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PRICE CONSIDERATIONS
IN THE MARKET FOR
CORPORATE LAW

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PRICE CONSIDERATIONS IN THE MARKET FOR CORPORATE LAW

Michal Barzuza*

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ABSTRACT

The long-standing debate over the market for corporate law has been premised on the assumption that to maximize its revenues, the dominant state, Delaware, seeks to maximize the number of domestic incorporations. This article questions the common assumption that increasing the number of incorporations necessarily increases revenues. Instead, it highlights the role that price, in addition to quantity, plays in determining Delaware revenues.

A price considerations analysis of the market for corporate law demonstrates that Delaware's revenues are determined by the following trade-off: On the one hand, the more pro-managerial Delaware law becomes, the more firms it attracts (because managers want to relocate firms to states with pro-managerial laws), while on the other hand, the less it can charge for incorporations (because shareholders will demand compensation in return for accepting pro-managerial laws). As a result, a law that balances managers' and shareholders' interests would result in higher state revenues than catering mainly to one of these groups by racing either to the top or the bottom.

*Presenting new data and analyzing existing ones, the article shows that Delaware law and the services it provides do not maximize the number of incorporations in the state; instead, they have the effect of deriving significant revenues for the state. Moreover, price considerations analysis accounts for developments in Delaware and other states' law, patterns of incorporations, the higher Tobin's *Q* ratios of firms incorporated in Delaware and the fact that these ratios decrease over time, the lack of competition, and other characteristics of the market for corporate law.*

The analysis has implications for the assessment of the current system of state corporate charters and the determination of the desirable extent of federal intervention in the market for corporate law.

Keywords: Delaware, Incorporation, Corporate Charters, Price, Regulatory Competition, Managers, Shareholders, Takeovers, Federalism

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I. INTRODUCTION

Which system, of all possible ones, is likely to produce corporate law that maximizes shareholder value? One of the most fundamental questions in American corporate law is whether the current system, which allows firms to incorporate in a state of their choice, enhances shareholder value or should be replaced, either in whole or in part, by federal legislation. As the recent corporate scandals illustrate the practical significance of this question, as the federal legislature has taken an important stab at it recently,¹ and as empirical evidence about it now abounds,² the question becomes ripe for reexamination.

Notwithstanding the extensive theoretical and empirical literature on this question, there is no consensus as to the desirability of the current system. Although some believe that it creates competition for incorporations among states that induces them to produce efficient corporate laws,³ others doubt that such competition is desirable⁴ or that it

¹ Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (2002) (codified at various parts of 15 U.S.C.).

² See, e.g., Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383 (2003); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 225 (2001) [hereinafter Daines, *Firm Value*]; Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002) [hereinafter Daines, *IPO Firms*]; Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L.ECON. & ORG. 32 (2004) [hereinafter Subramanian, *Disappearing Effect*]; Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795 (2002) [hereinafter Subramanian, *Incorporation Choice*].

³ See generally FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 1-40 (1991) [hereinafter EASTERBROOK & FISCHEL, *ECONOMIC STRUCTURE*]; ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1993) [hereinafter ROMANO, *THE GENIUS*]; Daines, *Firm Value*, *supra* note 2; Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395 (1983); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 (1998) [hereinafter Romano, *Empowering Investors*]; Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985) [hereinafter Romano, *Law as a Product*]; Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 THEORETICAL INQUIRIES L. 387, 493-544 (2001) [hereinafter Romano, *The Need for Competition*]; Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977) [hereinafter Winter, *Shareholder Protection*]; Ralph K. Winter, Jr., *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 COLUM. L. REV. 1526 (1989) [hereinafter Winter, *Race for the Top Revisited*].

⁴ See generally Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992) [hereinafter Bebchuk, *Desirable Limits*]; Bebchuk & Cohen, *supra* note 2; Lucian A. Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775 (2002); Lucian A. Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001) [hereinafter Bebchuk & Ferrell, *New Approach*]; Lucian A. Bebchuk & Allen Ferrell, *The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999) [hereinafter Bebchuk & Ferrell, *The Race to Protect Managers*]; William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974); Subramanian, *Incorporation Choice*, *supra* note 2; OREN BAR-GILL, MICHAL BARZUZA & LUCIAN A. BEBCHUK, *THE MARKET FOR CORPORATE LAW* (John M. Olin Ctr. for Law, Econ. & Bus., Discussion Paper No. 377, 2002), available at http://papers.ssrn.com/abstract_id=275452.

even exists.⁵ While race to the top proponents point to the relative performance of Delaware, the dominant state in the market for corporate law, as an indication that the race is indeed one to the top,⁶ others argue that the current system provides incentives to produce corporate laws catering to the interests of managers.⁷ Puzzlingly, evidence exists to support all sides in the debate.⁸

Although commentators hold opposing views regarding the desirability of the current system, they all share certain assumptions. Generally, they assume that Delaware designs its law to maintain and enhance its incorporation-related revenues.⁹ In addition, they share the belief that Delaware derives significant revenues from attracting a great number of incorporations and from charging a price significantly higher than its marginal cost for those incorporations.¹⁰ Yet, in applying the assumption of revenue maximization to analyze Delaware's choices commentators generally focus exclusively on Delaware's interest in attracting more firms, setting price considerations aside. Thus, during this three-decades-old debate, one dominant assumption on all sides of the debate has been that Delaware seeks to maximize the number of domestic incorporations.¹¹

⁵ See generally Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition Debate over Corporate Charters*, 112 YALE L.J. 553 (2002) [hereinafter Bebchuk & Hamdani, *Leisurely Walk*]; Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002) [hereinafter Kahan & Kamar, *The Myth*]; Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205 (2001) [hereinafter Kahan & Kamar, *Price Discrimination*]; Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998); see also Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588 (2003) (arguing that Delaware's competition comes primarily from the federal government rather than from other states).

⁶ See, e.g., Romano, *Empowering Investors*, *supra* note 3, at 2383-88; Romano, *The Need for Competition*, *supra* note 3, at 506.

⁷ See, e.g., Bebchuk, *Desirable Limits*, *supra* note 4; Bebchuk & Ferrell, *New Approach*, *supra* note 4; Bebchuk & Ferrell *The Race to Protect Managers*, *supra* note 4; Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 599-601, 606-07; Bar-Gill, Barzuza & Bebchuk, *supra* note 4.

⁸ For evidence that arguably supports the race to the top view, see Daines, *Firm Value*, *supra* note 2; Romano, *Empowering Investors*, *supra* note 3, at 2383-88 (describing and evaluating the evidence). For evidence that arguably supports the race to the bottom view, see Bebchuk & Cohen, *supra* note 2; Subramanian, *Incorporation Choice*, *supra* note 2.

⁹ See, e.g., Romano, *Law as a Product*, *supra* note 3, at 228; Subramanian, *Incorporation Choice*, *supra* note 2, at 1798 (stating that “both sides of the debate have noted that their opposing views in fact share fundamental assumptions about...the states' objective (maximization of incorporation revenue)”).

¹⁰ See Kahan & Kamar, *Price Discrimination*, *supra* note 5.

¹¹ See, e.g., Bebchuk, *Desirable Limits*, *supra* note 4, at 1451-55 (discussing some objections to this assumption but stating that “[b]oth the race for the bottom and the race for the top theories make this assumption, at least implicitly” and concluding that “for the purpose of analyzing the effects of state competition, the appropriate assumption remains that state law is shaped by states' desire to attract incorporations”); Romano, *Law as a Product*, *supra* note 3, at 228 (stating that both the race to the bottom and the race to the top schools adopt the assumption that the “objective of states is revenue maximization, which is thought to depend directly upon the volume of domestic incorporations”); Bebchuk & Cohen, *supra* note 2, at 384 (“In this debate, most scholars have made similar assumptions about the supply side of the market, namely, that states seek to attract incorporations.”); Bebchuk & Ferrell, *New Approach*, *supra* note 4, at 133 & n.64 (asserting that “[t]he whole focus on the debate over the effects of federalism on the provision of desirable corporate rules is based on this assumption”); Bebchuk & Ferrell, *The Race to Protect Managers*, *supra* note 4, at 1173 (noting that the “starting assumption of the ‘race to the top’ / ‘race to the bottom’ debate” is that “a state wishes to maximize the number of companies that are incorporated there”); Kamar, *supra* note 5, at 1909 (stating that “[f]ederalism in American corporate law is widely thought to have bred a system of

By contrast, this article argues that Delaware revenues do not necessarily increase in quantity. Instead, it highlights the role that price, in addition to quantity, plays in determining Delaware revenues.¹²

Unlike a producer in a competitive market that gets a competitive price from the market, Delaware, which enjoys substantial market power, can increase the price it charges for its law above its marginal cost of production.¹³ The extent to which Delaware can raise its price is affected by the two special characteristics of this market: the shareholder-manager agency problem on the demand side and the current American corporate law rule that requires manager initiation of and shareholder approval for any re-incorporation decision.¹⁴

Given these characteristics, to induce managers to reincorporate to Delaware, Delaware must cater to their interests. To induce shareholders to approve reincorporation to Delaware, and to attract firms when they first go public, Delaware must ensure that firm-value will be greater in Delaware than in other states. Thus, it must not charge firms more for incorporation than the net value that Delaware incorporation confers upon them.¹⁵ This

regulatory competition in which states formulate law to attract incorporation”); Subramanian, *Incorporation Choice*, *supra* note 2, at 1810 (stating that “both sides assume that states seek to maximize the number of companies incorporated within their boundaries”). In other articles, commentators have made this assumption implicitly, at least with respect to some of their conclusions. See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 559-600 (assuming that Delaware designs its corporate law to retain and attract incorporations); Kahan & Kamar, *The Myth*, *supra* note 5, at 739-40 (assuming that “Delaware aims to attract incorporations” they suggest that “[b]ecause both managers and shareholders influence incorporation decisions, Delaware can benefit from designing its product to be attractive, if not equally so, to both shareholders and managers of as many corporations as possible”); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 849-51 (1995) (assuming that as long as there is no risk of Delaware losing firms Delaware has no incentives to invest in the quality of its laws). This assumption is also common to the literature that discusses international regulatory competition in securities regulation. See Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 901, 906 (1998) (stating that “[i]n a world where both investor capital and issuer demand for capital are mobile, countries compete to attract market participants” and that “[a]n increase in the number of market participants adopting a particular country’s regulatory regime leads to more tax revenue”).

¹² In this article, the term price refers to the fees that Delaware charges for incorporations. To be sure, the state derives additional revenues from incorporations, such as collections of abandoned property and UCC filing fees. As these fees in general are not higher in Delaware than in other states, I consider them separately. See E-mail from David Singleton (Apr. 12, 2004) (on file with author) (noting that “[w]ith very limited exceptions, a company would expect to make roughly the same amount of payments to the 50 states as a group, regardless of where they are incorporated”); see also E-mail from Richard J. Geisenberger (Apr. 12, 2004) (on file with author) (whereas Delaware UCC paper filing fees are relatively high, its fifteen dollar fees for Internet filing, an option that is open for every firm, is one of the lowest in the nation). In addition, different constituencies such as the Delaware bar, registered agents in Delaware, and business owners in Delaware benefit from incorporations in the state. Yet, these fees are primarily determined by factors in the local markets rather than by the strategies Delaware adopts. For the effects of price considerations on the Delaware bar, see discussion *infra* section III.F.2.

¹³ See DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 87-92 (3d ed. 2000) (explaining that unlike a firm in a competitive market, which takes price as given from the market, a monopolist faces a downward sloping demand curve); JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 65-69 (1988).

¹⁴ These unique characteristics do not allow for a straightforward application of the classic monopolist analysis. Part III of the article develops a specific analysis of this market that incorporates these unique features.

¹⁵ Otherwise, firms would not choose Delaware as their initial place of incorporation and

net value equals the value arising from Delaware's competitive advantages—such as its specialized judiciary, its developed body of case law, and the network externalities associated with its law—minus the harm to shareholders that is caused by its pro-managerial corporate laws.¹⁶

Delaware revenues, therefore, do not necessarily increase as the volume of incorporations increases. Instead, price considerations present Delaware with the following trade-off: the more pro-managerial its law is, the more managers it attracts but the less it can charge each firm. As managers have heterogeneous preferences toward the extraction of private benefits, the more Delaware offers corporate law that appeals to managers, the more managers it attracts. Yet, the more its law protects managers, the greater the decline in firm value and hence the less it can charge for incorporation.¹⁷

As a result, if Delaware indeed maximizes its revenues as commentators assume, it necessarily designs its law taking into account not only its effect on the number of firms Delaware attracts but also its effect on the price Delaware charges.¹⁸ Moreover, price considerations are

shareholders would not give their approval to reincorporation to Delaware. This constraint, however, does not apply to all of the firms that Delaware attracts. In particular, it does not apply to the firms whose shareholders are passive enough to approve reincorporation that is not in their favor. For a detailed discussion on why Delaware is not expected to attract only the firms whose shareholders are passive, and therefore is expected to take price constraints into account, see *infra* section III.F.1.

¹⁶ If Delaware incorporation confers a value of V upon firms, and Delaware allows managers to extract B in order to induce them to initiate reincorporation to Delaware, then the maximum price Delaware could charge is $P = V - B$. To induce more managers to incorporate in Delaware, B has to be increased. This, however, means that Delaware would have to decrease P .

¹⁷ The trade-off Delaware faces is different than the one usually exhibited in the case of a monopolist. Typically, a monopolist faces a trade-off between price and quantity as a result of facing a downward sloping demand curve, which represents consumers with different valuations. The more consumers it attracts, the more it needs to decrease its price to reflect the value to the marginal consumers it attracts. See CARLTON & PERLOFF, *supra* note 13, at 87-92; TIROLE, *supra* note 13, at 65-69. This distortion is less harmful in our context, because it exists only to the extent that the monopolist needs to charge a uniform price. As shown persuasively by Kahan and Kamar, Delaware price discriminates among firms according to the different values they attach to incorporation in Delaware. For a detailed discussion of this issue, see *infra* section III.D.

¹⁸ Although most previous work did not incorporate price considerations at all, some of the articles have discussed different aspects of Delaware's price. First, in a seminal article, Roberta Romano has noted as a virtue the fact that Delaware makes significant revenues from incorporations. Delaware's historical dependency on franchise tax revenues, she suggests, creates a credible commitment to remain responsive to corporate needs. See Romano, *Law as a Product*, *supra* note 3, at 276. Second, Ehud Kamar and Marcel Kahan were the first to point out that Delaware also makes choices with respect to the price that it charges. They have shown that Delaware uses its market power to price discriminate among public and non-public firms and, within that first group, among large and small firms. See Kahan & Kamar, *Price Discrimination*, *supra* note 5. Third, Oren Bar-Gill, Lucian Bebchuk, and I construct a formal model of the market for corporate law in which Delaware sets its rules and prices to maximize revenues. See Bar-Gill, Barzuza & Bebchuk, *supra* note 4. Some of the analysis in section III.C of this article builds on that article. Lastly, in recent work in which they persuasively challenge the assumption that other states compete with Delaware—unlike their approach to issues that involve conflicts of interests between managers and shareholders—when they turn to discuss issues that do not involve such conflicts Kahan and Kamar take price considerations into account. In particular, they suggest that in general Delaware is expected to invest in quality since “[b]y offering a higher quality, it can increase the number of public firms that incorporate in the state or raise the price it charges for incorporations.” See Kahan & Kamar, *The Myth*, *supra* note 5, at 741. For similar reasons, they suggest that Delaware is expected to invest in legal innovations. See *id.* Similarly, Ehud Kamar also included price considerations to a certain extent in showing how Delaware might incorporate excessive indeterminacy to its law: “As long as the relative value of Delaware law

important even if one were to accept the conventional wisdom that Delaware seeks to maximize merely the number of domestic incorporations and not revenues, if Delaware cannot or is not interested in raising its price above a certain threshold, if it is merely interested in retaining its revenues rather than enhancing them, or if different constituencies in Delaware that have influence on Delaware law promote other interests. As long as Delaware charges a significant price, this price constrains the incentives of the legislative body and the incentives of other constituencies to cater to managers' interests, since doing so might cause Delaware to lose its leading position in the market.¹⁹ Lastly, the analysis is important even if Delaware adopts its law for reasons other than price considerations as it can explain why Delaware does not have strong reasons to change its law.

The price considerations analysis has important implications for the corporate law that Delaware and the other states produce, the assessment of the current system of state corporate charters, and the determination of the desirable extent of federal intervention in the market for corporate law.

First, the analysis solves one of the main puzzles about Delaware's strategy. Conventional wisdom has it that Delaware provides managers with excessive hostile-takeover protection devices. At the same time, Delaware has traditionally been relatively mild on this front as compared to other states. As a recent work forcefully points out, since Delaware did not seem to be engaged in a race to the top or to the bottom, both sides of the debate could not fully account for its behavior.²⁰ The account put forward

rises, Delaware's equilibrium price and market share—and hence its profit—increase.” See Kamar, *supra* note 5, at 1931. In this respect, Kahan and Kamar's analysis is reconcilable with the view in this paper, and the analysis in section III.E builds upon and complements theirs. This article differs from previous work in several respects. First, whereas some of the previous work concentrated mainly on the strategic decisions that Delaware makes as to its price structure in order to maximize its profits and secure its dominance, this article shows how price considerations affect the corporate law that Delaware produces. Second, this article exposes the trade-off that Delaware faces between managers' and shareholders' interests and, accordingly, between price and quantity when it faces demand from managers with heterogeneous preferences. As a result, this article illustrates that price considerations might limit Delaware from maximizing the volume of incorporations. It challenges, therefore, the conventional wisdom that a higher quantity of incorporations will always increase Delaware revenues. Third, this article demonstrates that price considerations account for developments in Delaware's antitakeover law, for the higher Tobin's Q ratios of firms incorporated in Delaware, for the fact that these ratios decrease over time, for patterns of incorporation, for the lack of competition, and for the seemingly contradictory evidence on these issues. Finally, this article establishes the basis for a novel form of federal intervention to improve the quality of corporate law—intervention in the incorporation tax law.

¹⁹ For a detailed discussion of the interests of the Delaware bar and Delaware judges see *infra* sections III.F.2-3. It is not the intention of this article to argue that the price serves as the decisive factor in Delaware's decisions nor is it to say that price has always served as a binding constraint on Delaware. Rather, it is to say that under some circumstances price considerations might limit Delaware from adopting certain strategies.

²⁰ See Roe, *supra* note 5, at 625 (“[N]either race theory nicely explains Delaware's takeover positions in the 1980s battles.”). Roe offers a persuasive explanation, one that is different from the one suggested here, for the relative mildness of Delaware antitakeover law during the 1980s. Roe argues that Delaware's competition comes primarily from the federal government rather than other states. He suggests that during the 1980s Delaware's pro-managerial tendencies were restrained by a concern about federal intervention in states' takeover law, a concern that has disappeared in the last decade. Roe's thesis also explains why Delaware has become more antitakeover in the 1990s. The theory developed here differs from Roe's not only in the explanation that it provides for this phenomenon but also in its implications. In particular, this article's theory suggests that even in times

in this article can explain Delaware's behavior. To attract and retain managers, Delaware needs to cater to their interests by producing pro-managerial rules that reduce firms' value. To be able to charge a positive price, however, Delaware needs, simultaneously, to take into account the interests of shareholders.²¹ Racing to the top or to the bottom instead of choosing a middle ground could only impair Delaware revenues.

Accordingly, the price considerations analysis accounts for the full body of evidence regarding the market for corporate law and reconciles seemingly contradictory evidence. Race to the top theorists point to the fact that Delaware adopted only a mild antitakeover law as indicating that the current system rewards states for, and as a result provides them with incentives to, adopt efficient corporate laws.²² Race to the bottom proponents point to other evidence showing that the current system rewards states for adopting strong pro-management antitakeover rules. In particular, it has been shown that among states other than Delaware, those that adopt stronger antitakeover protections are more successful in retaining incorporations than states that adopt weaker ones.²³ The inconsistency is apparent: if states retain an increased number of incorporations after enacting antitakeover laws, why is Delaware, a state with a relatively mild antitakeover law, the most successful in the market and why doesn't it strengthen its antitakeover law to attract more incorporations?²⁴ The answer lies in price considerations. Even though Delaware could attract more incorporations by strengthening its antitakeover law, Delaware will not do so because doing so would require it to reduce the price it charges for incorporations.

Third, the price considerations analysis is also reconcilable with developments in Delaware takeover law over time, which, as Mark Roe has demonstrated, pose another puzzle for scholars on both sides of the debate.²⁵ Whereas during the 1980s Delaware law was clearly pro-shareholder, by the end of the 1980s it had become more pro-managerial. Over time, because of network externalities and other effects, Delaware's

in which there is no fear from federal intervention or in which the federal environment is pro-managerial, Delaware's pro-managerial tendency might be restrained by price considerations. Indeed, as demonstrated in *infra* section IV.B.1, even in the last decade in which, according to Roe, the federal actors "left the field," Delaware antitakeover law has been considered mild relative to that in many of the other states. By raising possible factors that constrain Delaware's choices, Roe's thesis and the thesis developed in this article complement each other.

²¹ This is not to say that Delaware judges necessarily intentionally design Delaware law to maximize revenues. Rather, it explains why the decisions of Delaware courts that balance shareholders and managers interests are not being overridden by the legislative branch. For a detailed discussion of price considerations and Delaware judges, see *infra* section III.F.3

²² See EASTERBROOK & FISCHER, *ECONOMIC STRUCTURE*, *supra* note 3, at 222-23; Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 *FORDHAM L. REV.* 843, 858-59 (1993).

²³ See Bebchuk & Cohen, *supra* note 2.

²⁴ One possible answer for the first question has been that Delaware offers other features that attract firms. Yet if strong antitakeover law helps states in retaining incorporations, why doesn't Delaware strengthen its antitakeover law to attract an even greater number of firms from other states?

²⁵ See Roe, *supra* note 5, at 625-26. As explained above, Mark Roe's thesis provides an alternative explanation for the developments in Delaware antitakeover law. See discussion *supra* note 13.

increased market share resulted in an increase in the value of incorporating in Delaware. Delaware could, therefore, have raised the price that it charged. Alternatively, it could have utilized its increased market share to attract more firms by catering to their managers. Since the value of its competitive advantages had increased, Delaware was still able to attract corporations and should have been able to continue to do so even though it weakened shareholder protection. Indeed over time, as its market share increased, Delaware degraded its corporate law in favor of managers' interests. As a result, even though Delaware maintains higher protection for shareholders than many of the other states, its antitakeover law is more pro-managerial than it was during the 1980s.

Fourth, the analysis provides an explanation for yet another puzzle in the market for corporate law. Whereas more than half of all publicly traded companies incorporate in Delaware, others remain in their home states. If Delaware corporate law is superior, why do all firms not just migrate there? This article shows that, because price considerations constrain Delaware's managerial favoritism, Delaware produces rules that cater only to some of the managers in the market, not to all of them. Managers that find Delaware law to be insufficiently protective remain in their home state if it provides them with better protection. Under the price considerations analysis, therefore, the division of the market on the basis of varying management preferences is a deliberate choice made by Delaware to keep its price higher than it otherwise would be.

Accordingly, the analysis explains why states that have strong antitakeover rules are more successful in retaining incorporations than states that do not have these rules. Given that Delaware law is sufficiently protective only to some of the managers in the market, other states could retain managers who find Delaware law to be insufficiently protective by offering them stronger protection than that offered by Delaware.

Fifth, the price considerations analysis also provides additional explanation as to why states other than Delaware do not manage to attract significant number of firms from Delaware and do not seem to even attempt to compete with Delaware. By reducing its price to reflect the harm caused to shareholders from the pro-managerial rules it adopts, Delaware makes its overall deal superior to any deal other states could offer. Even if other states offered optimal rules that maximize shareholder value, shareholders would prefer Delaware since it offers them other advantages for gratis. Given Delaware's strategy, an effort by another state to attract these shareholders is doomed to fail. The only groups that other states might hope to retain are those firms that display home state bias,²⁶ or those firms whose managers are especially opportunistic. Under price considerations analysis, therefore, the only dimensions of regulation on which other states are expected to be active are those that involve conflicts of interests between shareholders and managers. To be sure, not all of the states are expected to be active on these dimensions, since some of the states are almost indifferent to the number of incorporations occurring in the state.

²⁶ For the factors that explain home state bias, see Bebchuk & Cohen, *supra* note 2, at 397-402.

However, states in which local managers and the local bar have significant influence on the shaping of corporate law are expected to provide strong protection to managers and to succeed in retaining some of their corporations.

Sixth, price considerations theory is fully consistent with the evidence regarding firms' performance in Delaware and Other states. First, it explains the higher Tobin's Q ratios exhibited by Delaware firms.²⁷ This characteristic stems from the fact that Delaware produces better corporate law, attracts the better managers in the market and does not attempt to attract those with an extreme preference toward protection. Second, the analysis is also in accord with the more recent observed decrease in Delaware corporations' Tobin's Q ratios. The Tobin's Q ratio of Delaware firms has decreased in concert with decreases in the quality of its law.

Lastly, price considerations are also important to Delaware's choices with regards to corporate law issues that do not involve conflicts of interests between managers and shareholders. Here, too, maximizing revenues is not one and the same with maximizing the volume of incorporations. Price induces Delaware to improve the quality of its law and to invest in innovations since by increasing the quality of its corporate law system regarding these issues, Delaware can raise the price it charges or, alternatively, further degrade the other parts of its law toward managers' interests in order to attract more firms.²⁸ In addition, the price considerations analysis shows why this would be the result despite the significant network externalities associated with Delaware law. Indeed, despite the possibility that Delaware may not face competitive pressures from other states and of the significant network externalities associated with incorporation in Delaware, Delaware tends to invest in innovations and modifications to its corporate law system.²⁹

Analyzing Delaware law and the services it provides, the article demonstrates with new and existing evidence that both do not maximize the volume of incorporations to the state but rather achieve a balance between price and quantity and derive significant revenues. It is first shown that Delaware franchise tax law is designed to charge significant prices and to acquire significant revenues for the state. In addition, it is shown that Delaware is perfectly aware of a possible trade-off between price and quantity and, as a result, exercises great care in raising its price. Yet, the article also demonstrates that Delaware's practice of increasing its tax no more than once every decade, as well as the franchise tax current structure, limit Delaware from maximizing revenues and as a result limit the effect price considerations have on Delaware law. The article also demonstrates

²⁷ Tobin's Q ratio is the market value of a firm's assets divided by their replacement value.

²⁸ In a recent paper Marcel Kahan and Ehud Kamar suggest that in general Delaware market power induces Delaware to invest in the quality of its law and in legal innovations since, as a monopolist, Delaware reaps the benefits created by its law. See Kahan & Kamar, *The Myth*, *supra* note 5, at 741-43. In that respect the price considerations analysis is reconcilable with and complements Kahan and Kamar's analysis. Like Kahan and Kamar, it suggests that price induces Delaware to invest in quality. In addition, it explains why price would induce Delaware to pursue such investment regardless of the significant network externalities associated with its law.

²⁹ See Romano, *Law as a Product*, *supra* note 3, at 237-40.

that, as predicted by the analysis, Delaware antitakeover law is milder relative to the antitakeover law in many of the other states. Lastly, it is shown that, in accordance with the price considerations analysis, Delaware invests significant efforts and costs to improve the accessibility and efficiency of its services and that such improvements are accelerated in the face of tax increases.

The analysis advanced in this article has fundamental implications for the federalism debate. First, it offers a refinement of the repeated argument of race to the top proponents that Delaware's superiority compared to other states is conclusive evidence for the desirability of the current system. Because Delaware, unlike other states, takes price considerations into account, it is expected to adopt better corporate law whether there is a race to the top or to the bottom. Race to the bottom analysis, however, also needs to be reconsidered because it does not take into account the effects of price considerations on Delaware. The price considerations analysis also has important implications for the recent literature that concentrates on Delaware's market power and its consequences. In contrast to conventional wisdom, price considerations analysis suggests that the concentrated structure of the market for corporate law possibly has some virtues. In particular, in a competitive market shareholders might have less protection than they would in a concentrated market, in which the major producer is restrained by price considerations. Lastly, the analysis has implications for the recent theory that focuses on the threat of federal intervention as Delaware's main constraint. First, it suggests that even when Delaware is not constrained by the fear of federal intervention, or if the federal environment is pro-managerial, Delaware law might still be relatively pro-shareholder since there is another constraint on Delaware's pro-managerial policy. In addition, it suggests that if this threat prevents Delaware from increasing its tax, it limits the positive effects for shareholders created by price considerations.

The price considerations analysis has important implications for the question of the desirability of federal intervention in corporate law. First, by questioning the main argument of the race to the top theory, the analysis shows that the concern that state law suffers from pro-managerial bias is well grounded and, therefore, strengthens the case for federal intervention. On the other hand, it suggests an additional element that might induce Delaware to further protect shareholders' rights. Consequently, the desirability of federal mandatory intervention in the substance of state corporate law under the price considerations analysis depends on further assessment of this factor. While it is difficult to reach firm conclusions with respect to direct federal intervention in corporate law, such as the Sarbanes-Oxley Act, the analysis certainly strengthens the case for federal interventions that preserve the advantages of the current system rather than replace it.³⁰ Furthermore, recognizing the importance of price

³⁰ Lucian Bebchuk and Allen Ferrell have promoted a proposal for choice enhancing federal intervention that preserves the advantages of the current system. See Bebchuk & Ferrell, *New Approach*, *supra* note 4.

considerations, the analysis lays the groundwork for consideration of a federal intervention in the form of regulation of the factors used in determining incorporation fees. Based on the price considerations analysis a proposal, elaborated upon by the author elsewhere, suggests that different forms of incorporation fees such as fees that are sensitive to firms' value might better align Delaware's incentives with those of shareholders.³¹ Such incorporation fees, unlike the current tax, would provide Delaware with ongoing incentives to protect shareholders' interests. Moreover, under the suggested system, Delaware could be induced to improve its law in spite of shareholders' passivity and even in the absence of competitive threats from other states.

The rest of this article proceeds as follows. Part II reviews the existing theories of regulatory competition in American corporate law and assesses them in light of the evidence and accepted notions that Delaware designs its law to maximize the volume of incorporations. Part III develops a theory for the market for corporate law that incorporates price considerations and discusses possible objections and limitations to this theory. Part IV demonstrates how Delaware law conforms to the price considerations analysis. Part V discusses the further implications of the price considerations analysis for the assessment of the current system and assesses these implications in light of the evidence. Part VI discusses the implications of a price considerations analysis for existing theories of regulatory competition. Part VII discusses the implications of the analysis for the desirability of federal intervention in corporate law. Part VIII concludes.

II. THE STATE COMPETITION DEBATE

A. *Factual Background*

Under America's federal structure, corporations are basically free to choose among the corporate law systems that are offered to them by the different states. American corporations are governed by the law of their state of incorporation regardless of where they conduct their business.³² In addition, corporations are free to change their state of incorporation by reincorporating in another state. Typically, reincorporation is done by establishing a new company in the target state and merging the old firm with it³³ and requires that the board of directors adopt a merger resolution,

³¹ See Michal Barzuza, *Delaware's Compensation* (unpublished manuscript 2004, on file with author) [hereinafter Barzuza, *Delaware's Compensation*].

³² The internal affairs doctrine mandates that disputes regarding the internal affairs of a corporation be governed by the laws of the state of incorporation. See, e.g., *McDermott Inc. v. Lewis*, 531 A.2d 206, 217 (Del. 1987) (“[A]pplication of the internal affairs doctrine is mandated by constitutional principles . . .”).

³³ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1458; Subramanian, *Incorporation Choice*, *supra* note 2, at 1803.

which then has to be approved by shareholders.³⁴

This system creates a market for corporate law in which states produce corporate law and judicial and administrative systems and derive incorporation fees and revenues for the local bar. There is a dominant producer, Delaware, which has been the leading state in the market for corporate law for almost a century. Delaware has attracted more than fifty percent of all publicly traded companies, almost sixty percent of Fortune 500 companies, and more than sixty percent of companies that went public in the period 1996-2000.³⁵

Delaware has several competitive advantages that are difficult for other states to emulate. First, Delaware's well-developed body of case law ensures a relatively high degree of certainty and predictability in litigated matters, which in turn reduces legal risk and facilitates business planning.³⁶ Second, Delaware judges are required to handle a relatively high proportion of corporate cases and have a well-earned reputation for expertise and efficiency.³⁷ Third, Delaware offers especially efficient administrative services such as simple and rapid filing.³⁸ Fourth, due to its large investment in its corporate law system and its prolonged dependence on franchise tax revenues, Delaware possesses a credible commitment to remain responsive to corporate needs.³⁹ Lastly, Delaware law, being the most widely used corporate law, exhibits network externalities that further reinforce its market power.⁴⁰

³⁴ See ROBERT C. CLARK, CORPORATE LAW §10.2.4, at 416-17 (1986) (describing requirements for mergers under state law).

³⁵ Bebchuk & Cohen, *supra* note 2, at 389-90 (reporting that Delaware attracts fifty-one percent of all publicly traded companies, fifty-eight percent of Fortune 500 companies and sixty-three percent of companies that went public in the period 1996-2000); see also Bebchuk & Hamdani, *supra* note 5, at 576-78.

³⁶ See Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1213; Romano, *Law as a Product*, *supra* note 3, at 273-79.

³⁷ See Curtis Alva, *Delaware and the Market for Corporate Charters: History & Agency*, 15 DEL. J. CORP. L. 885, 903 (1990); Bernard Black, *Is Corporate Law Trivial?: A Political And Economic Analysis*, 84 NW. U. L. REV. 542, 589-90 (1990) ("Because of Delaware's small size and its many corporate charters, Delaware judges see a high proportion of corporate cases. . ."); Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 BROOK. L. REV. 1, 5-8 (1995) (arguing that because corporate cases take up a significant portion of the Delaware chancery court's time "[the] Chancery's bench has developed the expertise in corporate matters"); Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1212 (arguing that Delaware courts provide the ability to resolve disputes quickly and sensibly).

³⁸ See Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1213; Romano, *The Need for Competition*, *supra* note 3, at 509.

³⁹ This important insight was raised and developed by Roberta Romano. See ROMANO, *THE GENIUS*, *supra* note 3, at 38; Romano, *Empowering Investors*, *supra* note 3, at 2391; Romano, *Law as a Product*, *supra* note 3, at 240-42; Romano, *The Need for Competition*, *supra* note 3, at 509. But see Black, *supra* note 37, at 586-87 (arguing that the costs of switching the state of incorporation are negligible and that a credible commitment to responsiveness is therefore not valuable).

⁴⁰ Network externalities exist when the value of the product increases with the number of users. The insight that Delaware corporate law exhibits network externalities was developed by Michael Klausner in Klausner, *supra* note 11.

B. *Current Views on the Market for Corporate Law*

1. Race to the Bottom

The discussion over the merits of the current state competition structure was initiated by William Cary in one of the most cited and influential law review articles ever written.⁴¹ Cary forcefully argued that Delaware, the predominant state for incorporations of publicly traded companies, is leading a “race for the bottom” in producing rules that benefit managers at the expense of shareholders and social welfare.⁴² Cary advocated, therefore, that Congress adopt federal standards for corporate responsibility.⁴³ Cary’s argument is now a benchmark for the spectrum of views on the market for corporate law, in which scholars largely differ over whether state competition is a “race to the bottom” or a “race to the top” and whether it should be replaced by federal legislation, either in whole or in part.⁴⁴

Cary was criticized for not taking into account market forces that work to align the interests of managers with those of shareholders. Recent race to the bottom theorists address this criticism by distinguishing between different kinds of corporate issues. Lucian Bebchuk has shown that although market forces do discipline managers to some extent, they cannot be counted on to perfectly align the interests of managers and shareholders with respect to all issues.⁴⁵ In particular, with respect to issues that involve large potential transfers to managers and issues that might themselves affect the strength of market forces, managers may seek inefficient rules that benefit themselves at the expense of shareholders.⁴⁶

As a result, the race to the bottom argument goes, in order to attract and retain firms, Delaware must cater to managers’ interests. First, since board initiation is required for reincorporation, it is impossible to attract corporations from other states without catering to managers’ interests.⁴⁷ To be sure, reincorporation from one state to another requires shareholder approval. Yet, race to the bottom proponents also explain why, in their opinion, this requirement does not ensure an efficient outcome either.⁴⁸ First, with respect to many decisions, shareholders may remain rationally

⁴¹ Cary, *supra* note 4. Cary’s paper is one of the most cited law review papers ever. See Fred R. Shapiro, *The Most Cited Papers From the Yale Law Journal*, 100 YALE L.J. 1449, 1462 (1991) (finding that Cary’s paper was the fourteenth most cited *Yale Law Journal* paper).

⁴² See Cary, *supra* note 4, at 668-70.

⁴³ *Id.* at 701.

⁴⁴ See, e.g., Bebchuk, *Desirable Limits*, *supra* note 4, at 1499-1507 (arguing for federal rules or at least federal minimum standards for self-dealing transactions, the appropriation of corporate opportunities, freeze-out mergers, takeover bids, proxy contests, and limitations on dividends); Romano, *Empowering Investors*, *supra* note 3, at 2386 (arguing for replacing federal securities regulation with state competition); Winter, *Shareholder Protection*, *supra* note 3, at 252 (arguing for the desirability of state competition in corporate law).

⁴⁵ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1458-70.

⁴⁶ *Id.*

⁴⁷ See *id.* at 1460; Bar-Gill, Barzuza, & Bebchuk, *supra* note 4, at 12-14 (showing formally that to lure firms from other states Delaware needs to cater to managers’ interests).

⁴⁸ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1470-76.

ignorant and uninformed.⁴⁹ For any shareholder who holds a small stake in the firm, the expected value of acquiring and assessing information is most likely to be outweighed by the costs required to become informed.⁵⁰ More importantly, Delaware has many competitive advantages that compensate shareholders for possible differences between Delaware's substantive corporate law and other states' substantive corporate law.⁵¹ Even if Delaware offers inefficient rules that cater to managers' interests, shareholders might approve a move into Delaware because, due to its other advantages, the overall package that it offers is better than the one offered by other states. In other words, if the benefits of its specialized judiciary, developed body of case law, and network externalities associated with its corporate law system outweigh the costs incurred by shareholders due to Delaware's pro-managerial bias as to particular substantive corporate law issues, shareholders would still approve a reincorporation to Delaware.

Another reason why Delaware wants to cater to managers' interests is to retain its current firms.⁵² Delaware's main advantages arise from the large number of firms it currently possesses. Losing firms might cause Delaware irreversible harm due to its losing market dominance to another state. Since board initiation is required for reincorporation, ensuring managers' satisfaction secures the existing firms that Delaware has already attracted.⁵³

2. Race to the Top

Race to the top proponents, on the other hand, believe that the desire to attract incorporations induces states, or at least Delaware, to adopt efficient corporate rules that benefit shareholders. In a reply to Cary, Ralph Winter argued that Delaware could not maintain its lead over other states if it were offering rules with relatively high inefficiency costs.⁵⁴ Such rules would result in lower corporate share prices in Delaware as compared to other states⁵⁵ and, accordingly, a higher likelihood of a hostile takeover.⁵⁶ To decrease the risk of being replaced in a hostile takeover, managers therefore seek—and states in turn provide—legal systems that “optimize the shareholder-corporation relationship.”⁵⁷

Frank Easterbrook, Daniel Fischel, and Roberta Romano join Winter in supporting the current system.⁵⁸ They do not dispute that managers'

⁴⁹ See *id.* at 1472-73.

⁵⁰ *Id.*

⁵¹ *Id.* at 1471-72.

⁵² *Id.* at 1460.

⁵³ See *id.* at 1459-61.

⁵⁴ See Winter, *Shareholder Protection*, *supra* note 3, at 256-66.

⁵⁵ See *id.* at 256.

⁵⁶ See *id.* at 264-66.

⁵⁷ *Id.* at 256.

⁵⁸ See Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 571 (1985); Fischel, *supra* note 3, at 919-20; Romano, *Empowering Investors*, *supra* note 3, at 2383-87; Romano, *The Need for Competition*, *supra* note 3, at 493-544.

interests might diverge, to some extent, from those of shareholders or that Delaware needs to cater to managers' interests in order to attract them from other states.⁵⁹ Like Winter, they stress that in order to succeed in attracting incorporations the leading state has to be superior to the other states, otherwise entrepreneurs, who compete for capital, would not choose it as their initial place of incorporation⁶⁰ and shareholders would not give their approval to reincorporation in that state.⁶¹ Lastly, they argue, even if competition does not lead to optimal corporate rules, federal corporate law is almost certain to be worse.⁶² State legislators have stronger incentives than federal officials to invest in and improve their corporate law.⁶³ State legislators face competitive forces that federal officials do not. Moreover, while revenues stemming from the incorporation business constitute a substantial portion of Delaware's budget, they would only constitute a small portion of the national budget if a federal regime were implemented.⁶⁴ State law makers also have better information than federal officials, simply because they get corrections from the market: a misperception as to the preferences of firms might lead to the migration of firms to other states.⁶⁵ Lastly, the argument goes, managers might have stronger political influence on the federal level than in Delaware.⁶⁶

3. Weak Competition

A third strain of research on the market for corporate law has moved from discussing demand side inefficiencies to focus on supply side inefficiencies. A major finding of this literature is that, for several reasons,

⁵⁹ Race to the top proponents acknowledge that managerial opportunism may lead to managers favoring corporate law with inefficient redistributive rules. See Winter, *Race for the Top Revisited*, *supra* note 3, at 1528 (acknowledging that there are "cases in which management may seek legal rules allowing side payments where those payments outweigh the negative effects of the capital market"); EASTERBROOK & FISCHEL, *ECONOMIC STRUCTURE*, *supra* note 3, at 217 ("once they are ensconced, and have raised the capital the firm needs, managers may elect to behave opportunistically"); Fischel, *supra* note 3, at 918 ("In any agency relationship—such as the relationship between shareholders and managers—the interests of the agent will diverge from those of the principal.").

⁶⁰ See EASTERBROOK & FISCHEL, *ECONOMIC STRUCTURE*, *supra* note 3, at 213.

⁶¹ See Romano, *The Need for Competition*, *supra* note 3, at 493-94; see also Romano, *Empowering Investors*, *supra* note 3, at 2416-17 (arguing that a requirement of shareholder approval protects shareholders from a migration from a superior regime to an inferior one); *id.* at 2415-16 (suggesting that a requirement of voting approval by securities holders for a domicile change could protect investors under a regulatory competition system for securities law).

⁶² See, e.g., ROMANO, *THE GENIUS*, *supra* note 3, at 75; Romano, *Empowering Investors*, *supra* note 3, at 2384 n.77; Romano, *The Need for Competition*, *supra* note 3, at 506.

⁶³ See, e.g., Fischel, *supra* note 3, at 922.

⁶⁴ Roberta Romano found that a responsiveness of a state to corporations' needs is positively correlated to the percentage of state revenues comprised by the franchise tax. See Romano, *Law as a Product*, *supra* note 3, at 233.

⁶⁵ See Winter, *Shareholder Protection*, *supra* note 3, at 291 ("Because federal legislation does not face direct competition with other legal systems, the behavior of investors under differing rules cannot be observed and we can only theorize about which rules optimize the underlying economic relationships.").

⁶⁶ See ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION*, 206-07 (2003).

which include economic barriers to entry,⁶⁷ network externalities,⁶⁸ and political obstacles,⁶⁹ Delaware does not face serious competitive threats. Hence, there is no race to the top or the bottom; rather, the dominant state Delaware takes a “leisurely walk” toward a corporate law that protects its market power and enhances its revenues. The result of this “leisurely walk” is a corporate law of suboptimal quality and pro-managerial bias.

This literature also has important implications for the assessment of the market for corporate law. First, the race to the bottom concerns do not disappear under the weak competition view. Scholars advancing this view argue that the corporate law of Delaware and the rest of the states at equilibrium would not optimally protect shareholders from managerial opportunism.⁷⁰ Some have even suggested that the managerial bias would be larger than under a market that was truly competitive.⁷¹

With respect to the effects of Delaware market power on issues that do not involve conflicts of interest between managers and shareholders, scholars are divided. All scholars agree that Delaware might adopt inefficient strategies to preserve, reinforce, and exploit its market power. Beyond that, however, Marcel Kahan and Ehud Kamar have suggested that Delaware might have significant incentives to invest in the quality of its law and in legal innovations, in some cases even stronger incentives than it would have if states were competing among themselves.⁷² Lucian Bebchuk and Assaf Hamdani, on the other hand, have voiced the concern that Delaware has suboptimal incentives to invest in its corporate law and improve it.⁷³ Inefficiencies might occur, Bebchuk and Hamdani argue, because a monopolist, in deciding which level of quality to produce, considers the preferences of the marginal consumer, which is rarely also the representative consumer.⁷⁴ Second, they suggest, Delaware’s monopolistic power provides it with a range of suboptimal behavior that would not hurt its dominant position.⁷⁵ Indeed, empirical studies show that monopolists tend to be less efficient than firms in competitive markets.⁷⁶

Lastly, the concern that Delaware would not perform optimally as to issues that do not involve conflicts of interests between managers and shareholders also arises because of the significant network externalities exhibited by Delaware law. Network externalities exist when the value of a product to consumers increases with the number of consumers who use that

⁶⁷ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 585-95.

⁶⁸ See Klausner, *supra* note 11; Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 586-88.

⁶⁹ See Kahan & Kamar, *The Myth*, *supra* note 5, at 727-34.

⁷⁰ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 599-601; Kahan & Kamar, *The Myth*, *supra* note 5, at 735-42.

⁷¹ See Kahan & Kamar, *The Myth*, *supra* note 5, at 735-42.

⁷² See *id.* at 742 (“Because monopolists reap the full benefit of their innovative efforts without sharing it with imitators, they innovate more than producers in a competitive market.”).

⁷³ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 596-99.

⁷⁴ *Id.* at 596-97; see also Michael A. Spence, *Monopoly, Quality & Regulation*, 6(2) BELL J. ECON. 417-29 (1975) (constructing a model that demonstrates this problem); TIROLE, *supra* note 11, at 100-01 (1988) (describing Spence’s results).

⁷⁵ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 597-99.

⁷⁶ See *id.* at 596-97.

product.⁷⁷ In an important article, Michael Klausner discusses the role of network and learning externalities in the production of corporate law.⁷⁸ Corporate law, Klausner argues, exhibits network externalities for several different reasons,⁷⁹ the main one being that the uncertainty involved in a contract term depends directly on the frequency with which this term is expected to be litigated. High frequency of litigation reduces uncertainty as to the interpretation of the term by the courts. Consequently, every firm that uses such terms, essentially increasing the likelihood that such a term will be litigated, provides “interpretive network externalities” for its peers.⁸⁰ In addition, a firm also provides “common practice network externalities” by increasing the quantity of future business practices to be analyzed by courts, which further reduces the uncertainty involved with such terms. Furthermore, a wide adoption of corporate law terms ensures familiarity with such terms by providers of legal and financial services, which in turn leads to lower costs associated with providing those services.⁸¹

Network externalities ensure that even if another state were to replicate Delaware’s judicial system, its success in attracting corporations would be doubtful. To accumulate the network externalities associated with incorporation in Delaware, a competing state would have to attract a large number of firms from Delaware.⁸² Uncertainty and delay might impede a states’ ability to attract the critical mass of firms essential to producing network externalities.⁸³ As a result, states’ charters may suffer from a lock-in effect so that both Delaware and other states are likely to become lax in maintaining and improving the quality of their law.⁸⁴

4. Race with the Federal Government

In a recent work, Roe develops a new theory, arguing that Delaware’s real competition comes from the federal government rather than the rest of the states.⁸⁵ As Roe demonstrates, federal authorities have displaced states’ corporate law on a set of important issues.⁸⁶ To mention a few of examples: in the 1930s federal securities laws took voting from the states, in the 1960s Congress sought to limit takeovers with the Williams Act, states’ first

⁷⁷ See Joseph Farrell & Garth Saloner, *Installed Base and Compatibility: Innovation, Product Preannouncements, & Predation*, 76 AM. ECON. REV. 940 (1986) [hereinafter Farrell & Saloner, *Installed Base*]; Joseph Farrell & Garth Saloner, *Standardization, Compatibility & Innovation*, 16 RAND J. ECON. 70 (1985); Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, & Compatibility*, 75 AM. ECON. REV. 424, 424-25 (1985).

⁷⁸ See Klausner, *supra* note 11.

⁷⁹ See *id.* at 778-79; see also Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, 750-51, 760-61 (1997).

⁸⁰ See Klausner, *supra* note 11, at 778-79; see also Kahan & Klausner, *supra* note 76, at 726.

⁸¹ Klausner, *supra* note 11, at 782-86.

⁸² *Id.* at 846-47.

⁸³ *Id.* at 849-50.

⁸⁴ *Id.* at 850.

⁸⁵ See Roe, *supra* note 5.

⁸⁶ *Id.* at 600-11.

generation antitakeover statutes were preempted by the federal court decision in *Edgar v. MITE, Corp.* and, most recently, as a response to corporate scandals, Congress adopted the Sarbanes-Oxley Act, which intrudes upon state corporate law.⁸⁷

Delaware has a lot to lose from federalization of corporate law and, as Roe demonstrates, designs its law with that risk in mind. For instance, during the 1980s the federal government was pro-takeover and, correspondingly, Delaware did not adopt strong antitakeover rules as other states did. When the federal government authorities left the field in the 1990s, Delaware's decisions became more pro-managerial.⁸⁸ Neither of the race theories, Roe argues, could explain these developments in Delaware antitakeover law.⁸⁹ "If Delaware was racing to the top by providing pro-shareholder takeover law in the 1980s, why did it stop racing by 1990? And if Delaware usually races to the bottom, pandering to managers, why did it take so long for it to get there for takeovers?"⁹⁰ Interstate competition might pressure Delaware, according to Roe's theory, to adopt strong antitakeover rules like the ones adopted by other states. Yet, "[f]or most of the 1980s, Delaware had as much reason to fear ouster from the federal authorities as it had to fear not meeting competition from the anti-takeover Rust Belt states."⁹¹ Since none of the theories included the federal vector in its account, the debate "has been and must be inconclusive."⁹²

Roe's "federal competition" theory has important implications for both race to the top and race to the bottom theories and for developments in Delaware law. In particular, if it is shown that Delaware law is efficient, it is not necessarily a result of a race to the top. If it shown that Delaware law is inefficient, it is not necessarily a result of a race to the bottom.⁹³ Instead, the development of corporate law in the U.S. is a result of a race with a threat of federal intervention. Delaware law, according to this theory is shaped both by interstate pressure and by the threat of federal intervention. When the federal actors are out, Delaware law might tilt toward managers, when the federal actors are in, Delaware law will reflect the federal environment. Accordingly, as a result of recent corporate scandals, "[o]ne would expect Delaware corporate institutions to get tough with insiders, controllers, and incumbents just as they did in the late 1970s and early 1980s."⁹⁴

C. *Current Views and the Evidence*

This subsection assesses the four views outlined above in light of the

⁸⁷ *Id.* at 632.

⁸⁸ *Id.* at 625-27.

⁸⁹ *Id.*

⁹⁰ *Id.* at 625.

⁹¹ *Id.* at 627.

⁹² *Id.* at 634.

⁹³ *Id.* at 635-37.

⁹⁴ *Id.* at 643.

currently available evidence. The last decade has seen the emergence of empirical studies using quantitative methods to assess the desirability of the current system. As will be shown, although each theory is supported by and is able to explain some of the empirical evidence, none accounts for the entire body of empirical evidence. As will be discussed later in the article, price considerations analysis complements each of the theories discussed below and helps provide a better explanation for the available empirical evidence than the existing theories do by themselves. However, price considerations analysis does not supplant these other theories; rather, it is a complementary consideration that helps make each of the other theories more complete when included in the overall analysis.

1. Race to the Top

Early empirical research supporting the race to the top view focused on stock price reactions to reincorporation decisions. Event studies demonstrated that reincorporation to Delaware resulted in a positive stock price reaction.⁹⁵ If reincorporation benefits shareholders, it was argued, then the current system must on average benefit shareholders.⁹⁶ Later studies showed that companies incorporated in Delaware enjoy higher Tobin's Q ratios and are more likely to be the target of takeover bids or acquisitions compared to companies incorporated elsewhere. If similar assets are worth more when governed by Delaware law, the argument continues, then Delaware corporate law must be superior and the race Delaware leads must be to the top. Lastly, race to the top proponents stress that Delaware's antitakeover law is relatively mild.⁹⁷

This evidence, under this view, tilts the balance in the debate in favor of the race to the top account.⁹⁸ Indeed, the fact that a state that produces

⁹⁵ See, e.g., Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1 (1989); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" vs. Federal Regulation*, 53 J. BUS. 259 (1980); Randall A. Heron & Wilbur G. Lewellen, *An Empirical Analysis of the Reincorporation Decision*, 33 J. FIN. & QUANTITATIVE ANALYSIS 549 (1998); Allen Hyman, *The Delaware Controversy—The Legal Debate*, 4 J. CORP. L. 368 (1979); Jeffery Netter & Annette Poulsen, *State Corporation Laws and Shareholders: The Recent Experience*, 18 FIN. MGMT. 29 (1989); Pamela Peterson, *Reincorporation Motives and Shareholder Wealth*, 23 FIN. REV. 151 (1988); Romano, *Law as a Product*, *supra* note 3.

⁹⁶ See, e.g., Romano, *Empowering Investors*, *supra* note 3, at 2383-87; Romano, *The Need for Competition*, *supra* note 3, at 494-505.

⁹⁷ See Romano, *The Need for Competition*, *supra* note 3, at 530-37 (arguing that race to the bottom proponents have not adequately addressed the fact that "the state with the largest stake in the chartering business, stands out as an anomaly in the pattern of takeover legislation"); Romano, *Competition for Corporate Charters*, *supra* note 20, at 858-59 (emphasizing that Delaware's antitakeover law is less draconian than the antitakeover law in some other states, such as Pennsylvania, and that Delaware was not the leader but the follower in adopting antitakeover rules); EASTERBROOK & FISCHER, *ECONOMIC STRUCTURE*, *supra* note 3, at 222-23 (stressing that Delaware antitakeover law is relatively mild); Winter, *Shareholder Protection*, *supra* note 3, at 289 (same).

⁹⁸ See Romano, *The Need for Competition*, *supra* note 3, at 497 (concluding that the findings of the event studies, "in my judgment, are compelling evidence that competition benefits shareholders"); Sanjai Bhagat & Roberta Romano, *Event Studies & the Law: Part II—Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 384 (2002). ("One certainly cannot read the event study literature and conclude that firms reincorporating are reducing their shareholders' wealth, as critics of the "race

relatively mild takeover law happens to attract most of the corporations in the market seems to indicate that the current system rewards states for, and provides them with the right incentives to, adopt efficient corporate laws.

At the same time, however, states produce laws that cannot be considered the result of a race to the top. Most notably, the proliferation of antitakeover statutes among states troubles race to the top scholars, since they believe that the market for corporate control is an important force that should not be limited.⁹⁹ Moreover, empirical studies support the view that takeover laws are inefficient, in that such studies have found either no price reactions or negative price reactions to their adoption.¹⁰⁰

Even more problematic for race to the top proponents, recent empirical studies show that states that offer strong antitakeover statutes are not penalized but rather rewarded, since they attract more incorporations in the market for corporate law.¹⁰¹ Puzzlingly, these results seem to indicate that the current system does not reward, but instead penalizes, states for adopting efficient rules, and that it, therefore, induces states to enact strong antitakeover laws.

2. Race to the Bottom

Following Cary, the race to the bottom literature addresses the empirical evidence analyzed by race to the top proponents. With regards to the findings about higher Tobin's Q ratios for Delaware corporations, it has been suggested that these differences could arise not from the superiority of Delaware's substantive corporate law but rather from competitive advantages Delaware's corporate law system enjoys over those of other states.¹⁰² The empirical evidence, it is argued, merely shows that Delaware's corporate law system is better than that of the other states. Since Delaware enjoys substantial advantages over the other states, it could

to the top" theory contend."); EASTERBROOK & FISCHER, *ECONOMIC STRUCTURE*, *supra* note 3, at 214-15 ("Empirical studies confirm the force of competition. These findings of the empirical literature fatally undermine the 'race to the bottom' position . . .").

⁹⁹ See, e.g., Winter, *Shareholder Protection*, *supra* note 3, at 288.

¹⁰⁰ See, e.g., Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second- Generation State Takeover Legislation*, 25 J. FIN. ECON. 291 (1989). For a survey of these studies, see ROMANO, *THE GENIUS*, *supra* note 3, at 62-66.

¹⁰¹ Two works, one by Lucian Bebchuk and Alma Cohen and the other by Guhan Subramanian, investigate the performance of non-Delaware states in the market. See Bebchuk & Cohen, *supra* note 2; Subramanian, *Incorporation Choice*, *supra* note 2. They concluded that those states that adopted takeover rules hospitable to managers did better in terms of maintaining their in-state corporations and attracting out-of-state incorporations. There is one exception to this rule. The most extreme antitakeover statutes hurt the ability of states to retain firms in the Subramanian study but not in the Bebchuk and Cohen study. See Bebchuk & Cohen, *supra* note *supra* note 2, at 23-25; Subramanian, *Incorporation Choice*, *supra* note 2, at 1857-64. Bebchuk and Cohen get different results because, unlike Subramanian, they use separate dummies for the recapture and the staggered board statutes and also control for state characteristics. In addition, Robert Daines did not find that antitakeover rules affect firms decisions about where to incorporate. Daines, however, focused only on IPO firms. See Daines, *IPO Firms*, *supra* note 2.

¹⁰² See Bebchuk & Ferrell, *New Approach*, *supra* note 4; see also Bebchuk et al., *supra* note 4, at 1799 (suggesting that reincorporation to Delaware often provides additional value due to advantages not reflected in Delaware's substantive legal rules).

be that competition drives all states to produce inefficient corporate laws, but that Delaware's advantages make it more attractive than other states.¹⁰³ In addition, the data unaccounted for by race to the top view, namely, that the market rewards states that adopt strong antitakeover laws, essentially supports the race to the bottom view.¹⁰⁴

Some data, however, is hard to reconcile with this view, most notably Delaware's relatively mild antitakeover law. It is still unclear why Delaware does not strengthen its antitakeover law in order to attract more incorporations.¹⁰⁵ Such an explanation is needed, especially in light of the findings that antitakeover laws help in attracting out-of-state and retaining in-state corporations. If the race to the bottom proponents' assumption as to Delaware's motivations is complete, Delaware could increase the number of incorporations by strengthening its antitakeover law. First, by strengthening its antitakeover law, Delaware might attract more firms from their home states. Second, some firms choose not to incorporate in Delaware or in their home state.¹⁰⁶ Typically, such firms choose to incorporate in states with strong antitakeover protection. It seems plausible to contend, therefore, that firms of this type prefer other states to Delaware because of the stronger antitakeover devices they offer. Delaware could attract these firms if it offered them comparable, more potent antitakeover law. It is not apparent, therefore, why Delaware does not adopt at least some of these antitakeover devices.

3. Weak Competition

The first puzzle for the literature focusing on Delaware's market power is Delaware's market share. In particular, if so many firms find Delaware attractive, it is not clear why many other firms do not. If Delaware law improves firm value all firms would be expected to move to Delaware.¹⁰⁷ By doing so, firms could increase their value in an amount

¹⁰³ In a different article, Bar-Gill, Bebchuk, and I construct a model that demonstrates formally how Delaware's superiority might stem from its institutional advantages. See Bar-Gill, Barzuza & Bebchuk, *supra* note 4.

¹⁰⁴ See Bebchuk & Cohen, *supra* note 2, at 409-17 (showing that the stronger the antitakeover protections offered were, the more successful the state was both in retaining in-state corporations and in luring reincorporations).

¹⁰⁵ For a detailed discussion on the relative mildness of Delaware's antitakeover law, see *infra* section IV.B.1. Bebchuk, Cohen, and Ferrell respond to this argument by first claiming that Delaware's substantive corporate law is in fact no better than the one in many other states. See Bebchuk et al., *supra* note 4, at 1803-04. Bebchuk, Cohen, and Ferrell further argue that even if Delaware law were better than other states' law, it would still not follow that competition is desirable. *Id.* at 1797-98. It might still be the case that competition pushes states to the bottom with the victorious states providing slightly better law than the rest. They do not explain, however, why this should be the case. This paper supports their argument and provides a theoretical justification to it.

¹⁰⁶ See Subramanian, *Incorporation Choice*, *supra* note 2, at 1816 fig.3 (finding that ten percent of the non-financial companies in his sample are incorporated neither in their home state nor in Delaware).

¹⁰⁷ See Bebchuk et al., *supra* note 4, at 188; Robert Daines found that Delaware incorporation was associated with an increase in Tobin's Q of 0.07 in 1996 which translates to an approximate five percent increase in value. In some of the other years in Daines' sample the increase was even higher. For instance, in 1986 and 1993 a Delaware incorporation was associated with an increase in Tobin's Q

that substantially outweighs the incorporation and franchise tax that they would pay in Delaware.

Since non-Delaware firms often choose to incorporate in their home state, scholars have attempted to explain the special tie firms seem to have with their home states. Among the factors they have identified are the higher costs of incorporation in Delaware, the ability to have political influence in the home state, and the influence of local law firms on the incorporation decisions.¹⁰⁸ However, not all of the cases could be explained by these factors. In particular, large firms, for which the costs of incorporating in Delaware are less significant, and which use the services of national law firms, sometimes choose to remain in their home state.¹⁰⁹ Moreover, all studies indicate that in general the home state bias is stronger in states with strong antitakeover laws than in states with weaker ones.¹¹⁰ Why then does Delaware attract only part of the market? Assuming that the answer lies in its antitakeover law, why does Delaware not strengthen it?¹¹¹

A second puzzle relates to the argument that, as a result of significant market power and network externalities, Delaware has weak incentives to invest in the quality of its corporate law. An examination of Delaware's behavior does not sustain this argument. In a seminal work, Romano found a correlation between the percentage of state franchise tax revenue to a state's total revenue and the responsiveness and speed of the state in designing and enacting legal innovations. Among all of the states, Delaware has the highest ratio and, accordingly, the highest responsiveness.¹¹² Moreover, despite the weak competitive threats that it

of 0.14. See Daines, *Firm Value*, *supra* note 2, at 533-35 & tbl.3.

¹⁰⁸ See Bebchuk & Cohen, *supra* note 2, at 8-14.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* at 14-26; see also Subramanian, *Incorporation Choice*, *supra* note 2, at 1857-64. Robert Daines did not find that antitakeover rules affect firms' decisions about where to incorporate. Daines's study, however, focused only on IPO firms, in which there is no conflict of interest between shareholders and managers. See Daines, *IPO Firms*, *supra* note 2.

¹¹¹ In their recent article, Kahan and Kamar suggest an alternative explanation for Delaware's relatively mild antitakeover law. According to their explanation, Delaware positions its product optimally relative to those of other states. Kahan & Kamar, *The Myth*, *supra* note 5, at 739-40. They suggest that "[b]ecause many noncompeting states had adopted antitakeover statutes, Delaware had to follow in order not to antagonize managers." *Id.* at 740. "But because, unlike noncompeting states, Delaware also had an interest in not antagonizing shareholders of companies that it might attract from other states or from the pool of companies that would go public, it passed a milder statute." *Id.* Yet, as other scholars have pointed out, shareholders might choose to incorporate in Delaware even if it adopted strong antitakeover rules, since Delaware has other benefits that it offers them, which may compensate them for the costs imposed by its pro-managerial rules. In fact, Delaware might attract shareholders even if it offered them antitakeover rules that are stronger than the ones offered by each of the other states. Thus, if Delaware were aiming to attract incorporations, as Kahan and Kamar suggest, it would produce rules that cater to all of the managers in the market rather than only to part of them, as long as the costs of these rules do not outweigh the value generated from its competitive advantages. Clearly, since Delaware charges a significant price, the value generated from its advantages significantly outweighs the costs from the pro-managerial bias in its rules. Yet, Delaware chooses to attract only part of the market and, therefore, essentially does not maximize the number of incorporations. Kahan and Kamar's analysis therefore does not account for the relative mildness of Delaware antitakeover law.

¹¹² See Romano, *Law as a Product*, *supra* note 3, at 2340. In fact, Delaware lagged behind only with respect to changes that were not considered to add value to the firm, such as changes in antitakeover laws. See Romano, *Empowering Investors*, *supra* note 3, at 2386 ("In contrast to its position as an innovator in corporation code provisions, in the takeover context Delaware was a

faces, Delaware invests significant efforts and money in providing services of high quality for its firms.¹¹³

4. Race with the Federal Government

Roe's theory provides a strong explanation as to why Delaware did not strengthen its antitakeover law during the 1980s. The pro-takeover federal environment kept Delaware on the mild side. During the 1990s, there was a shift in the federal government's view, and Delaware, which could suddenly "breathe more freely,"¹¹⁴ strengthened its antitakeover law in favor of managers.

Setting price considerations aside, federal theory, although it explains many of Delaware choices, does not explain everything. First, Delaware law remained mild relative to other states even during the 1990s.¹¹⁵ If there was no threat during these years, one would expect Delaware to strengthen its antitakeover law further. It seems, therefore, that the fear of federal intervention is not the only constraint that Delaware faces. More importantly, according to this theory we would expect to sometimes see Delaware being more pro-managerial than other states. Federal authorities are affected by two conflicting considerations. On the one hand, federal authorities are concerned with the management of the economy and the protection of shareholders. On the other hand, however, they are affected by interest group pressure. The fear of federalization of corporate law, therefore, could affect Delaware to race either to the top or to the bottom, either toward shareholders or toward managers.¹¹⁶ Yet, since Delaware's pro-managerial tendency, as explained before, is consistently restrained relative to other states, there must be another factor, in addition to the fear of federal intervention, that restrains Delaware from catering to managers' interests.

D. *The Assumption that Delaware Maximizes the Volume of Incorporations*

The previous sections have shown that, even though each of the current theories is sustained by some of the evidence, none of them seems

laggard behind other states, and its regulation is considerably less restrictive of bids"). Klausner himself found Delaware's high responsiveness puzzling in light of his analysis. See Klausner, *supra* note 11, at 850 n.283. As explained above Kahan and Kamar partly solve this puzzle by suggesting that Delaware's incentives to invest in quality and to innovate are higher than they would be if states were competing with each other. See *supra* note 69. One still needs to explain, however, how it is that Delaware is so responsive given the significant network externalities associated with its law.

¹¹³ For a detailed description of Delaware investments in its business, see *infra* section IV.C.

¹¹⁴ See Roe, *supra* note 5, at 642-43.

¹¹⁵ See discussion *infra* section IV.B.1.

¹¹⁶ See Roe, *supra* note 5, at 634-35 ("[W]e cannot tell whether the big issues that remained with the states and were resolved with efficient rules were shaped by the federal government's good influence . . . we cannot tell whether the big ones that remained and were resolved with inefficient rules were shaped by the federal government's pernicious influence.").

to explain the body of empirical evidence as a whole. Even more puzzling, the evidence seems to include several contradictions. This section will describe the assumption that is central to these theories and, as will be argued later, is the source of the seeming incompatibility between the theory and the evidence.

While commentators continue to disagree about the desirability of the current system, they generally share the assumption that Delaware designs its law with the goal of maximizing the number of incorporations,¹¹⁷ as more incorporations are thought to bring with them more revenues to the state.¹¹⁸

To start with, this assumption is an important building block in the race to the bottom theory. For instance, Bebchuk, a prominent race to the bottom scholar, asserts that states' corporate "law is shaped by states' desire to attract incorporations."¹¹⁹ Building on this assumption, he predicts that Delaware would cater to managers' interests. In a later article that further develops the race to the bottom view, Lucian Bebchuk and Allen Ferrell similarly assume that "[states] are interested in maximizing the number of companies that are incorporated there."¹²⁰ The desire to maximize incorporations is a source of inefficiency under the race to the bottom view. To that end, given managers' power over reincorporation decisions, Delaware must cater to managers' interests. Indeed, they argue, this desire has led Delaware to offer strong antitakeover law that excessively protects managers.¹²¹

The recent literature on the market for corporate law also does not consider the ways in which price considerations, as opposed to volume maximization, may affect Delaware's choices in choosing between shareholders' and managers' interests. In their recent article, Kahan and Kamar seem to take into account price considerations in suggesting that even in the absence of competition Delaware can benefit from increasing the quality of its law and investing in innovations.¹²² In that respect, Kahan and Kamar's analysis is reconcilable with the view in this article and the analysis in section III.E builds on theirs and complements it. Yet, they do not challenge the conventional wisdom that quantity always contributes to Delaware revenues. In particular, in discussing Delaware's choice between managers and shareholders, an issue which is in the heart of the race debate and that raises the tension between price considerations and quantity, Kahan and Kamar stick to the widely held assumption that Delaware "aims to

¹¹⁷ See sources cited *supra* note 11.

¹¹⁸ Romano, *Law as a Product*, *supra* note 3, at 228; see also Bebchuk, *Desirable Limits*, *supra* note 4, at 1451 (arguing that states have an interest in increasing in-state incorporations because "[i]ncorporations bring with them franchise tax and fee revenues as well as patronage for in-state law firms, corporation service companies, and other businesses"); Choi & Guzman, *Portable Reciprocity*, *supra* note 11, at 906.

¹¹⁹ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1455.

¹²⁰ See Bebchuk & Ferrell, *New Approach*, *supra* note 4, at 133.

¹²¹ See Bebchuk & Ferrell, *The Race to Protect Managers*, *supra* note 4.

¹²² Similarly, Kamar also included price considerations in showing how Delaware might incorporate excessive indeterminacy to its law in order to raise the costs for other states to emulate its law. "As long as the relative value of Delaware law rises, Delaware's equilibrium price and market share—and hence its profit—increase." See Kamar, *supra* note 5, at 1931.

attract incorporations”¹²³ and suggest that “[b]ecause both managers and shareholders influence incorporation decisions, Delaware can benefit from designing its product to be attractive, if not equally so, to both shareholders and managers of as many [corporations] as possible”¹²⁴ Bebchuk and Hamdani similarly suggest that Delaware caters to managers’ interests since this strategy is useful both to retaining existing incorporations and to attracting reincorporations, that is, to maximize the number of incorporations in the state.¹²⁵

Interestingly, race to the top scholars also do not challenge the assumption that Delaware designs its law with the exclusive goal of attracting the maximum amount of incorporations. Romano, one of the most influential writers on the market for corporate law, states explicitly that the common assumption is that the “objective of states is revenue maximization, which is thought to depend directly upon the volume of domestic incorporations.”¹²⁶ Unlike race to the bottom scholars, for race to the top scholars the desire to maximize the volume of incorporations is a source of efficiency. Since Delaware maximizes the number of incorporations, the argument goes, it has incentives to produce an efficient corporate law rather than a pro-managerial one. Exploiting shareholders, whose approval is required for reincorporation, would decrease Delaware’s ability to attract firms.

Lastly, the analysis of the effects of network externalities on Delaware law also implicitly assumes that Delaware wishes to maximize only the number of incorporations that it attracts. Leaning on this premise of volume maximization, Klausner argues that Delaware might produce suboptimal law.¹²⁷ As a result of network externalities, he argues, firms might not leave Delaware even if other states were offering them an inherently better product.¹²⁸ Consequently, Delaware does not need to make a significant effort to attract and retain firms—a limited effort suffices.¹²⁹ According to this analysis, Delaware’s choices about whether

¹²³ Kahan & Kamar, *The Myth*, *supra* note 5, at 739.

¹²⁴ *Id.* at 739-40.

¹²⁵ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 599-600 (arguing that to retain and attract corporations Delaware has incentives to offer rules that favor managers). This assumption, though less important to its conclusions, also underlies implicitly the recent analysis that argues that Delaware designs its law in light of a concern that it could trigger federal intervention. In analyzing Delaware behavior during the 1980s, Mark Roe suggests that Delaware’s antitakeover law cannot be explained by race theories but only by the fear of federal intervention. Assuming that Delaware maximizes the volume of incorporations, Delaware’s choices with respect to its antitakeover law cannot be explained by either of the race theories. But, as shown in Part III, if one assumes that Delaware also takes into account how the design of its laws will affect the price it can charge, its behavior is explainable even without a threat of federal intervention.

¹²⁶ Romano, *Law as a Product*, *supra* note 3, at 228; See also Romano, *Need for Competition*, *supra* note 3, at 511 (noting that the data “suggesting that states are competing for domestic incorporations”); Romano, *Empowering Investors*, *supra* note 3, at 2361 (stating that “the fifty states and the District of Columbia compete for the business of corporate charters”). In addition, in replying to assertions of the race to the bottom school race to the top proponents did not suggest that adopting inefficient law might require Delaware to reduce its price but only that adopting such law will result in Delaware losing firms to other states.

¹²⁷ See Klausner, *supra* note 11, at 849-50.

¹²⁸ See *id.*

¹²⁹ *Id.*

or not to invest in innovations and modifications depend solely on the potential contribution of such investment to the number of incorporations in Delaware.

Contrary to this dominant assumption, the following part of this article argues that Delaware revenues are affected not only by volume considerations but also by price considerations and that these considerations are sometimes in opposition to each other. As shown below, the recognition of this tension leads to a different analysis of the market for corporate law, one which helps in explaining the evidence, accounting for Delaware's behavior, and solving the puzzles described in this part.

III. TOWARD A NEW THEORY: PRICE CONSIDERATIONS IN THE MARKET FOR CORPORATE LAW

This Part develops an economic analysis of price considerations in the market for corporate law to show exactly how the different components of Delaware's strategy affect the price it is able charge and generates testable predictions regarding the way these considerations affect Delaware revenues. Such an analysis is needed since, as shown below, the market for corporate law contains specific supply side and demand side characteristics that do not allow for a straightforward application of existing models from the economic literature. After developing the analysis, the next Part then investigates to what extent Delaware choices conform to the price considerations analysis.

To develop the analysis, sections A and B of this Part present the assumptions that underlie the analysis. Section A describes states motivation on the supply side. Section B describes the features of the demand side. It discusses the reasons for the divergence between shareholders' and managers' interests and explains why managers are heterogeneous in their preferences toward extracting private benefits. Section C analyzes the way price considerations could affect Delaware's choices between shareholders' and managers' interests. It shows that a profit-maximizing strategy would require a balancing of managers' and shareholders' interests. In order to attract firms from other states and initial incorporations, Delaware must reduce its price to reflect the harm that is caused to shareholders from having inefficient pro-managerial rules. Consequently, since it observes demand from managers with varying preferences, Delaware faces a trade-off between managers and shareholders and, accordingly, between quantity and price, with price considerations inducing Delaware to cater to shareholders' interests while at the same time quantity maximization considerations inducing it to cater to managers' interests. Section D explains why the suboptimal quantity that typically results from monopolists' price considerations is not a concern in this case. Section E discusses the ways in which price considerations affect Delaware's choices with respect to issues that do not involve conflicts of interest between managers and shareholders. It contends that price considerations should induce Delaware to improve the quality of its

corporate law, notwithstanding the presence of network externalities. Finally, section F addresses possible objections and discusses limitations to the price considerations analysis.

A. *On the Supply Side*

1. What Does Delaware Maximize?

The initial assumption of scholars from all sides of the debate has been that Delaware maximizes the significant revenues that it makes from incorporations.¹³⁰ There is no doubt that the revenues stemming from incorporations serve as an important source of incentives to the state. Delaware revenues from its franchise tax amount to approximately twenty percent of its total revenues. In per capita terms, Delaware's franchise tax revenues constitute an annual income of \$3,000 for every family of four.¹³¹ Recently an increase in the franchise tax was a major source to cover the expected deficit in the state's 2004 budget.¹³²

It has also been recognized, however, that there are limitations to the desire to maximize pure revenues. To start with, unlike a typical producer, Delaware charges its price principally through its franchise tax law. The franchise tax law is not as flexible as a price in the market. Delaware has not changed its franchise tax structure since 1937 and traditionally updates its rates no more than once every decade. As shown in section IV.A.3 below, this reluctance to deviate from past practices might result in a lower price and fewer revenues to the state. For several reasons Delaware might choose not to change its franchise tax structure, update its rates more frequently or simply increase its rates beyond a certain level.¹³³ For instance, different constituencies in Delaware—like the Delaware bar, which has substantial influence on the design of Delaware law—might be interested in having a low tax that would bring more incorporations to the state.¹³⁴ In addition, lack of information and career concerns might lead officials not to make significant changes to the franchise tax structure.¹³⁵ Moreover, officials might be more interested in retaining revenues than in maximizing them.¹³⁶ Lastly, other considerations such as a concern about

¹³⁰ See, e.g., Romano, *Law as a Product*, *supra* note 3, at 228.

¹³¹ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 556.

¹³² See sources cited *infra* note 214.

¹³³ See Bar-Gill, Barzuzza & Bebchuk, *supra* note 4 (demonstrating that Delaware price is constrained both for strategic and political reasons); Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1229 (suggesting that “political considerations induce Delaware not to increase its franchise-tax rates”).

¹³⁴ See Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 503-04 (1987). Similar arguments apply to registered agents and business owners in Delaware to the extent that these groups influence the tax rates.

¹³⁵ An official who deviates from past precedents is more likely to be held liable for unsuccessful consequences than one who simply followed tradition.

¹³⁶ See GILLIAN HADFIELD & ERIC L. TALLEY, ON PUBLIC VERSUS PRIVATE PROVISION OF CORPORATE LAW (2004) (working paper), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=570641 (suggesting that legislators generally

federal intervention or just a desire not to be perceived as rapacious might limit Delaware's ability to increase its price.¹³⁷

The analysis put forward here, therefore, does not assume that Delaware maximizes revenues. Rather, for the purpose of our analysis, it is sufficient to assume that other things being equal Delaware legislature is interested in maintaining its dominant position and the significant profits that it makes from its incorporation business or, at the very least, that Delaware is interested in maintaining its position and the current price that it charges.¹³⁸ Indeed, since it first adopted the current structure of its franchise tax, more than six decades ago, Delaware has never reduced its franchise tax rates.¹³⁹

This is not to say, however, that the Delaware bar or Delaware judges operate with the same goal in mind, namely to maintain Delaware price and revenues. Yet, the bar influence on the tax is limited. Interestingly, unlike general amendments to Delaware corporate law that are generally drafted and need to be approved by the Corporation Law Council, amendments to franchise taxes and fees are typically initiated by the Office of the Secretary of State and the Governor and are subject to approval only by the Delaware General Assembly.¹⁴⁰ Once the price is set the Delaware bar needs to take it into account when it exercises its influence on Delaware corporate law. Designing a law while ignoring this price would lead Delaware to lose its firms and its dominant position. As for Delaware judges, as will be shown later, for several reasons the law that they produce corresponds to the price considerations analysis even if not intentionally so. The analysis therefore explains why their decisions are rarely being overridden.¹⁴¹

maximize their reelection prospects rather than revenues to the state). See also Robert H. Sitkoff, *Corporate Political Speech, Political Extortion, and the Competition for Corporate Charters*, 69 U. CHI. L. REV. 1103, 1143-44 (2002) (suggesting that "individual legislators cannot fully internalize the benefits of increased tax revenues, which are in effect a public good"). Another version of this argument suggests that a state prefers not to raise taxes if it is not necessary. See Interview with David Singleton, Secretary of Finance, Delaware Divisions of Corporations (Mar. 12, 2004). Note, however, that increasing franchise tax rates could help Delaware to decrease taxes collected from its citizens.

¹³⁷See Interview with David Singleton, *supra* note 136. There is an additional argument for why Delaware would not want to raise its price even if such a step could increase its revenues. To some extent it is beneficial for the state to have various sources of income. Delaware does not want its tax to comprise too large a part of its revenue, as it might adversely affect its rating with the rating agencies. See Interview with David Singleton, *supra*; see also Triple-A Bond Rating Reaffirmed by Wall Street for the Fifth Consecutive Time: Delaware only One of Seven States to Have a Triple-A Rating (Jan. 6, 2004) (statement of Governor Ruth Ann Minner) ("Delaware has maintained the highest possible rating with all three nationally recognized rating agencies—Standard and Poor's, Moody's and Fitch—since the spring of 2000. Delaware is one of only seven states currently holding these top ratings."), at <http://www.state.de.us/governor/010604%20-%20aaa%20bond%20rating .shtml>. This argument however, applies only to significant increases.

¹³⁸ Under this assumption Delaware is indifferent to the possibility that some firms leave Delaware as long as it does not have to reduce its price and does not lose its dominant position.

¹³⁹ For additional data on the importance of the tax as a source of income to Delaware see discussion *infra* section IV.A.

¹⁴⁰ See E-mail from Richard J. Geisenberger (June 2, 2004) (on file with author).

¹⁴¹ For a broader discussion of the Delaware bar and judges, see *infra* sections III.F. 2-3.

2. What do other States Maximize?

States other than Delaware do not possess the market power that would enable them to charge a positive price for the incorporation of out-of-state firms. First, no other state has established a specialized court that could effectively compete with Delaware's.¹⁴² Second, no other state attracts a portion of the market that is sufficiently large to create the network benefits associated with Delaware law.¹⁴³ Political and economic barriers also make it unlikely that states would take steps in the near future to increase their market power. To start with, for many states the revenues that they derive from incorporations are only a negligible part of their annual budget and would continue to be so even if they attracted a large number of incorporations. Second, for the small states that might be motivated by the prospect of revenues from incorporations, establishing an incorporation business requires an up-front investment in a specialized court and administrative system that would not be recoverable if the state did not succeed in attracting firms from Delaware.¹⁴⁴ Furthermore, even if some other state managed to establish a similar infrastructure, in order to succeed in attracting firms from Delaware, this state would need to offer law that is significantly superior to Delaware's law.¹⁴⁵ Lastly, assuming that this state overcame these hurdles and succeeded both in establishing a legal infrastructure and in offering a superior corporate law, it is still far from clear that the endeavor would be profitable. During the time in which that state established its infrastructure and developed its corporate law, Delaware could retaliate by improving its own law to match the other state's law or by reducing its price towards its marginal cost.¹⁴⁶

Without market power, states cannot make significant financial revenues from out of state incorporations. If another state charged a positive non-negligible price, it would lose its firms either to Delaware or other states. To be sure, states are expected to enjoy market power over some firms. In particular, each state is expected to have some market power with respect to firms that are headquartered in it. Yet, states have many reasons to not charge high taxes to firms based in the state.¹⁴⁷ Indeed, the price of incorporation charged by states other than Delaware is only a nominal fee and certainly is not a price that would generate any substantial

¹⁴² See Kahan & Kamar, *The Myth*, *supra* note 5, at 708-15.

¹⁴³ While Delaware attracts more than fifty percent of the publicly traded firms in the U.S., no other states attracts more than five percent of these firms. See Subramanian, *Incorporation Choice*, *supra* note 2, at 1815 fig.2.

¹⁴⁴ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 588-89. *But see* Kahan & Kamar, *The Myth*, *supra* note 5, at 725-26 (arguing that a specialized court would not be expensive to establish).

¹⁴⁵ See Bar-Gill, Barzuza & Bebchuk, *supra* note 4, at 25-26; Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 588-89.

¹⁴⁶ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 593-95; *see also* Bebchuk & Ferrell, *New Approach*, *supra* note 4, at 154-55 (relying on this point to argue for the necessity of federal optional takeover law).

¹⁴⁷ States do not charge local companies directly for many other services and benefits they provide them with. See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 582.

revenue in excess of costs.¹⁴⁸

Even though states do not hope to make revenues from out of state incorporations, however, they might still design rules that maximize the number of in-state incorporations. First, in many states, the local bar, whose revenues increase with the number of firms, has significant influence on the design of corporate law. Second, managers, who in many states also have significant influence on the design of corporate law, press for rules that benefit them. These rules have been found to have a positive effect on the number of incorporations in a state.¹⁴⁹

As a result, although states are not likely to attempt to attract firms from Delaware, states might design law that helps in retaining incorporations as long as such strategy is supported by internal politics and does not require a significant investment.¹⁵⁰ In particular, states in which the local bar and local managers influence state politics are likely to design rules that maximize the number of in-state incorporations. Other states might choose different rules even at the cost of losing corporations.

B. *On the Demand Side: Managerial Opportunism and Heterogeneity*

1. The Interests of Shareholders and Managers are not Perfectly Aligned

Both race to the top and race to the bottom theorists agree that managers' interests are not perfectly aligned with the interests of shareholders, although they disagree about the extent to which these interests diverge.¹⁵¹ To be sure, the markets for managerial labor, corporate control, capital, and products all work to align managers' and shareholders' interests.¹⁵² However, these markets, either singly or together, can not completely eliminate agency costs. To start with, the disciplinary effects of the managerial labor market are limited. For several reasons, CEO compensation schemes are only partially sensitive to firm value, and managers' future hiring and promotion does not depend significantly on firms' performance.¹⁵³ Takeovers are costly and thus managers can extract

¹⁴⁸ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 580-81; Kahan & Kamar, *The Myth*, *supra* note 5, at 687-701 (finding that no state structures its taxes to gain significant revenues from incorporations).

¹⁴⁹ See Bebchuk & Cohen, *supra* note 2.

¹⁵⁰ Even scholars with the most skeptical views about the incentives of other states to compete do not argue that states other than Delaware would not change their rules to retain incorporations if such a change did not require a significant investment and was not expected to raise political opposition. See Kahan & Kamar, *The Myth*, *supra* note 5, at 700 (stating that "states are unlikely to take measures to retain existing incorporations that generate political opposition or involve material fiscal outlays"). It is worthwhile noting however, that this assumption is not crucial to our analysis. For a broader discussion on why the price considerations analysis applies even if states do not behave strategically, see *infra* section III.F.4.

¹⁵¹ See Bar-Gill, Barzuza & Bebchuk, *supra* note 4, at 7-9; Bebchuk, *Desirable Limits*, *supra* note 4, at 1458-68. See sources cited *supra* note 59.

¹⁵² See Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540, 543-53 (1984); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 289 (1980); Winter, *Shareholder Protection*, *supra* note 3, at 264-66.

¹⁵³ See Lucian A. Bebchuk et al., *Managerial Power and Rent Extraction in the Design of*

significant private benefits before hostile takeovers become a real threat.¹⁵⁴ Moreover, in choosing an incorporation venue, managers are expected to prefer regimes that provide them with strong antitakeover defenses.¹⁵⁵ The market for products disciplines managers only to the extent that corporate law affects profitability, and even then it is weak for companies that retain monopolistic rents.¹⁵⁶ Lastly, as to the market for capital, the costs it imposes are incurred mainly by existing shareholders rather than by managers.¹⁵⁷ Private contracting, though it can potentially reduce agency costs, cannot be relied on to eliminate them completely. Contracting is costly, and the parties cannot always predict all future contingencies.¹⁵⁸

The following analysis correspondingly assumes that to some extent the interests of shareholders and managers diverge, so that managers might seek inefficient rules that benefit them at the expense of shareholders.

2. Private Benefits Vary Across Managers and Firms

Another assumption that is relevant for the price considerations analysis relates to differences among managers in their ability and willingness to extract private benefits of control. For many reasons, managers are not identical but rather vary in their ability and willingness to extract private benefits and, accordingly, in their preferences with respect to the corporate laws that govern the firms they run.¹⁵⁹

In particular, the ability of managers to extract private benefits varies across industries (whether the industry is competitive or allows monopolistic rents)¹⁶⁰ and ownership structures (specifically whether or not there is a controlling shareholder)¹⁶¹ and depends on the existence of institutional shareholders and the amount of stock they hold.¹⁶²

Executive Compensation, 69 U. CHI. L. REV. 751, 775-77 (2002); Bebchuk, *Desirable Limits*, *supra* note 4, at 1463-65.

¹⁵⁴ See Bebchuk et al., *supra* note 153, at 777-78; Bebchuk, *Desirable Limits*, *supra* note 4, at 1462-63.

¹⁵⁵ See Bebchuk et al., *Desirable Limits*, *supra* note 4, at 1467-70.

¹⁵⁶ See *id.* at 1466-67; see Bebchuk et al., *supra* note 153, at 778; Black, *supra* note 37.

¹⁵⁷ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1465-66; see Bebchuk et al., *supra* note 153, at 778.

¹⁵⁸ See Jennifer Arlen, *Designing Mechanisms to Govern Takeover Defenses: Private Contracting, Legal Intervention, and Unforeseen Contingencies*, 69 U. CHI. L. REV. 917 (2002); Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-74 (1989) [hereinafter Gordon, *Mandatory Structure*].

¹⁵⁹ The article relates to managers with preferences to law that allows extraction of high private benefits of control as “opportunistic” or “bad” managers and to managers with preferences to law that limits the extraction of private benefits as “less opportunistic” or “better” managers. One should remember, however, that these preferences stem not only from managerial willingness to extract but also from ability to extract, which has to do with firm-specific characteristics.

¹⁶⁰ See Mark J. Roe, *Rents and Their Corporate Consequences*, 53 STAN. L. REV. 1463 (2001) (arguing that increased monopoly induces higher potential agency costs).

¹⁶¹ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1476-78 (analyzing agency problems in companies with a dominant shareholder); see also Kahan & Kamar, *The Myth*, *supra* note 5, at 740 (noting that the influence of managers and shareholders on reincorporation decisions varies across different ownership structures).

¹⁶² See ROMANO, *THE GENIUS*, *supra* note 3, at 68-69 (describing how institutional investors forced

The degree to which managers are willing to extract private benefits of control also differs from one firm to another, depending on the amount of stock that the managers hold, the extent to which their compensation scheme is aligned with firm performance, and other specific factors such as managers' personality, inhibitions, and moral values.

C. *Price Effects and Managerial Favoritism*

A major question in the market for corporate law is how managers' power over incorporation decisions affects states' legislative incentives. In this section, I will illustrate the central role price considerations play in answering this question. To that end subsection 1 demonstrates how the price that Delaware charges for reincorporations and initial incorporations depends on the balance between shareholders' and managers' interests in its laws. Having analyzed the effects of price considerations, subsection 2 discusses the strategies that would maximize Delaware revenues.

1. Delaware's Trade-Off: Managerial Favoritism Requires Delaware to Reduce Its Price

This subsection demonstrates that Delaware faces a trade-off between the number of firms it attracts and the price it can charge them. Section (a) shows that the more pro-managerial Delaware law is, the more firms it attracts and retains, but the lower is the price it can charge to corporations it attracts from other states. Section (b) shows that the more pro-managerial Delaware law is the lower the price it can charge from initial incorporations.

a. The Price that Enables Delaware to Attract Firms from Other States

Unlike a firm in a competitive market that cannot charge a price that is higher than its marginal costs because its consumers would migrate to another firm, a producer possessing market power can raise its price to reflect the value that is generated from its product.¹⁶³ Since none of the other states offers substitutes to Delaware's advantages, Delaware can charge a price that reflects the value that is generated by these advantages.

If, however, Delaware increases the agency costs of its rules to the point at which its overall quality just barely exceeds the next best state, it can no longer charge a higher price than its competitors, because if it does,

managers to opt out of Pennsylvania's disgorgement statute); Kahan & Kamar, *The Myth*, *supra* note 5, at 740 (suggesting that the influence of managers and shareholder on reincorporation decisions depends on, among other things, the amount of stock held by institutional investors); Romano, *The Need for Competition*, *supra* note 3, at 535-37 (arguing that institutional investors restrain managers from choosing regimes with strong antitakeover law).

¹⁶³ See CARLTON & PERLOFF, *supra* note 13, at 87-92; TIROLE, *supra* note 13, at 65-69.

shareholders will not approve managers' reincorporation initiatives. To assure shareholder approval for reincorporation to Delaware, Delaware would need to reduce the price it charges by an amount equal to the harm caused to shareholders from adopting inefficient redistributive corporate rules.¹⁶⁴ Otherwise, other states will be able to lock in their firms by catering to the interests of shareholders, who would then not approve reincorporation to Delaware.¹⁶⁵ The more pro-managerial Delaware law is, therefore, the less Delaware is able to charge each firm it attracts.

Recall, however, that reincorporation requires managers' initiation. To attract firms from other states, therefore, Delaware needs to cater to the interests of managers; otherwise, other states will be able to lock in their firms by catering to managers' interests, and the managers in turn would not initiate a move to Delaware. In addition, degrading its rules toward managers also helps Delaware in retaining its own corporations. Since managers have the power to initiate reincorporations, a useful way for Delaware to prevent its existing firms from leaving is to make sure that managers are satisfied. Because managers have heterogeneous preferences toward the extraction of private benefits, the more pro-managerial Delaware's law is, the more managers it attracts and retains.

To demonstrate this point, assume that Delaware has to choose its corporate law from among three possibilities. X is the most pro-managerial structure, Z is the optimal structure maximizing shareholder value, and Y is in the middle, that is, a bit less pro-managerial and more efficient than X, but not as optimal as Z. Assume also that all of the managers prefer Y to Z, and that while some of them, the most opportunistic ones, prefer X to Y, the rest, who either because they are not able to or because they are not willing to do not expect to extract more private benefits than the ones offered by rule Y, are indifferent between X and Y.

If Delaware offered rule Z, other states could dissuade firms incorporated in their states from migrating to Delaware by offering either rule X or Y. As a result, none of the managers would initiate a move to Delaware. In addition, some of the managers in Delaware would try to convince their shareholders to migrate to other states with stronger managerial protection. In some firms, uninformed shareholders might give their support for leaving Delaware under these circumstances. At the same time, the incorporation price that Delaware charges would reflect the full value generated by its infrastructure and network externalities. Even if the other states charge a "zero" price, this lower price would not cause either the shareholders or the managers of firms incorporated in Delaware to migrate to the other states, as long as the price that Delaware charges is not higher than the value of its legal infrastructure and network externalities.

If, instead of rule Z, Delaware adopted rule X, both the quantity of firms it could attract from other states and the price it could charge those firms would change. With the X rule, Delaware would be able to attract all

¹⁶⁴ For a formal illustration of this point, see Bar-Gill, Barzuza & Bebchuk, *supra* note 4.

¹⁶⁵ Some of the states will not adopt this strategy even though it helps them in retaining incorporations either because the local bar in these states is not sufficiently influential or because local managers have stronger influence than the local bar.

the firms. Other states could not lock in their managers. Even if the other states offer the X rule, managers would prefer Delaware since it offers additional advantages. In addition, none of the managers in Delaware would want to migrate out of it. In order to secure shareholders approval, however, Delaware would now have to reduce its price to reflect the losses caused to shareholders by having rule X instead of rule Z. Otherwise, other states could lock in their corporations by offering Z to shareholders who then would not approve a move to Delaware. If, and only if, Delaware offers a price that reflects shareholders costs from having rule X relative to Z will it be able to prevent other states from locking in their corporations.¹⁶⁶ If the harm that is caused by X is sufficiently large, Delaware would have to charge a zero or even negative price to get shareholder approval for reincorporation.

Finally, assume that Delaware offers rule Y. With rule Y Delaware will be able to attract fewer firms than with rule X, but more firms than with rule Z. In particular, it will attract some managers from other states, but not the most opportunistic ones who prefer rule X to rule Y. Also, the price that Delaware will be able to charge is somewhere between the price it can charge in the first case and the price it can charge in the second case.

Delaware, therefore, faces a trade-off between quantity and price in which price maximization considerations incent Delaware to increase corporate law quality while at the same time quantity maximization considerations incent Delaware to decrease corporate law quality. To put it in a more concrete context, if Delaware changed its rules to be more pro-management, it might help it in attracting more incorporations from other states but at the same time it would require Delaware to decrease its current tax rates.¹⁶⁷

b. The Price that Enables Delaware to Attract Initial Incorporations

Luring existing public firms subsequent to their incorporation in other states is not the only reason why Delaware would need to reduce its price to reflect the harm that is caused to shareholders from being governed by pro-managerial rules if it adopts such rules. The rules Delaware chooses to adopt also affect the price that it can charge to firms at the time of their initial incorporation decision when they first go public.

¹⁶⁶ It is worthwhile noting that Delaware needs to reduce its price even if the other states eventually, in equilibrium, adopt X as well. If Delaware does not reduce its price to reflect shareholder costs, other states will then be able to lock in their corporations by offering Z. See Bar-Gill, Barzuza & Bebchuk, *supra* note 4.

¹⁶⁷ If Delaware could charge each firm a price that reflects the exact harm that is caused to its shareholders it would not have to face this trade-off. Instead of reducing the price for all of the firms, it could reduce it only to the marginal ones: those firms whose managers will take advantage of the protection offered to them by Delaware law. Yet, to price discriminate among firms according to managers' willingness and ability to extract private benefits requires private information that Delaware doesn't possess. Delaware does discriminate among public and non-public firms and within the first group among large and small firms, but these factors reflect only to a limited extent the agency costs that protective rules will impose on each of these firms.

A company that wishes to sell its shares to public investors in a public offering is generally looking for a place of incorporation that maximizes the price it can obtain from the market. The price in the public offering is expected to reflect, at least to some extent, the value generated by the corporate law governing the company and the additional advantages that the state offers. As with out-of-state firms, Delaware can charge, at the maximum, the value that is generated by its competitive advantages minus the harm that is caused by its pro-managerial bias.¹⁶⁸

Adopting rule X rather than Z in the example above will force Delaware to charge these firms a lower price. If Delaware charges a price that reflects the value of its competitive advantages and doesn't decrease it to reflect the harm that is caused by rule X, it is easy to see that Delaware will no longer attract firms in their initial incorporation stage. If Delaware adopts such a strategy, another state could attract all of these firms simply by offering rules that benefit shareholders, without incurring any significant costs, establishing a specialized court, or being required to create network externalities. Once this state attracts a sufficiently large number of incorporations, it might even threaten to attract firms from Delaware.

To be sure, scholars have noted that the incentives of other states to compete with Delaware are limited. Yet, even the scholars who are most skeptical with respect to the incentives of other states to compete with Delaware would agree that under these circumstances another state would have sufficient incentives to offer such rules. More important, there is no need to speculate whether there would be a state that would choose to adopt rules that benefit shareholders. In fact, such a state may already exist. For instance, California's substantive corporate law is considered more pro-shareholder than Delaware's substantive corporate law. California has no antitakeover statute,¹⁶⁹ it has not validated the most common version of the poison pill—the flip-in pill—and it “has long been known for its shareholder rights stance.”¹⁷⁰ If Delaware charges a price that is higher than the value generated by its competitive advantages minus the harm that is caused by its pro-managerial rules, the package that California offers could become more valuable than the package that Delaware offers.

Since we know that firms in their initial incorporation stage choose Delaware rather than their home state even when their home state offers

¹⁶⁸ To be sure, recent literature has documented that firms in their IPO stage sometimes choose to adopt certain rules that are considered inefficient while rejecting these rules in the midstream stage. See Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs*, 17 J.L. ECON. & ORG. 83 (2001); Michael Klausner, *Institutional Shareholders' Split Personality on Corporate Governance Active in Proxies, Passive in IPOs*, 152 U. PA. L. REV. 755 (2003). Different explanations have been offered to this phenomenon. Yet, as Jennifer Arlen correctly points out, these choices might reflect no more than shareholder preferences to adopt what they have knowledge about in the presence of uncertainty with respect to future developments in states' corporate law. See Arlen, *supra* note 158. If Delaware were willing to adopt a whole policy that is more pro-shareholder, shareholders would be willing to pay more for its law. Yet, Delaware has in the past adopted the poison pill and applied it to shareholders without giving them the opportunity to choose. To charge a higher price, therefore, Delaware would have to signal to its shareholders that it would better protect their interests in the future.

¹⁶⁹ See Subramanian, *Incorporation Choice*, *supra* note 2, at 1854-55.

¹⁷⁰ See MARIA CARMEN S. PINNELL, *STATE TAKEOVER LAWS*, at California-1 (2000).

rules that are better for shareholders, it is clear that Delaware price reflects the effect of its rules on the value of the firms it attracts; that is, the price is not higher than the value of its specialized judiciary, developed body of case law, and administrative system minus the costs imposed by its pro-managerial rules.¹⁷¹

2. The Results of Delaware's Trade-Off

a. Static Effects

The preceding subsections have shown that in order to lure firms from other states and to attract initial incorporations Delaware needs to reduce its price to reflect the harm that is caused to shareholders from producing inefficient rules. At the same time, in order to attract and retain managers, Delaware needs to cater to their interests. The more pro-managerial Delaware law is, the more firms it retains and attracts but the less it can charge for incorporations.

Essentially, the assumption that Delaware maximizes the volume of incorporations implies that Delaware has incentives to degrade its law by catering to managers' interests as long as it is able to retain a relative advantage in the overall package it has to offer, that is, as long as the harm caused by its corporate law almost equals, but does not exceed, the benefits generated by Delaware's other advantages. With this strategy Delaware incorporation would be approved by shareholders and be attractive to as many managers as possible. It would be irrational for Delaware, assuming that it maximizes the number of incorporations, to offer rules that are less pro-managerial because to do so would decrease the number of firms it is able to attract or retain.

If Delaware also takes into account the effects of its strategies on the price that it charges, however, its pro-managerial policy should be constrained. Delaware's strategy, instead, would not be to eliminate its advantages completely relative to other states. In particular, it will maintain a balance between managers and shareholders so that the costs imposed by its rules on the shareholders do not reduce the value of incorporation in Delaware to below the tax it charges.¹⁷² What seems to be a puzzle under

¹⁷¹ See Subramanian, *Incorporation Choice*, *supra* note 2, at 1820-22 & n.100 (reporting that around forty percent of the reincorporations of IPO firms to Delaware were from firms headquartered in California).

¹⁷² Theoretically, Delaware could have chosen one of the following extreme options: First, Delaware could choose to attract all of the firms in the market even if that would require it to charge a zero price. Second, Delaware could choose the other extreme possibility, which is to offer optimal rules, charge the highest price it can, and, as a result, forgo luring firms from other states and risk some of its existing firms—those firms whose managers have sufficient power to get shareholders approval for a migration to an inferior state. It is not likely, however, that either of these solutions would be more profitable than an intermediate one. More importantly, we know from reality that Delaware has chosen an intermediate path. First, Delaware has not chosen rules that cater to all of the managers in the market. Many managers choose to remain in their home state and use their influence on the state to adopt antitakeover rules that provide them with stronger protection than that provided by Delaware. Second, Delaware neither seems to choose the second extreme since the price that it charges does not

existing theories, therefore, is completely comprehensible when one incorporates price considerations to the analysis.

b. Dynamic Effects

Up to now the analysis has taken a static approach in the sense that it has analyzed Delaware's strategy at a defined moment. This section will analyze Delaware's dynamic strategy, i.e., how price considerations affect Delaware's choices over time.

Since firms continue to incorporate in Delaware in large proportions, over time the advantage of a Delaware charter is constantly increasing.¹⁷³ Firms that join Delaware increase the likelihood of judicial rulings on Delaware corporate law and, therefore, provide positive interpretive network externalities on their peers that are also governed by Delaware law.¹⁷⁴ Firms that join Delaware also increase the incentives for the financial and legal services industries to invest the fixed costs required to research Delaware law. Since these services involve economies of scale, by joining the group of Delaware corporations, firms reduce the marginal costs of these services to other group members. Accordingly, as the number of firms incorporated in Delaware increases, the value of its charter increases.¹⁷⁵

Once Delaware has increased its market share to a value-creating extent, firms should be willing to pay more for Delaware law. Delaware therefore could increase its price to reflect the increase in its advantages. Alternatively, instead of increasing its price, Delaware can utilize the increase in its market power to attract additional firms. If the advantages are bigger, the pro-managerial rules that offset them can become that much worse without changing the price Delaware charges. Over time Delaware can either increase its franchise tax, degrade its rules toward managers, or

seem to reflect the entire value generated by its competitive advantages.

¹⁷³ See Klausner, *supra* note 11, at 844. One could argue that if every firm that joins Delaware also increases its network benefits Delaware could raise the price with every firm that joins, even if it caters to managers' interests. According to this approach, Delaware would have incentives to attract all of the firms in the market. This analysis is not likely to apply because of differences in the marginal network benefits of each firm that joins Delaware and the marginal costs imposed by the rules that cater to managers' interests. While the former is likely to decrease, the latter is likely to increase. Whereas it is crucial for the network externality that Delaware's market share be much larger than the market share of other states, it is much less important whether Delaware attracts fifty percent or sixty percent of the market. Under both scenarios Delaware would have a developed body of case law, its judges would remain experienced, and law firms in New York and other major corporate law markets would specialize in Delaware law. The marginal harm that results from catering to managers' interests, however, is expected to increase, since the inefficiencies in enabling managers to extract private benefits increase in private benefits' size. The more Delaware caters to managers' interests, therefore, the lower the price it is able to charge.

¹⁷⁴ See *id.* at 775-79.

¹⁷⁵ See *id.* at 782-85. To be sure, the number of incorporations also increases in states other than Delaware. However, in many of the states the number of firms has not reached a threshold necessary to exhibit network externalities. Moreover, it is not only the absolute number of Delaware firms that increases over time; Delaware's market share is also increasing. As a result, even if incorporation in other states generates network benefits, Delaware is constantly increasing the gap between itself and other states.

both.

D. *Price Effects and the Quantity of Firms Delaware Attracts*

The common concern with regard to producers with market power is that price considerations would lead them to produce a suboptimal quantity. Because a producer possessing monopoly power, unlike a firm in a competitive market, can raise its price above its marginal cost without losing all of its consumers, it faces a downward sloping demand curve; that is, the more consumers it attracts the less it can charge for the product.¹⁷⁶ Such a firm if it sells a small quantity can charge a price that only consumers who value its product highly would be willing to pay. If, however, it wants to sell a greater quantity, it needs to lower its price so that consumers with lower valuations of the product will also find it profitable to purchase the product. If the producer needs to charge one price to all consumers, therefore, it faces a trade-off: the more consumers it attracts the less it is able to charge each consumer. The monopolist will choose the price and quantity that maximizes its profits. Such price will be higher than the marginal costs of production and, accordingly, the quantity will be socially suboptimal. This behavior creates a deadweight loss, since the product is not consumed by all consumers who value it at more than its cost of production.

This distortion, though exists is less harmful in our context because it exists to the extent that the monopolist needs to charge a uniform price to all consumers. If, however, a monopolist is able to charge consumers different prices, the problem is mitigated. In the extreme case in which the monopolist is able to charge each consumer exactly that consumer's valuation of the product, the problem disappears completely.¹⁷⁷ As shown persuasively by Kahan and Kamar, Delaware price discriminates among firms according to the value they attach to incorporation in Delaware. Since Delaware does not charge each firm its exact valuation price discrimination does not eliminate this distortion, but it certainly mitigates it.¹⁷⁸

E. *Price Effects and Quality*

The role of price considerations is also important in analyzing Delaware's willingness to invest in its corporate law and improve it with

¹⁷⁶ See CARLTON & PERLOFF, *supra* note 13, at 87-92; TIROLE, *supra* note 13, at 65-69.

¹⁷⁷ See TIROLE, *supra* note 13, at 135-37

¹⁷⁸ Theoretically, price discrimination could be also effective in mitigating the trade-off described in the previous section. Yet, to that end, Delaware needs to price discriminate among firms according to their managers' ability and willingness to extract private benefits. This kind of discrimination requires private information that Delaware does not possess. Indeed, the price discrimination displayed by Delaware, among public and non-public firms, and among large and small firms within the latter group, is sensitive to firms' agency costs only to a limited extent.

regard to issues and services that do not involve conflicts of interest between managers and shareholders. Recall that scholars are concerned that, given the presence of network externalities in the market for corporate law, Delaware's market dominance reduces the competitive threats from other states and, in turn, weakens Delaware's incentives to invest in innovations and modifications to its law. In addition, a general concern has been raised that, as a result of its monopolistic power, Delaware's incentives to invest in the quality of its product are not optimal. Lastly, scholars have argued that Delaware might adopt inefficient strategies to preserve and reinforce its market power. In the following, I will discuss how price considerations interact with these concerns. As Kahan and Kamar have pointed out, Delaware has incentives to invest in the quality of its law because, given its market power, such investment would enable it to increase the price that it charges.¹⁷⁹ Yet, for several reasons, Delaware might still not produce optimal quality, and the following section describes how price considerations affect these potential sources of inefficiency.

First, it is worthwhile to discuss how price considerations influence the adverse effects that network externalities might have on Delaware's incentives. Recall Klausner's argument that network externalities might lead Delaware as well as other states to produce lax rules. Assume, for example, that another state, say Nevada, offers better corporate law than Delaware offers. Since Delaware law exhibits network externalities, incorporating in Delaware is more valuable than incorporating in Nevada. If all of the firms migrate to Nevada, so that network externalities pass from Delaware law to Nevada law, all of the firms would be better off. However, uncertainty and delay, it has been argued, might prevent such migration from happening.¹⁸⁰ First, even if firm A prefers Nevada's law to Delaware's, it might not be certain that other firms also prefer it. Since Nevada law is more valuable only if all of the firms move together, none of the firms would take this risk. Second, even if firm A believes that after it moves other firms would progressively migrate to Nevada, the time that will pass until the migration of the rest might make it unprofitable for firm A to migrate. During this time firm A would have to incur the costs of not having network externalities. For instance, it would have to pay its lawyers for the time that they would need to learn Nevada's law. If none of the firms wants to be the first, migration might not occur even if it would have been profitable to the firms as a group to do it. The absence of such a threat, it has been argued, "could make Delaware as well as competing states lax in maintaining the quality of their laws."¹⁸¹

This analysis, however, is applicable only if Delaware solely seeks to maximize the volume of incorporations. Price considerations incent Delaware to invest in innovations and modifications to its law despite the significant network externalities and the absence of competitive threats. Although network externalities do significantly impair the credibility of

¹⁷⁹ See Kahan & Kamar, *The Myth*, *supra* note 5, at 742.

¹⁸⁰ See Klausner, *supra* note 11, at 849-50.

¹⁸¹ *Id.* at 850.

threats by other states to lure firms from Delaware, competitive forces are not the exclusive source for Delaware's incentives. The ability of Delaware to extract, either partially or completely, the value generated by its law through the price that it charges may produce incentives for Delaware to increase this surplus. Price considerations, therefore, are likely to induce Delaware to invest in innovations and modifications notwithstanding the existence of network externalities and the absence of competitive threats.

That Delaware has incentives to improve the quality of its law even in the absence of competitive threats, however, does not solve all of the problems created by network externalities. In particular, network externalities might impede a transfer from one Delaware law to another. For the same reasons detailed above, firms might choose not to switch from rule A to B even if rule B is more efficient at least until they are certain that other firms will also switch. Consequently, if Delaware switches from rule A to B, new firms might not incorporate in Delaware unless rule B applies to all of the firms already incorporated in Delaware. But this universal application of rule B might not be possible, since existing firms could already have rule A embedded in their charters. Delaware, however, is able to overcome the hesitation of firms to switch to the new rule by using its price strategically. In the economic literature, an analogous case is presented by Michael Katz and Carl Shapiro.¹⁸² Katz and Shapiro distinguish between two cases. In the first, free entry into the supply of technology leads to marginal cost pricing. In that case, the basic intuition developed by Farrell and Saloner applies. The technology that is superior today has a strategic advantage and can become, therefore, locked in as the standard.¹⁸³ If, however, "a single firm controls the property rights to a given technology or if there are other entry barriers into the supply of that technology, then a supplier will be willing to make investments in the form of penetration pricing to establish the technology because such investments can later be recouped by pricing in excess of marginal costs."¹⁸⁴ Such a firm is defined to be a "sponsor," since it sponsors the entrance of a new product until all firms adopt the product.¹⁸⁵ The problems of uncertainty and delay described by Klausner are essentially coordination problems. In cases where it is efficient for firms to move to another product, Delaware can solve the coordination problem in order to extract higher prices in later periods. Even if some firms would get smaller gains for a few financial periods and, therefore, would only be willing to pay less for Delaware law.

¹⁸² See Michael L. Katz & Carl Shapiro, *Technology Adoption in the Presence of Network Externalities*, 94 J. POL. ECON. 822, 823 (1986) (constructing a model of the dynamics of industry evolution in a market with technological change). The Farrell and Saloner model produces different results because it treats prices as exogenous. See Farrell & Saloner, *Installed Base*, *supra* note 77, at 943 (stating that their analysis applies "if the technologies are competitively supplied," which is not the case in the market for corporate law).

¹⁸³ See Katz & Shapiro, *supra* note 182, at 825.

¹⁸⁴ *Id.*

¹⁸⁵ *Id.* To be sure, the ability to sponsor could help Delaware in beating superior laws elsewhere. See *id.* at 825. ("When one technology is sponsored and the other is not, the sponsored technology tends to be adopted too much."). Yet, if Delaware is able to offer these superior products, because it will be able to charge a higher price for these products than for inferior ones it is expected to produce the better ones by itself.

As in the case of the sponsor in Katz and Shapiro's model, Delaware would find it profitable to extract smaller profits for a short while in order to increase price in the long run.

Scholars have also expressed concerns that, in general, a firm exercising monopolistic power does not necessarily produce an optimal level of quality since it might choose the quality preferred by the marginal consumer rather than the average one. The concern about suboptimal choices as to quality arises, however, only when the monopolist needs to charge the same price to all of its consumers.¹⁸⁶ If the monopolist is able to price discriminate among consumers according to their willingness to pay, it would have the right incentives to produce the optimal quality. Delaware price discriminates among firms according to the value they attach to Delaware's product.¹⁸⁷ Public firms pay more than non-public ones and, within the group of public firms, large firms pay more than small ones. Since Delaware is able to price discriminate, it is more sensitive to the average consumer. As a result, suboptimal quality, though it might exist to some extent, is not a significant concern in the case of Delaware. The extent to which Delaware would take advantage of its monopolistic slack also depends on the degree to which Delaware price discriminates. The stronger the ability to engage in price discrimination, the stronger the incentives to invest even within the monopoly slack.

Lastly, we are left with the concern that Delaware might adopt inefficient strategies that enhance, reinforce, and exploit its market power.¹⁸⁸ Price considerations would not necessarily alleviate these concerns, to the extent that they exist, because they affect Delaware in conflicting directions. Reducing the quality of its law might require Delaware to charge a lower price, yet, at the same time, to the extent that lower quality also impairs the quality of other states' laws, it enables Delaware to charge a higher price than that charged by other states.¹⁸⁹ The effect of price consideration on Delaware's incentives to incorporate indeterminacy to its law is therefore uncertain.

F. *Responses to Possible Objections*

This section addresses different objections to the theory that price considerations affects Delaware's strategies and accounts for the development of its corporate law.

¹⁸⁶ See Spence, *supra* note 71, at 419.

¹⁸⁷ See Kahan & Kamar, *Price Discrimination*, *supra* note 5.

¹⁸⁸ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 596-97; Kahan & Kamar, *The Myth*, *supra* note 5 at 740-42.

¹⁸⁹ By adopting indeterminate law, Delaware enhances its competitive advantages relative to its rival states. See Kamar, *supra* note 5, at 1927-37. Therefore "[a]s long as the relative value of Delaware law rises, Delaware's equilibrium price and market share—and hence its profit—increase." *Id.* at 1931. Similarly, even if litigation intensiveness impairs the quality of Delaware law by enabling Delaware to price discriminate among firms, as Kahan and Kamar demonstrate, it might increase Delaware revenues overall. See Kahan & Kamar, *Price Discrimination*, *supra* note 5.

1. Shareholders' Ignorance

At first glance, the price considerations theory seems to assume a significant role, maybe too significant, for shareholders in approving reincorporation decisions. Yet, some shareholders are rationally ignorant—they choose not to invest the time and effort that are required to evaluate and compare the corporate laws of different states. Moreover, even in cases in which shareholders are informed, managers may get their approval for a value-reducing incorporation move by bundling the decision with another act that is desirable to shareholders.¹⁹⁰

Ostensibly, the analysis also assumes that shareholders have no influence on managers' decisions to initiate reincorporations. One might question such an assumption, especially with respect to those shareholders who are assumed to be informed and active in giving their approval to reincorporations. Indeed, shareholders are sometimes active enough to try to influence managers' decisions even when they do not have the authority to intervene in their decisions.¹⁹¹

For price considerations to affect Delaware revenues, however, it neither has to be the case that all shareholders of all firms have the information that is required to make an informed decision about reincorporation nor that shareholders do not have any influence on managers in initiating reincorporating decisions. Rather, as long as there are firms in which shareholders are passive and firms in which shareholders are active, Delaware is most likely to be better off adopting a middle ground that balances between price and quantity.

To be sure, if all shareholders were completely ignorant, Delaware should simply produce rules that benefit managers and charge the maximum price, that is, a price that reflects that entire value that is generated from its advantages. Similarly, if all shareholders were sufficiently active and capable of influencing managers to initiate reincorporation decisions, Delaware should produce optimal law and charge maximal price. Moreover, under some circumstances, it might be the case that Delaware would choose one of those two extreme options even if shareholders differ from each other. First, Delaware could completely ignore price considerations and cater to managers' interests if it completely gave up attracting those firms whose shareholders make informed decisions. Alternatively, Delaware could cater to shareholders' interests and give up attracting managers who are not complete saints, that is, managers that intend to extract some level of private benefits of control.

For several reasons, neither of the foregoing possibilities seems maximize Delaware revenues. First, Delaware has a broad range to choose from in selecting between shareholders' and managers' preferences. Rather than choosing to forgo all of the firms with informed shareholders, it can

¹⁹⁰ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1475; Gordon, *Mandatory Structure*, *supra* note 158, at 1577-78.

¹⁹¹ For instance, shareholders vote for advisory resolutions to redeem poison pills or to declassify staggered boards. See Bebchuk & Ferrell, *New Approach*, *supra* note 4, at 127-28.

choose to be a bit more pro-shareholder and to forgo some firms whose managers are especially opportunistic. Similarly, rather than choosing to give up attracting managers it can choose to be a bit more pro-managerial and to slightly reduce its price. Indeed, Delaware does not seem to adopt either of these extremes. To start with, the price that Delaware charges seems to be too low to reflect all of its advantages; the price would be much higher if it attracted only firms with uninformed shareholders or if it produced optimal law. Second, the fact that many managers choose to remain in their home state and exercise their power to influence the state to adopt strong antitakeover rules indicates that Delaware has not chosen to ignore price considerations.

This is not to say, however, that potential ignorance on shareholders' side does not impose some constraints on the power of price considerations in influencing Delaware. For instance, whereas shareholders might be sensitive to significant differences among states laws they are less likely to notice small differences. Delaware, therefore, might not pursue small improvements that shareholders do not notice. As long as shareholders are sensitive to some difference, however, price considerations matter to a certain extent.

2. The Delaware Bar Maximizes Incorporations Not Revenues

It has been well established that the Delaware bar takes an active part in the design of Delaware corporate law.¹⁹² The Delaware bar is generally assumed to be interested in maximizing the fees to Delaware lawyers.¹⁹³ To that end, it will arguably support rules that maximize the volume of incorporations rather than franchise tax revenues.¹⁹⁴ Moreover, the bar is also expected to support lowering franchise tax fees.¹⁹⁵ With a lower tax, more firms will choose to incorporate in Delaware and, as a result, use the services of the local bar.¹⁹⁶

It is far from clear, however, that the Delaware bar merely maximizes the number of incorporations in the state. Members of the bar are also motivated by reputational concerns as well as their professional integrity.¹⁹⁷ Because of Delaware's size, these effects assume large proportions, since the contribution of many Delaware players can be recognized both by their peers and by the public. The members of the bar, therefore, might be interested in producing law that maximizes shareholder value to a certain extent. Likewise, Delaware officials might prefer that the state attracts the better firms, those that are less vulnerable to expropriation by their

¹⁹² See generally Macey & Miller, *supra* note 134.

¹⁹³ See *id.*, at 503-04.

¹⁹⁴ See *id.*; see also Sitkoff, *supra* note 136, at 1146 (stating that "the core interest of the Delaware bar is in preserving Delaware as the dominant place of incorporation").

¹⁹⁵ See Macey & Miller, *supra* note 134, at 503-04.

¹⁹⁶ See *id.*

¹⁹⁷ See Interview with Professor Lawrence A. Hamermesh, Chair of the Corporation Law Council, Delaware Bar Association, Wilmington Delaware (Mar. 12, 2004).

managers.¹⁹⁸ Such preferences are reconcilable with the predictions of the price considerations analysis.

In addition, the Delaware bar can also benefit to some extent from taking into account price considerations. Once the price has been set, the bar can theoretically charge the rest of the surplus.¹⁹⁹ It is completely possible, therefore, that in maximizing its profits the bar also faces a trade-off between price and quantity.

Lastly, given Delaware's franchise tax rates, even if the bar maximizes the number of incorporations, it needs to take price considerations into account. Otherwise, a lack of ability to attract firms would result in the bar losing fees.²⁰⁰ Being aware of the fact that firms will incorporate and remain in Delaware only if the whole package that it offers adds more value than the tax that they pay to incorporate there, the bar would not push for rules that reduce Delaware's advantages below this threshold. The current franchise tax, therefore, is a constraint for the Delaware bar.²⁰¹ If the bar pushes too much toward pro-managerial rules, firms would not be willing to pay the price that Delaware charges and refrain from incorporating in Delaware. Given that this is the price that Delaware charges, therefore, the bar needs to take it into account when it exerts its influence on Delaware law.

3. Delaware Judges Do Not Consider Price

It might be argued that the analysis above, even though it describes the interests of the members of Delaware's legislative branch, does not apply to Delaware judges, who play a central role in designing Delaware's law. There are several reasons to believe, however, that Delaware judges decide cases in a way that corresponds to the price considerations analysis described above, even if not deliberately so. For one, it is not at all clear that judges would ignore the state's interest in revenues.²⁰² First, Delaware judges are certainly aware of the important role that the franchise tax plays in the Delaware budget. Second, judges are not completely isolated from influence. To be sure, Delaware judges on the Supreme Court and the Chancery Court are appointed based on merit for a period of twelve years. However, they are appointed by the state governor, with the consent of the

¹⁹⁸ See Interview with Vice Chancellor Leo E. Strine, Jr. at Harvard Law School (Mar. 23, 2004)

¹⁹⁹ The extent to which the bar can extract this surplus depends on conditions within the industry. In particular, competition among law firms in Delaware, to the extent that it exists, might drive the prices lower than the consumer surplus.

²⁰⁰ Assuming that the value of Delaware advantages is V and that the price for incorporation is P the bar should design a corporate law under which $B < V - P$. Otherwise, firms would not choose Delaware as their initial place of incorporation and shareholders would not give their approval to reincorporation to Delaware.

²⁰¹ Interestingly, unlike general amendments to Delaware corporate law, amendments to franchise taxes and fees are not drafted by the Delaware bar and are subject to approval only by the Delaware General Assembly. See *supra* text accompanying note 140.

²⁰² See Bebchuk, *Desirable Limits*, *supra* note 4, at 1453 n.74 (detailing the reasons why Delaware judges design the law according to the state's goals, under the assumption that Delaware's goal is to maximize the volume of incorporations).

state senate, and might, as a matter of human nature, tend to satisfy those who appointed them.²⁰³ Lastly, they are aware of the fact that if they choose a direction that is not reconcilable with the state's goals, the legislature might overturn it. For instance, the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*,²⁰⁴ which increased directors' liability and could have caused a migration of firms from the state, was followed promptly by the adoption by the legislature of section 102(b)(7) of the Delaware General Corporation Law,²⁰⁵ which enables companies to limit directors' liability.²⁰⁶

Second, even if one believes that judges are not interested in the state's goals, judges have their own incentives to attract incorporations and to maintain Delaware's status as the most successful state in the market and, as a result, the Delaware court as the most influential corporate law court in the nation. Like the Delaware bar, even if Delaware judges' primary interests lie in having a large volume of incorporations, they still have to take into account price considerations. Given Delaware's franchise tax, any decision as to the quality of Delaware's corporate law is likely to result in an effect on the number of corporations choosing to incorporate in Delaware.

Lastly and most importantly, Delaware judges are also highly motivated by their reputational considerations and judicial integrity. Under the price considerations analysis, the approach that would maximize revenues for Delaware requires a balance between managers and shareholders. Given no clear guidance from the legislative branch to protect one of these groups exclusively, balancing these interests is naturally conceived as the appropriate role for Delaware judges and as reconcilable with legislative intent.²⁰⁷

For all of the above reasons, the decisions of Delaware judges should be, and as will be shown below, are reconcilable, to a certain extent, with a view that takes into account price considerations. If this were not the case, the Delaware legislature, which is the law-making body most concerned with franchise tax revenue, could decrease judges' discretion by further codifying Delaware's corporate law.

4. Other States Do Not Compete with Delaware

As mentioned at the outset, this analysis does not assume that other states are likely to adopt measures that are either expensive or raise political opposition to retain and attract incorporations. Moreover, even if the other states are not strategic in their choices and will continue to do what they do

²⁰³ *Id.*

²⁰⁴ *Smith v. Van Gorkom*, 488 A.2d 858, 874-78, 881 (Del. 1985).

²⁰⁵ DEL. CODE ANN. tit. 8, §102(b)(7) (1991).

²⁰⁶ *Id.*

²⁰⁷ See William T. Allen et al., *The Great Takeover Debate: A Meditation on Bridging the Conceptual Divide*, 69 U. CHI. L. REV. 1067, 1082 (2002) [hereinafter Allen et al., *The Great Takeover Debate*] (noting that without clear legislative guidance the court is not likely to abandon the status quo that balances shareholders' and managers' power).

today regardless of Delaware's strategy and the implications on the number of firms they attract, price considerations analysis still applies.

The reason for this is straightforward: As long as there are states that cater to the interests of managers and states that cater to the interests of shareholders, Delaware might not be able to ignore either of these groups. In order to attract firms from other states and to maintain its own firms, Delaware needs to cater to managers' interests. Even if no other state plans to attract incorporations, there are several states that offer pro-managerial rules. If Delaware does not protect managers, not only would it be impaired in its ability to attract incorporations but it would also risk a migration of managers to one of these other states.

Similarly, even if none of the other states behave strategically, Delaware still needs to take into account price considerations so long as there are states that offer substantive corporate law that benefits shareholders to a greater degree than Delaware's substantive corporate law does. If Delaware does not reduce its price to reflect the harm that is caused to its shareholders by offering pro-managerial rules, Delaware would not be able to attract firms from these states and, even worse, Delaware would not be able to attract more incorporations of firms at the initial offering stage. Instead of choosing Delaware, these firms would choose one of the states that offer more efficient rules. As time passes, one of these states could accumulate enough power to try and attract firms from Delaware. If Delaware, therefore, does not want a pro-shareholder state to threaten its dominant position in the market for incorporations, it would have to reduce its price to reflect the costs imposed on shareholders by its pro-managerial rules.

IV. HOW DOES DELAWARE DERIVE SIGNIFICANT REVENUES?

This part demonstrates, by new and existing evidence, that Delaware law and the services it offers conform to the price considerations analysis to a certain extent, as they do not maximize the volume of incorporations to the state but rather have the effect of deriving significant revenues. Three components of Delaware's system reflect this policy. First, in designing its franchise tax Delaware utilizes its market power to charge a price that is much higher than its marginal costs of production and to make significant profits. It is also demonstrated, however, that as a result of the structure of Delaware tax and the practice to increase it no more than every decade Delaware does not maximize revenues. Second, focusing on specific fields in corporate law it is shown that Delaware corporate law complements its tax law in two different respects. First, Delaware antitakeover law has been and still is milder than the antitakeover law in many other states. Second, with regard to issues that do not involve conflicts of interests between managers and shareholders, Delaware generally invests in quality and innovation in its law. Lastly, even though Delaware faces no significant competition from other states it invests significant efforts and costs to provide services of high quality and expediency.

A. Delaware Franchise Tax Law

As the following part shows, in accordance with the price considerations analysis Delaware franchise tax law is not designed to maximize the number of incorporations but rather to derive significant profits. In addition, it is shown that Delaware is perfectly aware of the trade-off between price and quantity. Yet, it is also shown that since the price might be constrained by different considerations and since Delaware increases its tax no more than once a decade, Delaware has not extracted the full value it could. Thus, the effect price considerations have had on Delaware law is at least somewhat limited.

1. Delaware Utilizes its Market Power to Charge Significant Prices

The most simple and straightforward evidence that Delaware takes into account price considerations is its significant franchise tax. If Delaware cared only for the number of incorporations it attracts, it would charge a price that does not exceed its marginal costs. Such a price, as shown above, would enable it to attract the greatest number of corporations. In addition, different constituencies that derive other fees from incorporations in Delaware would support a lower tax.²⁰⁸ Moreover, Delaware as a state would have significant profits even if it has reduced its tax to zero, since it derives additional revenues from incorporations such as UCC filing fees and collections of abandoned property.²⁰⁹ Nevertheless, the franchise tax that Delaware charges to public firms is both significantly higher than its marginal costs and much higher than the franchise tax in any other jurisdiction.²¹⁰

The structure of Delaware tax also indicates that Delaware aims to utilize its market power to charge high prices. The unique structure of Delaware's franchise tax creates price discrimination among firms according to their willingness to pay for Delaware's legal system.²¹¹ Through price discrimination among public and non-public firms and among large and small firms, Delaware extracts more of its consumers' surplus and, in turn, derives significant revenues.

²⁰⁸ Incorporations bring fees to the Delaware Bar, Delaware registered agents, and business owners in Delaware. These constituencies would prefer Delaware to charge as low a tax as possible since a lower tax would attract more corporations whose matters would be litigated in the Delaware courts.

²⁰⁹ With respect to these fees, the differences between Delaware and other states are negligible. See references cited *supra* note 12. Since other states charge similar fees, these fees do not limit Delaware's choices with respect to its corporate law. These fees, however, all add to Delaware revenues from incorporations.

²¹⁰ See Kahan & Kamar, *The Myth*, *supra* note 5, at 690 tbl.1 (reporting that the maximal annual tax in Delaware is more than ten times larger than the annual tax in the next most costly state, Georgia, and more than hundred times larger than the annual tax in many of the other states); Romano, *Empowering Investors*, *supra* note 3, at 2429 tbl.1 (reporting that from 1966 to 1996 Delaware appropriated less than three percent of its revenues to its corporations division). To be sure, this conclusion does not apply to the minimum rates of franchise taxes in Delaware, which are almost competitive. Yet, these fees generally do not apply to public corporations.

²¹¹ See Kahan & Kamar, *Price Discrimination*, *supra* note 5.

2. The Significant Weight of the Price in Delaware Revenues

Delaware revenues also point to the fact that Delaware is interested in more than attracting incorporations. Delaware revenues from its franchise tax amount to approximately twenty percent of its total revenues. In per capita terms, Delaware's franchise tax revenues constitute an annual income of \$3,000 for every family of four.²¹² The major part of these revenues results from the fact that the franchise tax rates are much higher than marginal costs. Romano has shown that during the years 1966-1996 Delaware's costs were less than three percent of its revenues.²¹³ Table 1 presents similar results for the years 1996-2002. Thus, more than ninety-five percent of Delaware revenues are derived from Delaware's ability to charge a price that is higher than marginal costs. Put differently, if Delaware was charging its marginal costs during these years, assuming that it could attract all of the firms in the market as a result, its revenues from the franchise tax would have been more than ten times smaller.

TABLE 1
Corporations Related Expenditures and Revenues
Fiscal Years 1997-2002

	FY 97	FY 98	FY 99	FY 00	FY 01	FY 02
Revenues						
Incorporation Fees	390,739,000	493,828,000	495,860,000	541,112,000	586,785,000	533,528,000
Expenditures						
Division Of Corporations	5,925,500	5,634,100	6,945,600	10,579,300	8,181,000	8,410,200
Court Of Chancery	1,752,300	1,904,800	1,967,500	2,030,100	2,077,100	2,693,200
Supreme Court	<u>2,698,900</u>	<u>3,060,400</u>	<u>3,000,100</u>	<u>3,058,600</u>	<u>3,195,300</u>	<u>3,587,100</u>
Total Expenditures	10,376,700	10,599,300	11,913,200	15,668,000	13,453,400	14,690,500
Net Revenues	380,362,300	483,228,700	483,946,800	525,244,000	573,349,600	518,837,500

Sources: Revenues from Incorporations were collected from U.S. Bureau of the Census, State Government Tax Collections (1997-2002). The state expenditures were received from Delaware Division of Corporations.

A current example demonstrates how the price level is important for Delaware and how Delaware uses its price to increase revenues to the state

²¹² See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 556. Moreover, Delaware has additional revenues from incorporations. First, the revenues from abandoned property amounted to an average of more than \$100 million per year during the last decade. See E-mail from David Singleton, Secretary of Finance (April 15, 2004). Second, Delaware raised this year additional \$16 million from UCC filing fees.

²¹³ See Romano, *Empowering Investors*, *supra* note 3, at 2429 tbl.1; see also Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1211.

when necessary. According to recent estimates, Delaware was expected to have a deficit of \$300 million in its 2004 budget. After she had decided on significant budget cuts, Ruth Ann Minner, the governor of Delaware, decided to balance the state budget by levying an average twenty-two percent increase in incorporations fees.²¹⁴ This increase is expected to generate an additional \$99 million of revenue in fiscal year 2004.

In addition to increasing the franchise tax, the governor increased the state's revenues by increasing cigarette taxes and increasing revenues from lotteries. The franchise tax, however, was by far the major source for covering the deficit. All of the other sources together amount to less than \$40 million in revenues for the same year and the highest among them amounts to only approximately one-quarter of the expected revenue from the increase in franchise taxes.²¹⁵

3. The Trade-Off between Price and Quantity: Is the Price Binding?

One possible argument, which could challenge the assertion that the franchise tax serves as a constraint on Delaware behavior is that the tax is too low, and therefore does not limit Delaware in any respect. Delaware does not keep legislative history that documents the considerations in setting its tax rates.²¹⁶ Yet, anecdotal evidence as well as comments by Delaware officials indicate that when raising the tax rates Delaware officials generally take into account market conditions and, at least in some cases, increase the tax to the highest level possible that would not create a risk to Delaware's business. At the same time, because they are aware of the possible effects of the increase on the number of incorporations and have limited information on these effects, they are very cautious in increasing the tax rates.

Rick Geisenberger, Assistant Secretary of State, explains that when deciding how much to increase the tax a main consideration is what the market can bear.²¹⁷ This policy is reflected in the governor's recent proposal to increase the franchise tax in order to cover the expected deficit in the state 2004 budget. The governor explained that the decision to raise franchise tax had been taken only after "[w]e [had] consulted with some

²¹⁴ See Telephone Interview with Richard J. Geisenberger, Assistant Secretary of State (February 20, 2004). Originally the governor proposed an eighteen percent increase in corporate fees. See Budget Address of Governor Ruth Ann Minner, January 30, 2003, State of Delaware, Office of the Budget, available at <http://www.state.de.us/governor/speeches/budget%20address%202003.shtml#TopOfPage>. Two other proposals, however, were not adopted and as a result the incorporation fees were further increased. The proposals that did not pass included a proposal to decouple estate taxes which generated significant opposition, and a proposal to impose estimated tax withholdings on LLCs that was later withdrawn out of concern that it could adversely affect their financial statements.

²¹⁵ Delaware is expected to gain in fiscal 2004 \$23.5 million from the increase in the cigarette tax and \$16 million from the video lottery industry. See *id.*

²¹⁶ Telephone Interview with Ruth Ann Melson, Legislative Librarian (Feb. 13, 2004).

²¹⁷ See Telephone Interview with Richard J. Geisenberger, Assistant Secretary of State (Jan. 28, 2004); see also Telephone Interview with Jeff Lewis, former Assistant Secretary of State (Jan. 28, 2004) (noting that the main consideration in deciding on the increase in 1994 was market conditions).

key leaders of the business community and we [were] comfortable that these proposed increases are equitable and will not deter firms from continuing to make Delaware their corporate home.”²¹⁸

The recent tax increase is not expected to cover the whole deficit. The governor has also decided on cutting government employment, reengineering programs, cutting healthcare costs, and raising additional taxes.²¹⁹ In addition to showing how important the tax is as a source of revenues for Delaware, this example demonstrates how the governor is aware of the trade-off between price and quantity. If the governor had thought that Delaware could increase the franchise tax further without losing firms, she likely would have proposed doing so instead of imposing budget cuts and other tax increases that more directly and adversely affect Delaware citizens.

Price considerations tend to be binding also because Delaware does not have complete information and therefore is very cautious in raising its tax rates. In deciding how much to increase the tax Delaware officials are aware of the connection between their judicial system, their corporate law and the price that firms would be willing to pay. Mr. Geisenberger explains that firms are willing to pay more to incorporate in Delaware due to its specialized judiciary, efficient administrative system, and most important, lower costs of capital and better protection for shareholders under Delaware corporate law. Most of the corporate scandals, he notes, did not occur in firms incorporated under Delaware law.²²⁰ Yet, since their information on the exact value of Delaware law for firms is limited, Delaware officials maintain a significant safe-range when raising taxes. As Mr. Geisenberger explains, nobody knows the threshold that could cause firms to leave Delaware: “We know what worked in the past and we follow it.”²²¹ There is some level that will push firms out of the market, he explains, but it’s not clear what this level is exactly and “no one wants to be the one who breaks the camel’s back.”²²²

In fact, Delaware officials are so careful that they follow closely past increases.²²³ In determining tax increases for the year 2004, Delaware officials have used the following table:

²¹⁸ See Budget Address of Governor Ruth Ann Minner, *supra* note 200.

²¹⁹ The plan included cutting government employment and programs, cutting district school funds, consolidating departments (e.g., consolidating the Delaware State Police, Delaware Emergency Management Agency, Capitol Police, Office of Highway Safety, EMS Office and emergency communications staff to one department, the Department of Safety and Homeland Security), and driving down healthcare costs. *See id.* To be sure, not all of these cuts are significant. *See* Interview with David Singleton, *supra* note 137. Yet, they could have been prevented by further increases in the franchise tax.

²²⁰ *See* Telephone Interview with Richard J. Geisenberger, *supra* note 217.

²²¹ Telephone Interview with Richard J. Geisenberger, *supra* note 214.

²²² *Id.*; *see also* Interview with Vice Chancellor Leo E. Strine, Jr., *supra* note 198 (noting that Delaware prefers not to charge as high as it can on risking losing everything).

²²³ *See* Telephone Interview with Professor Lawrence A. Hamermesh, Chair of the Corporation Law Council, Delaware Bar Association, Wilmington Delaware (Jan. 28, 2004). In following precedents differences in inflation rates are taken into account. *See* Telephone Interview with Richard J. Geisenberger, *supra* note 217.

TABLE 2
Incorporation Fees

	Type	Code Reference	Pre-1969	1969	1984	1991	2003
Approved				6/23/1969	7/2/1984	7/1/1991	6/23/2003
Effective				7/15/1969	1/1/1984	1/1/1991	1/1/2003
1) Maximum Franchise Tax	Tax	8 / 503 [c]	\$100,000	\$110,000	\$130,000	\$150,000	\$165,000
% Increase				10.0%	18.2%	15.4%	10.0%
% Increase Per Year					1.2%	2.2%	0.8%
2) Gross Asset Multiplier on Assumed Par Value Method	Tax	8 / 503 [a]	\$110	\$121	\$140	\$200	\$250
% Increase Per Year					1.0%	6.1%	2.1%
3) Minimum Taxes							
1 to 1,000 shares			\$10.00	\$20.00	\$30.00	\$30.00	\$35.00
1,001 to 3,000 shares	Tax	8 / 503 [a]	\$22.00	\$24.20	\$30.00	\$30.00	\$35.00
3,001 to 5,000 shares			\$27.50	\$30.25	\$35.00	\$50.00	\$62.50
5,001 to 10,000 shares			\$55.00	\$60.50	\$70.00	\$90.00	\$112.50
Per 10,000 Thereafter			\$27.50	\$30.25	\$35.00	\$50.00	\$62.50
% Increase of > 10,000				10.0%	15.7%	42.9%	25.0%
% Increase Per Year					1.0%	6.1%	2.1%
4) Annual Reports	Fee	8 / 391 [a][17]	\$5	\$10	\$10	\$20	\$25
Annual Report Penalty			\$25	\$25	\$25	\$50	\$100
5) LP/LLC Annual Tax *	Tax	6 / 18-1107(b)				\$100	\$200
6) LLC Document Filings*	Fee	6 / 18-1105(3)				\$50	\$90
7) Good Standing (Short)	Fee	Various	\$6.00	\$10.00	\$10.00	\$20.00	\$30.00
8) Certification Fees	Fee	Various	\$6.00	\$7.50	\$10.00	\$20.00	\$30.00
CPI				1968 34.8	1983 99.6	1990 130.7	2002 179.9
CPI GROWTH RATE					186%	31%	38%
					12.4%	4.5%	3.1%
Division of Corporations Revenue Collected in Fiscal Year of Effective Date				\$40.4	\$92.2	\$202.2	\$495.3
Division of Corporations Revenue Collected Following Fiscal Year				\$52.6	\$120.9	\$290.9	\$604.8
% Increase				30%	31%	44%	22%

* LLC Taxes and Fees were established in 1995.

Sources: Delaware Division of Corporations

Delaware's franchise tax is computed in two alternative ways. The first one is based solely on the number of authorized shares.²²⁴ Firms pay a fixed price for the first 10,000 authorized shares and \$62.50 for every additional 10,000 shares.²²⁵ The second method is based on the product of the assets of the firm and the ratio of the authorized to issued shares, which is defined as the "assumed par value capital" ("APVC") of the firm. Firms with an APVC above one million dollars pay \$250 for each additional million dollars of APVC.²²⁶ Firms have the option to pay the lower between the two methods. This formula has not been changed since 1937.²²⁷ Delaware changes its rates approximately every decade.

As past experience demonstrates, the market shows no negative impact to an increase in the maximum tax of ten to twenty percent and increase of the multipliers of ten to forty percent. Traditionally, both multipliers have been increased the same percentage. After looking at the history, Geisenberger explains, Delaware officials check the state needs and, given these needs, try to stay on the safe side, that is, on the lower range of these rates. Accordingly, the maximum tax was increased ten percent from \$150,000 to \$165,000 in 2003. The APVC multiplier was increased twenty-five percent from \$200 to \$250, and then, keeping with history that raises both multipliers the same, the multiplier under the authorized shares method was increased in twenty-five percent from \$50 to \$62.50. It is worthwhile to notice that according to this method the effective increase of revenues to the Division of Corporations is significantly higher than the change to the maximum tax rate alone indicates. For instance, in the last two decades amendments to Delaware incorporation fees were designed to increase the revenues for the Division of Corporations by forty-four percent in the year 1991 and twenty-two percent in 2003.

Looking at the tax rates, one might still ask whether some of the firms would not be willing to pay more for Delaware incorporation. For the purpose of our analysis, even if firms were willing to pay more, what is more important is what the state thinks will happen rather than what will actually occur. Moreover, Delaware as a state actually receives more from incorporations, since it also collects UCC filing fees and abandoned property of firms that incorporate there. Lastly, for a sizable portion of the publicly-traded firms incorporated in Delaware, the current tax that Delaware charges is far from negligible. The aggregate present value of the

²²⁴ DEL. CODE ANN. tit. 8, § 503(a)(1) (1991).

²²⁵ *Id.* According to current tax rates Firms with less than 3000 shares pay thirty-five dollars, firms with more than 3000 but less than 5000 authorized shares pay \$62.5, and firms with more than 5000 but less than 10,000 authorized shares pay \$112.5. *Id.*

²²⁶ For firms with APVC that is less than \$1 million the tax is calculated by dividing the assumed par value capital by \$1 million then multiplying that result by \$250.

²²⁷ The structure has been changed four times until it reached its current form in 1937. See Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1220-21 & n.66. At the beginning the tax was based on the par value of "capital stock issued and outstanding." 21 Del. Laws, ch. 166, § 4 (1899). In 1901, the tax base was changed to "capital actually paid in." 22 Del. Laws, ch. 16, § 2 (1901). In 1907, the tax base was changed to the amount of the authorized capital stock. 24 Del. Laws, ch. 47, § 1 (1907). In 1927, the tax base was changed to the number of authorized shares. 35 Del. Laws, ch. 5, § 4 (1927). In 1937 Delaware adopted the current structure. 41 Del. Laws, ch. 5, § 1 (1937).

future stream from Delaware's franchise tax is approximately \$60 billion.²²⁸ For the individual firm that pays the maximum tax, the present value of the expected annual tax is approximately \$16.5 million.²²⁹ Some firms that owe the maximum franchise tax have assets valued at less than \$100 million.²³⁰ For such a firm, the present value of the franchise tax is more than fifteen percent of its assets.

To be sure, the tax is not significant for all of the firms in Delaware. In particular, for the largest firms in Delaware, the tax is negligible. One puzzling issue is why Delaware does not charge more to larger firms willing to pay more. In order to do this, however, Delaware would need to change the structure of the franchise tax, which hasn't been changed since 1937, when firms values were different than today. Delaware officials argue that making significant changes to its franchise tax structure would impair Delaware's efforts to cultivate a long-term sense of stability.²³¹ The important point is that under its current structure, many firms might leave Delaware if the state ignores the trade-off between price and quantity, that is, if it either increases its tax or further degrades its rules toward managers.

There are additional indications that given Delaware's price, the demand for incorporation in Delaware is elastic at least for some of the firms incorporated there. First, the Delaware bar and Delaware registered agencies commonly resist increases in franchise taxes since they predict adverse effects on the number of incorporations in the state.²³² Second, firms cite differences in franchise tax rates as a major reason for migrating out of Delaware²³³ and firms choose to incorporate in Nevada because of price differences between Nevada and Delaware.²³⁴ Third, Delaware

²²⁸ To estimate the net present value of the future cash flow stream expected from the Delaware franchise tax I have used a risk free discount rate of one percent because, in the last twenty years, Delaware increased its tax to reflect inflation. See Budget Address of Governor Ruth Ann Minner, *supra* note 214 ("Historically, Delaware has enacted increases in these revenues about once a decade, reflecting inflation and the increasing cost of doing business"). The current free risk rate is even lower than one percent. See 3-Month Treasury Bill: Secondary Market Rate, at <http://research.stlouisfed.org/fred2/series/TB3MS/22> (showing interests rate of 0.94% on 3-month treasury bill for March 2004). To be sure, recent rates are especially low but the current value of the tax is significant also if computed assuming higher rates.

²²⁹ I do not include here the collections from abandoned property and UCC filings fees, as those by and large are not especially high in Delaware relative to other states. See sources cited *supra* note 12. Yet, the price of incorporating in Delaware might be higher than this, to the extent that the price of other services in Delaware, such as lawyers and registered agents fees and hotels and restaurants prices, are more expensive than similar services in other states.

²³⁰ See Interview with Richard J. Geisenberger in Wilmington, Delaware (Mar. 12, 2004).

²³¹ See Telephone Interview with Professor Lawrence A. Hamermesh, *supra* note 223; see also Interview with David Singleton, *supra* note 137. Some changes to Delaware tax law, however, would probably not impair stability, given the significant amount of time that has passed since the structure was set.

²³² For opposition of the Delaware Bar, see Kahan & Kamar, *The Myth*, *supra* note 5, at 726 n.167, referring to an email from Professor William T. Allen, Delaware Chancellor between 1985 and 1997, to Marcel Kahan (Oct. 18, 2002) that describes opposition from the Delaware Bar. For opposition of the registered agents, see Interview with Michael Houghton, Esq., Partner at Morris Nichols Arshnt & Tunnell, Wilmington, Delaware (Mar. 12, 2004).

²³³ See Kahan & Kamar, *The Myth*, *supra* note 5, at 726 n.167; Romano, *Law as a Product*, *supra* note 3, at 256-60.

²³⁴ See Telephone Interview with Richard J. Geisenberger, *supra* note 217 (noting that some of these firms contact Delaware with requests for tax waivers).

invests significant resources in justifying the tax that it charges. As shown below, even though Delaware does not face credible competitive threats from other states, it invests significant efforts and incurs costs in improving the efficiency, accessibility, and overall quality of its system.²³⁵ Moreover, such improvements are accelerated in the face of a tax increase.²³⁶

It is important to notice, however, that the forgoing does not mean to say that Delaware could not make higher revenues. First, if Delaware had charged more for large firms it could probably better extract the value that its law creates. Since Delaware tax does not differentiate between large and small incorporations the state is limited from increasing the price for the large firms to reflect the value they attach to incorporating in Delaware. Second, Delaware could probably increase its profits had it increased its tax more frequently. Since Delaware increases its price only every decade it has no incentives to improve the law toward shareholder benefits during this decade. Moreover, if Delaware advantages increase over time and the price does not increase to reflect it the law can become more pro-managerial as it had during the last decade. Consequently, when the time comes for tax increases, the state is already limited by the changes that have happened during the decade. Third, it could be that if Delaware simply further improved its law toward shareholder benefits and increased its price its profits would have been higher.

As mentioned previously, however, several reasons such as career concerns and political pressures from outside and inside might prevent Delaware from increasing its price, changing the structure of the tax and updating its tax rates more frequently.²³⁷ The fact that the tax might be constrained does not at all refute the price considerations analysis but rather implies that Delaware revenues are lower and its law is less pro shareholder than they would have been had Delaware maximized revenues.²³⁸

²³⁵ See *infra* section IV.C

²³⁶ *Id.*

²³⁷ To be sure, Delaware follows its precedents also in order to maintain stability. Indeed, since reincorporations involve some costs firms would like a state to make some kind of commitment not to make significant changes to its taxes. Yet, it is doubtful that such considerations should lead to raising the taxes as rarely as every decade and keeping the same structure for more than six decades. In fact, this kind of stability is more important to managers than to shareholders as it assures that Delaware's incentives to cater to shareholders' interests would not increase constantly. To the extent that Delaware current practices create a commitment to managers to continue to cater to their interests after they reincorporate to Delaware than the tendency to follow precedents, though not efficient, might maximize Delaware revenues.

²³⁸ Even if the tax that Delaware charges is constrained the price can be binding and the demand elastic since Delaware can, instead of raising its price, debasing its law in favor of managers. To be sure, the price would not necessarily always be binding. If, for instance, different considerations simultaneously prevent Delaware both from raising its taxes and from debasing its law in favor of managers, due for instance, to a concern of federal intervention in corporate law, price considerations might not be binding. The point made in this article is not that the tax is always binding, but rather that when other constraints are more lax, price considerations come into play in restraining Delaware from solely catering to managers' interests. Indeed, as shown from the evidence, at least during some periods, price considerations certainly are binding.

B. Delaware Corporate Law

This part shows that Delaware antitakeover law conforms to the price considerations analysis by enabling Delaware to charge significant prices and receive significant profits. As explained before, it is not the intention of this article to claim, that Delaware judges necessarily intentionally design the state's antitakeover law in a way that maximizes revenues. Rather, it suggests that even if judges decide cases ignoring the state's goals since Delaware case law, which balances shareholders' and managers' interests, is reconcilable with the goal of deriving significant revenues, the Delaware legislature has no incentives to change its current law as other theories would predict.²³⁹

1. Shareholder Protection

At the core of the price considerations theory of regulatory competition in corporate law, as advanced in this article, is the trade-off Delaware faces between managers' and shareholders' interests. The more pro-managerial Delaware law is, the more managers it will attract and the lower the price it will be able to charge each of the firms it attracts. The more pro-shareholder Delaware law is, the higher the price Delaware will be able to charge each firm, but the fewer incorporations it will be able to attract and retain.

This trade-off is reflected in Delaware's antitakeover law. Delaware's policy on takeover law has been, on the one hand, to offer its managers substantial powers to resist hostile takeovers,²⁴⁰ but on the other, not to provide them with the most potent tools that exist in the market.²⁴¹ Since Delaware did not seem to race to the bottom or to the top, as recent work by Roe has forcefully pointed out, none of the theories could fully account for its behavior.²⁴² Scholars from all sides of the debate consider the antitakeover tools with which states have equipped managers to be excessive.²⁴³ Race to the top proponents, however, have emphasized that, with respect to its antitakeover law, Delaware "stands out as an anomaly" in

²³⁹ For a detailed discussion of the incentives of Delaware judges and the Delaware bar, see *supra* sections III.F.2-3.

²⁴⁰ See Lucian A. Bebchuk et al., *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887 (2002) (showing how the combination of classified boards and poison pills in some Delaware firms significantly impedes takeovers); Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 600-01; Bebchuk & Ferrell, *The Race to Protect Managers*, *supra* note 4, at 1178-91 (analyzing the entrenching effects of Delaware takeover law).

²⁴¹ See Romano, *The Need for Competition*, *supra* note 3, at 531-37.

²⁴² See Roe, *supra* note 5, at 625. Roe demonstrates that Delaware law was relatively mild during the 1980s. The part of the present analysis that relates to the 1980s builds on Roe's analysis. Unlike Roe, however, this article argues that also during the 1990s, when the federal government authorities left the field, Delaware law remained relatively mild.

²⁴³ See, e.g., EASTERBROOK & FISCHEL, *ECONOMIC STRUCTURE*, *supra* note 3, at 221-22 (1991); Bebchuk & Ferrell, *The Race to Protect Managers*, *supra* note 4, at 1193-97 (citing race to the top scholars' objections to states' antitakeover laws).

consistently keeping its antitakeover law relatively mild.²⁴⁴ As Romano has pointed out Delaware enacted its first antitakeover statute only seven years after similar statutes were introduced in other states.²⁴⁵ Delaware did not adopt a second-generation statute until after other such statutes were upheld by the Supreme Court in *CTS Corp. v. Dynamics Corp. of America*,²⁴⁶ even though twenty other states did so.²⁴⁷ Eventually, Delaware adopted only one statute, which is relatively mild, while most other states adopted three, four, and in some cases five antitakeover statutes.²⁴⁸

True, in Delaware antitakeover devices are developed primarily by the courts rather than by the legislature.²⁴⁹ Yet, the Delaware courts have followed the relatively mild approach of the legislative branch.²⁵⁰ As three Delaware judges recently stated, “the Delaware courts have not given the board a blank check to block takeover bids.”²⁵¹ Rather, in developing antitakeover law, the Delaware courts seem to attempt to achieve some kind of balance in allocating power between managers and shareholders.²⁵² In *Unocal*, for instance, the Delaware Chancery court limited directors’ power to use a defensive tactic only to cases in which they are able to show that they had “reasonable grounds for believing that a danger to corporate policy and effectiveness existed”²⁵³ and that the defensive measure was “reasonable in relation to the threat posed.”²⁵⁴

A few years later in *Interco*, the Delaware Chancery Court interpreted *Unocal* as prohibiting managers from using a poison pill in the face of a noncoercive takeover bid unless it is used for a limited period of time “while the board exercises its good faith business judgment to take such steps as it deems appropriate to protect and advance shareholder interests.”²⁵⁵ Once it was clear that the board was not using the pill to initiate an auction, negotiate a better price for shareholders, or pursue another plan that would maximize shareholder value, Chancellor Allen stated that “then, in most instances, the legitimate role of the poison pill in the context of a noncoercive offer will have been fully satisfied.”²⁵⁶ This approach was so moderate relative to other states that it triggered Martin

²⁴⁴ See EASTERBROOK & FISCHER, *ECONOMIC STRUCTURE*, *supra* note 3, at 222-23 (stressing that Delaware’s antitakeover law is relatively mild); Romano, *Competition for Corporate Charters*, *supra* note 20, at 858-59; Romano, *The Need for Competition*, *supra* note 3, at 530-37, *see also supra*, note 94.

²⁴⁵ See ROMANO, *THE GENIUS*, *supra* note 3, at 59; Romano, *The Need for Competition*, *supra* note 3, at 531.

²⁴⁶ 481 U.S. 69 (1987).

²⁴⁷ See Romano, *The Need for Competition*, *supra* note 3, at 531-33.

²⁴⁸ *Id.*

²⁴⁹ See Bebchuk, Cohen & Ferrell, *supra* note 4, at 1083.

²⁵⁰ See Roe, *supra* note 5, at 624-626.

²⁵¹ See Allen, Jacobs & Strine, *The Great Takeover Debate*, *supra* note 207.

²⁵² See Bernard Black & Reinier Kraakman, *Delaware’s Takeover Law: The Uncertain Search for Hidden Value*, 96 NW. U. L. REV. 521, 558 (2002) (showing that Delaware antitakeover law reflects a “hidden value model” that “arose to reconcile this director-centered approach with . . . the conviction that corporations must be governed in the interests of their shareholders”).

²⁵³ *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955 (Del. 1985).

²⁵⁴ *Id.*

²⁵⁵ See *City Capital Assocs. Ltd. P’ship v. Interco*, 551 A.2d 787, 798 (Del. Ch. 1988).

²⁵⁶ See *id.* at 798.

Lipton's famous memo recommending that his clients consider moving from Delaware to other states that offer better protection to managers.²⁵⁷ Consistent with this reading of Delaware case law on takeovers, Robert Daines has found that during the late 1980s firms in Delaware were more likely to be the subject of a takeover bid and to be acquired than firms incorporated in other states.

At the end of the 1980s, Delaware case law empowered managers to resist takeovers vigorously. In *Paramount Communications v. Time*, the Delaware Supreme Court enabled target managers to pursue an acquisition of a desired merger partner in the face of a noncoercive all-share and all-cash takeover bids. The *Time* court, in a dictum, disapproved of *Interco's* bright line rule suggesting that the only conceivable threat from such a bid is an inadequate value to shareholders.²⁵⁸ Rather, the court determined that the board is "not obliged to abandon a deliberately conceived corporate plan for a short-term shareholder profit unless there is clearly no basis to sustain the corporate strategy."²⁵⁹ Some scholars interpreted the court's reasoning as suggesting that the board could "Just Say No" to a hostile bid.²⁶⁰ A few years later, the Delaware Supreme Court arguably further empowered management by essentially limiting the *Unocal* proportionality test to defensive measures that are either coercive or preclusive. A defensive measure that is neither preclusive nor coercive is merely required to be within "the range of reasonableness."²⁶¹ Consistent with the tilt back toward managers during the early 1990s, Guhan Subramanian has recently found that the Delaware effect on firms' likelihood to receive a takeover bid and to be acquired and on firms' Tobin's Q has decreased over these years.²⁶²

Yet, as Roe recently puts it: "if Delaware was racing to the bottom, why did it take it so long to get there?"²⁶³ Moreover, as described below, even post-*Paramount* the protection that Delaware provides managers with, even though excessive, is not as strong as that provided by many other states.

²⁵⁷ See Roe, *supra* note 5, at 21; see also Martin Lipton, To Our Clients: The Interco Case, Nov. 3, 1988, cited in Roe, *supra* note 5, at 21. Lipton also pointed to particular states as desirable destinations because they offer better protection than Delaware does:

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

See *id.*

²⁵⁸ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989).

²⁵⁹ See *id.* at 1154.

²⁶⁰ See Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 YALE L.J. 621, 626 (2003).

²⁶¹ See *Unitrin v. Am. Gen. Corp.*, 651 A.2d 1361 (Del. 1995); see also Jeffery N. Gordon, "Just Say Never?" *Poison Pills, Deadhand Pills and Shareholder Adopted Bylaws: An Essay for Warren Buffet*, 19 CARDOZO L. REV. 511, 524-25 (1997). [hereinafter Gordon, *Just Say Never?*]

²⁶² Comparing the Tobin's Q of firms incorporated in Delaware to the average Tobin's Q of non-Delaware firms, Subramanian finds that the advantage Delaware firms have in Tobin's Q is disappearing. For the purpose of this analysis, however, the average is less informative. For a broader discussion in this subject, see *infra* section V.B.

²⁶³ See Roe, *supra* note 5, at 20.

To start with, the Delaware courts are known for their tendency to keep the law indeterminate to a certain degree.²⁶⁴ Rather than adopting bright line rules, the judges in Delaware apply fact specific, standard-based tests.²⁶⁵ Accordingly, Delaware judges did not articulate a clear and sharp test that allow managers to just say no in the face of a hostile bid, even not in the *Paramount* decision.²⁶⁶ Rather than providing a bright line test as to managers' power to use the poison pill, using the words of Vice Chancellor Leo E. Strine, the Delaware courts have used a doctrinal route "to sidestep the fundamental Just Say No issue."²⁶⁷

Indeed, it is far from clear that *Time* and *Unitrin* have established a "Just Say No" defense and diminished *Unocal* proportionality test.²⁶⁸ In fact, both cases involved unique circumstances that account for their results. Unlike the typical adoption of managers' use of defensive tactics the *Paramount* hostile bid for *Time* occurred after *Time* had announced merger plans with *Warner*.²⁶⁹ In addition, as the Chancery Court noted, the defensive measure did not block *Paramount* completely from acquiring *Time* as would have been the case, at least for a certain period of time, if *Time* had, for instance, a poison pill and a staggered board.²⁷⁰ *Unitrin* was also unusual in having a relatively small number of institutional shareholders holding a significant part of the firms' shares. As a result, the Delaware Supreme Court adopted the board's argument that "it is hard to imagine a company more readily susceptible [than *Unitrin*] to a proxy contest concerning a pure issue of dollars."²⁷¹ In addition, the court found it unpersuasive that insiders with significant holdings would choose a repurchase program that would impair their share value and dilute their portion.²⁷² Thus, the pure case, in which a bidder cannot proceed with an all cash all shares premium tender offer and cannot take over the board as, for instance, a classified board uses a poison pill to "Just Say No" is still an open question under Delaware law.²⁷³ Moreover, subsequent decisions of

²⁶⁴ See Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1232-40; Kamar, *supra* note 5.

²⁶⁵ See Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1236-37. This approach, though it has been criticized, might be beneficial for shareholders to some extent as it also imposes uncertainty on managers with respect to the defensive tactics they are allowed to use.

²⁶⁶ See, e.g., Leo E. Strine, Jr., *The Professional Bear Hug: The ESB Proposal as a Conscious Effort to Make the Delaware Courts Confront the Basic "Just Say No" Question*, 55 STAN. L. REV. 863, 875 (2002) [hereinafter Strine, *Bear Hug*] ("In neither case was the Supreme Court asked to, nor did it, articulate whether a threat of substantive coercion could sustain a board's determination never to pull the pill in response to a bid whose only threatening aspect was inadequacy of price . . .").

²⁶⁷ See Strine, *Bear Hug*, *supra* note 266, at 864.

²⁶⁸ See STEPHEN M. BAINBRIDGE, *MERGERS AND ACQUISITIONS* 378-80 (2002).

²⁶⁹ See *id.*

²⁷⁰ See *id.*

²⁷¹ 651 A.2d at 1383.

²⁷² *Id.*; see also Gordon, *Just Say Never?*, *supra* note 261, at 523-24.

²⁷³ Interpreting Delaware law, a federal court allowed a staggered board to sustain the pill in the face of an all cash tender offer at a twenty-seven percent premium. Despite the fact that seventy-five percent of the shareholders tendered their shares, the *Wallace* court recognized a cognizable threat. See *Moore Corp. Ltd. v. Wallace Computer Servs.*, 907 F. Supp. 1545 (D. Del. 1995). Yet, this decision seems to deviate from Delaware law. See Interview with Justice Jack B. Jacobs, Supreme Court of Delaware, in Wilmington Delaware (Mar. 12, 2004); Interview with Vice Chancellor Leo E. Strine, Jr. *supra* note 198; see also Allen, Jacobs & Strine, *The Great Takeover Debate*, *supra* note 207, at 1080 n.39 (noting that "that decision is nonauthoritative, since the Delaware state judiciary has

Delaware courts seem to maintain substance and bite in the proportionality test. For instance, in *Chesapeake*, the Delaware Chancery court draws limits to the threat of substantive coercion that was approved by the *Paramount* court.²⁷⁴ In particular, Vice Chancellor Strine seems to embrace Gilson and Kraakman's original suggestion that managers who argue for substantive correction should demonstrate how they expect the target to do better if it remains independent.²⁷⁵ The court also refused to read *Unitrin* as a "reformulation of *Unocal*'s focus on the actual substantive reasonableness of defensive measures."²⁷⁶ Recently, in *Omnicare*,²⁷⁷ the Supreme Court of Delaware held that a lock up device in a merger agreement which consisted of a stockholders' voting agreement and a board commitment to let shareholders decide on the merger even if the board does not recommend it did not stand up to the *Unocal* proportionality test. Both cases have demonstrated that even *Unitrin*'s most lax standard, according to which the defensive measurement should fall within the "range of reasonableness," is effective at prohibiting certain kinds of defensive tactics.²⁷⁸

Moreover, the question of what the exact interpretation of the *Paramount* test is not the only concern that board members have when they must decide whether they are allowed, under Delaware law, to use a pill to block a hostile bid. To start with, in the *Paramount* decision itself there was no poison pill. Even if the *Paramount* test is as protective as some people believe, therefore, its applicability to the use of a poison pill is still uncertain.²⁷⁹ Moreover, even if the *Paramount* test applies to the use of a poison pill, before embarking on such a use a board of directors would have

not yet spoken on the issue"); Gordon, *Just Say Never?*, *supra* note 261, at 523-24 (opining that "under the approach employed by the Delaware Supreme Court in *Unitrin*, *Wallace* is an incorrectly decided case").

²⁷⁴ See *Chesapeake Corp. v. Shore*, 771 A.2d 293 (2001).

²⁷⁵ See *id.* at 327-32; see also Ronald J. Gilson & Reinier Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 BUS. LAW. 247, 268-69 (1989).

To make such a claim requires more than the standard statement that a target's board and its advisers believe the hostile offer to be "grossly inadequate." In particular, demonstrating the existence of a threat of substantive coercion requires a showing of how—and when—management expects a target's shareholders to do better.

Id. Referring to Gilson and Kraakman's analysis, Chancellor Strine warns against a wide interpretation of the substantive coercion argument: "[T]he use of this threat as a justification for aggressive defensive measures could easily be subject to abuse. The only way to protect stockholders is for courts to ensure that the threat is real and that the board asserting the threat is not imagining or exaggerating it." See *Chesapeake Corp.*, 771 A.2d at 327; see also Allen et al., *The Great Takeover Debate*, *supra* note 207, at 1078 n.30 (noting that "the logical force of *Interco* still resonates in some later decisions" among them *Chesapeake*).

²⁷⁶ *Chesapeake Corp.*, 771 A.2d at 333-34.

²⁷⁷ See *Omnicare Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003).

²⁷⁸ One might argue that *Omnicare* was motivated by the fear of federal intervention, but, there is no pending or threatened federal law or SEC rule that could be relevant. (I thank John C. Coates for making this point). Even if there were, the point made here still exists to the extent that the Delaware law that developed in light of price considerations is mild enough to enable the court to reach such a decision.

²⁷⁹ See Strine, *Bear Hug*, *supra* note 266, at 873 ("Nonetheless, the absence of any frontal attack on the poison pill's use in *Time-Warner* left the full extent of that view's legal force in the netherworld of dicta and, therefore, uncertain."); see also Allen et al., *The Great Takeover Debate*, *supra* note 207, at 1079-80 & n.39 (noting that "[i]t must be remembered that *Time-Warner* was not a 'pill case'" and that the extent of the just say no defense "still remains a theoretically open issue").

to ensure that their case does not fall in the so-called “*Revlon* Land.” In *Revlon*, the Delaware courts further limited the board’s power to resist hostile takeovers in those circumstances in which the sale or break up of the company is inevitable. In these circumstances, the boards’ role changes “from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.”²⁸⁰

If this was not enough for managers to have some doubts about the scope of protection Delaware courts provide them compared to what is provided to them by other states, Delaware judges continue to remind them about how uncertain this protection is. In their scholarly writings, three of the most prominent Delaware judges, Vice Chancellor Strine, Justice Jacobs, and former Chancellor Allen, constantly explain that the fullest possible availability of the poison pill defense is uncertain even after *Paramount*.²⁸¹ Delaware judges also send the same message to managers and shareholders in the predictions that they make with respect to future developments in Delaware corporate law. Recently these judges stated that “[i]t is . . . doubtful that courts [would] establish a bright-line precedent that gives boards a carte blanche to ‘just say no.’ Rather, boards will continue to be subjected to a probing case-specific review in which the court will adjudicate the propriety of the board’s reasons for saying no.”²⁸²

Conversely, states other than Delaware make significant efforts to provide managers with certainty with respect to their protections under their antitakeover statutes. In some cases, most notably Massachusetts, Pennsylvania, and Ohio, states clearly went out of their way to empower managers.²⁸³ More importantly, the protection that Delaware offers is not as certain and strong as that in many of the remaining states. In particular, those states that adopted relatively strong forms of pill endorsement and other constituency statutes tend to replace Delaware standards of review in change of control situations with more lenient standards of review.²⁸⁴ Based on these statutes, states have replaced the *Unocal* proportionality test with the business judgment rule, rejected *Revlon* enhanced duties, approved the dead-hand and the slow-hand pill, and even rejected Delaware’s compelling justification test for interference with shareholder franchise.²⁸⁵

²⁸⁰ See *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 44-45 (Del. 1994); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986).

²⁸¹ See, e.g., references cited *supra* note 279.

²⁸² See Allen, Jacobs & Strine, *The Great Takeover Debate*, *supra* note 207, at 1094.

²⁸³ See *supra* section II.C.1.

²⁸⁴ For a systematic comparison of states’ antitakeover law, see Michal Barzuza, *The State of State Antitakeover Law* (unpublished manuscript 2004, on file with author).

²⁸⁵ See, e.g., *Ipalco Enters. v. PSI Res., Inc.*, No. IP 93-325-C, 1993 U.S. Dist. LEXIS 19805, at *13 (S.D. Ind. June 18, 1993) (“[T]he court is aware that, unlike under Delaware law, Indiana corporate directors are not held to a particularly higher level of scrutiny in the context of corporate takeovers. Ind. Code § 23-1-35-1(f).”); *AMP Inc. v. Allied Signal Inc.*, 994 F. Supp. 187 (S.D.N.Y. 1998) (validating a slow-hand pill); *Safety-Kleen Corp., v. Laidlaw Env’tl Servs., Inc.*, No. 97 C 8003, 1999 WL 601039 (N.D. Ill. Feb. 4, 1998) (rejecting *Revlon* duties under Wisconsin law); *Invacare Corp. v. Healthydyne Techs., Inc.*, 968 F. Supp. 1578, 1581 (N.D. Ga. 1997) (validating the dead-hand pill and rejecting the compelling justification standard for interference with shareholder franchise); *First Union Corp. v. Suntrust Banks, Inc.*, No. 01-CVS-10075, 2001 WL 1885686, at *39 (N.C. Super. Aug. 10, 2001) (rejecting *Revlon* duties under North Carolina law); *Stepak v. Schey* 553 N.E.2d 1072 (Ohio 1990) (rejecting *Revlon* duties under Ohio law).

Indeed, the strongest indicator of Delaware's mild approach is the silence of Delaware's legislative branch. If the Delaware legislature wanted to make clear that managers can use a pill for an unlimited time to defend against a hostile takeover bid as long as they believe that the price is inadequate, it could say so, as it did in a previous case in which it wasn't satisfied with the judicial ruling.²⁸⁶ For instance, like Maryland, it could require the courts to apply the business judgment rule standard of review to defensive actions adopted by the board.²⁸⁷ Or, at the very least, it could adopt other constituency statute and a pill validation statute that would signal the state's willingness to protect managers.²⁸⁸ Yet, adopting such rules might require Delaware to decrease the price it charges for incorporations.²⁸⁹

The price considerations analysis is also consistent with the development of Delaware's takeover law over time. The dynamic analysis of price considerations theory, put forth above, predicts that over time Delaware will either increase its franchise tax price or degrade its corporate law for the benefit of managers.²⁹⁰ This prediction goes hand in hand with the developments of takeover law in Delaware.

During the 1980s Delaware's market share increased by more than twenty percent.²⁹¹ At the same time, its tax rates though increased, did not seem to reflect the entire additional value. A few reasons may explain Delaware's abstention from raising its tax rates, among them pressure from the Delaware bar or strategic considerations. For our purposes, however, the important point is that instead of raising its tax, Delaware used its increased market power to attract more corporations. With more features benefiting shareholders, Delaware could become more pro-managerial without having to lower its incorporation prices. And so it did. Delaware's pro-managerial bias has increased in tandem with the increase in its market power.

2. Delaware Invests in Quality and Innovations

The price considerations theory of regulatory competition illuminates Delaware's incentives with respect to rules that do not involve conflicts of interest between shareholders and managers. If Delaware were only trying

²⁸⁶ See *supra* text accompanying notes 204-206.

²⁸⁷ See MD. CODE ANN., CORPS. & ASS'NS § 2-405.1(f) (2001).

²⁸⁸ See, e.g., Jonathan M. Karpoff & Paul H. Malatesta, *The Wealth Effects of Second-Generation State Takeover Legislation*, 25 J. FIN. ECON. 291, 299 (1989) ("the right to use poison pill defenses is presumably more secure when explicitly authorized by statute and is thus less likely to be limited by the courts").

²⁸⁹ For instance, research has shown that a state's adoption of a poison pill statute causes an average decline of 1.125% in the market value of public companies in such states. See *id.* at 313 tbl.5. To be sure, Delaware's adoption of such a law would probably be less significant since the Delaware court has already provided managers with some defenses. Nevertheless, even if the effect were much smaller it would result in Delaware collecting significantly less in annual tax revenues.

²⁹⁰ See *supra* section III.C.2.b.

²⁹¹ See Daines, *Firm Value*, *supra* note 2, at 538 tbl.5 (reporting that Delaware's market share of incorporations for public companies increased from 44.3% in 1981 to 53.3% in 1988).

to maximize the number of incorporations, given that it faces no serious competitive threats, it would not be expected to invest in the quality of its law.

Since investing in and improving its corporate law enables Delaware to charge a higher price to the firms it attracts, Delaware is incented to pursue such investments. Moreover, these considerations also induce Delaware to invest in innovations regardless of the significant network externalities associated with its law. Keeping price considerations in mind, Delaware's interest in legal innovation becomes clear, even in the absence of any competitive threats and in the presence of network externalities.

The predictions of price considerations theory are consistent with Delaware's actual behavior. Delaware is, and has consistently been, one of the first states to adopt major corporate law innovations.²⁹² In fact, Delaware lagged behind other states only with respect to changes in antitakeover laws,²⁹³ which have been found to have adverse effects on firm value.²⁹⁴

C. *Delaware's Business*

The price considerations analysis also implies that Delaware has strong incentives to invest in innovations and improvements to its corporate law system in general. As recent theories persuasively demonstrate, Delaware faces very weak competitive pressures from other states, if it faces competitive pressures at all. Notwithstanding these findings, there seem to be intensive efforts on Delaware's part to constantly improve the efficiency and accessibility of its system and services.

To start with, Delaware offers especially efficient administrative services.²⁹⁵ The Delaware Division of Corporations has launched a web based filing system and is offering expedited incorporation and related services that include "24-hour," "Same Day," and "2-Hour" service.²⁹⁶ To provide services in this expediency, the Division of Corporations operates in two shifts from 7:30 A.M. to 12:00 A.M., Monday through Thursday, and until 10:30 P.M. on Friday.²⁹⁷ With advance notice, the Division of Corporations is able to accept and file documents on weekends and holidays.²⁹⁸

Delaware also constantly invests in technological innovations to

²⁹² See Romano, *Law as a Product*, *supra* note 3, at 237-40.

²⁹³ See ROMANO, *THE GENIUS*, *supra* note 3, at 59; Romano, *The Need for Competition*, *supra* note 3, at 531-32. For a detailed discussion of Delaware responsiveness, see *supra* section II.C.3.

²⁹⁴ See Karpoff & Malatesta, *supra* note 288.

²⁹⁵ See Kahan & Kamar, *Price Discrimination*, *supra* note 5, at 1213; Romano, *The Need for Competition*, *supra* note 3, at 509.

²⁹⁶ Delaware's web-based filing is available at <http://ecorp2.state.de.us/default.sph/ecorpWeb.class>. Rates for expedited services are available at <http://www.state.de.us/corp/expserv.shtml> (last visited on Feb 2004).

²⁹⁷ See Telephone Interview with Eileen Simpson, *supra* note 231; E-mail from Richard J. Geisenberger (March 8, 2004) (on file with author).

²⁹⁸ See *id.*.

improve its services. Delaware was the first state to develop a corporate database (1984), a corporate workflow tracking system (1989), and a corporate document imaging system (1989).²⁹⁹ The state has a sophisticated Disaster Recovery System capable of recovering all digital records and being back in operation at an offsite, out-of-state location, within forty-eight hours.³⁰⁰ For the fourth year, corporations are able to file their tax forms and pay their taxes online. Soon corporations will be able to amend their tax filings online and pay a delinquent tax balance.³⁰¹ In addition, Delaware has placed its entire corporate law online with a promise that when the law changes the website will be updated within three days.³⁰²

Second, Delaware courts maintain an exceptional quality on different levels. The U.S. Chamber of Commerce's annual litigation survey has judged Delaware to be the best legal system in the United States for three straight years.³⁰³ Delaware judges are known for their expertise and ability to solve disputes in an expedited and professional manner.³⁰⁴ Significant efforts are made and significant costs are incurred to maintain this reputation. In a recent example, when due to inclement weather state offices were closed, Vice Chancellor Lamb offered to hear a case in a private law office: "Vice Chancellor Lamb knew that several out-of-town attorneys had flown in especially for the hearing, so he agreed to abandon protocol and the trial moved forward."³⁰⁵ Delaware judges also take part in innovative steps that speed-up the process and save the parties costs. For instance, Delaware recently initiated mediation procedures,³⁰⁶ which could save legal costs in the magnitude of hundreds of thousands of dollars.³⁰⁷

To be sure, price considerations are not necessarily the exclusive motivation for the described improvements. Judges, public officers, and academics all have independent incentives to produce work of high quality.³⁰⁸ Yet, if those incentives were irreconcilable with the goal of revenue maximization so that actions by private individuals reduced state revenues, the state might well have regulated or limited these activities.

²⁹⁹ See *id.*

³⁰⁰ *Id.*

³⁰¹ See Telephone Interview with Eileen Simpson, *supra* note 231.

³⁰² See Telephone Interview with Richard J. Geisenberger, *supra* note 217.

³⁰³ See U.S. Chamber Announces State Legal Fairness Rankings National Poll, Ad Campaign Highlight Urgent Need for Reform, at <http://www.uschamber.com/press/releases/2004/march/04-23.htm>. Copies of the survey results are available at <http://www.legalreformnow.com/study030804.cfm>.

³⁰⁴ See Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1077-78 (2000); Kahan & Kamar, *Price Discriminations*, *supra* note 5, at 1212-13. A notable example of the extraordinary efficiency of the Delaware Chancery Court can be found in the *HP* case. Chancellor William B. Chandler of the Delaware Chancery Court issued his decisions only thirty-three days after the lawsuit was filed and less than a week after the end of the trial. Walter Hewlett's response to the decision reflects how valuable for all sides the expedition of the process was: "While we are disappointed with the court's decision, we are grateful that it heard this case on such an expedited timeframe." See <http://www.pcmag.com/article2/0,4149,24089,00.asp> (last visited Mar. 31, 2004).

³⁰⁵ See E-mail from Richard J. Geisenberger, *supra* note 297.

³⁰⁶ See Interview with Vice Chancellor Stephen P. Lamb (March 12, 2004).

³⁰⁷ See Interview with Michael Houghton, *supra* note 232.

³⁰⁸ See Interview with Vice Chancellor Leo E. Strine, Jr, *supra* note 198; Interview with Professor Lawrence A. Hamermesh, *supra* note 197; see also *supra* sections III.F.2-3.

Moreover, Delaware incurs significant costs in improving its system. For instance, over the last few years, the state has built or funded new state-of-the-art courthouses in each of the three counties. Facing almost no competitive pressure, aside from price considerations, there seem to be no strong explanation to such an investment.

That price considerations induce Delaware to invest in quality is also demonstrated by recent improvements to Delaware's services. On Feb 4, 2004, Governor Minner unveiled new online services from the Delaware Division of Corporations that allow customers to reserve corporate names, get basic corporate information, confirm the status of Delaware corporations, and get filing history and other information on Delaware corporations.³⁰⁹ Lastly, the state has added a "1-Hour" service to the expedited incorporation options.³¹⁰ Though these amendments were planned regardless of the changes to the tax rates, Delaware has put more urgency on these changes because of the perception that tax increases are more tolerable when they come with improved services.³¹¹

V. MORE IMPLICATIONS: PREDICTIONS AND ASSESSMENTS IN LIGHT OF THE EVIDENCE

Part IV has shown that Delaware law is reconcilable with the implications of the price considerations analysis. This part analyzes further implications of that analysis for the evaluation of the current system. Discussing the predictions of the theory, it will be shown that, the price considerations theory is fully in accord with and is able to explain all currently existing empirical evidence such as the fact that other states do not attempt to compete with Delaware, that Delaware maintains its superiority, that Delaware attracts only a portion of the firms in the market and that firms that do not incorporate in Delaware choose to incorporate in their home state.

A. *Other States' Law*

1. Shareholder Protection

The price considerations analysis explains not only why Delaware produces better law but also why many other states, as shown above, tend to offer stronger protections for managers than those offered by Delaware. We have seen that Delaware prices its package in a way that ensures that it will be better both for shareholders and managers of some of the firms in

³⁰⁹ See <http://www.state.de.us/corp/denewscorpweb.htm>.

³¹⁰ See <http://www.state.de.us/corp/1hrservice.shtml>.

³¹¹ Telephone Interview with Richard J. Geisenberger, *supra* note 217 (explaining that these improvements were rushed on the assumption that "when you raise your price you better improve your services as well").

the market to incorporate in Delaware. Given Delaware's strategy, the other states have no way to retain the firms Delaware chooses to attract, that is, the firms whose managers find Delaware's law to be sufficiently protective. Offering rules that are more pro-managerial than the ones Delaware offers would not make much of a difference for the managers who either cannot or do not plan to extract more private benefits than is currently possible in Delaware. Offering rules that benefit shareholders wouldn't help either, because Delaware offers unique advantages for the shareholders in these firms, in the form of a specialized judiciary and network externalities, which make its package better than the package any other state can offer.

We have also seen, however, that due to rational price considerations Delaware is not seeking to attract all of the firms in the market, but only some of them. In particular, it does not seek to attract the firms whose managers exhibit the strongest preference for protection. States can, therefore, retain their corporations by offering them rules that cater to the interests of those managers who find Delaware law to be insufficiently protective. These managers, if offered stronger protection in their home state, would refrain from reincorporating in Delaware.

As shown above, the tendency to adopt rules that provide stronger protection to managers is manifested in the antitakeover rules of many states. Consistent with the price considerations analysis, in many cases the adoption of antitakeover devices was supported by local managers and the local bar.³¹²

Yet, the tendency of other states to enact laws exhibiting greater pro-managerial bias than Delaware depends on the extent to which local interest-groups push in that direction. In-state politics may, in some cases, push the other way. If so, the analysis suggests, these states would end up losing many firms to Delaware. To be sure, these states may still retain some firms that prefer to remain in their home state for reasons other than the corporate law provisions offered by their home state.³¹³ Yet, the states that cater to managers' interests will succeed both in retaining firms with home-state bias and in retaining firms whose managers find Delaware law insufficiently protective. These predictions correspond to current evidence showing that enacting strong antitakeover protections is helpful in attracting both local and out-of-state firms.³¹⁴ In addition, the analysis is also consistent with evidence showing that antitakeover rules do not help states attract firms at the IPO stage, when there is relatively little, if at all, divergence of interests between managers and shareholders.³¹⁵

³¹² See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 750-752 (1998) (noting that most antitakeover rules were sponsored either by managers or the local bar); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461 n.11 (1988).

³¹³ For example, firms might choose to remain in their home state in order to save the costs associated with incorporating out of state. See Bebchuk & Cohen, *supra* note 2, at 397-98. (finding that small firms, for whom the costs of incorporating out of state are relatively large, have a stronger tendency to remain in state).

³¹⁴ See *id.*

³¹⁵ See Daines, *IPO Firms*, *supra* note 2, at 1597 (finding little support for the argument that

2. Quality and Innovations

Because states other than Delaware could not hope to make significant profits from out of state incorporations, they have few incentives, in general, to invest in innovations and modifications to their laws.

As explained above, however, the fact that states do not gain financial benefits from incorporations does not necessarily mean that they would not design their law so as to retain and attract incorporations. If states can attract firms with measures that do not require a significant investment, they are likely to do so, especially if the local bar has some influence over the legislative process in the state.

According to price considerations analysis, since Delaware provides only intermediate protection to managers, the most effective tool that could help states in retaining and attracting incorporations is adopting rules that cater to managers' interests. In this context, price considerations analysis reveals that states are expected to be entrepreneurial and innovative. This prediction of the theory is also consistent with reality. The only field in which states other than Delaware tend to innovate is that of antitakeover rules.³¹⁶ According to price considerations analysis, this is also one of the few fields worth the states' investment, since not all managers would find Delaware law to fit their preferences.

B. Delaware's Superiority

An influential study by Robert Daines has shown that firms in Delaware have higher Tobin's Q ratios than firms in other states.³¹⁷ As noted above, race to the top proponents have relied on these studies to argue for the desirability of state competition. A recent study by Guhan Subramanian shows that that this effect has been steadily decreasing during the 1990s.³¹⁸ Price considerations theory accounts for differences in value between firms incorporated in Delaware and firms incorporated elsewhere.

antitakeover law affects the domicile choices of IPO firms). It worth noting that, according to the analysis put forth in this article, the success in attracting incorporations by states that offer strong protection to managers could never match the success in retaining incorporations by these same states. The reason is the requirement of shareholder approval for reincorporation: managers can use their veto power on reincorporation decisions to remain in a state that offers them strong protection than migrate. If however, they want to move to another state to increase their protection, they need shareholders' approval. Shareholders would give their approval to a migration to a state that has no competitive advantages to compensate them for the efficiency loss due to stronger pro-managerial bias only if they are not informed about such consequences. Such ignorance can be reasonably assumed only in a small fraction of the cases. This analysis is consistent with the findings of empirical research. See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 568-69 (stating that “[o]verall, there is an enormous difference between states’ attractiveness to in-state and out-of-state companies”).

³¹⁶ See Kahan & Kamar, *The Myth*, *supra* note 5, at 703-05 (stating that “[t]he single most important field for statutory innovation in corporate law . . . has been statutes designed to assist management in fending off unsolicited takeover bids”).

³¹⁷ See Daines, *Firm Value*, *supra* note 2.

³¹⁸ See Subramanian, *Disappearing Effect*, *supra* note 2.

It also explains why this difference is declining.

Under this framework, firms incorporated in Delaware should have higher values because Delaware is expected to produce better corporate law than the law in the other states and to attract, as a result, firms with better managers. Managers who do not choose Delaware are most likely motivated primarily by preferences for strong protection; the most opportunistic managers, therefore, prefer to incorporate in states that offer them better protection. Interestingly, in his study Robert Daines suggests that differences between managers who choose to incorporate in Delaware and managers who choose not to could be driving his results.³¹⁹ The price considerations analysis provides the theoretical account for this observation.

Over time, however, as explained in Section III.C.2.b above, Delaware is expected to debase its law so as to attract “worse” firms (i.e., firms whose managers exhibit higher protection preferences). As a result, the Tobin’s Q ratios of firms incorporated in Delaware are expected to decrease over time, an effect that is evident in the data.³²⁰

C. *Patterns of Incorporations*

1. Not All Firms Are Expected to Incorporate in Delaware

Price considerations analysis is also consistent with observed patterns of incorporations. As discussed throughout this article, one of the puzzling issues in the market for corporate law relates to Delaware’s market share. Delaware attracts most but not all of the market. If Delaware is good enough to attract so much of the market, why isn’t it good for every firm? What makes some firms choose to remain in their home state rather than incorporating in Delaware?³²¹

Since firms that do not choose Delaware choose to remain in their home state, it has been suggested that home state bias prevents firms from incorporating in Delaware. For example, it has been suggested that small

³¹⁹ See *id.* at 553.

Note that there is one endogeneity account that is consistent with the evidence. If Delaware law facilitates the sale of the firm, good managers might be more likely to incorporate there because they have less reason to fear a disciplinary takeover. Poor managers, or those valuing private benefits, would thus avoid Delaware incorporation because it would be more costly.

Id.

³²⁰ Guhan Subramanian suggests that Delaware’s superior Tobin’s Q is not only decreasing but is also disappearing because the Tobin’s Q in Delaware has become similar to the average Tobin’s Q of firms incorporated outside of Delaware. In addition, in a recent update to his paper Subramanian found that the Delaware advantage exists only for small firms. These results are also consistent with the price considerations analysis. To start with, the Tobin’s Q of firms in Delaware is still higher than the Tobin’s Q of firms in states with stronger antitakeover rules like Pennsylvania and Massachusetts and might be lower than the Tobin’s Q of firms in states with better antitakeover rules like California. Second, as Subramanian suggests, large firms are less sensitive to hostile takeovers and accordingly are less affected by antitakeover law.

³²¹ For a detailed discussion of this puzzle, see section II.C.3 *supra*.

firms that use local law firms might be advised by their law firms to incorporate in the home state. However, it has been shown that also other firms choose to incorporate in their home state and that states that offer strong antitakeover protection retain a greater percentage of in-state firms than those states without strong antitakeover protections.³²²

The prediction of the price considerations analysis adds another possible explanation for the fact that firms choose to incorporate outside of Delaware—Delaware deliberately targets only part of the market. Firms that reveal home state bias are not necessarily firms that Delaware could not attract under any possible strategy. If Delaware wanted to attract more firms, it could do so by adopting stronger antitakeover laws, but it would have had to reduce its price. Price considerations analysis, therefore, provides an additional criterion for identifying firms that will tend to remain in their home state instead of migrating to Delaware. The firms that do not choose Delaware are those whose managers find Delaware law insufficiently protective of them.

2. Home State Bias

Price considerations theory also provides an additional explanation as to why firms that do not choose Delaware remain in their home state rather than incorporate in a third state. Some managers, according to the theory, find Delaware law to be insufficiently protective. If their home state provides them with the protection they desire, these managers would choose to remain there. If their home states do not offer sufficiently strong protection, these managers prefer to migrate to another state that offers stronger antitakeover protection. Yet, they may be unable to secure shareholders' approval for such a migration unless the destination state compensates shareholders for the costs they are to suffer as a result of the stronger antitakeover laws. Because other states, unlike Delaware, do not have significant advantages with which they can compensate shareholders for suboptimal rules, managers would find it difficult to reincorporate there.

As a result, the decision of where to incorporate is typically a choice between only two options: Delaware or a firm's home state. Firms that choose not to incorporate in Delaware are usually firms whose managers want stronger protection than Delaware provides and whose home state provides them with such protection. Whereas managers in these firms could easily decide to use their veto power to remain in their home states, it would be more difficult for them to succeed in moving their firms to a third state that they might prefer over Delaware and their home state.³²³

³²² Bebchuk & Cohen, *supra* note 2 (finding that adopting antitakeover rules help states in attracting and retaining incorporations); Subramanian, *Incorporation Choice*, *supra* note 2 (finding that, in general, adopting antitakeover rules helps states in attracting and retaining incorporations, except when these rules are especially draconian).

³²³ Obviously, this analysis also explains why states that offer strong antitakeover statutes succeed in retaining their firms more than states that offer weaker protection.

D. *Delaware's Dominance and the Absence of Vigorous Competition*

The price consideration analysis also provides additional explanation as to why other states do not manage to attract a significant number of firms and do not seem to attempt to compete with Delaware. By reducing its price to reflect the harm caused to shareholders from the pro-managerial rules it adopts, Delaware makes it unprofitable for shareholders to incorporate in any of the other states.

Even if a state other than Delaware offers rules that are optimal for shareholders, it would not succeed in attracting firms in their IPO stage because of Delaware's pricing strategy, which does not charge the whole value generated by its network externalities and other advantages. Moreover, even if another state changes its switching rules so that shareholders themselves would be able to initiate a move to another state, it would still be more profitable for other firms to incorporate in Delaware. To be sure, if a state other than Delaware builds a judicial infrastructure similar to the one Delaware has and offers different switching rules, such a state might be more successful in attracting incorporations. Yet once another state establishes such an infrastructure, Delaware would react by cutting its prices and/or changing its laws.

The only group that other states might hope to retain is the group of firms whose managers are especially opportunistic, and the only method to retain these firms is providing their managers with stronger protection. Accordingly, even if some of the states would like to retain and attract incorporations, this desire is manifested only by their tendency to adopt strong antitakeover protections.

VI. IMPLICATIONS FOR THEORIES OF REGULATORY COMPETITION

Even with thirty years of literature on the subject, the debate over the market for corporate law has not come to a conclusion. Evidence has been adduced to support each side of the debate. Price considerations analysis shows that because all sides of the debate have overlooked an important dimension, the debate could not have been resolved. Accordingly, the analysis has implications for all sides of this debate.

To start, as the price considerations analysis demonstrates, Delaware is expected to produce better corporate law than the other states regardless of the direction in which the race is headed. This is so because, unlike other states, the higher the quality of Delaware's corporate law, the more Delaware can charge for it. The evidence regarded by race to the top scholars as compelling, that Delaware law is better than other states' law, is in fact, of little relevance to the task of assessing the performance of the current system and determining its desirability. In this sense the price considerations analysis strengthens the view that the current system produces pro-managerial bias in the corporate law of Delaware and many other states.

The analysis also has important implications for the race to the bottom view. In particular, price considerations analysis exposes an overlooked factor that induces Delaware to cater to shareholders' interests. Race to the bottom proponents have underscored Delaware's ability to compensate shareholders with its competitive advantages, but they have not recognized that Delaware pays a price for providing managers with protections. They have not, therefore, recognized that Delaware's pro-managerial bias is constrained by price considerations.

Also the recent literature that focuses on the concentrated structure of the market for corporate law and its consequences is affected by the conclusions from price considerations analysis. The analysis in this article suggests, in contrast to conventional wisdom, that a concentrated market might protect shareholders better than a competitive market. In a competitive market, no state can charge a positive price because another state could immediately attract its firms by charging a slightly lower one. In such a market, states would have weaker incentives to protect shareholders.³²⁴ In addition, and consistent with Kahan and Kamar's views, price considerations analysis suggests that Delaware's market power induces Delaware to invest in innovations to and modifications of its corporate law. It also explains why this would be the case despite the network externalities in this market.

In addition, the analysis developed here provides another explanation as to why other states do not attempt to compete with Delaware, either by adopting better corporate law or by offering better switching rules. By reducing its price to reflect the harm that is caused to shareholders from the pro-managerial rules it adopts, Delaware makes its overall package superior for shareholders to any possible deal offered by any other states, including a deal with different switching rules. The fact that other states do not seem to make such efforts to compete with Delaware therefore, does not indicate that states other than Delaware do not want to compete with Delaware, but rather that they do so through the methods that might make some difference.

Lastly, the price considerations analysis also has implications for the thesis that Delaware's real competition comes from the federal government. First, it suggests that, even when Delaware is not constrained by the fear of federal intervention, during the periods in which, in Roe's words, Delaware could "breathe more freely," there is another constraint on Delaware's pro-managerial policy, namely the constraint arising from price considerations. The price consideration analysis therefore is reconcilable with and complements Roe's theory. Second, Roe's thesis could be broadened to Delaware tax law. To minimize the risk of federal intervention in corporate law, Delaware might choose to keep its price below a certain threshold. As this article shows, the ability that Delaware has to increase its price creates incentives for Delaware to protect shareholders and to invest in the quality

³²⁴ To be sure, this is not the only equilibrium that could emerge in a competitive market. If none of the states had market power in equilibrium they might choose to differentiate their products. The fact that states do not choose to differentiate their products in the current market indicates that such a scenario is unlikely to happen in a competitive market.

of its corporate law. If the price is constrained, these incentives are constrained as well. Therefore, another implication of our analysis for Roe's theory is that the threat of federal intervention, if it applies to Delaware's price as well, limits Delaware's incentives to protect shareholders and invest in the quality of its corporate law.

VII. IMPLICATIONS FOR THE ROLE OF FEDERAL LAW

This Part will analyze the implications of the analysis for the question of the desirability of federal intervention. Section A discusses the implications of the analysis for the question of the desirability of mandatory federal intervention in substantive corporate law. Section B discusses the implications of the analysis for the question of the desirability of federal intervention in rules governing changes to a corporation's state of incorporation. Section C discusses a novel suggestion for federal intervention in the form of intervention in states' franchise tax law rather than corporate law. Although this suggestion is fully developed in a different article, I will briefly discuss its features here.

A. *Mandatory Intervention in State Corporate Law*

The debate over the market for corporate law has focused, in large part, on the choice between federal and state law.³²⁵ Opponents of the current system have suggested that federal intervention is required in corporate law, at least as to a certain set of corporate issues.³²⁶ Race to the top proponents have opposed any of these suggestions and have even called for expansion of regulatory competition to securities laws.³²⁷

The call for federal intervention is generally based on two different grounds. First, because the current bias in favor of managers is so significant, eliminating this bias will outweigh the disadvantages accompanying federal regulation.³²⁸ The second argument is based on recent evidence purporting to cast doubt on the existence of vigorous competition among states.³²⁹ Because the competitive pressure from other

³²⁵ See Bebchuk, *Desirable Limits*, *supra* note 4 (arguing for federal rules, or at least federal minimum standards, with respect to self-dealing transactions, taking of corporate opportunities, freeze-out mergers, all aspects of takeover bids and proxy contests, and limitations on dividends); Cary, *supra* note 4, at 701 (proposing that Congress adopt federal standards for corporate responsibility); Romano, *Empowering Investors*, *supra* note 3, at 2386 (arguing for replacing federal securities regulation with state competition); *cf.* Bebchuk & Ferrell, *New Approach*, *supra* note 4 (suggesting federal intervention in the switching rules among states).

³²⁶ See, e.g., Bebchuk, *Desirable Limits*, *supra* note 4.

³²⁷ See Choi & Guzman, *Portable Reciprocity*, *supra* note 9; Romano, *Empowering Investors*, *supra* note 3. *But see* Merritt B. Fox, *Securities Disclosure in a Globalizing Market: Who Should Regulate Whom*, 95 MICH. L. REV. 2498, 2501-06 (1997) (arguing against regulatory choice and advocating instead that the home country of an issuer should regulate the disclosure regime for the issuer regardless of where investors are located or transactions take place).

³²⁸ See Bebchuk, *Desirable Limits*, *supra* note 4, at 1499-1507.

³²⁹ See Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 608-10.

states is actually weaker than has been previously recognized, the potential advantage of state law rules compared with mandatory federal rules is significantly smaller than has been suggested by race to the top scholars.³³⁰

Indeed, such intervention has been pursued several times by the federal government as a response for presumed inefficiencies in states' corporate laws.³³¹ Most recently, in response to corporate scandals at Enron and WorldCom, Congress passed the Sarbanes-Oxley Act of 2002, which intervenes in issues that were traditionally considered "internal affairs" of firms.³³² Moreover, even when such intervention does not occur, the rules that Delaware chooses might reflect the possibility of such intervention. Being aware of and concerned about the possibility of federal intervention if the federal government is not satisfied with Delaware's performance, Delaware designs its corporate law so that it does not diverge significantly from the corporate law that the federal regulator would have chosen.³³³

Price considerations analysis has implications both for the opponents and for the proponents of mandatory federal intervention. On the one hand, by questioning the argument of the race to the top theory, the analysis shows that the concern that state law suffers from pro-managerial bias is well grounded. The fact that Delaware is better than the other states is not necessarily relevant to the debate and, therefore, might not mitigate these concerns. By confirming the concerns of the race to the bottom view, the analysis strengthens the case for federal intervention. Moreover, another implication of the analysis is that the desirability of federal intervention is not static but rather changes over time. As Delaware's market power increases, Delaware can either increase its franchise tax or, alternatively, bias its law in favor of managers. During the last two decades, although Delaware's market power increased significantly, Delaware increased its tax only moderately. Instead, Delaware utilized its market power to debase its law for the benefit of managers' benefits. Accordingly, over this period, the desirability of federal intervention increased significantly.

On the other hand, though, the analysis exposes an overlooked factor that induces Delaware to restrain its managerial favoritism to some extent and to invest in innovations to and modifications of its corporate law. Proponents of federal intervention in corporate law will need to take this into account when they assess the desirability of federal intervention in corporate law. As explained above, Federal corporate law has several recognized disadvantages relative to state corporate law.³³⁴ A more definitive determination, therefore, of whether federal intervention in corporate law is desirable or not requires further assessment in light of the new factors revealed by the analysis developed here.

³³⁰ *Id.* But see Kahan & Kamar, *The Myth*, *supra* note 5, at 735-36 ("[U]nlike Bebchuk and Hamdani . . . we do not share the assessment that the virtual lack of competition strengthens the case for a mandatory federal corporate law.")

³³¹ For a detailed description of all federal intrusion into state corporate law, see Roe, *supra* note 5, at 607-34.

³³² *See id.* at 639.

³³³ *See id.*

³³⁴ *See* discussion *supra* section II.B.2

B. *Choice Enhancing Intervention*

While it is hard at this stage to draw a firm conclusion about the implications of the price considerations analysis for the desirability of federal intervention in substantive corporate law, the analysis clearly lends support for federal intervention if such intervention preserves the incentives of the current system and improves on them.

One suggestion that manages to preserve the benefits of the current system and potentially to improve on it is the proposition for “choice enhancing intervention” promoted by Bebchuk and Ferrell.³³⁵ Choice enhancing intervention, which increases the spectrum of choices that shareholders have and, as a result, incents Delaware to take actions to improve shareholder value, consists of two components.

First, in order for more choices to have some meaning for shareholders, Bebchuk and Ferrell suggest that mandatory rules create voting procedures that enable shareholders to initiate reincorporation in any state.³³⁶ Indeed, as the price considerations analysis shows, under the current switching rules, which provide managers with a veto power over reincorporation decisions, all of the states, including Delaware, offer inefficient rules that benefit managers at the expense of shareholders. Giving shareholders power to initiate reincorporation could decrease the pressure on Delaware to cater to managers’ interests.

However, even if shareholders have the freedom to opt out of Delaware law, other states have weak incentives to compete with Delaware.³³⁷ First, these states could not charge a positive price for out-of-state incorporations. Second, if they change their law to attract corporations, Delaware could match its law to theirs and by these means dissuade shareholders from leaving.³³⁸ The federal government, presumably, has better incentives to protect shareholders from expropriation of firm value by management.³³⁹ The price considerations analysis, therefore, also supports the second component of Bebchuk and Ferrell’s suggestion for “choice enhancing intervention”: Optional federal takeover law. Under their suggestion, shareholders could opt-in to (and out-of) a

³³⁵ See Bebchuk & Ferrell, *New Approach*, *supra* note 4; see also 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 reaction by Stephen Choi and Andrew Guzman to the choice-enhancing approach); Lucian Arye Bebchuk & Allen Ferrell, *On Takeover Law and Regulatory Competition*, 57 BUS. LAW. 1047 [hereinafter Bebchuk & Ferrell, *Reply to Critics II*] (replying to a critical reaction by Jonathan Macey); Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5 at 610-12 (grounding the case for such intervention in skepticism about the existence of vigorous competition).

³³⁶ Bebchuk & Ferrell, *New Approach*, *supra* note 4, at 147-49.

³³⁷ To be sure, as the analysis shows, Delaware has incentives to protect shareholders even in cases where it faces no competition. Yet, there could be some advantages for having another producer in the market, which produces corporate law that caters to shareholders’ interests. For instance, comparison between the two could provide shareholders with better information on their options and as a result improve Delaware’s incentives.

³³⁸ *Id.* at 154-55; see also Bebchuk & Hamdani, *Leisurely Walk*, *supra* note 5, at 612-14.

³³⁹ Bebchuk & Ferrell, *New Approach*, *supra* note 4, at 154-55.

federal takeover regime.³⁴⁰

The effectiveness of Bebchuk and Ferrell's suggestions, however, hinges on one main factor. In particular, its usefulness depends on the extent to which shareholders would find it profitable to become informed and to act upon the information they collect. Shareholders clearly invest the time and effort to become informed in some cases, yet in many other cases they do not.³⁴¹ The pressure on Delaware to improve its law exists only to the extent that shareholders get involved.

C. *Federal Intervention in Franchise Tax Law*

The analysis developed in this article has examined the role that the price plays in improving the quality of Delaware corporate law. By creating a focus on price as an important source for incentives, the analysis lends support to a federal intervention in the form of regulation of the factors used in determining incorporation fees. This form of intervention, suggested and elaborated upon by the author elsewhere, focuses on Delaware franchise tax law rather than on its corporate law.³⁴² As shown above, the structure of the franchise tax affects the corporate law that Delaware chooses to produce.³⁴³ It is worthwhile, therefore, to consider different tax structures and their potential influence on the corporate law that Delaware would choose to produce. For instance, tying the price that Delaware charges either to profits or to market value could induce Delaware to further improve the quality of its corporate law and enhance shareholders' benefits.

Recall Winter's argument that Delaware's corporate law affects both the earnings and the share value of corporations governed by that law.³⁴⁴ If Delaware permits corporate management to profit at the expense of shareholders, the investment returns to shareholders of firms governed by Delaware law will decline. Inevitably, the prospect of low investment returns will lead to a decline in the value of the shares of those firms. This relation between the quality of corporate law and the performance of the firms could be used to improve Delaware incentives in producing its corporate law. With a tax that is sensitive to firm performance, the revenues collected by Delaware could be strongly affected by the quality of the corporate law it produces. Enticing managers with redistributive inefficient corporate rules might attract more managers, but would also impair the economic performance of those firms it attracts and the tax that charged to each firm.

³⁴⁰ *Id.* at 143-47.

³⁴¹ For a criticism on this aspect of Bebchuk and Ferrell's proposal, see Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 989 (2001). Bebchuk and Ferrell also acknowledge that the problem of collective action and rational apathy affects shareholder voting. See Bebchuk & Ferrell, *Reply to Critics I*, *supra* note 240, at 995-96.

³⁴² See Barzuza, Delaware's Compensation, *supra* note 31.

³⁴³ See discussion *supra* section IV.A.

³⁴⁴ See Winter, *Shareholder Protection*, *supra* note 3, at 256.

To be sure, the effect of such a tax would be similar to the effects of the price considerations described above. There are several advantages, however, that this kind of system has over the current tax. To start with, unlike the current tax, a proportional tax would provide Delaware with ongoing incentives to protect shareholders and to generally improve the quality of its law. Second, an important virtue of such a system is that it relies less on activism on the part of shareholders. Third, with such a tax, Delaware would have better incentives since its tax collections will be sensitive to the value of large firms. Fourth, a proportional tax could be designed in a way that makes it more sensitive to firm value than it is now and by this strengthen the quality prong in Delaware's trade-off.

Improvements of the tax system, for several reasons, might not occur by themselves but rather require federal intervention.³⁴⁵ This kind of intervention, if adopted would have advantages over other tools that we have to reduce agency costs within firms. To start with, as in the case of Bebchuk's and Ferrell's suggestion, the proposal to intervene in the franchise tax law does not replace states legislating corporate law but rather is directed at improving their incentives. As a result, this limited intervention preserves the advantages of the current system. Another virtue of intervention in the tax system is that it does not assume and does not rely on competitive forces. Even if Delaware faced no competition at all and even if there were no chance that firms would ever migrate from Delaware, Delaware would still have incentives to invest in the quality of its law and to take into account shareholders' interests. The reason for this is simple—if the tax is correlated with firm performance, then tax collections would be higher with a high quality corporate law system than with a low quality corporate law system.³⁴⁶

In fact, the way such compensation could incent Delaware or any other state with market power is similar to the way in which executive compensation schemes sometimes are designed to align managers' incentives with shareholders' interests. Tying Delaware revenues to the performance of firms incorporated in Delaware, however, can achieve better results, on a relative basis, for shareholders than tying managers' compensation to the performance of the firm. Unlike managers who are risk averse, Delaware is diversified and likely more risk-neutral. The choices that Delaware makes affect not one firm but thousands of firms from a wide range of industries.³⁴⁷ Tying Delaware's compensation to the performance of firms incorporated in Delaware, therefore, would involve much lower costs of risk aversion than is the case for managers.

³⁴⁵ For a discussion on whether such intervention is required and justified, see Barzuza, Delaware's Compensation, *supra* note 31.

³⁴⁶ *See id.*

³⁴⁷ *See Daines, Firm Value, supra* note 3, at 532 tbl.1.

VIII. CONCLUSION

This article has shown that price considerations play an important role in the market for corporate law. Specifically, it showed that Delaware revenues do not increase in quantity but rather are determined by a trade-off between the quantity and price of incorporations: The more pro-managerial Delaware law is the more firms it attracts, but the less it can charge each firm. The article further showed that price considerations may induce Delaware to invest in innovations and modifications to its corporate law even in the absence of external competitive pressures. Thus, regardless of the correct position in the current debate in the literature as to whether the current system leads states into a race to the top, a race to the bottom, no race at all or one with the federal regulator, the market for corporate law is affected by price considerations and these considerations cannot be left out of the regulatory discussion.

After presenting the significance of price considerations to the debate and then offering the trade-off framework to analyze how it affects market dynamics, the article presented and analyzed evidence showing that Delaware law and the services it provides do not maximize the volume of incorporations in the state but rather enhance and retain Delaware revenues.

Having presented the evidence this article derived the following concrete implications for the debate. First, it offered new perspectives on the market. Although it reasoned that Delaware's winning the race does not mean that the race is desirable, it exposed an overlooked factor that restrains Delaware's managerial favoritism and induces it to invest in the quality of its law. It also suggested that the concentrated market structure might lead to better protection for shareholders than would be the case in a competitive market.

The debate on competition between states for corporate charters and the quality of corporate law has been going on for over thirty years and has not yet reached firm conclusions. This article suggests that this puzzling state of affairs is largely attributable to the neglect of the role price considerations play in the market. Incorporating price considerations into the debate makes it possible, for the first time, to present a coherent explanation that accounts for the full body of empirical evidence available regarding patterns of incorporations, changes in Delaware corporate law, the performance of firms incorporated in the various states, and the lack of competition in the market.

Lastly, the article offered new perspectives on the role federal law should play in the market. It reasoned that the desirability of mandatory federal intervention of the kind manifested by the recent Sarbanes-Oxley Act can be determined only after further assessment in light of the new price factors herein discussed. Recognizing the importance of price considerations, the analysis called for a consideration of a limited federal intervention in the franchise tax law rather than in corporate law. Different tax structure could better align Delaware's incentives with shareholders'

interests and provide it with ongoing incentives to improve its law. This could be the case even in the absence of competitive pressures and even if shareholders were unaware of such improvements.