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The Myth of State Competition in Corporate Law

by

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Introduction

That states compete for incorporations by publicly traded companies has long been a paradigm in corporate law scholarship. The premise of state competition is the basis of a debate over whether such competition results in a "race to the top" or a "race to the bottom" which started last century and continues up to today.¹

Signifying the long history and acclaim of the assertion that states compete for incorporations, regulatory competition theorists regularly derive lessons from, draw parallels to, or distinguish between competition for incorporations and competition in other areas. Thus, for example, the proposal that federal securities law be repealed and responsibility for securities regulation be devolved on the states is explicitly

¹ See William W. Cook , A Treatise on Stock and Stockholders 1604-05 (3d ed. 1894) (noting that federalism in corporate law in the United States was driving some states to liberalize their corporate statutes); Russell Carpenter Larcom, The Delaware Corporation v-vi (1937) ("Two points of view may be held concerning the effects of this kind of law making in the competing states. On the one hand it may be maintained that, in the effort to procure revenue, law making is reduced to a competitive basis and that this is undesirable, or at least of questionable social value. ... The other point of view visualizes this competition, induced perhaps by selfish motives, as leading to progress"); Cary; Winter, Romano, Bebchuk Harvard, Bebchuk now, Romano now, Easterbrook & Fischel)

based on the view that state competition for incorporation is effective and beneficial.² Similarly, the debate over how financial institutions should be regulated has been said to parallel the debate over state competition for incorporations.³ By contrast, the proposal that states should have greater authority over the design of environmental protection is premised on the argument that competition in this area differs from competition for incorporations.⁴ Other

² See Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359 (1998) (analogizing purported state competition for incorporations to proposed system of state competition in securities regulation); Roberta Romano, *The Need for Competition in International Securities Regulation*, 2 *Theoretical Inquiries L.* 387 (2001) (defending a proposal to permit state competition for securities regulation by arguing that states effectively compete for incorporations); see also Stephen J. Choi and Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 *Fordham L. Rev.* 1855 (1997).

³ See Howell E. Jackson, *Centralization, Competition, and Privatization in Financial Regulation*, 2 *Theoretical Inquiries L.* 649 (2001) (regulation of financial institutions); see also Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 *Cornell L. Rev.* 677 (1988); Mark David Wallace, *Life in the Boardroom After FIRREA: A Revisionist Approach to Corporate Governance in Insured Depository Institutions*, 46 *U. Miami L. Rev.* 473 (1992) (regulation of savings and loans).

⁴ See Richard L. Revesz, *Rehabilitating Interstate Competition: Rethinking the "Race to the Bottom" rationale for Federal Environmental Regulation*, 67 *N.Y.U. L. Rev.* 1210 (1992); see also Daniel C. Esty, *Revitalizing Environmental Federalism*, 95 *Mich. L. Rev.* 570 (1996); Peter P. Swire, *The Race to Laxity and the Race to Undesirability: Explaining*

fields drawing on the notion that states compete for incorporations include bankruptcy law,⁵ tax policy,⁶ limited liability company law,⁷ blue sky law,⁸ secured transactions law,⁹ corporate law in the European Union,¹⁰ computer law,¹¹

Failures in Competition Among Jurisdictions in Environmental Law , 14 Yale J. on Regulation 67 (1996); Jonathan H. Adler, Wetlands, Waterfowl, and the Menace of Mr. Wilson: Commerce Clause Jurisprudence and the Limits of Federal Wetland Regulation, 29 Env't'l. L. 1 (analyzing wetlands regulations).

⁵ See, e.g., Wells M. Engledow, Cleaning Up the Pigsty: Approaching a Consensus on Exemption Laws, 74 Am. Bankr. L.J. 275, 296-97 (2000) (analyzing state bankruptcy exemption laws); David A. Skeel, Jr., Lockups and Delaware Venue in Corporate Law and Bankruptcy, 68 U. Cin. L. Rev. 1243 (2000) (analyzing bankruptcy venue).

⁶ See Peter D. Enrich, Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business, 110 Harv. L. Rev. 377 (1996) (examining implications of state competition theory on state tax incentives for business locations).

⁷ Carol A. Goforth, The Rise of the Limited Liability Company: Evidence of a Race Between the States, But Heading Where?, 45 Syracuse L. Rev. 1193 (1995) (analyzing LLC statutes); Larry Ribstein, Statutory Forms for Closely-Held Firms: Theories and Evidence from LLCs, 73 Wash U. L.Q. 369 (1995) (analyzing LLCs).

⁸ Mark I. Steinberg, The Emergence of State Securities Laws: Partly Sunny Skies for Investors, 62 U. Cin. L. Rev. 395 (1993) (analyzing blue sky laws).

⁹ Edward J. Janger, Predicting When the Uniform Law Process Will Fail: Article 9, Capture, and the Race to the Bottom, 83 Iowa L. Rev. 569 (1998) (secured transactions law).

¹⁰ See, e.g., David Charny, Competition among Jurisdictions in Formulating Corporate Law Rules: An American Perspective on the "Race to the Bottom" in the European Communities, 32 Harv. Int'l L.J. 423 (1991) (using the state

welfare policy,¹² choice of law,¹³ trust law,¹⁴ and legal ethics.¹⁵ In short, the state competition paradigm has profoundly influenced the scholarship of corporate and several other areas of law.

The thesis of this Article is that the very notion that states compete for incorporations is largely a myth. Other than Delaware, no state is engaged in significant and sustained efforts to attract incorporations of public

competition paradigm to analyze whether corporate law in the European Union should be harmonized); Karsten Engsig Sorenson & Mette Neville, *Corporate Migration in the European Union*, 6 Colum. J. Eur L. 181, 186-87 (2000) (noting that European choice law of rules for corporations are justified as preventing an American style race to the bottom); Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 Am. J. Comp. L. 329, 350-56 (discussing possible implications of American style regulatory competition on structure of corporate law in the European Union).

¹¹ Brian D. McDonald, *The Uniform Computer Information Transactions Act*, 16 Berkeley Tech. L.J. 461 (2001) (analyzing computer information transaction law).

¹² See, e.g., Sherryl D. Cashin, *Accounting for the Tyranny of State Majorities*, 99 Colum. L. Rev. 552 (1999) (analyzing welfare policy).

¹³ See, e.g., Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 Del. J. Corp. L. 999 (1994).

¹⁴ Stewart E. Sterk, *Asset Protection Trusts: Trust Law's Race to the Bottom?*, 85 Cornell L. Rev. 1035 (analyzing asset protection trusts).

¹⁵ H. Geoffrey Moulton, Jr., *Federalism and Choice of Law in the Regulation of Legal Ethics*, 82 Minn. L. Rev. 73 (1997) (analyzing legal ethics).

companies.¹⁶ Modern state competition scholars¹⁷ have

¹⁶ We focus on competition for public corporations for two reasons. First, the prior literature, including many of the arguments made and much of the evidence adduced, relates to public corporations. [Cite Winter; Romano (reincorporation, important provisions); Lucian Bebchuk & Alma Cohen, *Firms' Decision Where to Incorporate* (unpublished manuscript, Nov. 2001) (on file with authors); Robert Daines, *Does Delaware Law Increase Firm Value?*, 62 *J. Fin. Econ.* 525 (2001), check other Bebchuk]. Second, the market for incorporations by public firms is segregated from the market for close corporations. In terms of substantive law, public corporations seek rules appropriate for companies with a large number of dispersed shareholders. Closely held firms, many of which have a single shareholder, are more concerned with administrative ease and veil-piercing rules. Even with respect to close corporations with more than one shareholder, for which fiduciary duty law matters more, different rules are likely to be optimal than for public corporations because the nature of the fiduciary duty problems differ [Rock/Wachter] and because various protective devices (such as most provisions of the securities laws, stock exchange rules, and independent board members) are not available to close corporations. In term of adjudication, public corporations care about the quality of courts, whereas close corporations care less about court quality (since shareholder disputes are infrequent) [Kahan/Kamar] and more about their geographic proximity. The market structure, where half of public firms are Delaware corporations but most private firms incorporate in their home state or seek an alternative organizational form (such as an LLC), even though Delaware assesses minimal franchise taxes on nonpublic corporations, is consistent with such segmentation. Also cite to Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 *Wash. U. L.Q.* 365, 377-78 (1992).

¹⁷ There is historical evidence that states may have competed for incorporations at about 1890. See, e.g., Seligman; Harold W. Stoke, *Economic Influences upon the Corporation Laws of New Jersey*, 38 *J. Pol. Econ.* 551, 575-76 (1930) (documenting chartermongering among states at the turn of the century), William E. Kirk, III, *A Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain Corporate Pre-Eminence*, 10 *J. Corp. L.* 233 (1984); Christopher Grandy, *New Jersey Corporate*

misconceived the incentives of states to attract incorporations and misinterpreted their actions.

Part I analyzes the incentives to compete. We show that, common assertions to the contrary notwithstanding, no state other than Delaware would earn substantial franchise tax revenues by attracting incorporations. The standard story -- that states compete to gain franchise tax revenues -- is just wrong. We also examine whether states would benefit from attracting legal business associated with incorporations. We show that the benefits from attracting such business are rather modest.

Part II considers whether states engage in actions that may reflect an effort to attract incorporations. We consider three types of actions: the design of statutory law (including the adoption of the Model Business Corporation Act, the

Chartermongering, 1875-1929, 49 J. Econ. Hist. 677, 688 fig.4 (1989); Larkom? We have not investigated this evidence and this Article does not address that time period. Markets and competitive dynamics obviously change over time, and the market for incorporations is no exception. Even if states competed for incorporations hundred years ago, most no longer do so and have not done so for quite some time. We note parenthetically, however, that many of the changes that took place in American corporate law and are attributed to state competition [free incorporations, unlimited life/size, others] occurred in other industrialized countries, that lack the federal structure giving rise to the possibility of state competition, at about the same time. Thus, even for that earlier time period, the significance of state competition may have been exaggerated.

adoption of anti-takeover laws, and other statutory revisions); the design of judge-made law; and the design of the court system. We find no significant state actions with respect to the design of judge-made law and the design of the court system. With respect to statutory law, we conclude that the activities of states do not evidence a significant effort to attract incorporations.

Part III examines why the profits that Delaware reaps from incorporations have not induced other states to compete. We argue that the existence of entry barriers that protect Delaware is but part of the answer. Another part is that Delaware's potential competitors are not business organizations motivated solely by profits. Rather, they are state bureaucracies seeking other goals as well and operating under political constraints. While states can and do compete in other areas of regulation, when the stakes are sufficiently high to dominate their action, the potential benefits to states from competing with Delaware for incorporations are just not enough to drive them to act. This explains why states have never tested their ability to compete with Delaware, rather than attempted to compete and failed.

We are still working on Part IV, and have not included it in this draft. It will discuss the implications of our

analysis.

I. Do States Have Incentives to Compete?

The most important element of the theory of state competition is that states have strong incentives to attract incorporations. In the context of state competition for incorporations, this incentive is said to derive from franchise tax revenues that corporations pay to their state of incorporation. Reflecting the conventional wisdom, Michael Klausner explains: "When a corporation incorporates in a particular state, the state gains franchise fees. States, therefore, have monetary incentives to produce ... corporate law with which to attract firms."¹⁸ Other state competition scholars agree.¹⁹

¹⁸ Michael Klausner, *Corporate Law and Networks of Contracts*, 81 Va. L. Rev. 757, 841-42 (1995).

¹⁹ See, e.g., William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 Yale L.J. 663, 664 (1974) ("While corporation statutes had been restrictive, the leading industrialized states began removing the limits upon the size and powers of business units. The states ... eager for the revenues derived from the traffic in charters, joined in advertising their wares."); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251, 255 (1977) ("An important mechanism generating change in American corporate law has thus been the competition among states for charters. Both Delaware ... and its competitors candidly admit that the purpose of corporate code revisions has been the attraction of charters to their state in order to produce significant tax revenues"); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 Yale L.J. 2359, 2388 (1998) ("In the corporate law setting, the benefit is financial: States collect franchise tax revenues from locally incorporated firms");

Roberta Romano, *The Genius of American Corporate Law* 15-16 ("In both the Cary and the Winter positions, the goal of maximizing [franchise tax] revenues functions as the invisible hand ... [T]he revenue-maximizing explanation of state chartering -- to which both sides of the debate subscribe -- is intuitively compelling to those familiar with the field ..."); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1437, 1451 (1992) ("States clearly derive benefits from in-state incorporations. Incorporations bring with them franchise tax and fee revenues as well as patronage for in-state law firms, corporation service companies, and other business. Thus, states have an interest in increasing in-state incorporations"); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 *Nw. U. L. Rev.* 542 (1990) ("states learned that writing flexible rules can increase franchise tax revenues"); Douglas J. Cumming & Jeffrey G. MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 *Intl. Rev. L. & Econ.* 141 (2000); Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 *Del. J. Corp. L.* 999, 1007 (1994) ("The standard explanation of the state competition for corporate law is based on the states' incentives to earn franchise and related fees from incorporating firms."); John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 *Nw. U. L. Rev.* 641, 650 (1999); William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 *Geo. L.J.* 201, 266 (1997) ("The states have competed for chartering businesses for a century, offering attractive codes and ancillary services in exchange for franchise tax revenues"); David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 *Tex. L. Rev.* 471, 517 & n.196; Jonathan R. Macey, *Corporate Law and Corporate Governance: A Contractual Perspective*, 18 *J. Corp. L.* 185, 195; Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* 212 (1991) ("Managers may incorporate in any state, no matter where the firm's assets, employees, and investors are located. States thus must compete with each other to attract incorporations. Jurisdictions successful in this competition obtain revenues from franchise fees and taxes and create demand for the services of the local bar"). Most

In Section A, we argue that the conventional wisdom that states stand to earn significant franchise tax revenues from attracting incorporations is incorrect. With the exception of Delaware's, franchise taxes are simply not structured to generate such revenues.

In Section B, we examine a secondary benefit sometimes cited to explain why states compete for incorporations: to

of these commentators do not provide support for the assertion that states earn franchise tax revenues by attracting incorporations. Rather, they cite to other commentators or, occasionally, to anecdotal evidence from the beginning of the twentieth century [cites]; but see Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 *Tex. L. Rev.* 469 (1987) (arguing that states design their corporate laws primarily to increase the legal business of its corporate bar, and only secondarily to increase their franchise tax revenues); William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 *J. Legal Stud.* 303, 306-07 (1997) ("States compete with each other for chartering business not only because it produces franchise tax revenues for the chartering state but also because interest groups within the state are benefitted by this activity"); Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 *Colum. L. Rev.* 1461, 1511 (1989) (remarking that legislatures, as public bodies, may be guided by moral concerns); Mark J. Loewenstein, *Delaware as Demon: Twenty-Five Years After Professor Cary's Polemic*, 71 *U. Colo. L. Rev.* 497, 506-07 (2000) (noting that, in thirty-three states, franchise tax revenues account for less than half percent of total taxes collected); William J. Carney, *The Production of Corporate Law*, 71 *S. Cal. L. Rev.* 715, 718 (1998) (noting that revenues from chartering do not present a significant income source for large states and that interest groups explain development of corporate law in most states).

attract legal business for the local bar.²⁰ We argue that the benefits to the state and to local lawyers from such additional business provide, at best, weak incentives for states to compete for incorporations.

In Section C, we address four potential objections to, and extensions of, our analysis: the claim that states are engaged in "defensive" competition; the argument that the present franchise tax structure represents a "bait and switch" strategy; the extent to which states would earn franchise tax revenues if several states restructured their tax and engaged in active competition; and the evidence that states that adopt corporate law innovations sooner earn higher franchise tax revenues.

A. Franchise Taxes and Incentives to Compete

Franchise taxes do not provide meaningful incentives for states to compete for incorporations. As presently structured, states other than Delaware would not gain significant franchise tax revenues even if they succeeded in attracting a substantial fraction of publicly traded

²⁰ See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225, 240-41 (1985); Klausner, *supra* note __, at 771; Bebchuk, *supra* note __, at __; Easterbrook & Fischel, *supra* note __, at __.

corporations.

1. Annual Franchise Taxes

Consider first annual franchise taxes, which provide the bulk of states' franchise tax revenues. Forty-five states charge companies that are incorporated in the state either a tax based on the amount of business conducted in the state, or a small flat fee (no more than \$150 a year in all states but Pennsylvania, and \$300 a year in Pennsylvania), or both. The former does not generate marginal revenues, since companies incorporated elsewhere but doing business in the state have to pay the same tax.²¹ The latter could generate only trivial revenues even if a state attracted a large portion of the 10,000 to 12,000 companies with publicly traded shares.²²

The remaining states employ different tax structures that can theoretically result in higher taxes for domestically incorporated firms than for foreign firms. With the exception of Delaware, however, none of these states would gain

²¹ The apportioned tax can generate small marginal revenues to the extent that a minimal tax is imposed even on firms that conduct no business in-state. Table 1 takes account of such minimum fees.

²² See Marcel Kahan & Ehud Kamar, Price Discrimination in the Market for Corporate Law, 86 Cornell L. Rev. 1205, 1225 (2001).

substantial amounts from attracting incorporations. To illustrate this, we calculate in Table 1 the marginal annual franchise taxes for a hypothetical company with 100 million authorized shares with a par value of 1 cent each, 60 million issued and outstanding shares, \$600 million worth of assets, and \$200 million in net worth.²³ Only one state -- Georgia -- would earn marginal revenues in excess of \$1000 (see Column 2), and even Georgia would earn such revenues only from companies that do little business in Georgia (compare Column 2 with Column 4). If Georgia attracted 2000 public companies, including all companies headquartered there (a respectable 20 percent market share, and 15 times more than its present share), its additional revenues would amount to \$9 million per year.²⁴ Though nontrivial in absolute terms, this amount would constitute only 0.06 percent of Georgia's total revenues. For a more typical state, such as Maryland, marginal revenues

²³ Column 2 of Table 1 provides the fee payable by the hypothetical firm if it is incorporated in the state but conducts all of its business elsewhere. Column 3 provides the maximum fee payable by any firm. Column 4 provides the fee payable by the hypothetical firm if it is incorporated outside the state but conducts 20% of its business in the state. The marginal fee from the incorporation of the hypothetical firm in the state is the excess of Column 2 over Column 4.

²⁴ About 200 companies are headquartered in Georgia, see Bebchuk & Cohen, *supra* note __, and Georgia would derive no marginal revenues from these companies if they incorporate in-state.

would be \$200,000 a year.

Table 1: Annual Fees Payable by the Hypothetical Corporation

Jurisdiction	Domestic Hypothetical Corporation	Maximum Fee Payable by a Domestic Corporation	Foreign Hypothetical Corporation
Alabama	\$ 30	\$ 100	\$ 10*
Alaska	\$ 50	\$ 50	\$ 100
Arizona	\$ 45	\$ 45	\$ 45
Arkansas	0	0	0
California	\$ 20	\$ 20	\$ 20
Colorado	\$ 12.50	\$ 12.50	\$ 50
Connecticut	\$ 75	\$ 75	\$ 300
Delaware	\$150000	\$150000	\$ 50
D.C.	\$ 100	\$ 100	\$ 100
Florida	\$ 150	\$ 150	\$ 150
Georgia	\$ 5000	\$ 5000	\$ 5000*
Hawaii	\$ 25	\$ 25	\$ 125
Idaho	0	0	0
Illinois	\$ 25	\$ 25	\$ 25
Indiana	\$ 15	\$ 15	\$ 15
Iowa	\$ 30	\$ 30	\$ 30
Kansas	0	0	0
Kentucky	0	0	0
Louisiana	\$ 25	\$ 25	\$ 25
Maine	\$ 60	\$ 60	\$ 60
Maryland	\$ 100	\$ 100	\$ 100
Massachusetts	\$ 85	\$ 85	\$ 85
Michigan	\$ 15	\$ 15	\$ 15
Minnesota	0	0	\$ 20
Mississippi	\$ 25	\$ 25	\$ 25
Missouri	\$ 40	\$ 40	\$ 40
Montana	\$ 10	\$ 10	\$ 10
Nebraska	\$ 455	\$ 11995	\$15000*
Nevada	\$ 85	\$ 85	\$ 85
New Hampshire	\$ 100	\$ 100	\$ 100
New Jersey	\$ 40	\$ 40	\$ 40
New Mexico	\$ 62.50	\$ 62.50	\$ 62.50
New York	\$ 4.50	\$ 4.50	\$ 4.50
North Carolina	\$ 10	\$ 10	\$ 10
North Dakota	\$ 25	\$ 25	\$ 25
Ohio	\$ 5	\$ 5	0
Oklahoma	\$ 10	\$ 10	\$ 10
Oregon	\$ 30	\$ 30	\$ 220
Pennsylvania	\$ 300	\$ 300	\$ 300
Rhode Island	\$ 250	none	\$ 250
South Carolina	\$ 25	\$ 25	\$ 25
South Dakota	\$ 10	\$ 10	\$ 10
Tennessee	\$ 20	\$ 20	\$ 20
Texas	0	0	0
Utah	\$ 10	\$ 10	\$ 10
Vermont	\$ 15	\$ 15	\$ 100
Virginia	\$ 850	\$ 850	\$ 850
Washington	\$ 50	\$ 50	\$ 50
West Virginia	\$ 340	\$ 2500	\$ 2500
Wisconsin	\$ 25	\$ 25	\$ 50
Wyoming	0	0	0

Source: [provide, except Massachusetts, Illinois Secretary of State web-site]
* Assuming that 20 percent of the business is allocated to the state.

2. Initial Incorporation Taxes

Another, albeit less significant, source of franchise tax revenues are one-time initial incorporation fees.²⁵ Just like annual franchise taxes, initial incorporation fees do not provide a significant impetus to attract incorporations. Most states either charge a low flat fee (between \$50 and \$300) or a low or capped fee based on the number of authorized shares or their aggregate par value. In those states, even public companies with a large number of authorized shares pay little in initial taxes. As Table 2 demonstrates, for a company with 100 million shares with a par value of 1 cent, one-time fees exceed \$10,000 in only six states: Connecticut (\$200,850); Kentucky (\$200,449); Massachusetts (\$100,000); Michigan (\$140,000); Ohio (\$100,000); and Rhode Island (\$200,420). If those states succeeded in attracting 20 percent of the firms that go public, they would earn (assuming the average public firm has 100 million authorized shares when going public)²⁶ between \$8 million and \$16 million a year between 1986 and

²⁵ Similar fees are payable when existing companies increase their authorized capital stock.

²⁶ Most companies have fewer authorized shares when they go public. For example, in a sample of 27 companies incorporated in Nevada between 1996 and 2000, the average number of authorized shares was 66 million. Companies, however, have to pay additional fees when they increase their authorized capital stock.

2000. A more typical state, such as Maryland, would earn a trivial \$4800 a year.

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

Table 2: Initial Incorporation Fees

State	Company with 100 Million shares, Par Value 0.1 Cent	Maximum Fee	Foreign Company	Fee Type or Base
Alabama	\$ 75	\$ 75	\$180+	Flat
Alaska	\$ 150	\$ 150	\$150	Flat
Arizona	\$ 60	\$ 60	\$175	Flat
Arkansas	\$ 50	\$ 50	\$ 50+	Flat
California	\$ 100	\$ 100	\$100	Flat
Colorado	\$ 50	\$ 50	\$175	Flat
Connecticut	\$200,850	none	\$225	No. of Shares
Delaware	\$ 75	none	\$150	Agg. Par Value
D.C.	\$ 120	none	\$150	Agg. Par Value
Florida	\$ 138.75	\$ 138.75	\$138.75	Flat
Georgia	\$ 60	\$ 60	\$170	Flat
Hawaii	\$ 100	\$ 100	\$150+	Flat
Idaho	\$ 100	\$ 100	\$100	Flat
Illinois	\$ 75	\$ 75	\$ 75	Flat
Indiana	\$ 90	\$ 90	\$ 90	Flat
Iowa	\$ 50	\$ 50	\$100	Flat
Kansas	\$ 75	\$ 75	\$ 95	Flat
Kentucky	\$200,449	none	\$ 83+	No. of Shares
Louisiana	\$ 70	\$ 70	\$100	Flat
Maine	\$ 120	none	\$180	Agg. Par Value
Maryland	\$ 60	none	\$ 62	Agg. Par Value
Massachusetts	\$100,000	none	\$300+	No. of Shares
Michigan	\$140,000	\$200000	\$ 60	No. of Shares
Minnesota	\$ 135	\$ 135	\$200	Flat
Mississippi	\$ 50	\$ 50	\$525	Flat
Missouri	\$ 83	none	\$155	Agg. Par Value
Montana	\$ 1020	\$ 1020	\$120	Agg. Par Value
Nebraska	\$ 300	none	\$130+	Agg. Par Value
Nevada	\$ 310	\$ 25,085	\$310	Agg. Par Value
New Hampshire	\$ 85	\$ 85	\$ 85	Flat
New Jersey	\$ 125	\$ 125	\$100	Flat
New Mexico	\$ 1020	\$ 1020	\$1025	No. of Shares
New York	\$ 175	none	\$235+	Agg. Par Value
North Carolina	\$ 135	\$ 135	\$260	Flat
North Dakota	\$ 140	none	\$135	Agg. Par Value
Ohio	\$100,000	\$100,000	\$50,500*	No. of Shares
Oklahoma	\$ 100	none	\$300+	Agg. Par Value
Oregon	\$ 50	\$ 50	\$440	Flat
Pennsylvania	\$ 100	\$ 100	\$180	Flat
Rhode Island	\$200,420	none	\$40,132*	No. of Shares
South Carolina	\$ 110	\$ 110	\$110	Flat
South Dakota	\$ 110	\$ 16,000	\$110	Agg. Par Value
Tennessee	\$ 100	\$ 100	\$600	Flat
Texas	\$ 300	\$ 300	\$750	Flat
Utah	\$ 50	\$ 50	\$ 50	Flat
Vermont	\$ 75	\$ 75	\$100	Flat
Virginia	\$ 2525	\$ 2525	\$2580	No. of Shares
Washington	\$ 175	\$ 175	\$175	Flat
West Virginia	\$ 50	\$ 50	\$100	Flat
Wisconsin	\$ 10,000	\$ 10,000	\$100+	No. of Shares
Wyoming	\$ 100	\$ 100	\$100	Flat

Source: [Provide except for California, Secretary of State web-site, and Rhode Island Code, tit. 7, Sections 8-1.1-121(1) and 7-1.1-123]

* Assuming that 20 percent of the capital is allocated to the state

3. Illustration: Nevada's Franchise Tax Revenues

To show that franchise tax revenues do not provide incentives to attract incorporations, we estimated the revenues of the state of Nevada. Nevada, sometimes referred to as "Delaware of the West" and by many accounts Delaware's leading competitor, is one of few states that attract more than a handful of corporations that are not headquartered in the state.²⁷

About 250 public companies are incorporated in Nevada, of which about 200 are headquartered outside Nevada.²⁸ According to Securities Data Corporation data, 26 companies went public as Nevada corporations between 1996 and 2000,²⁹ of which 18 were headquartered outside Nevada. How much do these companies contribute to Nevada's till?

Nevada charges companies an annual "report fee" of \$85 plus an additional annual "license fee" depending on the

²⁷ The only other states that attract incorporations by companies headquartered outside the state are Delaware and Maryland. Maryland, however, mostly attracts real estate investment trusts and closed-end investment funds. See *infra* TAN.

²⁸ See Subramanian (217 company of which 175 non-headquartered); Bebchuk (243 companies of which 195 non-headquartered).

²⁹ One company listed by Securities Data Corporation as incorporated in Nevada, Netivation.com, actually reincorporated to Delaware shortly before its IPO.

number of Nevada employees. Both fees are also payable by foreign companies doing business in Nevada. The marginal annual revenues to Nevada from the report fee are thus about \$17,000 (assuming that only companies headquartered in Nevada do business there). Since being incorporated in Nevada has no effect on the number of Nevada employees, Nevada earns no marginal revenues from the license fee.

In addition, Nevada earns one-time fees based on the aggregate par value of authorized capital stock when firms incorporate or increase their capital stock. We calculated the fee payable by the 26 companies that went public as Nevada corporations between 1996 and 2000. These fees amounted to \$60,075, of which \$14,075 were paid by eight companies headquartered in Nevada and would therefore have been payable by those companies whether or not they had been incorporated in Nevada. In other words, marginal one-time fees from companies going public as Nevada corporations were \$9200 per year. Annual and one-time fees taken together thus amounted to \$26,200 per year.³⁰ It is hard to see how fees in that order of magnitude could provide incentives for Nevada to

³⁰ This figure slightly understates Nevada's income as Nevada may have earned additional fees from existing public companies as they increase their authorized capital stock and some additional filing fees for filing articles of amendment, dissolution, and the like.

compete for incorporations.

B. Legal Business and Incentives to Compete

The second, though less commonly cited, reason why states compete for incorporations is that incorporations increase the demand for the services of local law firms.³¹ A company that is incorporated in, say, Minnesota, is presumably more likely to hire a Minnesota law firm, suited to render advice on Minnesota corporate law, than a similar company incorporated elsewhere. Moreover, a Minnesota corporation may be more likely to be sued in Minnesota in its corporate and other disputes, and is therefore more likely to hire a Minnesota law

³¹ See supra note ___. Another, less well-known, benefit from incorporations is that unclaimed interest, dividend, and principal payments held by financial intermediaries as record owners can escheat to the state of incorporation of the intermediary. See *State of Delaware v. State of New York*, 507 U.S. 490 (1993) (holding that unclaimed funds escheat to the state of the last known address of the beneficiary and, if such address cannot be determined, to the state of incorporation of the intermediary holding the funds). In 1995, Delaware received \$220 million in one-time funds from unclaimed assets that had accumulated over several years and an expected annual revenue stream of \$35 million. Martha M. Canan, *Delaware Governor Lists His Priorities for Allocating Money From Settlement, The Bond Buyer*, Jan. 20, 1995, at 3. In this regard, a state obviously benefits only if certain financial intermediaries incorporate in it, not corporations generally.

firm to represent it.³²

In this Section, we first show that Delaware lawyers indeed receive substantial revenues as a result of Delaware's status as incorporation haven. Revenues, however, do not equal profits, and Delaware is situated differently from other states. The benefits that other states and their lawyers could expect to receive from an increase in legal business are of much lower magnitude and provide at most only weak incentives to compete for incorporations.³³

1. Delaware's Legal Business

Delaware residents derive financial gains from providing professional services to public corporations incorporated in Delaware. The bulk of these gains go to corporate lawyers and corporate litigators.³⁴ A simple calculation using 1990 United

³² Consistent with this hypothesis, Robert Daines finds that local lawyers recommend to their clients to incorporate locally, rather than in Delaware. See Robert Daines, *The Market for Corporate Law: Lawyers, Takeovers, and the Home Court Advantage* (unpublished manuscript, 2002) (on file with authors).

³³ See also Ribstein, *supra* note __ (expressing doubt whether states will engage in effective competition if competition is driven solely by the legal services industry).

³⁴ See Telephone Interview with Norman M. Monhait, Member of the Council of the Corporation Law Section, Delaware Bar Association, July 12, 2001 [hereinafter Monhait Interview]; Telephone Interview with Donald A. Bussard, Chair of the

States Census data suggests that legal practice in Delaware is indeed lucrative: even before adjusting to differences in living costs, the average income of Delaware lawyers is higher than that of lawyers in any other state, or even any city, in the country.³⁵

In this Subsection, we derive a more precise estimate of

Council of the Section of Corporation Law, Delaware Bar Association, July 17, 2001 [hereinafter Bussard Interview]. Corporate service companies and registered agents also gain from incorporations. The Delaware Division of Corporations currently refers incorporators to 114 registered agents who provide registration and administrative services to Delaware corporations. See Delaware Division of Corporation, Registered Agents, <http://www.state.de.us/corp/agents/agt2.htm> (last visited July 18, 2001). While it is hard to estimate their gain from incorporations, one can infer that it is small compared to the lawyers' from the fact that they are not consulted during the process of corporate legislation. See Bussard Interview.

In addition to corporate disputes, many patent disputes and bankruptcy petitions are brought in Delaware. See Monhait Interview. The benefits Delaware lawyers derive from such cases, however, are only tangentially related to Delaware's status as domicile of choice for public corporations. Jurisdiction and venue rules in patent cases are liberal, leading a recent commentator to conclude that "national corporations may be sued in virtually any U.S. district court." Kimberly A. Moore, 83 J. Pat. & Trademark Off. Soc'y 558, 565 (2001). Similarly, bankruptcy petitions may be brought in any district where the debtor *or any co-filing subsidiary* is either incorporated, head-quartered, or otherwise subject to personal jurisdiction. Since public corporations tend to have a large number of subsidiaries and companies are subject to personal jurisdiction where they transact business, public corporations can file bankruptcy petitions in virtually any U.S. district court.

³⁵ See ____.

the additional legal business for Delaware using 1990 census data, the most recent data available. According to 1990 census figures, 1855 Delaware lawyers had a total income of \$199 million (or \$107,350 per lawyer). To derive the amount of *additional* income resulting from Delaware's special position in the incorporation market,³⁶ we estimate separately the per-lawyer income and the number of Delaware lawyers if Delaware were not an incorporation haven. To estimate per-lawyer income, we regress per-lawyer income in each state on state per-capita income, two demographic variables, and a dummy variable that takes the value of 1 for Delaware and 0 for any other state. The results of the regression are reported in Table 3. All independent variables are statistically significant and the regression has a relatively high R-square of 0.75.

Table 3: Average Income of Attorneys by State

The dependent variable is the average attorney income by state as reported in the 1990 census. Independent variables are the following: Per-Capita Income is the per-capita income by state as reported in the 1990 census; City is the 1990 population of the largest metropolitan area in each state, rounded down to the nearest million as reported in Table No. 34 of the Statistical Abstract of the United States (in thousands); Urbanization is the log of the percentage of each state's population living in urban areas in 1990; and Delaware dummy takes the value of 1 for Delaware and 0 for other states. "State" includes the 50 states and the District of Columbia.

³⁶ [Note also that DE special position as a banking center.]

Variable	Coefficient	t-statistic
Per-Capita Income*	0.662	1.87
City***	0.885	3.09
Urbanization***	14016	4.59
Delaware Dummy***	34859	5.53

R² = 0.749; N = 51

* significant at 10%; *** significant at 1%.

[Add physicians' income to the regression for comparison:

Delaware physicians do not earn higher income than physicians in other states. Same for other high-income professionals.]

The coefficient estimate for the Delaware dummy indicates that Delaware lawyers earn, per lawyer, \$34,859 more than what is predicted by Delaware's per capita income and its demographic characteristics and is highly significant. This is consistent with the hypothesis that Delaware attracts additional legal business by being a prime state of incorporation and suggests that, but for Delaware's special status, per-lawyer income would be \$72,491 (or 7 percent less than the average per-capita income of lawyers in the United States).

To estimate the number of lawyers that would practice in Delaware if Delaware were not a prime corporate domicile, we employ two alternative methodologies.³⁷ First, we assume that

³⁷ Deriving a plausible estimate is somewhat complicated by the fact that Delaware has fewer lawyers per capita than the national average, and regressions similar to the one used

all of Delaware's corporate lawyers and half of its litigators would not practice in Delaware but for the state's status as domicile of choice for corporations.³⁸ Second, we assume that all Delaware lawyers serving public corporations practice in multi-lawyer firms and that, but for Delaware's special status, the ratio of solo practitioners to lawyers practicing in multi-lawyer firms in Delaware would be the same as in other states.³⁹ These methodologies yield a range of 240 to 431 additional Delaware lawyers.⁴⁰ Taken together with the

for lawyer income indicate that Delaware has fewer lawyers than would be predicted, though the coefficient for the Delaware dummy is insignificant.

³⁸ To estimate the number of corporate lawyers and litigators, we obtained section membership data for 2000 from the Delaware State Bar Association (1990 data were not available). We eliminated section members who worked for the government, were academics, or had an office address outside Delaware, and made an adjustment for persons who were members of more than of the corporate law and the litigation sections. To account for changes in the number of lawyers and for lawyers who are not members of the state bar, we divided the result by the total number of 2000 bar association members with Delaware addresses and multiplied it by the number of Delaware lawyers in 1990.

³⁹ For this calculation, we average data from 1988 and 1991 contained in ____.

⁴⁰ The higher estimate is almost certainly too high as it implies that Delaware, without the additional lawyers, would have the highest population to private practitioner ratio of any state in the country. Note also that this estimate is likely to overstate the number of additional Delaware lawyers due to its status as incorporation haven since it would lead to the inclusion of Delaware patent and bankruptcy lawyers.

estimate of the additional per-lawyer income, this results in additional total lawyer income for Delaware of \$82 to 96 million (see Table 4 below). Several Delaware lawyers we talked to considered the lower range of these figures plausible.

Table 4: Additional Income for Delaware Lawyers

Methodology	Additional Lawyers	Regular Lawyers	Regular Income	Additional Income	Additional Income per Additional Lawyer
Bar Membership	240	1615	\$117 million	\$82 million	\$342,000
Solo Practice	431	1424	\$103 million	\$96 million	\$223,000

Adding to such lawyer income an estimated \$100,000 per lawyer for other office expenses yields total lawyer revenue of \$106 to \$139 million.⁴¹ For comparison, the 1990 gross revenue of the New York firm Davis Polk & Wardell (397

See supra note __. Even based on the former estimate, Delaware would have the 46th highest ratio of population to private practitioners without the additional lawyers attributable to incorporations. See Barbara A. Curran & Clara N. Carson, *The U.S. Legal Profession in 1988* (1991).

⁴¹ This estimate is derived from Robert I. Weil, *Overhead Up! Incomes Up! The 1990 Survey of Law Firm Economics*, in *The Lawyer's Almanac 1990* 217-19 (Prentice Hall) (listing expense categories which aggregate to about \$95,000 per lawyer).

lawyers) was \$250 million, of the Houston firm Baker & Botts (375 lawyers) was \$136.5 million, and of the Cleveland firm Squire, Sanders & Dempsey (390 lawyers) was \$125 million. All of Delaware's additional legal business, it appears, amount to one of the larger non-New York law firms.

2. The Benefits of Additional Legal Business

Other states may be able to generate revenues proportionate to Delaware's to the extent that they attract incorporations. Since Delaware has a market share of roughly 50 percent, lawyers in other states would gain somewhat less than \$2 million in income, and somewhat more than \$2 million in revenues, for each percentage increase in the market share of public corporations. In this Subsection, we will argue that the benefits to states from such an increase are not substantial.

For one, another state that started to compete with Delaware could not reasonably expect to attain a 50 percent market share. If another state attracted, say, a 20 percent market share in 1990, it would have earned at most a proportionate \$50 million in additional lawyer revenue, of which \$36 million is additional lawyer income.

Moreover, lawyer revenue, or even lawyer income, does not

represent economic profit. Some of this revenue would not even remain in state as it is used to pay out-of-state suppliers of goods and services (such as malpractice insurance) or to pay federal income taxes. But, most importantly, even the revenue that stays in-state largely represents compensation for the opportunity costs of the goods and services provided by its residents. Indeed, absent barriers to entry, providers of such goods and services would make no long-term economic profits.

To be sure, states would still derive some benefits from attracting legal business. First, the state derive some additional tax revenues from direct and indirect taxes on such business. Depending on the state, state and local taxes amount to 9 to 15 percent of personal income⁴² and taxes paid by high-income professionals such as corporate lawyers may well exceed the cost of providing services to such persons.

Second, state residents may derive some short-term rents from additional legal business, especially if such business employs resources that are presently underused.⁴³ Even in the

⁴² State taxes average about 7% of personal income and local taxes about 4%. See [just the facts website].

⁴³ Similarly, Delaware corporate lawyers, who have invested their human capital in acquiring expertise on Delaware's corporate law and the operation of its court, could suffer substantial losses if, say, corporate law were

short-term, however, such rents are likely to amount to only a small fraction of the additional revenue generated (maybe in the order of 5 percent to 20 percent).

In sum, the benefits to states and local lawyers of generating legal business through incorporations are relatively low (though for most states higher than the benefits from increased franchise taxes). While such benefits may provide an impetus for some local lawyers -- who stand a good chance to be hired should more companies indeed decide to incorporate in their state -- their size, both in absolute terms and in relation to the size of the state economy, does not appear sufficient to induce states to make major efforts to compete.

C. Potential Objections and Extensions

This Section addresses potential objections to and extensions of our analysis. First, we analyze the implications of the claim that states engage in a more limited form of "defensive competition," rather than in wholesale competition. Second, we explore the possibility that states

federalized. See Carny, *supra* note __ at 721 (noting that lawyers with capital invested in local law may collect quasi rents that could be dissipated if clients reincorporated elsewhere).

are pursuing some form of "bait and switch" strategy, of attracting incorporations by charging a low franchise taxes with the aim of increasing franchise taxes once sufficient companies have incorporated in the state. Third, we ask whether vigorous competition for incorporation would ensue if states restructured their franchise taxes to generate revenues from attracting corporations. Fourth, we examine evidence that states that take less time to adopt corporate law innovations earn higher franchise tax revenues.

1. Defensive Competition

Some scholars have suggested that, even if states may not engage in wholesale competition for incorporations, they do engage in a more limited forms of competition. Roberta Romano, for example, has argued that states engage in "defensive competition" designed to keep local firm incorporated in state. Similarly, Lucian Bebchuk and Alma Cohen have argued that states adopt antitakeover laws to attract locally headquartered public corporations.

But however limited the incentives for states to engage in wholesale competition, the incentives to engage in defensive competition are even smaller. The most that a state can achieve by defensive competition is -- by definition -- to

retain locally headquartered companies. Most states, however, derive no marginal franchise tax revenues whatsoever from incorporations by firms doing business in-state.⁴⁴ Of those that do, the largest is Massachusetts, which could at best hope for an 6 percent market share and annual revenues of \$2.5 million. Revenues of that amount are unlikely to have a significant influence on Massachusetts' public policy. Fiscal gains from increased legal business are likewise small, in relation to state size.

If at all, states are motivated to engage in defensive competition by the gains to local lawyers. Whether such gains will induce a state to compete for incorporations will depend on the political influence of local lawyers and the degree to which lawyer interests coincides with increasing incorporations. These issues are further explored in Part II. But since even gains to local lawyers are at best modest, states are unlikely to take measures to attract incorporations that involve material fiscal outlays or generate political opposition.

2. Bait and Switch

Another possibility -- raised by our discussion of

⁴⁴ See Tables 1 and 2.

franchise tax structure -- is that states are pursuing a "bait and switch" strategy: they presently charge only small taxes in order to attract corporations, but are planning to raise their taxes once they have attracted a significant market share or have proven their worth and reliability as incorporation havens.

To be sure, nothing prevents states from changing the way in which they assess franchise taxes. However, if states are pursuing a "bait and switch" strategy, they are both secretive and exceedingly patient. In our considerable research on the market for incorporations, we have found no suggestion from any source that a state planned to raise franchise taxes after attracting incorporations.⁴⁵ Moreover, after supposedly many decades of state competition, no state has raised its franchise taxes to produce meaningful revenues from incorporations by public companies. In short, while any state may, in the future, revamp its franchise tax structure and

⁴⁵ If states pursued such a strategy, we would have expected to find some evidence for it since those who want to induce their state to compete have an incentive to highlight the benefits a state stands to gain from attracting incorporations and since -- as Delaware's practice shows -- there is nothing illicit about charging substantial franchise fees as long as the state supplies a product to match. Given the turnover among politicians, it is also hard to see how a secret strategy to raise franchise taxes could have been pursued over many years.

decide to seriously compete for incorporations, the notion that some state politicians presently pursue a long-term, secret plan to attract incorporations and then raise franchise taxes does not seem plausible.

3. The Prospect of Vigorous Competition

Even as a hypothetical strategy, active competition by states other than Delaware to attract incorporations seems questionable. Our reasoning is simple. Even though Delaware presently derives substantial profits from attracting incorporations -- about \$300 million in 1997 -- other states would earn much smaller profits if several of them actively competed for incorporations.

For one, Delaware has a market share of about 50 percent. If several states actively competed, none could expect to have an equivalent market share. A more plausible outcome of, say, active competition by four to five states would result in smaller market shares of 10 to 15 percent. At a 15 percent market share, a state's revenues in 1997 (if it charged fees equivalent to Delaware's) would be \$94 million.

More importantly, Delaware is presently able to charge high incorporation fees because Delaware enjoys substantial market power (due, among other things, to the absence of

active competition by other states). But if several states actively competed for incorporations, none would enjoy market power equivalent to Delaware's present market power. Incorporation fees would thus drop from the present monopolistic level charged by Delaware to a level closer to the states' marginal cost of chartering an additional firm. These costs, however, are much lower than \$150,000 a year, and states would earn profit margins far below Delaware's present margin of several thousand percent. If, as a result of competition, charges had dropped to a quarter of the present charges, 1997 revenues for a state with a 15 percent market shares would have been \$24 million.

4. The Correlation Between "Responsiveness" and Revenues

In her influential study of the incorporation market, Roberta Romano has found that there is a statistically significant correlation between a state's franchise tax revenues (as a percentage of the state's total tax collections) and the speed at which the state legislature enacted certain corporate law innovations.⁴⁶ Romano interprets this relation as evidence of a functioning market for incorporations driven by franchise taxes: states that are more

⁴⁶ See Romano, *supra* note ___, at ___.

"responsive" attract more incorporations and hence earn more franchise taxes, and the desire to earn franchise taxes induces states to be responsive.

Our analysis indicates that Romano's data do not warrant her conclusions. With few exceptions, attracting incorporations *does not* increase a state's franchise tax revenues.⁴⁷ As a case in point, consider Nevada. As discussed above, Nevada's additional franchise tax revenues from incorporations are trivial.

For states other than Delaware, significant franchise tax revenues can emanate from companies that conduct business in the state, regardless of where they are incorporated. Once a corporation is doing business in a state, it pays the same franchise taxes whether it is incorporated in the state or in another state.⁴⁸ Thus, the percentage of franchise tax

⁴⁷ The most important exception is Delaware which, as discussed, earns franchise taxes from incorporations. We take no issue with Romano's analysis to the extent that it indicates that Delaware is motivated by a desire to earn franchise taxes. Romano's correlation, however, holds even if one excludes Delaware and Romano claims that the desire for franchise tax revenues induces states other than Delaware to be responsive.

⁴⁸ Since Romano argues that states are engaged in defensive competition for locally headquartered firm, they presumably are not trying to earn franchise tax revenues from firms doing no business in the state. Moreover, as discussed, even such revenues would be small.

revenues of any of those states' total tax revenues does not indicate the importance of incorporations to that state. Rather, differential franchise tax revenues are a function of the type of tax a state assesses -- a (low) flat annual tax or a (higher) tax on the amount of business conducted in-state -- and, in the latter group, of the rate charged and the tax base. Thus, any explanation of the correlation between tax revenues and responsiveness would have to be based on a relation between responsiveness and the type and amount of tax charged, rather than on any relation between responsiveness and a state's success in attracting incorporations.⁴⁹

⁴⁹ We wish to offer two suggestions of what may account for the correlation found by Romano. First, it may be that states where corporations are relatively important to the local economy tend to have a more active local corporate bar. Such states would earn greater franchise tax revenues. Such states may also be more likely to impose a franchise tax on the amount of corporate business, rather than a flat tax, further increasing their franchise tax revenues. A more active local corporate bar, in turn, may induce such states to keep their corporate code up to date, either to benefit corporations that are incorporated locally in any case or on the odd chance that this will attract new corporations which will become clients of local corporate lawyers. See *infra* TAN (discussing reasons why states update their corporate laws). These two correlations, in turn, would result in a correlation between franchise tax revenues and responsiveness without, however, implying that states are responsive in order to increase their franchise tax revenues.

Second, antitakeover laws may drive the correlation. As we discuss below, *infra* TAN, these laws protect corporations doing substantial business in the state. As such, these laws may have been passed by states business the well-documented motivation for these laws in all states in which public

5. Summary

For states other than Delaware, franchise tax do not provide significant incentives to compete for incorporations. Most states would derive only trivial revenues even if they attracted a 20 percent market share. For a handful of states, revenues would be higher, but still modest (\$10 million to \$20 million a year). No state other than Delaware presently gains significant revenues from public companies or, for that matter, would gain significant revenues even if all public companies headquartered in the state incorporated in the state. By comparison, Delaware earns over \$500 million dollars in franchise taxes from public companies. There is no evidence that any state plans to revise the structure of its franchise taxes to collect significant revenues from incorporations of public firms. While franchise taxes are clearly an important reason why Delaware wants to attract incorporations, they are unlikely to matter to legislators in other states.

For most states, any benefits from attracting

corporations conduct a relatively large amount of business (e.g. states with large industrial rather than rural states), and franchise tax revenues emanating from this instate business would be relatively high. Once antitakeover laws are omitted from the regression, one is left with only three statutory provisions, and unknown statistical significance.

incorporations are related to increasing the amount of legal business. Even these benefits are modest. Local law firm revenues increase by about \$2 million (1990 dollars) for each percentage in market share of public companies. Increased revenues benefits the state directly (to the extent it profits by taxing such revenue) as well as lawyers and law firm employees. The amount of profits to lawyers and law firm employees, however, is much lower than the amount of revenues in the short term and probably close to zero in the long term.

That the total amount of benefits to a state from attracting incorporations is negligible suggests that states other than Delaware will engage in no, or only in low-cost, measures to attract incorporations. That states' benefits derive mostly from increasing legal business suggests that any measures will be primarily directed to increasing the income of local lawyers, as opposed to attracting incorporations. Rather than inducing vigorous competition for incorporations, this incentive structure suggests that states will mostly adopt measures that cost next to nothing to the state, have only the incidental effect of attracting incorporations, and make their lawyers a little wealthier.

II. What Do States Do To Compete?

In this Part, we analyze to what extent take actions that are designed to attract incorporations. Race-to-the-bottom scholars claim that states attract incorporations by catering to the parochial interest of managers, who decide where to incorporate.⁵⁰ Race-to-the-top scholars, by contrast, argue that market forces will induce managers to select as state of incorporation that state the law of which maximizes the value of the firm.⁵¹ Both camps agree, however, that states actively devise their corporate legal regime to attract incorporations (hence the race metaphor).

Let us clarify at the outset that not every state action that makes it more attractive for corporations is evidence of state competition for incorporations. As we discuss in greater detail below, states have incentives to take steps that make them attractive to corporations and that are unrelated to any benefit from attracting incorporations.

The remainder of this Part is organized as follows. In the first three Sections, we examine three aspects of the legal structure governing corporations to see whether states compete: the statutory law affecting corporations; the

⁵⁰ See, e.g., Cary, *supra* note __, at 669-84.

⁵¹ See, e.g., Winter, *supra* note __, at 264-266.

structure of the court system; and the judge-made law affecting corporations. In each Section, we consider both whether states have taken steps that make them attractive as domiciles and whether these steps should be interpreted as efforts to attract incorporations. In the fourth Section, we address potential objections to, and extensions of, our analysis: the argument that the diffusion of corporate law innovations is evidence of competition; the argument that state antitakeover laws are designed to attract incorporations; the argument that Nevada and Maryland actively compete for incorporations; the argument that states actively promote themselves as incorporation havens; the fact that state competition theory cannot explain why state actions are exclusively directed to statutory revisions, or why no state has copied Delaware's statute; and the argument that the mere fact that states update their corporation laws constitutes evidence that states compete.

A. State Competition in Designing Statutory Law

1. The Model Business Corporation Act

Many changes in corporate law statutes are due to states adopting proposed modifications of the Model Business Corporation Act. The Model Business Corporation Act is a set

of proposed state corporate law provisions devised (and periodically revised) by the Committee on Corporate Law of the Section of Corporation, Banking and Business Law of the American Bar Association and intended to serve as a model code for wholesale or piecemeal adoption by the various states. As of 1999, 24 states largely followed the Model Business Corporation Act.⁵²

The significance of the Model Business Corporation Act is hard to reconcile with the notion that states actively compete for incorporations.⁵³ The drafters of the code -- a committee of a national bar association, most of whose members do not even hail from Model Business Corporation Act states⁵⁴ -- can hardly be motivated by a desire to increase incorporations in any particular state. Rather, they are likely to participate

⁵² See Model Business Corporation Act Annotated xxvii (3d ed. 1998/9 supp.)

⁵³ But see Romano, *Theoretical Inquiries* L. at 509 n.314; Lawrence A. Cunningham, *The New Corporate Law--The 1999 Model Business Corporation Act*, 71 *Corp. (Aspen L. and Bus.)* 1, 5 (2000) (suggesting that adoptions of Model Business Corporation Act are evidence of competition).

⁵⁴ Of 23 members on January 1, 1999, only 7 came from states that had adopted or or substantially all of the Model Business Corporation Act. Of 12 past or present chairs of the Committee, only 2 came from such states. Compare Model Business Corporation Act Annotated, *supra* note __, at xl (list of members) and xxvi (list of chairs) with *id.* at xxvii (list of Model Business Corporation Act states).

in the drafting process because it enhances their reputation or because they enjoy the opportunity to have a broader impact on the world.⁵⁵ That states entrust the design of their principal product to a national organization [whose stated aim is to produce a harmonized corporate law - check] seems more consistent with an effort to economize on drafting costs or with the presence of network effects than with vigorous competition.⁵⁶

To further examine whether adoptions of Model Business Corporation Act provisions indicate the presence of state

⁵⁵ To the extent that states are motivated to attract incorporations and are more likely to adopt the Model Business Corporation Act if it serves this function, the drafters of the Model Business Corporation Act may obtain greater reputation and have a greater impact if they draft the Model Business Corporation Act accordingly. This, however, would only generate weak incentives for the Model Business Corporation Act drafters.

⁵⁶ See also Carney, at 741 (noting that copying Model Business Corporation Act reduces cost of devising law). Indeed, Model Business Corporation Act states tend to be relatively small. It has been suggested to us that the Model Business Corporation Act may reflect an effort of states other than Delaware to compete with Delaware and economize on the cost of such competition. Even if that is the case, state competition would be rather limited, both in scope (since states other than Delaware do not compete with each other) and in degree of effort (getting the ABA to do all the work is about as little effort as a state can make). Moreover, this hypothesis is hard to square with the fact that most drafters of the Model Business Corporation Act come from non-Model Business Corporation Act states and that Delaware lawyers participate in the drafting of the Model Business Corporation Act. See supra note __.

competition, we investigated the diffusion pattern of four Model Business Corporation Act provisions identified as "major" by William Carney: the authorization of a share exchange, the substitution of insolvency tests for the legal capital rule, the substitution of plurality voting for majority voting in shareholder actions, and the making of dissenters' rights exclusive.⁵⁷ Using Romano's methodology, we ranked states based on the speed in which they adopted these. We then computed the Spearman ranking correlation between the resulting ranking and the responsiveness ranking that Romano reports.⁵⁸ The two rankings were negatively related, with no statistical significance.⁵⁹

The lack of significant positive relation in the ranking of states adopting the innovations identified by Romano and those identified by Carney is troubling from the state competition perspective. If both Romano and Carney identified important provisions, the lack of positive relation in ranking suggests the adoption of important provisions is random or, at least, that states do not engage in sustained competition.

⁵⁷ See Carney, *supra* note __, at 746.

⁵⁸ See Appendix A. We used the rankings provided by Romano, *supra* note __, at 247.

⁵⁹ The Spearman correlation coefficient is -0.13472, and the significance level is 37.21%.

Conversely, if the provisions identified by Carney as major are not in fact important, one may question whether adoption of the Model Business Corporation Act matters much and, accordingly, should not infer that states adopting the code do so to attract incorporations.

2. Antitakeover Statutes

The single most important field for statutory innovation in corporate law, and the one attracting the most attention by commentators, has been state antitakeover statutes. Modern (i.e. second generation and beyond) state antitakeover statutes come in five major categories, with countless variants and some additional minor categories. With respect to antitakeover statutes, states have clearly been active, both in terms of devising new provisions and in terms of adopting them.

This activity, however, does not show that states are passing antitakeover statutes in order to attract incorporations. Rather, commentators that have examined the motives for the adopting of modern antitakeover statutes have concluded that the principal motive for their adoption had been to protect local firms against hostile bids. Roberta Romano, William Carney and Henry Butler, for example, each

identify a large number of modern antitakeover statutes that were passed either to protect a local firm against an impending bid (takeover-specific statutes) or otherwise at the behest of a single company (corporation specific statutes).⁶⁰ Robert Daines relates the vivid history of Massachusetts statute designed to protect ___ against a takeover bid by _____.⁶¹ Even laws not driven by a specific company or a specific bid are generally intended to protect local companies from takeovers.⁶²

⁶⁰ See Roberta Romano, *The Political Economy of State Takeover Law*, __ Va. L. Rev. __; Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cin. L. Rev. 457, at n.11 (1988) (listing 12 statutes passed at the behest of a single company); Henry Butler, *Corporate-Specific Anti-Takeover Statutes and the market for Corporate Charters*, 1988 Wis. L. Rev. 365 (mentioning at least 12 states that have passed takeover specific laws and others than have passed corporation specific laws); Carney, Table 3 (detail).

⁶¹ Robert Daines, *Staggered Boards*.

⁶² For example, Maryland's strict antitakeover law, which is being cited as a reason to incorporate in the state (see James J. Hanks, Jr., *M&A Law.*, Oct. 1999 at 12 (article by partner in Baltimore firm citing takeover law as the reason to incorporate in Maryland); James J. Hanks, Jr., *Maryland Legislation Offers New Benefits for Corporations, REITs, and Investment Companies*, *Insights*, May 2000, at 8 (same); Robert B. Robbins & Dava R. Casoni, *Maryland's "Just Say No" Law*, *Insights*, September 1999, at 27 (article by two Washington, DC lawyers citing takeover law as a reason to incorporate in Maryland)), was enacted to protect local companies. See Peter Behr, *The Washington Post*, Feb. 25, 1999, at E1 (quoting state politicians and business executives to that effect); *Anti-Takeover Measure Draws Broad Support*, *The Baltimore Sun*, Feb. 17, 1999, at 1C (same); *Bid to Fight Takeovers Criticized*, *The*

That antitakeover statute are motivated by a desire to protect local companies, rather than to attract incorporations, is also consistent with the way these statutes have evolved. The precursor to modern statutes were so-called first-generation statutes, which were adopted by 37 states, mostly in the 1970s.⁶³ Unlike modern statutes, first-generation statutes applied to locally headquartered corporations conducting substantial business in the state regardless of where they were incorporated.⁶⁴ That design, however, would have been perverse if the state had aimed to attract incorporations. From the perspective of attracting incorporations, the benefit of the statute should be *withheld*

Baltimore Sun, Jan. 17, 1999, at 1D (same); Telephone Interview with James J. Hanks, Partner, Ballard Spahr, Mar. 22, 2002 (stating that the principal reason for antitakeover law was to protect, and principal support came from parties interested in protecting "existing Maryland corporations from bad effects of hostile takeovers," and not to attract incorporations).

⁶³ Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. Cin. L. Rev. 457, 458.

⁶⁴ See, e.g., Ill. Rev. Stat., ch. 121 1/2, para. 137.54.A (1979) (Illinois statute); see generally Donald Langevoort, *State Tender-Offer Legislation: Interests, Effects, and Political Competency*, 62 Cornell L. Rev. 213, 219 (1977) (concluding that these statutes apply to any "target company [that is] in some way a 'local enterprise'"). By contrast, these statutes did not apply to firms incorporated in the state unless they were either also headquartered in the state and conducted substantial business in it. [Illinois stat.]

from locally headquartered firms incorporated in a different state -- the prime group of firms that the state would seek to attract. Protecting local firms regardless of where they are incorporated, however, makes perfect sense if the aim of the statute is to protect local management.⁶⁵ To be sure, modern statutes apply only to domestically incorporated corporations.⁶⁶ But the reason for this change is not that proponents of first-generation statutes suddenly realized that these statutes were ill-designed to attract incorporations. Rather, it was that the United States Supreme Court held they violated the dormant commerce clause by applying to firms incorporated in a different state.⁶⁷ Moreover, adoptions of

⁶⁵ Recall, in this regard, that most public corporations incorporate either in Delaware or in their headquarter state and that Romano postulates that states compete to retain existing (locally headquartered) corporations. See supra _____. From that perspective, a state aiming to attract incorporations would want to deny the benefit of the statute to a locally headquartered company that is incorporated in Delaware.

⁶⁶ It was that limitation that won states constitutional approval. See *CTS Corp. v. Dynamics Corp. of America*, 481 U.S. 69, 82-84 (1987). Indeed, prior to *CTS*, modern statutes did not invariably apply to domestically incorporated firms. See Manning Gilbert Warren, III, *Developments in State Takeover Regulation: MITE and Its Aftermath*, 40 *Bus. Law.* 671 (1985) (noting that Ohio and Wisconsin statutes required nexus to state beyond incorporation).

⁶⁷ *Edgar v. Mite Corp.* 457 U.S. 624, 645 (1982) (rejecting argument that Illinois antitakeover statute constitutes legitimate regulation of internal affairs by noting that

modern takeover statutes are highly correlated with adoptions of first-generation statutes.⁶⁸ This constitutes further evidence that the motivation underlying modern statutes is the same as the one underlying first-generation statutes: to protect local firms, rather than to attract incorporations.

3. Other Statutory Revisions

State corporate statutes are not confined to copies of the Model Business Corporation Act and to antitakeover laws. Many states, including the largest ones, have not substantially adopted the Model Business Corporation Act and even Model Business Corporation Act states sometimes deviate from the Model Business Corporation Act.⁶⁹ States do not generally explain why specific laws were passed, and so an extensive historical analysis of each state's revisions of its corporation law would be beyond the scope of this Article. The political economy and incentive structure underlying

statute applies to companies not incorporated in Illinois).

⁶⁸ The 14 states that did not adopt a first-generation statute had, as of [Subramanian's table], adopted 1.71 of modern statutes. The 37 states that did adopt first-generation statutes adopted 3.05 modern statutes. Calculate Spearman correlation index.

⁶⁹ See, e.g., Carney, at 748-749 (listing important Georgia departures from the Model Business Corporation Act);

corporate law revisions, however, suggests that attracting incorporations is neither their principal objective nor their predominant effect.

The main driving force behind corporate law revisions are corporate lawyers.⁷⁰ Most corporate law reforms neither require fiscal outlays nor generate political opposition.⁷¹ The main constraint on the passage of such reforms is that state legislators want to devote limited time to passing corporate laws. Thus, the corporate bar and advisory committees can expect that, if placed on the legislative agenda, proposed revisions of the corporation code will be enacted.⁷²

But the interest of lawyers in corporate law reform is multi-faceted and, in many ways, not significantly related to attracting incorporations. To the extent that laws are meant to benefit particular clients or close corporations generally, they are neither intended nor likely to be particularly

⁷⁰ See Carney, at 737-49 (noting that lawyers initiate most corporate law changes).

⁷¹ Exceptions: NY employee protection, court reforms discussed below, Illinois refusal to pass a 102(b)(7)-like statute. Also, antitakeover laws.

⁷² Even Delaware, the state most interested in attracting incorporations, basically delegates the design of its corporate statute to the local bar committee. See ...

effective in attracting incorporations.⁷³ Similarly, to the extent that bar committee members try to enhance their general reputation, serve their vision of the public good, or enjoy the exercise of power, they are only tangentially concerned with attracting incorporations.

Even to the extent that lawyers are interested in generating business from public companies, their interest cannot be equated with the goal of attracting incorporations. To be sure, domestically incorporated firms are more likely than Delaware corporations to hire local lawyers. But, in other respects, generating business can conflict with attracting incorporations.

For starters, local lawyers benefit from increased incorporations only if the increase is unexpected and occurs at a rate faster than the rate at which new lawyers can easily enter the relevant market. Thus, for example, present local lawyers do not benefit much from laws that attract incorporations slowly or mostly in the long term.⁷⁴

⁷³ See Carney, at 748 (noting that many of Georgia's departures from the Model Business Corporation Act are meant to fix a problem that a specific client has encountered).

⁷⁴ Local lawyers also have mixed feelings about having the quality of the law advertised. While such advertisement may attract incorporations, it may also induce competing lawyers to set up shop in-state.

Second, as others have noted, lawyers have an interest in laws that increase the need for legal advice and generate litigation -- even if such laws reduce incorporations.⁷⁵

Third, local lawyers have an interest in laws that reduce competition by out-of-state law firms. Thus, local lawyers may benefit little from, say, copying Delaware law or the law of a large neighboring state -- even if such copying would attract incorporations.⁷⁶

Fourth, members of the bar or advisory committee that drafts the proposed revisions are more interested in generating business for themselves than in benefitting local lawyers generally. As a result, they may, for example, favor provisions that are excessively idiosyncratic, arcane or complex -- in order to enhance their reputation or increase the human capital derived from committee membership -- with

⁷⁵ See Macey & Miller, *supra* note ___, at 504-05; Carney, at 721. Competitive pressure constrain, but do not eliminate, this preference. Corporations are immobile in the short-term (due to reincorporation costs and lack of information about the quality of the law) and many close corporations tend to be immobile even in the long-term. Thus, lawyers can generate short-term profits by devising the law in a manner that increases the need for their services. Moreover, as explained, lawyers predominantly benefit (and are hurt by) the short-term effect of new laws.

⁷⁶ See also Carney, at 723 (noting interest of local lawyers to exclude potential competition from lawyers specializing on Delaware law).

little attention to the effect of these provisions on incorporations.

Finally, even to the extent that lawyers benefit from attracting incorporations, their incentive to have the state compete for incorporations are highly attenuated. As explained, the potential benefits to lawyers from attracting incorporations are modest to start with. Moreover, local lawyers face collective action problems. They will not want to expend significant resources to attract incorporations and instead try to free-ride on the efforts of others.⁷⁷ Local lawyers will therefore be reluctant to make significant investments in devising attractive corporate law reforms⁷⁸ or in ensuring that their reforms are passed should they require fiscal outlays or run into political opposition.

B. State Competition with Respect to Judge-Made Law

⁷⁷ See also Carney, at 747 (finding that collective action problems retard creation and adoption of innovations). Bar associations help overcome this collective action problem only to some extent. While bar associations organize committees to propose legal reform, the members of the committee are not compensated for the time spent on committee business. Moreover, bar associations do not typically fund lobbying efforts.

⁷⁸ See Carney, at 749 (noting that many provisions of Georgia corporate law are designed as "low-cost solutions to problems as they arise," rather than as "ideal" ones).

A second, important element of a state's corporate legal structure is the state's judge-made law affecting corporations. We will deal only briefly with the extent to which states have taken steps that could plausibly be regarded as making them attractive as incorporation states. To our knowledge, no commentator has claimed that states try to compete with Delaware in their design of judge-made law.⁷⁹

Indeed, we would regard such a claim as implausible. Attracting incorporations has not become an important part of state policy for any state but Delaware. Thus, most judges would be surprised to learn that their states wants them to render corporate law decisions that attract incorporations. Moreover, even if judges believed their states wanted them to render such decisions, they would have only weak incentives to do so. Since, outside Delaware, corporate law decisions represent only a tiny fraction of a judge's caseload,⁸⁰ it is

⁷⁹ Even with respect to Delaware, commentators have claimed that a desire by judges to consciously participate in the state's efforts to attract incorporations. See Cary, *supra* note __, at 670-84 (arguing that judges aid their states in attracting incorporations); Romano, *Genius* at 40 ("[T]his appointment process [for chancery court judges] helps to ensure that members of the chancery court will be sensitive to the state's policy of responsiveness in corporate law, since judges who ignore the political consensus in the state will not be reappointed").

⁸⁰ This is true for judges in states that have not established any specialized business courts as well as, for

unlikely that their outcome would have much of an impact of whether the judge is renominated or reelected.⁸¹ Nor, for that matter, would it always be evident for a judge, who ordinarily lacks prior background and judicial experience in corporate law disputes, how a case should be decided to attract incorporations.⁸²

the reasons discussed below, for judges in states that have established specialized business courts. It is also true for courts of appeals, the primary generators of case law, in all states other than Delaware.

⁸¹ Moreover, outside Delaware, many corporate cases are decided by federal courts. See Keith Paul Bishop, *Battle for Control of ITT Corporation Spotlights Nevada (and Delaware) Corporate Law: Did Nevada Law Get Stockholders A Better Deal?*, 12 *Insights*, Jan. 1988, at 15, 18 (stating that most reported Nevada decisions involving takeovers have been rendered by the federal courts). Federal judges have even less incentives than help a state attract incorporations than state judges. See *id.* (noting that rulings by federal courts "may frustrate the Nevada Legislature's intent to create alternatives to Delaware law").

⁸² To be sure, a judge trying to attract incorporations could just follow Delaware case law in resolving a dispute. Due to their experience, Delaware judges are likely to have a greater capacity than judges in other states to determine what corporate rules attract incorporations. In fact, judges in other states often follow Delaware precedents. For two reasons, however, we believe that the tendency of judges in other states to follow Delaware precedent does not indicate that they participate in state competition. For one, as one of us has argued, the rules that help to attract incorporations to Delaware, a state with an expert corporate judiciary, may not be well suited to help a state that lacks such a judiciary attract incorporations. See Kamar, *supra* note __, at __; Carney, *supra* note __, at 727. Second, judges may follow Delaware precedent because of the presence of relevant case law and of the recognized experience of Delaware

We note in conclusion that issues such as the fiduciary duties of directors and controlling shareholders in self-dealing transactions, the scope of corporate opportunities, the obligations of a board in dealing with control challenges, the prerequisites for a derivative suit, the board's disclosure obligations when it seeks a shareholder vote, and the scope of impermissible corporate waste are largely enshrined in judge-made, rather than statutory, law.⁸³ Many observers consider fiduciary duty law to be one of the most important elements of state corporate law.⁸⁴ Any state competition over the content of corporate law rules that did not include these important areas would be highly incomplete at best.⁸⁵ But the absence of state competition in the

courts in resolving disputes, without regard to any effort to attract incorporations. Indeed, Delaware corporate cases are widely cited by federal district and circuit courts in deciding corporate disputes. See Alva, *supra* note __, at __, note 92 (stating that four important Delaware cases were cited by federal circuit courts in 6 circuits, by federal district courts in 12 states and by state courts in 12 states). Yet no one claims that federal courts are somehow part of a scheme to help the states where they sit in attracting incorporations.

⁸³ The Model Business Corporation Act devotes a mere three medium-length sections to directors' standard of conduct.

⁸⁴ Cite to Interview with Bussard + literature on case law as the backbone of Delaware law

⁸⁵ Also note that, because courts in other states do not hear many corporate cases, Delaware case law cannot diffuse quickly to their case law. Cf. Bradley C. Canon & Lawrence

dimension of judge-made law presents even greater challenge for scholars who posit that states compete for incorporations. If judge-made law is important and states are actively competing, why do they leave the design of an important aspect of their product to judges who lack proper incentives?⁸⁶

C. State Competition in Designing the Structure of the Court System

One principal attraction of incorporating in Delaware is the high quality of Delaware's chancery court.⁸⁷ The chancery

Baum, Patterns of Adoption of Tort Law Innovations: An Application of Diffusion Theory to Judicial Doctrines, 75 Am. Pol. Sci. Rev. 975 (1981) (finding that the diffusion of judicial doctrines among states is a very different process from the diffusion of legislation because courts depend on litigants' demands). According to Romano, rapid diffusion of innovations is an element of competition.

⁸⁶ States have alternatives. They could enact a detailed statute that would reduce judicial discretion. Alternatively, they could try to align incentives of judges with the goal of the state to increase incorporations.

⁸⁷ There is a wide consensus on this point shared by academics, practitioners, and members of the judiciary. See, e.g., Klausner, *supra* note __, at 845; Kahan & Kamar, *supra* note __, at ___; Romano, *supra* note __, at 277; Lipman, *infra* note __ (conceding that Pennsylvania judges lack the experience of the Delaware chancery court judges in corporate matters and cannot as expeditiously resolve disputes); Sara- Ellen Amster, Others Try to Imitate Delaware, Gannett News Service, July 7, 1998 (stating that Delaware's chancery court "is widely cited as a major reason more than 270,000 businesses make Delaware their corporate home"); William H. Rehnquist, The Prominence of the Delaware Court of Chancery in

court combines several attractive features. First, it has limited jurisdiction and its caseload consists mainly of corporate cases.⁸⁸ Moreover, it hears all cases without juries.⁸⁹ Thus, corporate disputes are decided by judges who have developed expertise in corporate law. Second, chancery court judges are selected based on merit through a nominating commission rather than being elected or appointed directly by a political body.⁹⁰ Once appointed, they receive the financial support from the state -- for law clerks, support staff, office space, courtroom facilities, and the like -- that is necessary to dispose of cases expeditiously. Thus, highly competent lawyers can be attracted and appointed to the chancery court, and they can maintain the high quality of the court. Third, the opinions of the court are published in the state and the regional reporter, and are available on electronic legal databases. They thus create a body of case

the State-Federal Joint Venture of Providing Justice, 48 Bus. Law. 351, 354-55 (1992).

⁸⁸ CITE. Similarly, its jurisdiction extends to all corporate cases.

⁸⁹ CITE.

⁹⁰ See The Lawyer's Almanac 1992 [get newer issue]. Delaware is one of just 15 states where trial court judges are initially appointed in this fashion and, of this group, one of six states where they do not face retention elections.

law that provides guidance to practitioners.

One would expect that any state trying to attract incorporations would establish a court with features similar to Delaware's chancery court.⁹¹ In this Section, we will argue that no state has made a serious effort to establish such a court.

To start with, the vast majority of states have no specialized courts dealing with corporate disputes. The court structure in these states is clearly not designed to compete with Delaware's.

A number of states have established some form of specialized judicial tribunals. These states include New York, Illinois, North Carolina, Massachusetts, Nevada, and Pennsylvania.⁹² Even these courts, however, are not

⁹¹ See Tougher Shareholder Suit Standards in Pennsylvania are Outlined, 1997 Andrews Del. Corp. Lit. Rep. 20510 (noting agreement by faculty in seminar at the Pennsylvania Bar Institute that a court that specializes in corporate governance issues as the Delaware chancery court does is necessary for Pennsylvania to attract incorporations). Moreover, unlike high-quality statutory corporate law, a high quality corporate court cannot simply be copied by another state (see *infra* TAN); and unlikely over the content of its case law, a state has direct control over the structure of its judicial system (see *supra* TAN). Thus, establishment of a high quality court may be an especially effective way for states to compete for incorporations.

⁹² Virginia has a State Corporation Commission with jurisdiction over challenges to corporate charters (but not over derivative lawsuits). American Bar Ass'n, The Status of

effectively designed to attract incorporations.

The first of these "special business courts" was New York's commercial division established in 1992 as a pilot and made permanent in 1995.⁹³ The commercial division differs from Delaware's chancery court in several fundamental respects.

Business Courts in the United States, available at [wysiwyg://24/http://www.abalawyersource.org/buslaw/buscts/ctsurvey.html](http://www.abalawyersource.org/buslaw/buscts/ctsurvey.html) [hereinafter ABA, The Status of Business Courts]. New Jersey is sometimes, albeit wrongly, cited as having a business court. The New Jersey State Bar Association had recommended to the state supreme court to establish a special business court for complex commercial matters. The supreme court rejected that recommendation and, instead, added a fourth track to its differentiated case management system. In that track, complex commercial cases are grouped with environmental coverage cases, mass torts, actions under the federal Y2K act, and others. Telephone Interview with Barry D. Epstein, former president of New Jersey State Bar Ass'n, May 24, 2001. The New Jersey Superior Court also maintains a chancery division that has been described as having "developed special expertise and abilities with regard to complex corporate law matters." See ABA, The Status of Business Courts, supra. The caseload of the chancery division, however, consists mostly of non-corporate cases and corporate cases involving a damage claim are transferred to the law division for trial. Telephone Interview with Peter D. Hutcheon, Norris McLaughlin & Marcus, PA, May 16, 2001. In 1996, Wisconsin administratively established a pilot "business court" in Milwaukee County by designating two judges to hear commercial disputes. ABA, The Status of Business Courts. The court was disbanded several years ago. Telephone Interview with Beth Perrigo, Deputy District Court Administrator, Milwaukee County, Mar. 31, 2001.

[Add fn to Maryland; see also Eric G. Orlinsky, Maryland Creates First Business and Technology Court Program, Corp. L. Weekly, Feb. 21, 2001, at 64]

⁹³ See NY ACCA General Counsels' Committee Supports Commercial Division of New York Supreme Court, The Metropolitan Corp. Counsel, Feb. 1996, at 20.

First, judges in New York are elected,⁹⁴ and hear all cases with a jury.⁹⁵ Second, jurisdiction is very broad and corporate disputes are likely to constitute only a small portion of any judge's caseload.⁹⁶ Finally, the fact that commercial divisions were only established in some counties⁹⁷ and that no equivalent division was established in the appellate division of the supreme court (New York's intermediate appellate court) make it harder to develop a

⁹⁴ In New York, supreme court judges are elected. However, among those elected, judges are assigned to the commercial division. This creates the possibility of assigning judges with business law expertise to the commercial division.

⁹⁵ Under New York law, plaintiffs have a right to jury trial in corporate disputes that involve a potential damage remedy even if the dispute involves an equitable procedure such as a derivative suit. *Fedoryszyn v. Weiss*, 310 N.Y.S.2d 55 (N.Y. Sup. Ct. 1970); *Lewis v. S.L. & E., Inc.*, 831 F.2d 37 (2d Cir. 1987). In Delaware, such disputes are heard by the chancery court without a jury.

⁹⁶ The division's jurisdiction includes cases involving the law of contracts, corporations and insurance, the Uniform Commercial Code, and other commercial matters. Commercial Division Celebrates First Anniversary, Metropolitan Corporate Counsel, Dec. 1996, at 46.

⁹⁷ Commercial divisions were initially created in New York county (Manhattan) and Monroe county (Rochester). Frederick Gabriel, *New York's Commercial Court is Where Business Speeds Along: New System Is Model for Other States*, *Crain's N.Y. Bus.*, Apr. 7, 1997, at 11. Later, divisions were added for Buffalo, Long Island, and Westchester. Steven Andersen, *Massachusetts Tackles Litigation Backlog With a New Business Court*, *Corp. Legal Times*, Apr. 2001, at 74.

coherent body of corporate law precedents.

While being hard to mesh with an effort to attract incorporations, these design features are consistent with the purported goal behind the establishment of the commercial division: to reduce the long delays in the resolution of commercial disputes in New York's overburdened trial courts.⁹⁸ Those delays used to reduce the attractiveness of New York state courts as a forum and, as a result, as a center of commercial activity giving rise to disputes that would likely be litigated in New York courts.⁹⁹ From this perspective, it is sensible that the jurisdiction of the commercial division encompasses a wide array of commercial disputes and that it was instituted only in some counties (where delay was a problem). It also explains why a court-annexed alternative dispute resolution mechanism was a significant component of the establishment of the commercial division.¹⁰⁰ Moreover, since dissatisfaction with the delay in resolving disputes,

⁹⁸ See Pilot Succeeds, Task Force Studies N.Y. State Commercial Court Plans, Commercial Lending Litigation News, May 5, 1995; Annemarie Franczyk, State Court System Floats Plan for Unit for Commercial Suits; New York State; Business First of Buffalo, June 19, 1995, at 2.

⁹⁹ Id.

¹⁰⁰ Commercial Division Celebrates First Anniversary, Metropolitan Corporate Counsel, Dec. 1996, at 46.

rather than with the final resolution, was the principal concern, there was no need to tinker with the right to a jury trial or to take steps to increase the cohesiveness of New York's case law.

As Table 5 below shows, the business courts in the other states largely resemble New York's commercial division, rather than Delaware's chancery court. All of these courts are divisions of the regular trial court and do not affect the right to jury trial. All have relatively broad jurisdiction and, with the exception of the North Carolina court, have several judges assigned to them. As a result, judges on these courts deal mostly with contract and commercial disputes, rather than corporate law disputes, which are less common outside of Delaware. Apart from New York and Massachusetts, where some state trial courts opinions are published, the opinions of the special business courts are neither published nor available on commercial electronic databases, greatly undermining the courts' ability to provide guidance to practitioners. And outside of North Carolina, only disputes filed in certain counties can even theoretically be adjudicated by the business court.

Table 5: Business Courts

	Delaware	New York	Illinois	Massachusetts	Pennsylvania	North Carolina	Nevada
Established	1792	1992 (pilot) 1995 (permanent)	1993	2000	2000	1995	2000
Separate Court	Yes	No	No	No	No	No	No
Created	Const.	Admin.	Admin.	Admin.	Admin.	Admin.	Admin.
Jury Trial for Corporate Cases	No	Yes	Yes	Yes	Yes	Yes	Yes
Judges Elected	No	Yes	Yes	No	Yes	?	Yes
Opinions Published	Yes	Yes	No	Yes	No	No	No
State-Wide	Yes	No	No	No	No	Yes	No
Size	5 Judges	Large	—	—	—	1 Judge	3 Judges
Subject Matter Jurisdiction	equitable remedies (mostly corporate)	contracts, commercial, corporate, other	broad	business, commercial, complex contract cases	corporate, commercial, trade secrets, business torts, intellectual property, other	complex business cases assigned	corporate, trademark, securities, deceptive practices, other

Source: [various]

As in the case of New York, the purpose of these courts appears to have been to streamline the disposition of commercial cases.¹⁰¹ The courts in North Carolina and Nevada

¹⁰¹ See Steven R. Stahler, *Illinois Lobbies Firms to Incorporate Here*, *Crain's Chicago Bus.*, Oct. 9, 1995, at 9 (article on efforts to attract incorporations, which mentions low franchise taxes and revisions to corporation law, but fails to mention the business court); William C. Smith, Md. Panel Urges Biz Court, *Nat'l L.J.*, Nov. 27, 2000, at B1 (noting praise by a Chicago lawyer for reduction in delay in disposing of commercial cases); Steven Andersen, *Massachusetts Tackles Litigation Backlog with a New Business Court*, *Corp. legal. Times*, Apr. 2001, at 74 (citing logjam of litigation and delays as reasons why business court was created); Thomas F. Holt, Jr., *Time is Right for a Business Court*, *Boston Globe*, Mar. 14, 2000, at D4 (arguing that court would reduce speed in which cases are dealt with); *Focus on Business Courts*, *Metropolitan Corp. Counsel*, Apr. 2000, at 40 (interview with Paul Dacier, a leading proponent of the business court, who cited delay with which Massachusetts courts disposed of intellectual property cases as a reason to create a business court); Sacha Pfeiffer, *To End Delay, Court Devotes All Its Time to Business Cases*, *Boston Globe*, Oct. 19, 2000, at A1 (noting that delay, which caused litigants to employ arbitrators, inspired the creation of Massachusetts' business court). The story in Pennsylvania is somewhat more complex. Proponents of a business court initially modeled the court after Delaware's chancery court and intended the court to help attract incorporations. See *infra* TAN. When bills to create such a court failed to pass, their proponents settled for the administrative creation of a commercial case management program modeled after the commercial division of New York's supreme court. *Partnering with Outside Counsel for a Philadelphia Business Court*, *Metropolitan Corp. Counsel*, Mar. 2000, at 1. Even that modest proposal was only adopted when the program could be staffed without the addition of new judges. *Id.*; see also Telephone Interview with William H. Clark, head of Pennsylvania chancery court coalition (June 1999) (stating that the proposal to create specialized commercial court, unlike an earlier failed effort to establish a chancery court, is not part of an effort to attract incorporations).

are a partial exception. In these states, there are indications that attracting incorporations may have been a partial motive.¹⁰² But the courts in both states suffer from severe design flaws -- broad subject matter, the retention of juries and the non-availability of opinions being the most important ones.¹⁰³ In addition, North Carolina's court suffers

¹⁰² Lawrence F. Dickie & John L.W. Garrou, *North Carolina Judge to Hear Complex Business Disputes*, Corp. Legal Times, June 1996, at 32 (noting the concern of North Carolina corporations over the absence of a specialized court); Jack Scis, *Greensboro Lawyer Gets New Business Judgeship*, News & Record (Greensboro, N.C.), at B5 (noting that the court is intended to speed up trials of significant business cases and quoting a legislative study commission as noting that "Lack of a business court ... puts North Carolina at a disadvantage when corporations are considering states in which to incorporate to do business"). Electronic mail from Steven B. Miller, Managing Editor, Nevada Policy Research Institute (Mar. 20, 2002) (noting that business courts are related to goal to attract incorporations, but are more relevant to Nevada's attempt to induce companies to locate operations and upscale professionals in Nevada). Despite these intentions, promoters of Nevada incorporations do not seem to place great a significance on the court. Nevada's Secretary of State does not mention the court in its official explanation for why companies should incorporate in Nevada. See web site. In other respects, as well, the court is not publicized. There are hardly any press reports referring to the establishment of the court; even incorporation services specializing in Nevada fail to mention the court as a reason to incorporate in Nevada. Cites.

¹⁰³ In North Carolina, only decisions by the state court of appeals and the supreme court are published. Doug Campbell, *Home Court*, News & Record (Greensboro, N.C.); May 3, 1998, at E1. Even an opinion that is clearly of general interest to corporate practitioners, such as *First Union Corp. v. Suntrust Banks, Inc.*, Civil Action 01-CVS-10075, Tennille, J. (N.C. Super. Ct. Div. July 20, 2001) (involving a hostile

from a shortage of funding for chambers and legal and clerical support,¹⁰⁴ leading a local newspaper to headline "North Carolina Business Court Pleads Poverty."¹⁰⁵

takeover battle among North Carolina banks), is not slated for publication in any law reporter. It should be noted that *First Union* is the only major corporate case thus far to land in the North Carolina business court docket. See Carrick Mollenkamp, *SunTrust Has Little Time Left To Divide Wachovia, First Union*, Wall St. J., July 23, 2001, at B4 (describing the case). Moreover, the court's opinions lack precedential value. Cite report.

¹⁰⁴ State Business Courts Here To Stay; Concept Gets Entrenched Despite Setbacks, *Commercial Lending Litig. News*, Sep. 5, 1997 (noting that the judge has been "outspoken concerning the lack of funds for chambers, and legal and clerical support"). Add info from web site.

¹⁰⁵ Leah Beth Ward, *North Carolina Business Court Pleads Poverty*, *The Charlotte Observer*, Mar. 24, 1998 (quoting North Carolina's secretary of state as saying that "[t]he state just hasn't put a whole lot of resources into [the business court]" and reporting statements by officials that the current judge has no law clerk and no way for his opinions to be published in the legal community so that a guiding body of case law might be built); see also Doug Campbell, *News & Record* (Greensboro, N.C.); May 3, 1998, at E1 (reporting that the court lacks a law clerk, an administrator, and up-to-date technology). The five Delaware chancery court judges, by comparison, have a total of seven clerks. Interview with William T. Allen, May 16, 2001, in New York, NY. The North Carolina legislature eventually approved the royal sum of \$118,000 to hire a judicial assistant, buy office equipment, and help establish an electronic filing system. Doug Campbell, *Business Court Will Not Come to City*, *News & Record* (Greensboro, N.C.), Oct. 28, 1998, at B7. But it took a private foundation to donate the funds for a lease to relocate the court from High Point to Greensboro. Doug Campbell, *Foundation Pays Lease for Business Court*, *News & Record* (Greensboro, N.C.), Mar. 1, 1999, at B6. The following year, the state decided to pick up the tab. Eric Dyer, *Local Projects Included in Budget*, *News & Record* (Greensboro, N.C.),

The problem with Nevada's recent business court is even more acute. As for Delaware (and unlike any other state), a large percentage of the public companies incorporated in Nevada are not headquartered in the state. But Nevada law, unlike Delaware law, does not require directors of domestic corporations to consent to being sued in the state for breaches of their fiduciary duties.¹⁰⁶ It is this statute, rather than the inherent ties between a director and the company's state of incorporation, that makes it constitutional for state courts to exercise personal jurisdiction over director defendants.¹⁰⁷ Since Nevada lacks such a statute,

July 2, 1999 (reporting that state budget includes \$52,000 to cover the rent of the business court).

¹⁰⁶ Compare Del. Code Ann. tit. 10, sec. 3114 (Delaware consent statute) with Nev. Rev. Stat. Ann., sec. 14.065 (Nevada long-arm statute not requiring directors of Nevada corporations to consent to jurisdiction).

¹⁰⁷ See *Shaffer v. Heitner*, 433 U.S. 187 (1977) (holding that directors of Delaware corporation lacked sufficient contacts with Delaware to grant Delaware courts personal jurisdiction over directors under Delaware's quasi in rem statute). Signifying the importance that Delaware places on its court having jurisdiction over directors of Delaware corporations, Delaware passed a specific statute deeming such directors to having consented to such jurisdiction within 13 days after *Shaffer*. John J. Cound et al., *Civil Procedure: Cases and Materials* 165 (8th ed. 2001). (Similar statutes have been adopted by Alaska, Illinois, Kansas, Maine, Michigan, Montana, North Carolina, North Dakota, Oregon, Pennsylvania, South Dakota, and Wisconsin.) See Casad & Richman, *supra* note, ___, Appendix E. This makes the absence of a specific statute by Nevada all the more remarkable.

there is substantial doubt whether Nevada courts have personal jurisdiction over directors of companies that are incorporated in Nevada but not headquartered in the state.¹⁰⁸ The ability

¹⁰⁸ Nevada's statute grants its courts jurisdiction "on any basis not inconsistent with the constitution of this state or the constitution of the United States." Nev. Rev. Stat. Ann., sec. 14.065. Despite its broad formulation, this statute may reach less far than statutes presuming directors' consent to jurisdiction or specifically conferring jurisdiction over directors of domestic corporations. See *Shaffer v. Heitner*, 433 U.S. at 216 (explaining that directors of a Delaware corporation "have simply had nothing to do with the State of Delaware. Moreover, appellants had no reason to expect to be haled before a Delaware court. Delaware, unlike some states, has not enacted a statute that treats acceptance of a directorship as consent to jurisdiction in the State"); see also *Hanson v. Denckla*, 357 U.S. 235 (1958) (noting the significance of specific statutes conferring personal jurisdiction on a state); *Kulko v. Superior Court*, 436 U.S. 84, 88 (1978) (noting that a lack of a special jurisdictional statute signifies a lack of particularized interest by the state in obtaining personal jurisdiction over a father of a child residing in the state and weakens the argument that the state has personal jurisdiction over the father in a child support dispute); *Armstrong v. Pomerance*, 423 A.2d 174 (Del. 1980) (upholding a Delaware consent statute because it provided explicit notice to directors that they could be haled into Delaware courts and because requiring them to impliedly consent to Delaware's *in personam* jurisdiction was not unreasonable); *Swenson v. Thibaut*, 250 S.E.2d 279 (N.C. App. 1978) (upholding a North Carolina statute and distinguishing *Shaffer*, among other, as not dealing with a statute clearly designed to protect the state's interest in serving as a forum and to give notice to directors); *Stearn v. Malloy*, 89 F.R.D. 421 (E.D. Wisc. 1981) (upholding a Wisconsin statute because, under the statute, a director of a domestic corporation consents to jurisdiction). We are not aware of any cases upholding the exercise of jurisdiction over a director of a domestic corporation where the state lacked a specific statute authorizing such jurisdiction and the director did not have other contacts with the forum state. Cf. *Pittsburgh Terminal v. Mid-Alleghany*, 831 F.2d 522 (4th Cir. 1987) (holding that

of a quality court to attract incorporations, however, wanes if that court lacks jurisdiction over directors residing in other states.

A further indication that these courts do not reflect a serious and sustained effort to attract incorporation is the manner and timing of their establishment. All of these business courts were established administratively and without legislative approval. Although legislative proposals to establish separate courts have been advanced in several states -- including Massachusetts,¹⁰⁹ New Jersey¹¹⁰ and Pennsylvania¹¹¹ -

directors of West Virginia corporation headquartered in West Virginia who approved a transaction by a telephone call to West Virginia are subject to personal jurisdiction in West Virginia under a statute conferring jurisdiction over any person who transacts business in the state). In the best known case arising under Nevada corporate law, *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342 (D. Nev. 1997), Hilton sought to enjoin ITT, a Nevada corporation, from implementing its reorganization plan. Since only the corporation itself, rather than its directors, were named as defendants, Nevada courts clearly had jurisdiction. In most shareholder disputes, however, the plaintiffs seek damages from corporate officers and directors instead of, or in addition to, an injunction against the corporation itself.

¹⁰⁹ Sacha Pfeiffer, *To End Delay, Court Devotes All Its Time to Business Cases*, *Boston Globe*, Oct. 19, 2000, at A1 (mentioning a bill filed by Senator David Magnani in 1998).

¹¹⁰ Michael Booth, *Lawmaker Proposes Statewide Business Courts*, *N.J.L.J.*, June 8, 1998, at 6 (mentioning a bill sponsored by David Russo).

¹¹¹ See *infra* TAN.

- none have ever been adopted. This suggests a lack of political support for business courts, especially for a more far-reaching reform involving changes in the right to jury trial and in the way judges are appointed, which would require legislative approval.

Finally, all business courts other than the Delaware chancery court were created after 1992, when New York established the commercial division in its supreme court on a trial basis. That no specialized business courts had been established until 1992, decades after states had purportedly started to compete for incorporations, poses a quandary for state competition scholars. Why would states, eager to compete with Delaware, permit Delaware to build up competitive advantages from case law, accumulated judicial expertise, and reputation? From our perspective, however, this is not surprising: it was New York's success in streamlining commercial litigation,¹¹² rather than Delaware's success in

¹¹² Commercial Division Celebrates First Anniversary, Metropolitan Corporate Counsel, Dec. 1996, at 46 (noting praise of the commercial division by the chair of the business law section of the American Bar Association and the chairman of the board of the directors of the American Corporate Counsel Association); Frederick Gabriel, New York's Commercial Court is Where Business Speeds Along: New System Is Model for Other States, Crain's N.Y. Bus., Apr. 7, 1997, at 11 (citing a study showing that the commercial division had shortened the time to resolution of contract cases by 29% and noting that several states have plans to establish similar systems).

attracting incorporation, that stimulated the creation of business courts.

D. Potential Objections and Extensions

In this Section, we address a number of potential objections to, and extensions of, our analysis: we analyze the claim that the diffusion pattern of corporate law innovations presents evidence of competition; we address the claim that state antitakeover laws are designed to attract incorporations; we consider the extent to which Nevada and Maryland actively compete for incorporations; we discuss the argument that states actively promote themselves as incorporation havens; we examine whether the purported strategy adopted by states signifies an intent to attract incorporations; and we assess whether the fact that states revise their corporations laws signifies such an intent.

1. Diffusion of Corporate Law Innovations

In an article that has become a classic, Roberta Romano examines four statutory innovations in corporate law and finds that they quickly diffuse among states, forming an ogive (S-

shaped) curve of cumulative adoptions as a function of time.¹¹³ The pattern of diffusion of statutory innovations, Romano argues, closely resembles the typical pattern in competitive markets.

We agree with Romano that competitive forces can give rise to an S-shaped diffusion pattern. We do not agree, however, that such a pattern is an indication of competition.¹¹⁴ Many statutory innovations in areas where states clearly do not compete diffuse among states along S-shaped curves. These areas include welfare, health, education, conservation, planning, administrative organization, highways, civil rights, corrections and police, labor, taxes, and professional regulation.¹¹⁵ Even abortion

¹¹³ The four statutory innovations in her study are the explicit elaboration of a standard for director and officer indemnification, the exemption from stockholder vote on mergers involving a specified percentages of the corporation's stock, the elimination of appraisal rights in corporations whose shares trade on a national exchange, and antitakeover statutes. See Romano, *Law as a Product*, at 233-40.

¹¹⁴ Romano, *Theoretical Inquiries L.*, at ____.

¹¹⁵ See Jack L. Walker, *The Diffusion of Innovations Among the American States*, 63 *Am. Pol. Sci. Rev.* 880 (1969); Virginia Gray, *Innovation in the States: A Diffusion Study*, 67 *Am. Pol. Sci. Rev.* 1174 (1973). For more recent studies see, for example, Henry R. Glick & Scott P. Hays, *Innovation and Reinvention in State Policymaking: Theory and the Evolution of Living Will Laws*, 53 *J. Pol.* 835 (1991); Henry Glick, *Innovation in State Judicial Administration: Effects on Court Management and Organization*, 9 *Am. Pol. Q.* 49 (1981);

laws exhibit a similar pattern of diffusion.¹¹⁶ More generally, almost every type of information, be it a statute, a custom, a rumor, or anything else, diffuses. What drives the diffusion in all of these areas and explains its typical S shape is information transfer.¹¹⁷ In the end, an ogive (S-shaped) diffusion curve is no less no more than the integration of a normal (bell-shaped) curve of new adoptions over time.¹¹⁸ A normal curve is called normal because it arises commonly, rather than being a special hallmark of competition. It is therefore not warranted to draw an

Lee Sigelman et al., *Social Service Innovation in the American States*, 62 *Social Sci. Q.* 593 (1981) (human services); James L. Ragens, *State Policy Responses to the Energy Issue*, 61 *Social Sci. Q.* 44 (1980) (energy); George W. Downs, Jr., *Bureaucracy, Innovation, and Public Policy* (1976) (juvenile correction); Fred W. Grupp, Jr. & Alan R. Richards, *Variations in the Elite Perceptions of American States As Referents for Public Policy Making*, 69 *Am. Pol. Sci. Rev.* 850 (1975) [Others].

¹¹⁶ See Christopher Z. Mooney & Mei-Hsien Lee, *Legislating Morality in the American States: The Case of Pre-Roe Abortion Regulation Reform*, 39 *Am. J. Pol. Sci.* 599 (1995).

¹¹⁷ Everett M. Rogers, *Diffusion of Innovations* __ (4th ed. 1995).

¹¹⁸ Mathematically, an S-shaped curve showing the number of total adoptions as a function of time is the integral of a normal-shaped curve showing the number of new adoptions as a function of time. In the case of state corporate laws, diffusion of statutory innovations may simply reflect a weak interest of states to provide services to chartered firms and the low cost of copying others.

inference of competition from an S-shaped diffusion of certain corporate statutory innovations.

Indeed, a closer look a Romano's data shows that corporate innovations spread for reasons unrelated to state competition for incorporations. One of Romano's provisions -- and the one whose diffusion most closely resembles an S-shaped curve¹¹⁹ -- are first-generation antitakeover statutes pioneered by Virginia in 1968. Of the four provisions analyzed by Romano, first-generation antitakeover statutes were adopted most rapidly, by 37 states in the 13 years until they were held unconstitutional by the United States Supreme Court.¹²⁰

However, as explained above, these statutes are not designed to attract corporations and, as Romano notes elsewhere, they are not intended to do so. That these statutes diffuse in an S-shaped manner demonstrates that S-shaped diffusion of statutory innovations is consistent with legislative motives other than competition for incorporations.

¹¹⁹ Four out of five faculty colleagues we polled concurred in this assessment. While we do not mean to quibble with Romano, our visual inspection suggests that the adoption pattern of the other three innovations -- indemnification, merger vote exemption, and appraisal rights exemption -- could easily be described to follow a differing pattern.

¹²⁰ See *Edgar v. MITE Corp.*, 457 U.S. 624 (1982)

2. The Effect of Antitakeover Statutes on Incorporations

In two recent papers, Guhan Subramanian, and Lucian Bebchuk and Alma Cohen argue that antitakeover statutes help states to attract incorporations and that this effect is consistent with state competition resulting in a race to the bottom.¹²¹

We do not dispute that firms base their incorporation decisions in part on the substantive laws of the incorporation state. Nor do we dispute that states differ in the quality of their laws and that certain laws can result in more incorporations. What we disagree with is that state are actively seeking to adopt laws in order to attract incorporations. Given the strong direct evidence that states adopt antitakeover laws to protect local firms against takeovers and that the benefits from attracting incorporations are low, evidence that such laws have a positive effect on incorporations does not warrant the conclusion that the laws were passed in order to attract incorporations.

3. Nevada

¹²¹ Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. Pa. L. Rev. (forthcoming 2002); Bebchuk & Cohen; but see Daines (finding that anti-takeover statutes do not attract incorporations).

Nevada is the poster child for those believing that states compete for incorporations. Described as "Delaware of the West,"¹²² Nevada is the state most likely to be mentioned as Delaware's competitor.

Indeed, Nevada is the only state other than Delaware that openly endeavors to attract incorporations.¹²³ Nevada also frequently revises its corporate statute.¹²⁴ But, in stark contrast to Delaware, Nevada's marketing efforts are principally directed at, and its revenues are derived from, a

¹²² Keith Paul Bishop, *The Delaware of the West: Does Nevada Offer Better Treatment for Directors?*, 7 No. 3 *Insights* 20 (Mar. 1993); Jill E. Fisch, *the Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 *U. Cin. L. Rev.* 1061, 1967 (2000); Richard C. Reuben, *Step Right Up for Some Nevada Snake Oil*, *Cal. Law.*, July 1992, at 17 (referring to Nevada's efforts to become the "Delaware of the West"); Roberta Romano, *Theoretical Inquiries L.*

¹²³ See, e.g., Lou Dobbs, *Nevada Pushes to Incorporate More Businesses*, *Moneyline* (Dec. 20, 1993) (noting that Nevada is trying to lure more businesses to incorporate there); Keith Paul Bishop, *Nevada Adopts Significant Changes to its Corporation Law*, *Insights*, Oct. 2001, at 24 (stating that Nevada has been a fierce competitor in the market for corporate charters for at least the last decade); John G. Edwards, *Committee Aims to Lure Firms*, *Las Vegas Review-Journal*, Nov. 28, 1999 (noting that legislative subcommittee is studying was to attract incorporations); *Nevada Seeks Companies to Incorporate in State*, *Bloomberg News*, Mar 5, 1997.

¹²⁴ CITE

particular segment of closely held corporations.¹²⁵ Thus, promoters of Nevada brag that Nevada is "the most difficult state in the country in which to pierce the corporate veil."¹²⁶ They also note that Nevada is "the only state in the country

¹²⁵ The web site maintained by Delaware's Division of Corporations lists as reason for incorporating in Delaware its advanced and flexible corporation statute; the quality of Delaware courts; the efforts by the legislature to keep Delaware law current; and the service quality of the office of the Secretary of State. See <http://www.state.de.us/corp/q&a.htm> (3/11/02). All of these features are important for public corporations. By contrast, the web-site by Nevada's Secretary of State highlights, in addition to low taxes and fees, that Nevada has "No I.R.S. Information Sharing Agreement" and "Minimal Reporting and Disclosure Requirements" and that "Stockholders Are Not Public Record." http://sos.state.nv.us/comm_rec/whyinc.htm (3/11/02).

¹²⁶ Web site of Nevada Corporation Services, <https://www.nevada-incorporations.com/whynevada2.html> (3/11/02); see also web-site of [nvinc.com](http://www.nvinc.com), <http://www.nvinc.com/piercecorp.htm> (2/25/02) (veil-piercing law is "number 1" reason to incorporate in Nevada); web site of [WhyIncorporateInNevada.com](http://www.whyincorporateinnevada.com), <http://www.whyincorporateinnevada.com/4advantages.phd> (3/11/02) (listing "hard to pierce corporate veil" together with tax savings, asset protection, and privacy, as advantages of incorporating in Nevada). Incorporation services, of course, do not speak for the state and may be prone to exaggerate the virtues of a state. No similar claims, however, are made for incorporation services specializing in Delaware. See, e.g., web site of Delaware Intercorp, <http://www.delawareintercorp.com/why.htm> (3/11/02) (listing quality of law and courts, availability of legal advice, service quality of Division of Corporations, and ability to connect directly to divisions database as advantages of Delaware); web site of Delaware Registry Ltd., <http://www.delreg.com/adv.html> (3/11/02) (listing 10 advantages of incorporating in Delaware).

that does not exchange information with the IRS,"¹²⁷ that it is "the only state that allows its corporations to use bearer stock certificates ... to ensure privacy,"¹²⁸ and that it otherwise protects shareholders' privacy.¹²⁹ In addition, the lack of a state corporate income tax¹³⁰ attracts corporations that hold only intangible assets and have no operations, which may thus be able to avoid any state's income tax by incorporating in a no-tax state.¹³¹ In sum, several features

¹²⁷ Web site of Nevada Corporation Services, supra note __; web site of Nevada's Secretary of State, http://sos.state.nv.us/comm_rec/whyinc.htm (last visited Apr. 29, 2002); see also web site of NevadaIncorporate.com, <http://www.nevadaincorporate.com/> (3/11/02).

¹²⁸ See web site of WhyIncorporateInNevada.com, supra note __.

¹²⁹ See id.; web site of Nevada Corporation Services, supra note __ (listing privacy first as reason to incorporate in Nevada); web site of Nevada's Secretary of State, http://sos.state.nv.us/comm_rec/whyinc.htm (last visited Apr. 29, 2002); web site of NevadaIncorporate.com (noting minimal reporting and disclosure requirements).

¹³⁰ See, e.g., web site of Nevada's Secretary of State, http://sos.state.nv.us/comm_rec/whyinc.htm (last visited Apr. 29, 2002).

¹³¹ Since all states assess income taxes on companies conducting business in the state regardless of where they are incorporated, the absence of income tax is, for most companies, no reason to incorporate in Nevada. However, companies that conduct no operations in any state and own no tangible property can evade all state income taxes by incorporating in Nevada (and conducting some minimal business there, such as opening a bank account) on the income derived from their intangible assets. (Companies can obtain similar

aimed at close corporations¹³² account for Nevada's success in attracting incorporations¹³³ and generate for Nevada modest franchise tax revenues of about [\$20 million] a year.

But with regard to public corporations, Nevada has done little, has derived minuscule benefits, and has had little success. Nevada lacks a developed corporate case law,¹³⁴ a fact not helped by its failure to publish trial court opinions.¹³⁵ Nevada's main draw for public corporations is allegedly its comprehensive corporation statute,¹³⁶ yet the

benefits by incorporating in Delaware. Explain) In fact, some public corporations specifically form Nevada subsidiaries to hold intangible assets in order to avail themselves of this advantage -- but themselves stay in Delaware. Support.

¹³² Public corporations with a large number of shareholders are rarely concerned that their corporate veil may be pierced and have to disclose a host of information under the federal securities laws, thus making state corporate law disclosure obligations irrelevant.

¹³³ NUMBERS/CITES.

¹³⁴ We conducted a Westlaw key search in the state court database for Nevada using Corporations key numbers 310, 314, 315, and 316. As of February 25, 2002, there were 8 Nevada cases with these key numbers, compared to 197 for Delaware, 53 for Michigan, 27 for Florida, 14 for South Carolina, and 6 for New Hampshire.

¹³⁵ According to practitioners, presents a serious impediment to competing with Delaware's extensive case law. See Roberts & Pivnick, *supra* note __, at 47.

¹³⁶ See, e.g., Proxy Statement by Condor Capital Inc. Mar. 28, 2000) at 7 (noting comprehensive and flexible law as the main reason to reincorporate from Colorado into Nevada).

Nevada legislature meets only every two years -- a feature hardly designed to keep the law up-to-date. Nevada's business court is of recent vintage, employs juries to resolve factual disputes, may lack personal jurisdiction over most officers and directors of Nevada's public corporations, and has as its main goal to induce companies to locate their operations in Nevada.¹³⁷ Nevada's additional franchise tax revenues from public corporations are trivial, about \$30,000 a year. The additional revenues from legal business, if proportionate to Delaware's, can be estimated at a modest \$6 million for the year 1990, only a fraction of which represent profits. Actual revenues are probably lower because Nevada courts lack personal jurisdiction over most individual defendants in shareholder disputes, reducing the incentive to bring such suits in Nevada. To put these figures in perspective, Nevada's general fund revenues are expected to total over \$3.74 billion in the 2001-2003 biennium, with revenues from sales and use tax and from gaming taxes alone amounting to \$2.74 billion.¹³⁸ [Find data for 1990]

¹³⁷ See *supra* TAN.

¹³⁸ See Executive Budget in Brief for the 2001-2003 Biennium, <http://www.budget.state.nv.us/budinbrief01.htm#Spending> Summary (last visited Apr. 29, 2002). Needless to say, revenue from incorporations is not even mentioned in that

Finally, Nevada's market share in the market for public corporations is tiny -- and shrinking.¹³⁹ During 1986-1990, about 3 percent of the companies that conducted initial public offerings and did not incorporate in their headquarter state incorporated in Nevada. During 1996-2000, that percentage dropped to 1.2 percent. In 2000, Nevada attracted 2 firms that conducted initial public offerings (one headquartered in Nevada). In 2001, Nevada attracted none. Delaware attracted in that year 325 firms conducting initial public offerings. That Nevada is considered a success in the market for public incorporations illustrates not the vigor of competition, but rather how tepid that market is.

4. Maryland

A more recent entry into the league of states competing for incorporations is Maryland.¹⁴⁰ Maryland indeed attracts a fair number of companies headquartered elsewhere. But most of

document.

¹³⁹ See also Daines, *supra* note __ (reporting a Nevada market share of 1.5% among companies going public between 1978 and 1997 and characterizing Nevada's success as trivial).

¹⁴⁰ See Bebchuk & Cohen; Subramanian.

these firms are regulated investment companies.¹⁴¹ Maryland's attraction to investment funds is based on the fact that Maryland law contains a number of statutory provisions targeted to such funds, including provisions designed to assure that the corporation satisfies federal tax requirements, a waiver of the requirement to hold annual meetings of shareholders, and a grant of power to the board of an investment company to increase the number of authorized shares without shareholder approval.¹⁴² In addition, as most other states, Maryland assesses only minimal franchise taxes on corporations.

The extent to which Maryland's status is the product of

¹⁴¹ See Daines, *supra* note ___. Between 1986 and 2001, 249 companies incorporated in Maryland when they went public, of which 215 were headquartered elsewhere. Of these, 6 companies were headquartered in Maryland and 187 headquartered elsewhere were investment companies (mostly closed-end funds and real estate investment trusts). See SDC printout. Maryland is also a popular domicile for open-end mutual funds, which are not included in the SDC database. See Bordewick Interview. Excluding investment companies, Maryland attracted only 56 companies over 15 years, out of a total of over 8,000 IPO companies and over 100 companies headquartered in Maryland.

¹⁴² See Section 2-501 (annual meeting); 2-105(c) (authorized shares). That Maryland's attraction is confined to investment funds, and extends to open-end funds, is inconsistent with the claim that companies incorporate in Maryland principally to take advantage of its tough antitakeover laws. See Bebchuk & Cohen; Subramanian. Antitakeover laws offer no special attraction to REITS and closed-end funds, and no attraction at all to open-end mutual funds.

an active effort by the state to attract mutual fund incorporations is unclear.¹⁴³ More importantly, the market for investment companies, however, is rather separate from the market for regular public corporations. For one, most investment companies are not even organized as corporations. Rather they usually take the form of a trust,¹⁴⁴ typically organized in Massachusetts or, more recently, in Delaware, and pay no organizational fees whatsoever to their host states. Second, the internal affairs of investment companies are largely regulated by the federal Investment Company Act of

¹⁴³ Mutual funds originally incorporated in Maryland because Maryland corporate law, unlike the corporate law of other states, did not restrict the ability of corporations to redeem their common stock. This lack was historically part of Maryland law, rather than an affirmative attempt by the state to attract mutual funds. Hanks Interview. As mutual funds flocked into Maryland, they became an important constituency for the state legislature and exerted political influence. In addition, several large mutual fund sponsors -- T. Rower Price, Legg Mason and Alex Brown are located in Maryland. Telephone Interview with Henry Hopkins, General Counsel, T. Rowe Price (Mar. 22, 2002). The monetary benefits that Maryland and its residents derive from investment companies are relatively low. Maryland derives no significant franchise tax revenues from such companies. See *supra* TAN. Maryland lawyers derive some modest benefits from providing corporate advice to such companies, though not from litigation. Hanks Interview (noting that mutual funds generate some business for Maryland lawyers, who help in forming such companies and provide corporate law advice, but hardly any litigation); Bordewick Interview (investment companies tend not to be involved in corporate disputes).

¹⁴⁴ Langbein, *supra* note ___, at 171.

1940. The choice in organizational form for such companies does not hinge on the affirmative substantive attraction of state law or the quality of state courts, but on minimizing state taxes and on avoiding a second lawyer of state law regulation on top of federal regulation.¹⁴⁵ The features of the incorporation "product" sought by investment companies -- minimal regulation and minimal taxes -- thus differs entirely from those sought by regular public companies -- developed substantive law and good courts. Thus, even if Maryland does compete for investment companies, this competition would be meaningless for regular public corporations. Indeed, to regular public companies, Maryland does not appear to hold special attraction.

5. Promotional Activities

Another argument suggested in support of the claim that states compete to attract incorporations is that states' corporate laws are promoted as a reason to incorporate in-state. As Romano has recently argued: "After revising their codes, the states then publicize their legislative reform efforts as a reason to retain an in-state domicile rather than

¹⁴⁵ Cite to Vanguard prospectus, Bordewick interview; and article. The only exceptions are substantive provisions for REITs enabling enforceability of share transfer restrictions.

incorporate in Delaware. If the states were indifferent to the retention of local incorporations, then they would have no reason to engage in such activity."

In our research, we have indeed encountered several articles touting the horn for one or another state's corporation law. These articles were invariably written by local lawyers.¹⁴⁶ None of the articles were written by state officials, and no other major promotional activities financed by states other than Delaware have come to our attention. [As to DE, document the delegation that visited in Israel a couple of years ago to do PR] These articles may well reflect competition by lawyers for clients. Lawyers can attract clients through such articles by advertising their expertise, obtaining referrals, and listing the articles on their resumes

¹⁴⁶ See Hanks, *supra* note __ (article by a Maryland lawyer); Byron F. Egan & Curtis W. Huff, Choice of State of Incorporation -- Texas Versus Delaware: Is It Now Time to Rethink Traditional Notions?, 54 SMU L. Rev. 249 (2001) (article by Texas lawyers); Charles W. Murdock, Why Illinois? A Comparison of Illinois and Delaware Corporate Jurisprudence, 19 S. Ill. U. L.J. 1 (1994) (article by a draftsman of Illinois' 1983 Business Corporation Act and an author of a two-volume treatise on Illinois law); Frederick D. Lipman, Alternatives to Incorporating in Delaware, N.Y.L.J., Nov. 6 1997, at 5 (article by a Philadelphia lawyer promoting Pennsylvania law). The same is true for the article cited by Romano in support of her claim. See James I. Lotstein & Christopher Calio, Why Choose Connecticut? Advantages of the Connecticut Business Corporation Act over the Delaware General Corporation Law, 10 Conn. Law. 10 (2000) (article by Connecticut lawyers).

-- regardless of whether they generate additional incorporations. To the extent that locally incorporated companies are more likely than Delaware companies to hire a local lawyer, lawyers may also attempt to increase local incorporations (though the benefits of increased incorporations accrue to all local lawyers, not just to the author). This only suggests that local lawyers may exaggerate the virtues of local law. It is not evidence that states are competing for incorporations.

6. Competitive Strategy

Giving credence to believers in state competition would imply that states other than Delaware compete principally by fashioning their corporate statutes to attract incorporations. However, from a strategic perspective, this alleged mode of competition raises questions. States are unlikely to gain a competitive advantage over other states by adopting statutory provisions because other states can easily copy these provisions. In fact, to the extent that states expend resources in determining the optimal set of provisions, they may not be able to recoup their investment. By contrast, competition by setting up specialized courts or by generating incentives for judges to fashion their case law to attract

incorporations cannot easily be copied. In short, the mode in which states allegedly compete -- through their corporate statutes -- is not well designed to generate profits.

Moreover, no state has adopted a strategy of copying Delaware's corporate statute and fashioning its case law in accordance with Delaware's.¹⁴⁷ Such a strategy would be sensible because Delaware, as a market leader, has the strongest incentives to identify the provisions that attract corporations and has a reputation in legal circles of having an up-to-date corporate law.¹⁴⁸ In addition, such a strategy would enable a state to hook into some of the learning and network benefits generated by Delaware law. To be sure, unless the state adopted the politically unthinkable rule that Delaware case law alone will carry a precedential weight in its courts, the state's home grown case law would gradually diverge from Delaware law. And even if the state adopted such

¹⁴⁷ Despite occasional claims to the contrary, Nevada does not imitate Delaware. See David Mace Roberts & Rob Pivnick, *Tale of the Corporate Tape: Delaware, Nevada and Texas*, 52 *Baylor L. Rev.* 45 (2000) (cataloguing differences between Delaware law, Nevada law, and Texas law).

¹⁴⁸ In a competitive setting, Delaware may not have significant incentives to innovate, but would still have significant incentives to figure out which innovations adopted by other states are worth copying. Incentives for Delaware to innovate would be higher (and closer to socially optimal incentives) in a less competitive setting.

a rule, without an expert judiciary its law would still fall short of Delaware law. This is particularly true because many substantive legal rules in Delaware are open ended and require an expert judiciary to apply them effectively.¹⁴⁹ But a lower-quality product is better than nothing, and the state could at least attempt to attract some incorporations by charging a lower price than Delaware.¹⁵⁰ Given the ineffectiveness of the strategy that states allegedly follow to attract incorporations, the fact that not a single state has ever experimented with the inexpensive strategy of emulating Delaware while charging a lower price suggests that states are not merely unsuccessful competing with Delaware. They are not even trying.

Classic state competition theory does not has a persuasive answer to these questions. In contrast, that states' actions are largely confined to revising their corporate statutes and that no state has consistently copied

¹⁴⁹ Kamar, *supra* note __.

¹⁵⁰ Romano argues that the low price that states presently charge is explained by the inferiority of the product they offer. Romano, 2 *Theoretical Inquiries L.*, at n.310. As discussed above, however, the incorporation price is presently so low that it generates no meaningful revenues for states. Moreover, deriving only small revenues from incorporations undercuts the credibility of states' commitment to corporate chartering which, by some accounts, is crucial to attracting incorporations

Delaware can easily be reconciled with the fact that states stand to gain little by attracting incorporations and that the driving force behind states' activities are corporate law committees of the local bar. The low fiscal gains to states from attracting incorporations, the significant influence of corporate law committees over corporation statutes, and the lesser influence of those committees over other issues all explain why states are largely confined to revising their corporate statutes.

The fact that no state has consistently copied Delaware, in turn, is consistent with the objectives of local lawyers. As discussed, local lawyers may well not want to copy Delaware -- even if copying Delaware would increase incorporations by public companies -- because doing so would expose local law firms to competition from national law firms specializing in Delaware law¹⁵¹ and because local bar committee members are likely to build less reputation and specialized expertise by copying Delaware than by devising idiosyncratic rules.

¹⁵¹ See also Carny, *supra* note ___ at 723 (noting interest of local lawyers to exclude potential competition by lawyers specializing on Delaware law). In contrast, experts on local law would not derive equivalent benefits from a greater ability to compete for business by companies incorporated in Delaware. The reason is that corporate lawyer advising public companies already have, or have partners who have, substantial experience in Delaware law.

Moreover, to the extent that committee members derive monetary benefits from promoting the interest of existing clients or non-monetary benefits from a feeling of empowerment or contribution to society, they are likely to find it constraining and less fulfilling if they merely copied Delaware law.

7. Activity as Evidence of Competition

Roberta Romano has recently argued that the mere fact that states periodically revise the corporate statute can be explained only as an effort to attract incorporations. Unlike in other settings, her argument goes, states do not have to provide a decent corporate law as a service to its citizens or to domestic firms because, if local law is deficient, firms can incorporate elsewhere. Therefore, she concludes, "the only plausible answer [to why a state updates its law] is that it wants domestic corporations."¹⁵²

Romano's argument, however, overlooks other reasons why states may revise their corporate laws. For one, states may

¹⁵² Romano, *Theoretical Inquiries L.*, at 510 nn.322-325. Romano also argues that the fact that Delaware updates its code indicates that Delaware is threatened by competition. *Id.* Even monopolists, however, have incentives to improve their product to the extent that they can charge a higher premium for it. See Tirole.

be induced to revise their law by the local bar. As explained above, local lawyers have interests that only partially coincide, and sometimes conflict with, attracting incorporations. Specifically, lawyers can gain from corporate law that increases the amount of legal work they provide to locally incorporated firms even if that law drives some firms to incorporate elsewhere. Furthermore, despite the ability of firms to incorporate elsewhere, states may revise their laws to benefit domestic firms and their managers. Every state has a large stock of existing corporations, virtually all of which are closely held and conduct the bulk of their business in the state.¹⁵³ For those firms, reincorporating is costly. Moreover, closely held firms may well prefer to incorporate in the state where they conduct their business because obtaining legal advice on that state's law is cheaper and because incorporating in a different state would expose them to

¹⁵³ For example, Michigan has about 250,000 active corporations, but less than 100 public corporations. See Bebchuk & Cohen (providing the number of public Michigan corporations); <http://www.cis.state.mi.us/bcs/corp/corpstat.htm> (providing the number of all Michigan corporations). The fact that only about 21,500 foreign corporations are actively engaged in business in Michigan suggests that most corporations operate in their state of incorporation).

lawsuits in a distant location.¹⁵⁴ That most closely held firms incorporate in the state where they conduct business¹⁵⁵ - - even though other states would assess to them minimal franchise taxes -- suggests that these costs are material. Similarly, managers of public firms may be able to benefit from state law changes in ways in which they could not by reincorporating. Reincorporation requires shareholder approval, and shareholders may not vote to move into a manager-friendly jurisdiction. Enacting laws that benefit voters or contributors, however, is not tantamount to competing for incorporations. Lawmakers could act similarly if corporations did not have the option of reincorporating. In fact, state-level lobbying is likely less intense when firms can reincorporate in a state that already offers the desired law. Paradoxically, federalism thus only weakens the responsiveness of states other than Delaware to calls for reforming their corporate laws.¹⁵⁶

¹⁵⁴ By incorporating in a state, a firm becomes a citizen of that state and would be subject to jurisdiction in the state's courts in all disputes, not just corporate disputes. cite

¹⁵⁵ For example, Michigan [complete].

¹⁵⁶ To be sure, reincorporation requires shareholder support, and so management may still prefer to lobby local lawmakers for legal reform. But this is true for the state competition paradigm as well. While race-to-the-top theorists

Moreover, since revising the corporate code requires minimal fiscal outlays and rarely generates political opposition, such revisions say little about the intensity of state competition. In sum, that states engage in a variety of low-cost measures is consistent with many motivations, including weak incentives to attract incorporations. In contrast, that states have not taken any costly measures -- despite the fact that Delaware earns profits of several hundred million dollars on minimal outlays -- is inconsistent with the presence of strong incentives to compete posited by classic state competition theorists.¹⁵⁷

see this is a support to their thesis that shareholders win the law of their choice, race-to-the-bottom theorists argue that managers still control the incorporation decision because they can tie reincorporation decisions to value-increasing transactions, or choose where to incorporate before going public. Cites. Either argument applies to our claim that, in the absence of a state interest in incorporations, the ability to reincorporate reduces, rather than augments, the pressure on state lawmakers to adopt that lobbyists endorse.

¹⁵⁷ We similarly do not believe that inferences about the intensity of competition can be drawn from the frequency at which individual states revise their corporate statutes. For one, not all revisions improve the law. Delaware, for example, never adopted the four statutory innovations that Carney identifies as significant. See Appendix A. Yet there is no doubt that Delaware pays considerable attention to its corporate statute. Just like any other state, Delaware may well be slow to adopt a certain statutory innovation, or never adopt it at all, because its legislature and bar remain unpersuaded of its desirability or importance. Bussard Interview, *supra* note __ (explaining that Delaware decided not to adopt a share exchange as an alternative to a triangular

III. Why Do States Not Compete?

Delaware is presently earning over \$300 million a year in profits from franchise taxes paid by public corporations. Delaware's outlays to generate these profits are minimal. In terms of profit margins, return on capital, and net present value, the incorporation business is highly attractive. Why is it, then, that no-one seriously competes with Delaware?

One possibility is that Delaware's profits are protected by entry barriers. We believe that entry barriers exist, but that they are only part of the answer. The other part of the answer lies in the nature of state competition. We will argue that potential state competition differs from potential competition between private firms in three fundamental respects. First, non-states are excluded from being competitors in the market for incorporations. Second, state decision makers may not be all that interested in maximizing their state's profits from business opportunities available to the state: they are politicians, not entrepreneurs. Third, even if interested in making profits, states face political

merger -- a provision that appears in Carney's list of substantive Model Business Corporation Act innovations -- because there were too few uses for such a provision to justify an amendment). States that do adopt revisions, in turn, may be driven by lawyers who endorse frequent legal change as evidence of their influence or to generate business.

constraints, not present to private firms, that hamper their ability to do so.

A. Economic Entry Barriers

At present, Delaware enjoys competitive advantages over other states that make Delaware more attractive as a domicile for incorporation. From the perspective of potential competitors, these advantages constitute economic barriers to entry. In this Section, we will discuss these entry barriers and the economic hurdle they present for potential competitors.

First, Delaware has a specialized corporate court, which is a major attraction of incorporating in Delaware. As we discussed, other states that wished to attract incorporations would be well advised to set up a court with features similar to Delaware's chancery court. Doing so would inevitably entail some costs. But at least the budgetary requirements of setting up a court similar to Delaware's chancery court would be modest. Total budget outlays for Delaware's five-member court are about \$2 million a year.¹⁵⁸ For a competitor state, which would have, at least initially, many fewer companies and much less corporate litigation, a one-member court would

¹⁵⁸ Kahan & Kamar, *supra* note __, at 1230 n.109.

suffice.

To be sure, a court in a competitor state would lack the prestige of Delaware's chancery court. Moreover, to the extent that the court initially fails to attract many corporate cases, the judge on the court may not develop the same judicial expertise as judges on the chancery court do.¹⁵⁹ These deficiencies, however, can at least partially be addressed. For example, the judge could be paid a higher salary to compensate for a lower prestige; and the court can be given jurisdiction over high-profile business law cases outside the corporate area, which would both boost the court's prestige and provide the judge with relevant expertise.¹⁶⁰

Second, Delaware has a well-developed corporate case law. In addition, many law firms possess expertise on Delaware law and market participants are familiar with the law. These factors reduce the cost of planning transactions for, obtaining legal advice for, and assessing the value of Delaware corporations.

States might find it difficult to manufacture comparable advantages overnight. But they could nevertheless take steps

¹⁵⁹ Kamar

¹⁶⁰ Discuss Division of Corporations. Costs also relate to non-public companies and to UCC searches. Many other states already have efficient/computerized division.

to narrow the gap between them and Delaware. For example, they could pass more rule-oriented corporate codes, reducing the significance of legal precedents. They could also attach an elaborate set of examples or comments to their codes, increasing their predictability and reducing the costs of learning them. Or they could base their corporate codes on a widely-known body of law such as the Model Business Corporation Act. Most simply, however, competitor states could adopt a code identical to the Delaware General Corporation Act and instruct their courts to interpret the code in light of Delaware precedent. In short, competitors could at least partially emulate Delaware.

To be sure, by copying Delaware, a competitor state would not deliver the exact same product that Delaware does. In particular, as one of us has noted, Delaware law employs open-ended standards that must be interpreted and applied to facts by expert judges. Thus, copying Delaware would not obviate the need for an expert court.¹⁶¹ Moreover, until the state has established its own reputation and attracted a substantial number of incorporations, its code would have to be updated periodically to keep up with developments in Delaware case

¹⁶¹ See Kamar, *supra* note __, at 1928-32.

law.¹⁶² Finally, since Delaware would be the recognized brand name, a competitor state would have at least initially to charge a lower franchise tax than Delaware.

But given the substantial profits earned by Delaware, the strategy of setting up a court modeled after the Delaware court of chancery and copying the Delaware code seems viable. Even if only modestly successful, such a strategy could generate a positive return on the investment. For example, even if a state, after several years of sustained competition, attracted only a 10 percent market share and charged franchise taxes at no more than one-half of Delaware's rates, it would earn revenues of \$30 million a year -- enough to cover the cost of the specialized court many times over.

Yet no state has pursued either prong of this strategy or has otherwise taken serious steps to address Delaware's competitive advantages. The reason why, we believe, can be found in the fact that competition among states differs fundamentally from competition in regular markets.¹⁶³ We address these differences in Section B.

¹⁶² See *id.* at 1929-30.

¹⁶³ [Cite to examples of attempted entries into network markets]

B. The Nature of State Competition

1. The Inability of Non-States to Compete

At present, only states can effectively compete in the market for incorporations. Private firms that wished to sell incorporations would face barriers to entry that would in practice be unsurmountable. In theory, a private firm could try to replicate an incorporation by devising a set of contractual rules to govern the internal affairs of a privately incorporated quasi-corporation and offer a private tribunal to resolve any disputes arising under these contractual arrangements. Such a quasi-corporations would, however, be less attractive than a regular corporation.

First, a quasi-corporation would lack limited liability of its shareholders for corporate debts. Moreover, limited liability for non-contractual obligations of the quasi-corporation, such a obligations under tort law or tax law, could not be obtained by agreement of creditors of the quasi-corporation not to seek recourse to shareholders. Second, any adjudications by the private tribunal would not be entitled to full faith and credit. Such adjudications would therefore be easier to challenge, and harder to enforce, than adjudications by a state court. Third, the power of the private tribunal would be limited in several respects. For one, the private

tribunal would lack jurisdiction over parties absent their consent. Such parties include potential defendants other than the corporation itself, witnesses, or parties in possession of important evidence.¹⁶⁴ Similarly, it is doubtful whether a private tribunal could entertain a derivative or class action the outcome of which would bind parties other than the litigants.¹⁶⁵ Derivative and class actions are, of course, indispensable devices for enforcing shareholder rights. Moreover, the private tribunal would lack the power to enforce its rules and orders through contempt sanctions, threat of disbarment, and the like. Thus, the tribunal may not be able to issue effective injunctions and parties may not comply with its discovery rules. Finally, there would be uncertainty about the legal enforceability of the contract that establishes the quasi-corporation.¹⁶⁶

¹⁶⁴ Discovery rights against non-parties is a question of state law. In some states, an arbitrator can subpoena third parties, while in others she cannot. An arbitrator in a state that grants a subpoena power still cannot subpoena a party in another state that does not grant that power. [Cite]

¹⁶⁵ [Cite to the case that held that one cannot have class actions etc. via arbitration]

¹⁶⁶ Any foreign country that tried to compete for incorporations would face similar obstacles. Though a corporation formed in a foreign country could enjoy limited liability, an adjudication by a foreign court would not be entitled to full faith and credit and a foreign court would have difficulty enforcing subpoenas and contempt sanctions on

2. States as Profit Seekers

Standard economic theory posits that firms attempt to maximize profits.¹⁶⁷ Even for firms, this assumption is no more than a first approximation. But whatever its validity for firms, the goal of profit maximization cannot be transposed to states. For that reason, government run enterprises are not generally regarded as paragons of efficiency. Indeed, political scientists and public choice economists agree that state decision makers generally pursue political and ideological goals, rather than the goal of profit maximization.¹⁶⁸

To be sure, profits earned from franchise taxes may aid state decision makers in achieving these other goals. But this does not imply that state decision makers will try to earn such profits. For one, the amount of profits may just be

United States residents. In addition, many foreign countries would face competitive disadvantages arising from language barriers, from an inconvenient geographic location, or from a dubious political reputation. Finally, foreign countries may be hampered by the same type of political constraints as are states.

¹⁶⁷ See, e.g., Edwin Mansfield, *Microeconomics* 141 (3d ed.).

¹⁶⁸ See, e.g., George J. Stigler, *The Theory of Economic Regulation*, 2 *Bell J. Econ. & Mgmt. Sci.* 3 (1971); Sam Peltzman, *Towards a More General Theory of Regulation*, 19 *J.L. & Econ.* 211 (1976) [others]

too small to show on a state's radar screen. A business proposal to raise profits by, say, \$2 million a year -- with a net present value of, say, \$20 million -- which would be attractive to a host of medium-size entrepreneurs, may not get no attention in state capitals. As an illustration, recall that Nevada's tax expected tax revenues from sales and use tax and from gaming taxes alone are expected to total \$2.74 billion in the 2001-2003 biennium.¹⁶⁹ Relative to that amount, \$20 million in speculative incorporations profits is a drop in the bucket.

Second, profits may come too late to be relevant for state politicians. A business proposal, say, to invest \$1 million over the next ten years to generate a payoff thereafter, may hold little attraction to a politicians concerned about the next election.¹⁷⁰

¹⁶⁹ See *supra* TAN.

¹⁷⁰ In a recent contribution to the incorporation scholarship, Gillian Hadfield and Eric Talley argue that state lawmakers rarely look beyond maximizing their reelection prospects, and so they are more concerned with maintaining the economic condition of the state than with improving it. See Gillian Hadfield & Eric Talley, *On Public versus Private Provision of Corporate Law* (unpublished manuscript, Oct. 2001) (on file with authors). One implication of this view for the incentives to compete is that states will not bother to attract new incorporations, and at most will try to retain existing ones. As we have argued above, the gains to states other than Delaware from retaining their chartered firms are meager. See *supra* note __ and accompanying text.

Third, state decision makers may lack the expertise, or simply the mind set, to engage the state in profit-increasing ventures. At a minimum, the threshold before states will engage in such activities is higher than the one for private firms, most of which are formed for the express purpose of making profits and are run by managers who think in profit terms.

Finally, state decision makers may have more important items on their agenda than pursuing some profit-generating ventures. Even if they are interested in profits because of its political payoffs, it is not sufficient that a venture generate profits. The venture must generate profits with political payoffs that exceed the payoffs from other political initiatives.

3. Political Constraints

Last but not least, political constraints may hamper the ability of states to compete for incorporations. These political constraints constitute entry barriers of sorts, but barriers that are particular to political entities. The presence of such entry barriers thus makes the fact that private firms are precluded from competing for incorporations

all the more important.

Political constraints arise because actions conducive to increasing the state's profits from incorporations conflict with the political goals of state decision makers. For the remainder of this Section, we relate examples of actions, by Delaware and other states, that illustrate the presence of such constraints. That even profit driven Delaware is subject to political constraints evidences the force of these constraints.

i. The Composition and Pay of Delaware's Chancery Court

Political constraints clearly account for the composition of Delaware's renowned Chancery Court, the most important of Delaware's competitive advantages. The five judges on the Delaware chancery court are selected from long-term state residents -- not from a national, or even a statewide, pool. At least one judge comes from each of the three Delaware counties -- including the counties of Sussex and Kent, each of which accounts for less than 7 percent of Delaware's lawyers.¹⁷¹ It is clear that these rules are not designed to

¹⁷¹ See Interview with William T. Allen, May 16, 2001, in New York, NY. For Information on Delaware lawyers, see Supreme Court of Delaware Lawyer Registration 2001 (June 13, 2001) (noting that 104 and 103 active private practice lawyers out of a total of 1518 come, respectively, from Kent and

produce the best qualified judiciary, but to satisfy traditions and legal requirements that would be politically costly to change.

Relatedly, chancery court judges receive the same pay as judges on Delaware's superior court, the regular state court that deals with most non-corporate cases and generate no tax revenues. Again, political factors -- rather than the goal of profit maximization -- are likely to account for this fact.

ii. The Failure by Other States to Establish Corporate Courts

For other states, as well, political constraints are most evident in relation to their failure to establish corporate courts. As discussed below, the creation of a court similar to the Delaware court of chancery involves some costs, and a new court may lack the reputation and quality of Delaware's court. But to compensate for these disadvantages, an entrepreneurial state could hire high-reputation individuals to the court. Surely, at the right price, such talent would be available. An entrepreneurial state could even approach present or former judges of the Delaware chancery court to induce them to move to its court. Political constraints,

Sussex counties).

however, limit the ability of states to compete for judges. Political norms require new judges to be long-term state residents and limit the compensation that can be paid to judges. Similarly, political constraints make it inappropriate for a state to induce a Delaware judge, and for a Delaware judge to agree, to resign and move to a different state court. Thus, while it would be perfectly normal for a large American company to hire an executive of a different firm (and a citizen of a different country) as its chief executive officer and offer to double her salary, it would be highly unusual for, say, Rhode Island to strike such a deal with any Delaware judge, and indeed with any Delaware lawyer.

Political factors also impede the ability of states to set up a special corporate court that disposes of cases without juries and the judges of which are selected on merit. Local political interest groups benefit from jury trials and judge elections. These groups may be indifferent to whether appointed judges without juries or elected judges with juries decide corporate cases. But they may fear that, once the djinni is out of the bottle, such courts could expand to dispose of a broader set of cases. Moreover, political constraints mandating equal access to justice may hamper efforts to set up specialized business courts. In fact, labor

unions¹⁷² and public interest lawyers¹⁷³ successfully opposed a bill to establish a chancery court with appointed judges and without a right to jury trial in Pennsylvania for exactly these reasons.¹⁷⁴

¹⁷² John L. Kennedy, Chancery Ct. Plan Sent to Senate, *The Legal Inteligencer*, May 17, 1993, at 1 (noting opposition to merit selection by "[p]owerful labor unions.")

¹⁷³ See Mark A. Tarasiewicz, Chancery Ct. Opposed By Bar Assn., *The Legal Inteligencer*, June 1, 1992, at 1 (noting an opposition to chancery court proposal by the executive director of Community Legal Services due to concern over "the potential for low-income individuals to be swept into the Chancery Court without the ability to exercise their right to a jury trial").

¹⁷⁴ Pennsylvania's original chancery court proposal was designed to attract incorporations into Pennsylvania. See Tarasiewicz, *supra* note __. Ultimately, however, a "commercial case management program" was administratively established in the trial court in Philadelphia County. Unlike the original proposal, judges assigned to that program were elected, the right to a jury trial was unaffected, the program was instituted in only one county, and its purpose was to speed up commercial litigation, rather than to attract incorporations. See *supra* TAN.

Appendix A

Speed of Adopting Statutory Innovations by State

State	Ranking from Carney Data	Ranking by Romano
Alabama	43	31
Alaska	39	29
Arizona	34	33
Arkansas	4	45
California	27	38
Colorado	21	28
Connecticut	1	16
Delaware	44	1
Florida	13	6
Georgia	9	22
Hawaii	13	
Idaho	22	36
Illinois	29	37
Indiana	9	11
Iowa	13	17
Kansas	44	13
Kentucky	9	30
Louisiana	41	4
Maine	44	18
Maryland	27	42 or 15
Massachusetts	44	21
Michigan	30	10
Minnesota	25	20
Mississippi	4	43
Missouri	41	42 or 15
Montana	24	32
Nebraska	25	34
Nevada	33	7
New Hampshire	8	41
New Jersey	39	3
New Mexico	13	35
New York	12	12
North Carolina	13	24
North Dakota	31	48
Ohio	44	14
Oklahoma	44	25
Oregon	4	26
Pennsylvania	34	2
Rhode Island	37	9
South Carolina	7	27
South Dakota	38	44

Tennessee	3	5
Texas	23	40
Utah	32	
Vermont	34	19
Virginia	2	8
Washington	13	39
West Virginia	44	47
Wisconsin	13	23
Wyoming	13	46