3

The Production of Corporation Laws

Corporation codes can be viewed as products, whose producers are states and consumers, private corporations. The readings in this chapter focus on the structure of corporation laws—enabling versus mandatory—and the dynamics by which they are produced.

A central question for corporate law concerns the competitive process by which state corporation codes are produced: Is there any reason to suppose that the provisions in state codes benefit shareholders? Roberta Romano reviews the positions in what is a long-standing debate in corporate law, whether competition among the states for the corporate charter business is a "race for the bottom," and the empirical evidence, which tends to support the federal system rather than its critics. An update of the empirical evidence she discusses is included in the notes to the readings. Romano also offers an explanation of the dominant position of Delaware in the chartering market, which draws upon Williamson's hostage analysis, in Chapter 1, of transaction-specific assets. Jonathan Macey and Geoffrey Miller emphasize a different concern in the calculus, the actors in the political process, whose interests may affect the contours of corporation codes as much as code consumers' interests.

The next two readings in part A, by Marcel Kahan and Ehud Kamar, and by Mark Roe, question whether state competition is the correct lens through which to view the making of state corporate law. Kahan and Kamar maintain, as the title of their article suggests, that

states do not compete with Delaware for incorporations—hence, competition is a "myth"—and correlatively that Delaware is, in essence, a monopoly provider of corporate laws, while Roe contends that there is competition, but that it is principally between Delaware and the national government in Washington, D.C., rather than other states.

Saul Levmore joins the state competition debate, and in particular Roe's emphasis on federal-state relations, with another literature, that of the choice of organizational form. Corporations not only have a choice concerning to which state's corporate law to subject themselves, but also a choice concerning whether to operate as a corporation or an unincorporated entity, such as a partnership or limited liability company, which have even more flexible legal regimes than corporations. Noting that Delaware has come to dominate the unincorporated, as well as the corporate, sector, Levmore suggests that this complicates Roe's perception of Washington's impact on corporate law, as well as conventional views of state competition: he contends that to the extent that the federal government takes over corporate law, businesses will shift to unincorporated forms, a transition for which Delaware is readying to take the lead. But he warns that if unincorporated forms replace corporations as the dominant form of doing business, federal regulation is not likely to be far behind.

Frank Easterbrook and Daniel Fischel address another foundational question that concerns the states' choice of product attributes: What is the role of corporate law? They contend that state corporation codes reflect the contractual context of the corporation by taking an enabling approach. Corporation codes provide a standard-form contract, which firms can tailor quite extensively to meet their particular needs. The policy issue posed, given this context, concerns the scope of an enabling regime: Should all provisions in corporation codes be optional, or is there a role for mandatory corporate laws?

Easterbrook and Fischel emphasize the important role of efficient capital markets in maintaining an enabling structure. In an efficient market, corporate charter terms are priced and, consequently, investors will not bear the cost of harmful provisions (they get what they pay for). This weakens the case for mandatory rules. Jeffrey Gordon, however, offers several justifications for mandatory rules that do not depend on market failure in the pricing of charter terms. His most compelling argument involves a problem that is also of concern to Easterbrook and Fischel, changes in corporate organization undertaken midstream, for here capitalization of corporate changes in stock prices is of little solace to the shareholders, as they already own the stock. Shareholders, not managers, bear the cost of unexpected value-decreasing decisions that occur midstream (postinvestment). Because shareholders must approve changes that amend the corporate charter, the midstream opportunism

problem would seem to be a nonissue: why would shareholders approve an amendment that is adverse to their interest? The response is that shareholders are rationally ignorant. They face a collective action problem in which the costs of gathering information on an amendment's price effects are greater than their pro rata share of the benefit obtained from an informed vote. Shareholder voting is a focus of Chapter 6.

John Coffee reminds us that there is another actor besides the legislature that affects the configuration of corporate laws: courts. He suggests that, from the perspective of shareholder protection, active judicial review is a substitute for mandatory rules. Concerns over institutional competence, however, limit the potential for benefits from judicial activism. These concerns are most forcefully conveyed in the application of the business judgment rule, through which courts hesitate to second-guess managers' decisions, even when there is evidence that the decision will not maximize shareholder value. See Fred S. McChesney and William J. Carney, "The Theft of Time, Inc.?," *Regulation* 78 (Spring 1991).

Part B concludes with Yair Listokin's empirical study examining a related question, does the form of an enabling corporation statute matter? In Easterbrook and Fischel's view, the standard-form contract of a corporation code reduces transaction costs (firms do not have to draft charters from scratch) and consequently, a code's defaults should replicate the choices that a majority of firms would want. Defaults in corporation codes have changed over time, reflecting changing corporate practices, which would seem to be consistent with their view: for example, the nineteenth century default establishing preemptive rights and cumulative voting, from which firms could opt-out, switched to the opposite default in the twentieth century, in which firms had to opt-in by expressly including provisions in their charters. One area in modern codes in which there is considerable variation in the default across states is antitakeover statutes, which attempt to increase acquisitions' costs to render their success less likely: most apply automatically but permit opt-outs; some require firms to opt-in; some are mandates and not enabling; and some states have no such statutes (firms in such states can adopt charter amendments that duplicate the statutes' content). The variation in these statutes' defaults affords Listokin the opportunity to test Easterbrook and Fischel's view of defaults along side two other views that can be related to the readings in Chapter 1: defaults as mechanisms to reduce agency costs and, defaults as inconsequential, a potential implication of the Coase Theorem. The substantive content and stock price effects of antitakeover statutes are discussed in Chapter 8.

A

State Competition for Corporate Charters

The State Competition Debate in Corporate Law*

ROBERTA ROMANO

A perennial issue in corporate law reform is the desirability of a federal system. For notwithstanding the invasive growth of regulation by the national government, principally through the federal securities laws, corporate law is still the domain of the states. While no two corporation codes are identical, there is substantial uniformity across the states. Provisions typically spread in a discernible *S*-shaped pattern, as one state amends its code in response to another state's innovation. The revision process is often analogized in the academic literature to market competition, in which states compete to provide firms with a product, corporate charters, in order to obtain franchise tax revenues. This characterization is the centerpiece of the federalism debate in corporate law—whether competition, and hence a federal system, benefits shareholders. The hero—or culprit—in the debate is Delaware, the most successful state in the market for corporate charters.

The State Competition Literature

The Classic Positions Revisited

The foundation of the federalism debate in corporate law is that revenues derived from franchise taxes provide a powerful incentive for state legislatures to implement corporation codes that will maintain the number of domiciled corporations, if not lure new firms to incorporate in their state. All participants in the debate believe that the income produced by the chartering business spurs states to enact laws that firms desire. This behavioral assumption is plausible: There is a positive linear relation between the percentage of total revenues that states obtain from franchise taxes and states' responsiveness to firms in their corporate codes. The more dependent a state is on income from franchise tax revenues, the more responsive is its corporation code. The potential revenue from this tax source can be substantial for a small state. Delaware's franchise tax revenue averaged 15.8 percent of its total revenue from 1960 to 1980, and while it is impossible to generate a precise figure, this income considerably outdistances the cost of operating its chartering business.

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Given the shared assertion that revenues compel states to be responsive to firms' demands for legislation, the crux of the dispute is, therefore, whether this responsiveness is for the better. Because of the separation of ownership and control in the management of many large public corporations, when a firm's managers propose a reincorporation or urge the enactment of a statute, no less the adoption of a charter provision, we are concerned about whether they are maximizing the value of the firm. This is the classic agency problem, which goes to the heart of corporation law ...: How do principals—the shareholders—ensure that their agents—the managers—behave faithfully?

Advocates of a national corporation law have termed state competition a race for the bottom because they believe that managers' discretion is unfettered, enabling them to promote laws that are detrimental to shareholders' welfare. They base this conclusion on a characterization of the statutes and case law of Delaware—which is the most frequent location for a reincorporation—as excessively permissive, by which they mean tilted toward management. Proponents of the current federal system, however, question this phrasing of the issue, typically viewing the agency problem as trivial. They maintain that the many markets in which firms operate—the product, capital, and labor markets—constrain managers to further the shareholders' interests. Accordingly, in their view, conflict between investors and managers over the content of state laws is largely illusory, and the laws that are promulgated can best be explained as mechanisms for maximizing equity share prices.

The initial articulation of the market argument in the state competition debate was by Ralph Winter. Responding to William Cary, who launched the first salvo in the modern debate, Winter contended that if management chose a state whose laws were adverse to the shareholders' interests, the value of the firm's stock would decline relative to stock in a comparable firm incorporated in a state with value-maximizing laws, as investors would require a higher return on capital to finance the business operating under the inferior legal regime. This impact in the capital market would affect managers by threatening their jobs. Either the lower stock price would attract a takeover artist who could turn a profit by acquiring the firm and relocating it in a state with superior laws, or the firm would go bankrupt by being undercut in its product market by rivals whose cost of capital would be lower because they were incorporated in value-maximizing states. In either scenario, in order to maintain their positions, managers are compelled, by natural selection, to seek the state whose laws are most favorable to shareholders.

Winter's critique is devastating to Cary's analysis because Cary completely overlooked the interaction of markets on managers' incentives. Yet Cary's position cannot be entirely dismissed: More sophisticated proponents of national chartering can move to another line of attack by maintaining that there is a true difference in opinion that turns upon Cary's and Winter's assessments of the disciplining effect of markets on managers. Winter can assume away the agency problem because of his view that the capital market is efficient such that information concerning the impact of different legal regimes is publicly available and fully assimilated into stock prices. In contrast, support for national chartering presupposes a market that is, at best, only weakly efficient, such that it does not digest information concerning legal rules. In addition, even if stock prices accurately reflect the value of different legal regimes, if product markets are not competitive or the costs of takeovers are substantial, then a manager's livelihood may not be jeopardized by the choice of a non-value-maximizing incorporation state. When the debate is phrased in this way, the disagreement is over an empirical question concerning market efficiency, for which, in principle, there is a clean answer.

To be sure, Cary sees a failure not only in financial and product markets, but also in local politics. His recommendation of national standards for corporations implies that the political process at the national level differs fundamentally from that of the states. Cary considers the flaw in Delaware's code to be a function of that state's desire for revenue and the close personal connections between Delaware legislators, judges, and corporate law firms. The national government certainly would not be as sensitive to franchise tax dollars as would a small state, and practically speaking, there would be no competing sovereigns to attract dissatisfied corporations.

But even if we grant Cary's premise that the states' responsiveness is the source of the problem, the elimination of intergovernmental competition is not necessarily the cure. The hitch in Cary's position is that he leaves unexplained why national legislators in pursuit of reelection would be less susceptible to the political influence of managers for "pet" statutes than state legislators. For why should diffuse and unorganized shareholders be appreciably better able to communicate their views to Congress when they cannot do so to state legislatures? There are countless pieces of legislation produced by pork barrel politics in Congress—the tax code is perhaps the most notable example—and there is no convincing reason to believe that firms' managers would be any less skilled at protecting their interests when it comes to a federal corporation code.

A Transaction Cost Explanation of the Market for Corporate Charters

Why Is Delaware the Destination State of Choice?

The transaction cost explanation of the corporate charter market provides a different perspective on state competition. Delaware's persistent large market share is maintained by a first-mover advantage created by the reciprocal relation that develops between the chartering state and firms due to their substantial investment in assets that are specific to the chartering transaction.... How does [Williamson's] analysis apply to the corporate charter market? Because the transactions between a firm and its incorporation state extend over a long period of time and

reincorporation is not costless, relocation makes a firm vulnerable to exploitation by the state. In particular, the state may charge a premium for incorporation and then alter its code or simply not implement the latest innovations, to the firm's detriment, knowing that the firm cannot quickly migrate again without incurring additional expenses. Hence, due to this nonsimultaneity in performance, a state with a favorable corporation code must guarantee its code's continued responsiveness to be successful in the corporate charter market.

Of all the states, Delaware is best positioned to credibly commit itself to responsiveness. First, its very success in the incorporation business serves, ironically, to constrain its behavior: The high proportion of total revenue it derives from franchise taxes guarantees continued responsiveness because it has so much to lose. For unlike states less dependent on franchise revenues, Delaware has no readily available alternative source to which it can turn in order to maintain expenditures. It cannot afford to lose firms to other states by failing to keep its code up-to-date. In this way, Delaware offers itself as a hostage by its reliance on franchise taxes to finance its expenditures.

Second, an additional institutional mechanism warranting responsiveness is Delaware's constitutional provision mandating that all changes in the corporation code be adopted by a two-thirds vote of both houses of the state legislature. This makes it difficult to renege on provisions already in the code and, correspondingly, on the overall policy of being responsive to firms. While the provision would appear to make future changes equally difficult, if firms are risk averse when it comes to corporation codes, they might favor a maximin strategy in which the constitutional provision would be desirable, since it helps to ensure that the legal regime will never be worse than it is at the time of incorporation. This provision thus complements Delaware's high proportionate franchise tax, for while the constitution is backward-looking, limiting radical revamping of the code, the incentives provided by the franchise tax revenue are forward-looking, as the state reacts to the high proportion of franchise tax revenues in the past by maintaining its responsiveness to incremental change in the future.

Third, Delaware has invested in assets that have no use outside of the chartering business. These assets, which can best be characterized as legal capital, consist of a store of legal precedents forming a comprehensive body of case law, judicial expertise in corporate law, and administrative expertise in the rapid processing of corporate filings. These features are not as easily duplicated by other states as the provisions of a corporation code because of the start-up costs in developing expertise and the dynamic precedent-based nature of adjudication by courts.

The combination of these factors—the high proportion of franchise tax revenue, the constitutional supermajority requirement, and the investments in legal capital—create an intangible asset with hostage-like qualities, a reputation for responsiveness, that firms weigh in their incorporation decision. The large number of firms already incorporated

in Delaware further solidifies its commanding position in the market by giving it a first-mover advantage. There is safety in numbers—the more firms there are the higher the level of franchise tax paid and the more the state relies on its incorporation business for revenue, which provides the incentive to behave responsively. In addition, the large number of firms makes it more likely that any particular issue will be litigated and decided in Delaware, providing a sound basis for corporate planning. This attracts even more firms for the more responsive a state and the more settled its law, the cheaper it is for a firm to operate under that legal regime. The first-mover advantage is self-sustaining because the more firms there are paying a franchise tax, the greater the return Delaware earns on its reputation for responsiveness, and the stronger its incentive to not engage in an end-game strategy of exploiting firms that would damage, if not destroy, its investment in a reputation.

This brings us to the demand side of the market, which also aids Delaware in maintaining an edge. There is a third party affected by the incorporation system, legal counsel, and the features of Delaware's legal regime that are attractive to firms—a well-developed case law with a pool of handy precedents and a means for rapidly obtaining a legal opinion on any issue—are also advantageous to corporate lawyers. For these features of Delaware law lower the cost of furnishing advice to clients. This is especially important for outside counsel, who service firms that are headquartered in different states, and who are instrumental in choosing the incorporation state. They realize cost savings by having clients operate under one legal regime. In addition to encouraging the choice of Delaware as the incorporation site for clients, specialization also provides an incentive for advising firms to remain in Delaware, because moving will diminish the attorney's human capital. Counsel's desire to recoup the investment in mastery of the institutional detail of Delaware law ties firms reciprocally to Delaware, just as Delaware is tied to firms.

Human capital is important in another way. Delaware's stake in the chartering business exceeds the revenues it receives from the franchise tax. A number of its citizens specialize in providing services to nonresident Delaware corporations. Accordingly, it is in the interest of those individuals that Delaware be responsive to corporations so that the demand for their services does not decline. Delaware's supermajority constitutional provision therefore serves an important function aside from credibly precommiting it to be responsive to firms: It protects the value of these individuals' personal investments by making it more difficult for a political realignment in the state to alter the longstanding course of corporate responsiveness.

This transaction-specific human capital, which creates a "mutual reliance relation" between firms and Delaware, joins the parties in long-term cooperation because of their reciprocal vulnerability and cements Delaware's market position, as it makes it difficult for a rival state to compete successfully. Another state cannot simply offer corporations the

same code at a lower price and attract the marginal firm because a switch would increase operating and legal costs, and more importantly, the state cannot provide a credible commitment of superior service. In particular, a rival state cannot place itself in the same vulnerable position as Delaware because it starts from a low franchise tax ratio and has not yet invested in legal capital. In order for a state to begin to compete, a significant number of firms would have to agree to move to it in concert. But there is no incentive for corporations to move to another state so long as Delaware continues to cooperate, and there are powerful incentives for Delaware to continue to do so.

Event Studies as Arbiters of the Debate

The debate over the efficacy of state corporation codes essentially boils down to an empirically testable hypothesis: whether managers or shareholders benefit from the market for corporate charters. If we could identify the beneficiaries, then fashioning a political consensus regarding the optimal level of government regulation would be straightforward. The best available means of generating information bearing on this issue is to examine the impact of reincorporations on stock prices, for a change in equity value conveys investors' assessment of the event's expected effect on shareholder wealth. A stock price increase upon a firm's reincorporation would mean that investors expect the change in incorporation state to increase the firm's future cash flows, and from this it could be concluded that shareholders benefit from a move. Similarly, a decline in stock price would indicate the anticipation that shareholder welfare will be diminished by the move and confirm the managerialist position.

Several event studies have been performed that bear on the state competition debate. Researchers have addressed the issue directly by investigating the impact of reincorporating, and indirectly by looking at the effect of state court decisions.... None of the studies support the managerialist position, for none found a negative effect on stock price. Rather, to the extent that they can be used to buttress any position, it is the value-maximizing view associated with Ralph Winter.

Event Studies on State Competition

Peter Dodd and Richard Leftwich, in the first empirical study concerning state competition, found statistically significant positive abnormal returns to the stock of reincorporating firms over the two-year period preceding the reincorporation. The returns around the event date were not, however, significant. While this finding undermines Cary's position, it is difficult to assert that it bolsters Winter's view because the period of abnormal returns is so far before the announcement of the move that it is possible the abnormal returns are due to some other factor affecting the firms.

I sought to refine the Dodd and Leftwich study by partitioning the portfolio of reincorporating firms according to the reasons for which the reincorporation was undertaken, and by using daily rather than monthly stock price data. I found that firms which reincorporated in order to embark on merger-and-acquisition programs, as well as the aggregate portfolio of reincorporating firms, experienced statistically significant positive abnormal returns on and around the event date. The signs of the cumulative average residuals for the other groups were also positive, although they were not significant. This finding creates further difficulty for the Cary thesis and provides more clear-cut support for Winter's value-maximizing interpretation of state competition.

Weiss and White examined another theme in the literature to get at the crux of the state competition debate: Who is helped out by Delaware court decisions? They investigated the effect of seven Delaware opinions that they characterized as reversals or departures from existing corporate law rules. They hypothesized that if the decisions benefitted shareholders, firms would experience abnormal positive returns, and if not, there would be negative returns. They found no statistically significant abnormal returns earned by Delaware firms, and the signs of the residuals were not consistent with any particular thesis.

Toward an Interest Group Theory of Delaware Corporate Law*

JONATHAN R. MACEY and **GEOFFREY P. MILLER**

[We posit] the existence of two groups within the state whose interests are differentially affected depending on the nature of the legal rules supplied to firms incorporated there: (1) the taxpayers and groups allied with them; and (2) the Delaware bar. We envisage the supply side as a political equilibrium in which each group obtains desired legal rules depending on its political influence. A principal hypothesis emerging from this model is that the bar is the most important interest group within this equilibrium. Thus, the rules that Delaware supplies often can be viewed as attempts to maximize revenues to the bar, and more particularly to an elite cadre of Wilmington lawyers who practice corporate law in the state.

From the standpoint of shareholders and corporate managers, both franchise fees and the panoply of indirect costs are largely interchangeable. These decision makers are ordinarily indifferent to whether the firm must pay an extra dollar to the state fisc in franchise fees, to a lawyer for defense of a lawsuit arising under Delaware law, or to someone else. As far as the firm is concerned, the dollar is a cost of Delaware incorporation regardless of the identity of its recipient.

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To the recipients, however, the identity of the payee is crucial. It makes a great deal of difference to Delaware taxpayers, lawyers, and corporation service firms whether the dollar is paid in franchise fees, legal fees, or for some other purpose. This observation is crucial . . . for it suggests that the shape of Delaware corporate law may be affected significantly by interest group rivalries, as different factions within the state vie to capture the lion's share of the revenues for themselves.

The trade-off between direct and indirect costs, however, is not simply a matter of allocating gains among different groups within Delaware. Although the direct costs of Delaware incorporation are all captured by the state's taxpayers in the form of revenues to the state's fisc, the indirect costs can only partially be captured by state residents. For example, very few investment banking services are provided in Delaware. The major investment banks that serve Delaware corporations are located almost exclusively in New York. To the extent that Delaware law encourages the use of investment banks, the benefits will largely be captured by people outside the state.

Another example of costs that are shared with people out of state is legal fees. Although the Delaware bar is clearly the most significant in-state recipient of indirect chartering revenues, the bar cannot capture all the legal work on corporate law issues arising under Delaware law. In advisory matters, for example, "Delaware lawyers" are scattered among major law firms across the United States. An attorney does not need to be a member of the Delaware bar in order to provide advice on that state's law. In fact, Delaware lawyers probably operate at a competitive disadvantage vis-à-vis lawyers in other states because of the need in advisory work for extensive and sustained client contact. Our theory, however, predicts that Delaware attempts to maximize the amount of advisory work performed by Delaware counsel. For example, firms chartered in Delaware must obtain Delaware counsel to review their documentation each year. Delaware attorneys also can capture a significant share of revenues from litigation because of legal regulations requiring that court appearances and filings be made by a member of the state bar and because actual court appearances necessarily will take place in Delaware. The filing requirement, however, can be partially avoided through retention of local counsel who adds his or her name to briefs and motions as an accommodation to an out-of-state lawyer who prepares the papers. Delaware lawyers reputedly have developed local counsel services into an art, providing their clients with details and gossip about the inner workings of the Delaware court system, as well as excellent assistance in finding lodging and entertainment while in Wilmington—all for a hefty hourly fee. The requirement that court appearances be by a bar member can easily be surmounted by a motion to appear *pro hac vice,* which is granted as a matter of course. Some lawyers, however, believe that the Delaware judiciary is likely to look with more favor on a case argued by a recognized member of the state's bar; thus many important cases are argued by local counsel.

The power of a political interest group—and therefore the degree to which the equilibrium conditions of legislation will favor its interests—is a function of several different variables. The most important of these variables include the number of members in the group, the amount of their individual stakes in the matter, and the degree to which they are able to cooperate as a single organized unit. The groups that this article identifies as interested in Delaware corporate law differ widely as measured by these variables. The bar is small, discrete, and highly organized. Its members tend to have a large personal stake in the subject matter of the regulation. They also tend to be more wealthy than other groups and to have good political connections. Indeed, many members of the Delaware legislature are themselves members of the bar. Such legislators tend to be represented disproportionately on legislative committees that draft the provisions of the Delaware Corporation Code. As noted above, the bar can be expected to capture much, although not all, of the gains from increasing the amount of legal fees generated by provisions of the Delaware corporate law. Accordingly, the bar is a powerful political force pressing for rules that maximize legal fees but do not necessarily maximize the revenues from corporations chartering in the state.

In contrast to Delaware attorneys, other interest groups within the state are unlikely to be able to galvanize into a coherent force to constitute a potent political threat to the bar. Although large in numbers, the individual stakes of the multitude of competing interests are small, and they are relatively unorganized. The economic theory of regulation predicts that free-rider problems will prevent them from having much success in countering the Delaware bar's drive for increased legal fees, especially because none of these individual interest groups has any assurance that it will be the one to enjoy the fruits of any overall increase to the general corporate treasury. In other words, the competing groups are not organized into an effective political coalition because they lack sufficient incentives to incur the costs of promoting laws that will increase the general revenues of the state. All the costs of pushing for efficient corporate laws must be borne by discrete groups or individual taxpayers. These costs consist of the expenses of making campaign contributions and engaging in other forms of lobbying activities, as well as the search costs of ascertaining what sort of laws are likely to lead to an increase in chartering revenues in the first place. Although the costs of pressing for efficient corporate law in Delaware must be concentrated in specific groups, the benefits of such laws, like the benefits from public interest laws generally, would be spread among all the groups, and perhaps even to the general population. Indeed, should rival interest groups prevail over the Delaware bar in achieving the legislation it wants, these groups would in all likelihood fight a second battle among themselves to determine how the spoils should be divided.

In other words, a rival interest group must win two political battles to achieve a favorable wealth transfer from a change in the Delaware

Corporate Code. First it must prevail in its contest with the Delaware bar to obtain the initial revenue increase, and then it must prevail over all other interest groups to obtain the specific legislation that will transfer this additional revenue to it. Perhaps the most important reason the Delaware bar is able to prevail over rival groups in procuring favorable corporate law rules is that, for reasons unrelated to lobbying, the bar has already internalized the significant start-up costs necessary to lobby effectively for the rules it wants. Rival groups must incur these costs in learning what the relevant corporate law rules are, and how they can be written to benefit the state treasury. The state's corporate lawyers, of course, obtain this costly information as a by-product of their normal activities.

The Myth of State Competition in Corporate Law*

MARCEL KAHAN and **EHUD KAMAR**

The thesis of this Article is that the very notion that states compete for incorporations is a myth. Other than Delaware, no state is engaged in significant efforts to attract incorporations of public companies. Modern state competition scholars have misconstrued the incentives of states to attract incorporations, misinterpreted their actions, misunderstood the economic and political barriers that states face, and arrived at mistaken conclusions about the market for incorporations.

This is not to say that active competition for incorporations never existed; that none of the participants in state legislation cares about incorporations; that states do nothing that could attract incorporations; or that active competition for incorporations could not develop in the future. As we will discuss, competition may well have existed in the distant past; some local lawyers may profit from incorporations; states may adopt laws that make them more attractive as corporate domiciles; and more serious competition could develop in the future. Rather than make sweeping generalizations, we recognize the incorporation market for what it is. The picture we portray is one where states other than Delaware stand to derive only small benefits from attracting incorporations, and take at most half-hearted steps to that end.

What Can States Gain from Competing?

The most important component of the theory of state competition for incorporations is the claim that states derive significant benefits from attracting incorporations. According to conventional wisdom, these benefits emanate primarily from franchise taxes assessed on incorporated firms, and secondarily from legal business generated by incorporations. Alas, the conventional wisdom is wrong. Other than Delaware, no state structures its taxes to gain from incorporations or stands to reap

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substantial benefits from legal business by attracting incorporations. . . . The choice that state lawmakers have made in this regard indicates that they do not try to attract incorporations in order to boost tax revenues.

The second reason why states are thought to compete for incorporations is that incorporations increase the demand for the services of local law firms. A company that is incorporated in, say, Minnesota, is presumably more likely than a similar company incorporated elsewhere to hire Minnesota lawyers to advise it on Minnesota corporate law. A Minnesota company is also more likely than a similar company incorporated elsewhere to be sued in Minnesota and employ Minnesota lawyers to represent it in court.

Delaware's Legal Business

Delaware residents derive financial gains from providing professional services to public corporations incorporated in the state. The bulk of these gains go to corporate transactional lawyers and corporate litigators. . . . Even before adjusting for differences in the cost of living, the average income of Delaware lawyers is higher than that of lawyers in any other state, or even any city, in the country. [The authors estimate what they consider to be the "additional income resulting from Delaware's special position in the incorporation market," compared to the income of lawyers had Delaware not had the incorporation business that it has, at $165 million, and additional lawyer revenue of $277 million, amounts they consider to be small, compared to gross revenues earned by very large law firms in other cities.—Ed.]

The Benefits of Additional Legal Business

Lawyers in other states may be able to generate revenues proportionate to those of Delaware lawyers to the extent that their states attract incorporations. Since Delaware's market share of roughly 50 percent of incorporations by public companies yields $165 million in income and $227 million in revenue from legal business, lawyers in another state would likely gain about $3.3 million in income and $4.5 million in revenue for each percentage increase in their state's market share of public corporations. Thus, if another state attracted a respectable 20 percent market share in 2001, its lawyers would earn a proportionate $90 million in additional revenue.

However, neither lawyer revenue nor lawyer income would represent economic profits. Some of the money would not even benefit state residents because it would be used to pay suppliers in other states or federal taxes. More importantly, even money that remained in the state would largely represent compensation for the opportunity costs of the goods and services provided by state residents. Indeed, absent barriers to entry, providers of these goods and services would earn no long-term economic profits.

To be sure, states could still derive some benefits from attracting legal business. First, such business would generate direct and indirect tax revenues for the state. Depending on the state, state and local taxes amount to 9 percent to 15 percent of personal income, and taxes paid by high-income professionals such as corporate lawyers might well exceed the state's cost of providing services to them. Second, state residents might derive short-term rents from additional legal business, especially if that business employed resources that were underused. Even in the short-term, however, these rents would likely amount to only a small fraction of the additional income generated.

In sum, the benefits to states and local lawyers from generating legal business through incorporations would be relatively low. Such benefits may provide an impetus for some local lawyers to take low-cost measures to lobby for laws that attract incorporations, and for states to pass such laws if they involve no fiscal outlays and raise no political opposition. But the size of these benefits is unlikely to engender more serious and costly efforts to compete.

Defensive Competition

Even if states do not engage in wholesale competition for incorporations, some scholars suggest that they at least engage in a more limited form of "defensive competition" to retain local firms incorporated in-state. But however modest the incentives for states to engage in wholesale competition, the incentives to retain existing incorporations are even weaker. Most states derive no marginal franchise tax revenues from incorporations by firms that do business in them. For the states that do, franchise tax revenues from the few firms already incorporated in them are trivial. The gains from legal business are likewise small.

If at all, states can be motivated to engage in actions to retain existing incorporations by the gains to local lawyers. Whether such gains will induce a state to compete will depend on the political influence of local lawyers, and the degree to which their interests coincide with maximizing the number of domestic incorporations.

What Do States Do to Compete?
Statutory Law

Many changes in corporate law statutes are based on the Model Business Corporation Act. The Model Act was devised and is periodically revised by the Committee on Corporate Laws of the Section of Corporation, Banking, and Business Law of the American Bar Association for wholesale or piecemeal adoption by states. As of 1999, twenty-four states largely followed the Model Act.

The significance of the Model Act is hard to reconcile with the notion that states compete for incorporations. Its drafters—members of a committee of a national bar association, most of whom do not even hail from states following the Model Act—can hardly be motivated by a

desire to increase incorporations in any particular state. Rather, they are likely to participate in the drafting process because it enhances their reputation and because they find the task personally rewarding and important. That states entrust the design of their corporation laws to such a committee seems more consistent with an effort to simplify the process of devising the law than with competition.

The driving force behind many corporate statutes is corporate lawyers. . . . But lawyers' interest in corporate law reform is multifaceted and in many ways not related to attracting incorporations. To the extent that laws are meant to benefit a particular client or close corporations generally, they are not intended to attract, and may not result in attracting, incorporations by public companies. Similarly, to the extent that bar committee members try to enhance their reputation or serve the public good, 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. One can think of a number of reasons why that would be the case. First, local lawyers benefit from increased incorporations only to the extent that they have market power or that the increase occurs at a faster rate than the rate at which new lawyers can enter the relevant market. Thus, for example, local lawyers may not benefit much from laws that will attract incorporations mostly in the long term.

Second, lawyers have an interest in laws that increase the need for their services. Therefore, transactional lawyers can benefit from complex laws that generate demand for sophisticated legal advice, and litigators can benefit from standard-based laws that entail litigation to resolve disputes, even if such laws reduce incorporations.

Third, local lawyers may want to limit competition by out-of-state law firms. They may not benefit from, say, copying Delaware law or the law of a large neighboring state, even if doing so would attract incorporations.

Fourth, members of advisory committees that draft revisions may be more interested in generating business for themselves than in benefitting local lawyers generally. As a result, they may favor provisions that are idiosyncratic, arcane, or complex in order to enhance their reputation or increase the value of the human capital they derive from participating in the drafting process with little attention to the effect of these provisions on incorporations.

Finally, even to the extent that lawyers benefit from attracting incorporations, they face collective-action problems.

The Court System

A principal attraction of incorporating in Delaware is the high quality of its chancery court. . . . One would expect states trying to attract incorpo-

rations to establish similar courts. But none has. A small number of states have established specialized judicial tribunals for business disputes.... But these courts are not designed to attract incorporations.

[T]he business courts in the other states largely resemble New York's commercial divisions, rather than Delaware's chancery court. All of these courts are divisions of the regular trial court and none affects the right to a jury trial. All have relatively broad jurisdiction, and thus deal mostly with more common contract and commercial disputes rather than with corporate law disputes, and none is designed to generate a coherent body of corporate law precedents.

The business courts in North Carolina and Nevada are a partial exception in that attracting incorporations may have been a secondary motive for their creation. But both suffer from the same severe design flaws—broad subject matter jurisdiction, retention of juries, and unpublished opinions being the most important ones—as the other business courts. Moreover, the judges on Nevada's business court either rotate every two years or are randomly assigned civil or criminal cases in addition to business matters. And the business court in North Carolina has been suffering from a shortage of funding for chambers and legal and clerical support from the day it was created.

Why Do States Not Compete

Delaware is presently earning about $500 million a year in profits from franchise taxes paid by public corporations. Its outlays to generate these profits are minimal. In terms of profit margins, return on capital, and net present value, Delaware's incorporation business is highly lucrative. Why is it, then, that no state seriously competes with Delaware?

[T]he explanation lies in a combination of economic entry barriers and the political contingency of state action.... [B]oth economic entry barriers and politics account for state inaction. Were Delaware not protected by competitive advantages, political constraints might not be enough to retard entry by other states. Similarly, if the political calculus in a state were to change, economic entry barriers might not suffice to deter entry.

Delaware's Competition*

MARK J. ROE

I argue that [the state competition for charters] debate is misconceived—and badly so. Whether or not the states are racing, and whether they are racing to the top or to the bottom, we live in a federal system where Washington can, and often does, take over economic issues of national importance. The issues most likely to move into the national arena are precisely those that could affect firm value so much that they would be

* Reprinted with permission from 117 *Harvard Law Review* 588 (2003).

central to state-to-state competition. That happened for securities trading during the Depression, takeovers in the early 1980s, and corporate governance after the Enron and WorldCom scandals. And if fundamental issues of corporate governance often move into the federal arena, then Delaware is not deciding all key corporate law matters. Moreover, even when those matters formally remain matters of Delaware law, if the risk of federal action heavily influences Delaware, it follows that even when federal authorities do not take the issue away, federal power may make Delaware law.

Even when, as now, the federal government does not threaten to take away Delaware's chartering business in its entirety—something it seriously threatened to do three times in the twentieth century—Delaware players know that the federal government can take away their corporate lawmaking power in whole or in part, because it has acted often enough. Because Delaware players can never be oblivious to the possibility of being displaced, we have never had, and we never could have had, a full state-to-state race in corporate law.

Delaware's competition in making corporate law thus comes not just—and at times not even primarily—from other states, but also from the federal government: It comes from Congress and the SEC, not just California, Nevada, Ohio, or New York. It comes from the Second Circuit Court of Appeals when that court interprets the scope of the securities laws, not just from a new or threatened commercial court in another state. And it comes from the New York Stock Exchange, which itself is often prodded to act by the SEC or Congress. Even if Delaware had all the chartering business, it might not make all (or, at the limit, any) corporate law.

And even if Delaware never acted with the risk of federal intervention in mind, Delaware corporate law would still effectively have a large federal component. Federal authorities reverse state corporate law that they dislike and leave standing laws that they tolerate. State power is to jigger the rules in the middle by adopting those rules that Washington does not gear up to reverse, even if the federal authorities would not have enacted them exactly as the states did.

The point here is surely not that every twitch in Delaware is determined by the prevailing tilt in Washington. Because Congress moves sporadically, because courts need a case or controversy, and because the SEC's power is incomplete, states often have room to maneuver. Nevertheless, federal authorities set the broad boundaries—of an uncertain and changing demarcation—within which the states can move. These boundaries both determine who really makes corporate law in the United States, and, when tight, weaken the mechanisms of the state-to-state race.

This federal-state interaction then has deep implications for the race debate: Even if empirical evidence showed incontrovertibly that Delaware was racing to the bottom, we would not know whether the state

reluctantly dropped down because of state-to-state competition or because it feared that congressional politics, errant judicial decisions, or an out-of-control SEC would have ousted Delaware had it risen to the top. And conversely, even if empirical evidence incontrovertibly showed the contrary—that Delaware was racing to the top—we would not know whether it was state-to-state competition or the threat of federal ouster that pulled Delaware up. Moreover, even if we knew which way states have raced thus far, we would not know whether the race would persist in that direction and with the same intensity if we sharply altered the domain of state corporate lawmaking.

. . .

The reality of American corporate lawmaking is that the United States has never had a pure interstate race. If the issue is important, federal authorities act on it immediately, take it away from Delaware, or threaten to do so. Delaware players have reason to fear that if they misstep, federal authorities (Congress, the courts, or the SEC) will enter the picture. If Delaware players appear to damage the economy, public-spirited lawmakers in Washington react. If they offend a powerful interest group too much, and that group lacks clout in Delaware, it can turn to Washington. As such, the United States has not had a pure interstate race.

Uncorporations and the Delaware Strategy*

SAUL LEVMORE

Will jurisdictions that dominate corporate law dominate partnership law, and other "uncorporate" (noncorporate) forms, as well? Should we anticipate federal legislation with respect to partnerships, limited liability companies, and other "uncorporations," to recapitulate federal involvement in corporate law? These are important questions without obvious answers. These questions are avoided, or perhaps simply not confronted, in the academic literature, which is otherwise rich in its discussion of incorporation and alternatives to it. In this essay, I set out a few claims with respect to these matters, and then a blueprint for future work. The first of these claims is that, contrary to conventional wisdom which depicts federal intervention as arising where there is a regulatory vacuum, national regulation often follows substantial state regulation. The second is that it is useful to think of Delaware as pursuing a distinct strategy with respect to corporations and uncorporations. The nature of this strategy and the thinking behind it is, however, open to interpretation, as the Delaware strategy is consistent with a variety of policies and assumptions about competitive behavior.

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This essay draws on two important articles as starting points for these inquiries. One is a paper by Professor Larry Ribstein on the puzzle of the dominance of the corporate form, and the other is one by Professor Mark Roe on the importance of federal-state, as opposed to interstate, competition in the regulation of corporations.

Why Corporations or Uncorporations?

Professor Ribstein first asks why corporations remain so popular and then declines to accept conventional—and inadequate—answers. The question arises because uncorporations' income is generally taxed less, which is to say once rather than twice, and because they offer substantial flexibility for co-venturers who want to blaze their own path even as there are default rules for those who want tried and true rules to govern their principal-agent, formation, dissolution, and other arrangements.[1] A sophisticated observer might insist that businesses prefer the corporate form, and especially Delaware's version of it, because there is a great deal of experience and settled law for such entities. The default rules for corporations may often be more mandatory than default in character, but they provide predictability, or at least a kind of mainstream solidity, that can be attractive to investors. If investors choose nonwaivable, clear rules of engagement over flexible, and even less expensive material, we might simply recognize this preference for experience and certainty.

The overall picture is one in which, setting tax considerations aside, the partnership form (along with other uncorporate forms) is superior for many sophisticated investors. Anything a corporation can do, a partnership can do better. The partners can contract, or select defaults, to be like corporations in terms of governance norms. But when they want something different, perhaps because their own principal-agent relationships will thrive with different rules, they can simply contract for that as well. Viewed this way, corporations are certainly more rigid than partnerships.

Professor Ribstein's own attempt to explain the evolutionary success of the corporate form is rather pessimistic in nature and gives a nod to the importance of tax law (which I, too, have tried to set aside) and center stage to the concept of rent-seeking (by which is meant the fact that while managers profit from being in control, they also service legislators, and waste resources in the process, in order to protect their comfortable positions). The argument is that corporations offer managers insulation from displacement; there is, after all, not much in the way of direct democracy [because corporate law requires board intermediation between managers and shareholders—Ed.] and there is a fair incentive to retain earnings if only to avoid dividend taxation. Law thus

1. I endeavor to use the terms uncorporations and uncorporate law interchangeably with expressions such as noncorporate forms, or partnership law and limited liability company law, meaning always to refer to the law enabling and regulating noncorporate forms of business activity.