vote a proposal to reincorporate in a different state.[144]

The conclusion that competition in the incorporations market is highly imperfect makes such a rule desirable. As we have shown, the existing rules governing reincorporation decisions give management a veto power over incorporations. This feature of the existing state of affairs reinforces the leading position of the dominant state, as long as it keeps managers content, and thereby weakens competition. Furthermore, this feature introduces managerial favoritism into states' decisions.

A federal mandatory process rule would address these problems. Most importantly, it would eliminate the managerial favoritism bias introduced by the existing switching rules. When it comes to rules that favor managers at the expense of shareholders, Delaware's adoption of such rules would expose it to the threat of shareholders' initiating and approving a proposals to reincorporate out of Delaware. It would no longer be the case that adopting such rules could entrench Delaware's leading position by inducing managers to stay in Delaware.

3. Federal Incorporation Option

In the absence of the barriers to entry discussed in the preceding Part, switching rules that empower shareholders would be sufficient to induce optimal state rules. If we had vigorous competition and shareholders were in control of switching decisions, competition would indeed operate very well. However, as discussed earlier, entry into the incorporation market is discouraged by Delaware's ability to match what the entrant does, thus undermining the profitability of such an entry. Accordingly, even with good switching rules, Delaware might not face the strong competitive threat that could make it very attentive to shareholder interests.

Competition might be improved by providing a federal incorporation option.[145] Federal law would provide another jurisdiction under which firms could choose to incorporate. Such a federal incorporation option exists in Canada, where firms can incorporate either in one of the provinces or federally.[146]

Even in the absence of imperfect competition, there should be no reason for a supporter of corporate federalism to oppose a federal incorporation *option* (as opposed to a mandatory federal regime). Expanding the menu of options available for companies cannot hurt and might improve the quality of corporate law. As long

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[144] See Bebchuk and Ferrell, *A New Approach, supra* note 6, at _.
[145] See Bebchuk and Ferrell, *A New Approach*, *supra* note 6.
[146] For a discussion of the Canadian federal option, see Douglas Cumming & Jeffrey MacIntosh, "*The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*," 20 INT. REV. LAW & ECON. 1 (2000).

as competition for incorporations is viewed as strong and vital, however, the value from adding such an option would seem rather limited. If a value-increasing regime could be developed, it might be argued, the market would offer it. Once the weakness of competition is recognized, however, the case for adding a federal incorporation option becomes strong, indeed compelling.

At first glance, it might be argued that introducing a federal incorporation option would simply add another potential competitor to Delaware to the fifty other potential competitors already in existence. Such observation might lead one to conclude that such addition would not affect significantly the vigor of competition. However, the federal competitor would be a different type of player, with different resources and incentives. Such a competitor might add substantially to the competitive threat facing Delaware.

Recall the analysis suggesting that states might be discouraged form mounting a challenge to Delaware's dominance by the difficulty of recouping a return on their investments and efforts. A challenge might lead Delaware to match whatever improvements are offered by the challenger, and the challenger might then find itself operating as a stalking horse that produced an improvement in corporate law but did not capture any benefit for itself. As long as a state cannot be expeg1cted to make sufficient profits from mounting a challenge, such a challenge would not be worthwhile even if it were expected to improve the overall quality of corporate law.

The federal government, however, has different incentives. In considering the benefits of making an effort to improve the quality of the corporate law offered by the federal incorporation option, the federal government would take into account not only the likely effects of this amendment on its incorporation-related revenues, but also the overall effect on the economy. Accordingly, the federal government might make the necessary effort to innovate and improve the quality of corporate law even if such a move would only push Delaware to imitate and thus result in no change in actual incorporation patterns. The ability of the federal government to mount a meaningful challenge would be facilitated by the resources available to the government, including the professional and experienced infrastructure provided by the S.E.C.

Finally, the experience in Canada supports the prediction that a federal option could substantially influence the outcome produced by competition among jurisdictions. In Canada, the introduction of a federal option has had a substantial impact on the rules offered by the provinces, which have been all induced to adopt the main reforms provided by the federal jurisdiction.[147]

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[147] See Cumming and MacIntosh, *id.*; Ronald Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, MCGILL L. J. 36 (1991).

VII. CONCLUSION

This paper has questioned the widely-held belief that, whether the race is toward the top or the bottom, states vigorously compete to attract incorporations. We have shown that, in contrast to this belief, the competitive threat to Delaware's dominant position in the incorporations market is rather weak. We have presented evidence that Delaware's position is far stronger and secure than has been previously recognized, and we have analyzed the structural features of the market for incorporations that explain this state of affairs.

The weak-competition account of state competition that we have developed in this paper has substantial implications for assessing the quality of rules produced by state competition and the desirable role of federal law in this area. This account casts substantial doubt on the extent to which state competition can be relied on -- even on the most favorable view of it – to produce optimal corporate rules. Given the highly imperfect nature of competition in the market for incorporations, no presumption of efficiency should be accorded to such rules. This account, furthermore, lends support to concerns that the rules produced by state law are tilted toward managerial favoritism. Finally, this account strengthens the case for some form of federal intervention; at the minimum, it would be desirable for federal law to invigorate competition by permitting shareholders to initiate and approve reincorporations and by providing a federal incorporation option.

TABLE 1
The Distribution of Companies
by State of Headquarters:

All Publicly Traded Companies

State	Number of firms located in state	Percentage
CA	1,254	19.20%
TX	586	8.97%
NY	576	8.82%
MA	360	5.51%
FL	328	5.02%
NJ	311	4.76%
PA	248	3.80%
IL	241	3.69%
MN	212	3.25%
CO	201	3.08%
OH	192	2.94%
GA	178	2.73%
VA	154	2.36%
CT	147	2.25%
WA	131	2.01%
MI	104	1.59%
MD	101	1.55%
MO	101	1.55%
NC	98	1.50%
AZ	91	1.39%
TN	81	1.24%
WI	72	1.10%
OR	70	1.07%
UT	70	1.07%
NV	63	0.96%
Other	560	8.58%
Total	6,530	100%

Fortune 500 Companies

State	Number of firms located in state	Percentage
CA	41	11.08%
TX	36	9.73%
NY	32	8.65%
IL	31	8.38%
PA	22	5.95%
OH	21	5.68%
NJ	18	4.86%
MI	14	3.78%
MO	14	3.78%
VA	13	3.51%
FL	12	3.24%
GA	12	3.24%
MN	10	2.70%
CT	9	2.43%
NC	8	2.16%
WA	8	2.16%
MA	7	1.89%
MD	5	1.35%
TN	5	1.35%
WI	5	1.35%
AL	4	1.08%
AR	4	1.08%
AZ	4	1.08%
CO	4	1.08%
DE	4	1.08%
Other	27	7.30%
Total	370	100%

Companies Going Public during 1996-2000

State	Number of firms located in state	Percentage
CA	549	27.31%
TX	172	8.56%
NY	165	8.21%
MA	137	6.82%
FL	113	5.62%
CO	67	3.33%
NJ	66	3.28%
GA	62	3.08%
PA	60	2.99%
IL	56	2.79%
WA	55	2.74%
VA	51	2.54%
MN	48	2.39%
CT	44	2.19%
MD	40	1.99%
NC	29	1.44%
OH	29	1.44%
AZ	27	1.34%
MI	23	1.14%
MO	23	1.14%
TN	21	1.04%
UT	17	0.85%
NV	15	0.75%
LA	13	0.65%
OR	13	0.65%
Other	115	5.72%
Total	2,010	100%

* The data in this and subsequent tables exclude financial companies. Tables based on data including financial companies are available upon request.

TABLE 2

The Distribution of Companies by State of Incorporation

All publicly traded Companies

State	Number of firms incorporate in state	Percentage
DE	3,771	57.75%
CA	283	4.33%
NY	226	3.46%
NV	217	3.32%
MN	178	2.73%
FL	165	2.53%
TX	147	2.25%
CO	132	2.02%
PA	124	1.90%
MA	118	1.81%
OH	112	1.72%
NJ	111	1.70%
GA	83	1.27%
WA	79	1.21%
VA	74	1.13%
MI	60	0.92%
WI	57	0.87%
MD	54	0.83%
OR	54	0.83%
UT	52	0.80%
IN	50	0.77%
NC	46	0.70%
TN	39	0.60%
MO	36	0.55%
IL	32	0.49%
Other	230	3.52%
Total	6,530	100%

Fortune 500 Companies

State	Number of firms incorporate in state	Percentage
DE	220	59.46%
NY	22	5.95%
OH	13	3.51%
PA	12	3.24%
NJ	11	2.97%
VA	9	2.43%
MD	8	2.16%
FL	7	1.89%
IN	6	1.62%
CA	5	1.35%
GA	5	1.35%
MI	5	1.35%
NC	5	1.35%
NV	5	1.35%
MN	4	1.08%
MO	4	1.08%
TX	4	1.08%
WA	4	1.08%
WI	4	1.08%
IL	3	0.81%
KS	3	0.81%
KY	2	0.54%
MA	2	0.54%
OR	2	0.54%
HI	1	0.27%
Other	4	1.08%
Total	370	100%

Companies going public 1996-2000

State	Number of firms incorporate in state	Percentage
DE	1,364	67.86%
CA	90	4.48%
NV	72	3.58%
FL	58	2.89%
TX	45	2.24%
CO	37	1.84%
MN	36	1.79%
WA	34	1.69%
GA	30	1.49%
MA	27	1.34%
NY	22	1.09%
PA	22	1.09%
OH	19	0.95%
MD	16	0.80%
VA	15	0.75%
NJ	13	0.65%
MI	12	0.60%
TN	12	0.60%
OR	11	0.55%
UT	11	0.55%
NC	10	0.50%
WI	9	0.45%
LA	7	0.35%
MO	7	0.35%
IN	6	0.30%
Other	25	1.24%
Total	2,010	100%

TABLE 3

Location and Incorporation: All Publicly Traded Companies

incorpn

state	AK	AL	AR	AZ	CA	CO	CT	DC	DE	FL	GA	HI	IA	ID	IL	IN	KS	KY	LA	MA	MD	ME	MI	MN	MO
AK	1								1																
AL		3				1			23																
AR			3						15						1										1
AZ				21		2			43		1				1	2					1			1	
CA	1				273	11			898	2	1	1				1					2			2	
CO					2	74			107					1		1					1				
CT						1	17		111	1										2					
DC								2	19												1				
DE									27																
FL						2	1		149	137					1	1								1	1
GA		1				2			89	4	71									1	1			4	
HI						1			4			6													
IA									9				10								1			2	
ID									9					2										1	
IL						1			189		2		1		27	1			1	1	2		1		
IN						1			15							39									
KS						3			16								11								4
KY									20	1								7							
LA						2			22										18						
MA					1				234	1										108					
MD						1			68												25			1	
ME									5	1												4			
MI									40		2					1				1			58		
MN						1			49															158	1
MO									62				1		1		5								26
MS									7		1													1	
MT																									
NC									48	2											1				
ND						1			2															1	
NE						1			11																
NH									23											1					
NJ					1				185	3						1					4				
NM						1			3																
NV					2	2			10															2	
NY						5	2		382	3						2			1	1	3			2	
OH						1			69	2						1		1			1				
OK						2			31								1				1				
OR									16												1				
PA					1	1			129	1	1										3				
RI									15	1										1					
SC									20																
SD									3																
TN									37		1							1						1	
TX		1			3	8			368	4	1	1	1				2		2		1		1	1	3
UT						2			27	1															
VA						1			78	1	2										4				
VT									6																
WA	1								57											2					
WI						1			16						1						1				
WV									2																
WY						3			2				1												
Total	3	5	3	21	283	132	20	2	3.771	165	83	8	14	3	32	50	19	9	22	118	54	4	60	178	36

state	MS	MT	NC	ND	NE	NH	NJ	NM	NV	NY	OH	OK	OR	PA	RI	SC	SD	TN	TX	UT	VA	VT	WA	WI	WV	WY	Total
AK																											2
AL							1											1									29
AR																											20
AZ							2		9	3				1					1	1						2	91
CA					1		4	1	34	6	1		1			1		2	1	7			2			1	1254
CO								1	7	2									1	1			1			2	201
CT							1		2	8											3			1			147
DC										2													1				25
DE																											27
FL			2		1		3		15	9				1					1	1	1					1	328
GA			1							1	1			1					1								178
HI									1											1							13
IA					1				2																		25
ID									2														1				15
IL						1			2	5		1		2						1	2			1			241
IN																					1						56
KS										1																	35
KY			1																								29
LA									3																		45
MA						3			4	3		1		4	1												360
MD			1						1	2											2						101
ME																											10
MI										1	1																104
MN									2											1							212
MO						1			1	3										1							101
MS	4																	1									14
MT		6																									6
NC			38						1	4				2				1			1						98
ND																											4
NE					4															1				1			18
NH						3																		1			28
NJ							80		7	19				11													311
NM								4	1																		9
NV									45	1									1								63
NY			1				3		22	141	1			1					1		3		1			1	576
OH			1				4		1	1	105			1							3		1				192
OK									3			22							1								61
OR									3				50														70
PA							2		5	4	2			98							1						248
RI										1					6												24
SC			1													9											30
SD																	4										7
TN							1		5	1								33		1							81
TX							2	1	26	3	1	3	2	1					139	4	1		2	1		3	586
UT									8											32							70
VA							2		2	4								1			56		2			1	154
VT										1												4					11
WA									1				1										68			1	131
WI							1																	52			72
WV									2					1											3		8
WY																										3	9
Total	4	6	48	0	7	3	111	7	217	226	112	27	54	124	7	10	4	39	147	52	74	4	79	57	3	15	6530

TABLE 4

Total In-state and Out-of-State Incorporations

	Number of In-state Incorporations	Percentage of Total Incorporations	Number of Out-of-state Incorporations	Percentage of Total Incorporations	Total Number of Incorporations
All firms	2137	32.7%	4393	67.3%	6530
Went public Pre-91	1213	37.3%	2036	62.7%	3249
Went public 91-95	417	32.8%	854	67.2%	1271
Went public 96-00	507	25.2%	1503	74.8%	2010
Fortune 500	110	29.7%	260	70.3%	370
Fortune 100	18	25.3%	53	74.7%	71

TABLE 5
The Division of the Market for Out-of-State Incorporations:

All companies

State	Number of firms located elsewhere but incorporated in state	As percentage of all out-of-state incorporation
DE	3,744	85.23%
NV	172	3.92%
NY	85	1.93%
CO	58	1.32%
NJ	31	0.71%
MD	29	0.66%
FL	28	0.64%
PA	26	0.59%
MN	20	0.46%
UT	20	0.46%
VA	18	0.41%
GA	12	0.27%
WY	12	0.27%
IN	11	0.25%
WA	11	0.25%
CA	10	0.23%
MA	10	0.23%
MO	10	0.23%
KS	8	0.18%
NC	8	0.18%
TX	8	0.18%
OH	7	0.16%
TN	6	0.14%
Other	49	1.12%
Total	4,393	100%

Fortune 500 companies

State	Number of firms located elsewhere but incorporated in state	As percentage of all out-of-state incorporation
DE	216	83.08%
NY	9	3.46%
NV	5	1.92%
MD	4	1.54%
NJ	4	1.54%
IN	3	1.15%
KS	3	1.15%
PA	3	1.15%
NC	2	0.77%
OH	2	0.77%
VA	2	0.77%
FL	1	0.38%
GA	1	0.38%
HI	1	0.38%
KY	1	0.38%
MA	1	0.38%
TN	1	0.38%
UT	1	0.38%
Total	260	100%

Companies that went public 1996-2000

State	Number of firms located elsewhere but incorporated in state	As percentage of all out-of-state incorporation
DE	1,356	90.22%
NV	61	4.06%
CO	18	1.20%
FL	11	0.73%
MD	6	0.40%
UT	6	0.40%
NY	5	0.33%
PA	4	0.27%
TX	4	0.27%
GA	3	0.20%
KS	3	0.20%
MN	3	0.20%
NC	3	0.20%
WA	3	0.20%
IN	2	0.13%
NJ	2	0.13%
OR	2	0.13%
TN	2	0.13%
CA	1	0.07%
IL	1	0.07%
LA	1	0.07%
MI	1	0.07%
MO	1	0.07%
Other	4	0.27%
Total	1,503	100%

TABLE 6

Delaware's Share of Out-of-state Incorporations Over Time

Years firms went public	Fraction of Firms Going Out-of-state	Delaware's Fraction of Out-of-state Incorporations	Delaware's Fraction of all Incorporations
Pre 1991	62.6%	80.4%	50.4%
1991 – 1995	67.2%	87.9%	59.1%
1996 – 2000	74.8%	90.2%	67.5%