PRICE CONSIDERATIONS IN THE MARKET FOR CORPORATE LAW

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ABSTRACT

The longstanding debate over the market for corporate law has been premised on the assumption that the dominant state, Delaware, seeks to maximize the volume of domestic incorporations. By contrast, this Article suggests that the incorporation price that Delaware charges serves as another important yet unexplored consideration in Delaware’s strategy. This Article’s major claim is that whether it leads a race to the top, a race to the bottom, no race at all or one with the federal regulator, Delaware designs its corporate law taking into account not only its effects on the number of firms it attracts but also on the price it can charge each firm as a result.

Developing a price considerations theory for the market for corporate law leads to important insights. First, it is shown that Delaware faces a trade-off between the quantity of firms it attracts and the price it can charge each firm: The more pro-managerial Delaware law is the more firms it attracts but the less it can charge for incorporations. Consequently, Delaware is expected to produce a body of corporate law that balances between shareholders’ and managers’ interests. Delaware’s pro-managerial bias is therefore constrained relative to many other states.

Second, price considerations theory reconciles and accounts for currently available empirical studies, and explains many developments in Delaware’s corporate law over the last three decades. In particular, it accounts for the higher Tobin’s Q ratios of Delaware firms and for the fact that these ratios are decreasing over time. It explains why not all firms choose to incorporate in Delaware and why Delaware does not strengthen its antitakeover law further, even though such a step would result in attracting more corporations. It also explains why, among states other than Delaware amassing antitakeover rules helps in attracting and retaining incorporations.

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Third, price considerations theory entails important implications for the assessment of the current system of state corporate charters and for existing theories of it. First, it casts doubt on the repeated argument of race to the top proponents that Delaware’s superiority over other states in attracting incorporations is conclusive evidence for the desirability of the current system. Second, it exposes a factor that restrains Delaware’s managerial favoritism and which implies that Delaware has better incentives to improve its law than was usually thought. Third, the analysis has important implications for recent developments in the literature on the market for corporate law. As for the literature that focuses on Delaware’s significant market power, the analysis shows - in contrast to conventional wisdom - that in a competitive market corporate law may provide less protection to shareholders than it would in a concentrated one. It also explains why, despite its market power and network externalities, Delaware is responsive to corporate needs. As for the literature that analyzes how the fear of federal intervention affects Delaware, the analysis suggests that such fear, to the extent that it deters Delaware from increasing its price, restrains its incentives to invest in the quality of its corporate law.

Lastly, price considerations theory entails important implications for determining the role federal law should have in the market. First, the analysis implies that the desirability of mandatory federal intervention of the kind manifested by the recent Sarbanes-Oxley Act requires further assessment in light of the new factors revealed. Second, recognizing the importance of price considerations, the analysis lends support to a limited federal intervention which requires states to adopt an incorporation tax structure that is based on firm value. Such federal intervention would align Delaware’s incentives with shareholders’ interests and would induce Delaware to improve its law. This would be the case even in the absence of competitive pressures and even if shareholders are unaware of such improvements.

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I. INTRODUCTION

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

Notwithstanding the extensive body of theoretical and empirical research on this question, there seems to be no consensus among scholars as to the desirability of the current system. Although some believe that it creates competition among states for incorporations that induces the states to produce efficient corporate laws,³ others doubt that such competition is desirable,⁴ or that it even exists.⁵ While the race to the top

⁴ See generally Lucian A. Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1435 (1992) [hereinafter Bebchuk, Desirable Limits]; Lucian A. Bebchuk & Allen Ferrell, A New
proponents point to the relative performance of Delaware, the dominant state in the market for corporate law, as an indication that the race is to the top, others argue that the current system provides incentives to produce corporate law that caters to the interests of managers. Puzzlingly, evidence exists to support each side in the debate.

This Article argues that during the past three decades in which the debate has been conducted, an important dimension was overlooked: price considerations. Commentators on all sides of the debate largely share the assumption that, to maximize revenues, Delaware seeks to maximize the number of domestic incorporations. By contrast, this


6 See, e.g., Romano, Empowering Investors, supra note 3, at 2383-2388; Romano, The Need for Competition, supra note 3, at 506.

7 See, e.g., Bebchuk, Desirable Limits, supra note 4; Bebchuk & Ferrell The Race to Protect Managers, supra note 4; Bebchuk & Ferrell, New Approach, supra note 4; Bar-Gill, Barzuza & Bebchuk, supra note 4; Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 599-601, 606-607; Kahan & Kamar, The Myth, supra note 5, at 736-741.

8 For evidence that supports the race to the top view see Daines, Firm Value, supra note 2; Romano, The Need for Competition, supra note 3, at 494-506 (describing and evaluating the evidence); Romano, Empowering Investors, supra note 3, at 2383-2388 (same). For evidence that supports the race to the bottom view see Bebchuk & Cohen, supra note 2; Subramanian, Incorporation Choice, supra note 2.

9 See, e.g., Romano, Law as a Product, supra note 3, at 228 (stating that both the race to the bottom and the race to the top schools adopt the assumption that the “objective of states is revenue maximization, which is thought to depend directly upon the volume of domestic incorporations.”); Bebchuk, Desirable Limits, supra note 4, at 1451-55 (discussing some objections to this assumption but stating that “[b]oth the race for the bottom and the race for the top theories make this assumption, at least implicitly” and concluding that “for the purpose of analyzing the effects of state competition, the appropriate assumption remains that state law is shaped by states' desire to attract incorporations’); Bebchuk & Ferrell, The Race to Protect Managers, supra note 4, at 1173 (noting that the “starting assumption of the ‘race to the top’ /’race to the bottom’ debate” is that “a state wishes to maximize the number of companies that are incorporated there’); Bebchuk & Ferrell, New Approach, supra note 4, at 133 & n. 64 (asserting that “[t]he whole focus on the debate over the effects of federalism on the provision of desirable corporate rules is based on that assumption’); Subramanian,
Article suggests that the price that Delaware charges its corporations serves as an important and as yet unexplored dimension of its strategy. Whether the race is to the top or to the bottom, whether there is no race at all or whether its real competition comes from the federal government, Delaware designs its corporate law taking into account not only its effects on the number of firms it attracts but also on the price it can charge each firm.

Unlike a producer in a competitive market, Delaware, which enjoys substantial market power, can increase the price it charges for its law above its marginal cost of production. The extent to which Delaware

Incorporation Choice, supra note 2, at 1810 (stating that “[b]oth sides assume that states seek to maximize the number of companies incorporated within their boundaries”); Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 559-600 (assuming that Delaware designs its corporate law to retain and attract incorporations); Kahan & Kamar, The Myth, supra note 5, at 739-741 (arguing that “since Delaware aims to attract incorporations… Delaware can benefit from designing its product to be attractive, if not equally so, to both shareholders and managers of as many corporations as possible”); Kamar, supra note 5, at 1909 (stating that “[f]ederalism in American corporate law is widely thought to have bred a system of regulatory competition in which states formulate law to attract incorporation”); Klausner, supra note 5, at 849-851 (assumining that as long as there is no risk for Delaware to loose firms Delaware has no incentives to invest in the quality of its law); Bebchuk & Cohen, supra note 2, at 1 (“In this debate most scholars have made similar assumptions about the supply side of the market. Namely, that states seek to attract incorporations.”). This assumption is also common to the literature that discusses international regulatory competition in securities regulation. See Stephen J. Choi & Andrew T. Guzman, Portable Reciprocity: Rethinking the International Reach of Securities Regulation, 71 S. CAL. L. REV. 901, 906 (1998) (“[i]n a world where both investor capital and issuer demand for capital are mobile, countries compete to attract market participants” and that “[a]n increase in the number of market participants adopting a particular country's regulatory regime leads to more tax revenue”). Two papers have assumed that Delaware makes choices with respect to the price it charges. See Kahan & Kamar, Price Discrimination, supra note 5 (showing that Delaware uses its market power to price discriminate among public and non-public firms, and within that second group, among large and small firms); Bar-Gill, Barzuza & Bebchuk, supra note 4 (constructing a formal model of the market for corporate law in which Delaware sets its rules and prices to maximize revenues). This Article differs from these works in several respects. First, these previous works concentrated on the strategic decisions that Delaware makes as to its price structure in order to maximize its profits and secure its dominance, whereas this Article shows how price considerations affect the quality of the law that Delaware produces. In particular, it shows Delaware’s trade-off between quantity and price when it faces demand from managers with different preferences. As a result, this Article shows how price considerations account for developments in Delaware’s antitakeover law, for differences between Delaware and non-Delaware firms and for the seemingly contradictory evidence on these issues. Finally, this Article establishes the basis for a novel form of federal intervention to improve the quality of corporate law -- intervention in the incorporation tax law.

See DENNIS W. CARLTON & JEFFREY M. PERLOFF, MODERN INDUSTRIAL ORGANIZATION 87-92 (3d ed. 2000) (explaining that a unlike a firm in a competitive market, which takes price as given from the market, a monopolist faces a downward sloping demand curve); JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 65-69 (1988). In this Article, the term price refers to the taxes that Delaware charges firms that incorporate there. To be sure, firms pay additional fees as a result of incorporating in Delaware, such as fees to the Delaware Bar. Yet, these fees are primarily determined by factors in the market for lawyers rather than by the strategies Delaware adopts. For
can raise its price depends on the other components of its strategy, which include, most notably, its substantive corporate law. In particular, it is shown that in order to attract firms, Delaware must not charge them more than the net value its corporate law system confers upon them. This net value equals the value arising from its competitive advantages such as its specialized judiciary, its developed body of case law, and the network externalities associated with its law, minus the harm to shareholders that is caused by the pro-managerial rules of its substantive corporate law.

For Delaware, therefore, maximizing revenues is not equivalent to maximizing the number of incorporations. Instead, price considerations present Delaware with a trade-off: the more pro-managerial its rules are the more firms it attracts but the less it can charge each firm. Since managers are those who initiate reincorporations, Delaware must offer them attractive rules. The more it does so, the greater the decline in firm value and hence the less it can charge for its incorporation services.

Accordingly, in designing its corporate law, Delaware balances managers’ and shareholders’ interests. Whereas its rules are protective enough to attract some of the managers in the market they are not sufficiently protective to attract the most opportunistic ones. As attracting these most opportunistic managers would necessitate Delaware to decrease its fees across the board, Delaware is better-off stopping short of complete market domination.

The price considerations approach has important implications for the analysis of the market for corporate law, the assessment of the current system of state corporate charters and the determination of the desirable extent of federal intervention in the market for corporate law. First, it solves one of the main puzzles about Delaware’s strategy. Conventional wisdom has it that Delaware provides managers with excessive hostile-takeover protection devices. At the same time, Delaware has traditionally been relatively mild on this front as compared with other states. If Delaware is racing to the top, why did it adopt inefficient rules? If it is racing to the bottom why hasn’t it strengthen its antitakeover rules as did many of the other states? Since both sides in the debate could not fully account for Delaware’s behavior, none can be said to have the upper hand in this debate with certainty. The account put forward in this Article explains Delaware’s behavior. To attract and retain managers Delaware needs to cater to their interests by producing pro-managerial rules that reduce firms’ value. To be able to charge a positive price, however, Delaware needs, simultaneously, to take into account the interests of shareholders.

In addition, the analysis also explains developments in Delaware antitakeover law. Over time, because of Delaware’s increased market share, the value of incorporating in Delaware increases. Delaware could, therefore, increase the price that it charges. Alternatively, it could utilize the effects of price considerations on the Delaware Bar see discussion infra Section III. G.2.
its increased market share to attract more firms by catering to their managers. Since the value of its competitive advantages increased, Delaware has still been able to attract corporations and should be able to continue to do so even if it weakened shareholder-protection. Indeed over time, as its market share increased, Delaware degraded its corporate law toward managers’ interests. As a result, even tough Delaware maintains higher protection for shareholders than many of the other states, its antitakeover law is more pro managerial than it was during the 80’s.\textsuperscript{11}

Second, the analysis in this Article is able to explain, the full body of evidence regarding the market for corporate law. Race to the top theorists point to the fact that Delaware adopted only a mild antitakeover law as indicating that the current system provides states with incentives to adopt efficient corporate laws.\textsuperscript{12} Race to the bottom proponents point to the fact that, among the other states, those that adopt stronger antitakeover protections are more successful in attracting incorporations than states that adopt weaker ones as indicating that the current system provides states with incentives to cater to managers at the expense of shareholders.\textsuperscript{13} The inconsistency is apparent: if states attract an increased number of incorporations after enacting antitakeover laws, why is Delaware, a state with a relatively mild takeover law, the most successful in the market, and why does Delaware not strengthen its antitakeover law to attract an even greater number of firms?

Price considerations drive the differences between Delaware and the other states and provide an answer as to why Delaware has not strengthened its antitakeover law. Even though Delaware could attract

\textsuperscript{11} In a contemporaneous work Mark Roe argues forcefully that Delaware’s competition comes primarily from the federal government rather than other states. See Mark J. Roe, \textit{Delaware’s Competition}, 117 HARV. L. REV. (forthcoming 2003) available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354783. Roe’s thesis provides persuasive explanation, that is different from the one suggested here, for the developments in Delaware antitakeover law. In particular, Roe suggests that during the 80’s Delaware’s pro-managerial tendencies were restrained by a concern about federal intervention in states’ takeover law, which concern has disappeared in the last decade. By raising possible factors which constraint Delaware’s choices, Roe’s thesis and the thesis developed in this paper complement each other. For example, the theory developed herein suggests, that even in times in which there is no fear from federal intervention, or in which the federal environment is pro-managerial Delaware’s pro-managerial tendency might be restrained by price considerations. Indeed, even in the last decade in which according to Roe, the federal actors “left the field” Delaware antitakeover law has been considered mild relative to the one in many of the other states. Similarly, Roe’s thesis suggests that when the federal environment is pro-shareholders the fear from federal intervention might restrain Delaware from being too pro-managerial even when price considerations do not create a significant constraint.

\textsuperscript{12} See EASTERBROOK & FISCHEL, \textit{ECONOMIC STRUCTURE}, supra note 3, at 222-223; Roberta Romano, \textit{Competition for Corporate Charters and the Lesson of Takeover Statutes}, 61 FORDHAM L. REV. 843, 858-59 (1993) [hereinafter Romano, \textit{Competition for Corporate Charters}]; see also Daines, \textit{Firm Value}, supra note 2 (concluding that firms incorporated in Delaware have a higher likelihood of being the target of takeover bids and ultimately, of being acquired).

\textsuperscript{13} See Bebchuk & Cohen, supra note 2.
more incorporations by strengthening its antitakeover law, Delaware would not make such a change because doing so would require it to reduce the price it charges for incorporations.

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

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

Fourth, the price consideration analysis also provides additional explanation as to why other states do not manage to attract significant number of firms and do not seem to attempt to compete with Delaware. By reducing its price to reflect the harm caused to shareholders from the pro managerial rules it adopts Delaware makes it unprofitable for shareholders to incorporate in any of the other states. The only group that other states might hope to retain is the group of firms whose managers are especially opportunistie. Consequently, states in which the local bar, which is interested in retaining incorporations, has significant influence on the shaping of corporate law are expected to provide strong protection to managers and to succeed in retaining some of their corporations.

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

Lastly, price considerations are important also to Delaware's choices with regards to corporate law issues that do not involve conflicts of

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14 Tobin’s Q ratio is the market value of a firm's assets divided by their replacement value.
interest between managers and shareholders. Here, too, maximizing revenues is not one and the same with maximizing the volume of incorporations. By increasing the quality of its corporate law system regarding these issues, Delaware could raise the price it charged or, alternatively, further degrade the other parts of its law toward managers’ interests in order to attract more firms. The conventional wisdom that because of its various advantages Delaware faces no competition and consequently has no incentives to invest in the quality of its law is, therefore, mistaken. Investments in parts of the law that benefit both shareholders and managers can become profitable because they enable Delaware to increase the price it charges for incorporations or to attract more incorporations. Indeed, regardless of the possibility that Delaware may not face competitive pressures from other states, the legislative record and the flow of court decisions show that Delaware tends to invest in innovations and modifications to its corporate law system.15

The analysis advanced in this Article has fundamental implications for the federalism debate. First, it casts doubt on the repeated argument of race to the top proponents that Delaware's superiority compared to other states is conclusive evidence for the desirability of the current system. Because Delaware, unlike many other states, takes price considerations into account as well, it is expected to adopt better corporate law whether there is a race to the top or the bottom. Race to the top proponents have mistakenly substituted the superiority of Delaware law for the superiority of the current system. Race to the bottom analysis also needs to be reconsidered because it does not take into account the effects of price considerations on Delaware. Delaware is motivated not only by the desire to attract incorporations but also by the desire to charge a positive price, the size of which depends on the extent to which its corporate law system adds value to firms incorporated there. The price considerations analysis also has important implications for the recent literature that concentrates on Delaware's market power and its consequences. Contrary to the conventional wisdom in this literature, according to which Delaware's market dominance inevitably leads to the production of a suboptimal corporate law, price considerations analysis suggests that the concentrated structure of the market for corporate law has some virtues. In particular, in a competitive market shareholders might have less protection than they have in a concentrated market, in which the major producer is restrained by price considerations. In addition, the analysis shows that price considerations induce Delaware to invest in innovations and modifications to its corporate law regardless of the significant network externalities that are associated with Delaware law. Lastly, the analysis also has implications for the recent theory which focuses on the threat of federal intervention as Delaware’s main constraint. In particular, it suggests that if this threat prevents Delaware from increasing its tax, it limits the positive effects created by price considerations.

15 See Romano, Law as a Product, Supra note 3, at 237-240.
The price considerations analysis has deep implications for the question of the desirability of federal intervention in corporate law. First, by casting doubt on the main argument of the race to the top theory, the analysis shows that the concern that state law suffers from pro-managerial bias is well grounded, and therefore strengthens the case for federal intervention. On the other hand, it suggests an additional element that might induce Delaware to further protect shareholders’ rights. Consequently, the desirability of federal mandatory intervention in the substance of state corporate law, under the price considerations analysis, depends on further assessment of the factors revealed.

While it is difficult to reach firm conclusions with respect to federal mandatory intervention in corporate law, such as the one adopted by congress in the Sarbanes-Oxley Act, the analysis certainly strengthens the case for federal interventions that preserve the advantages of the current system rather than replace it. Furthermore, recognizing the importance of price considerations, the analysis lays the ground for a policy recommendation of federal intervention in the form of pricing regulation. This type of intervention, elaborated upon by the author elsewhere, suggests that a federal law mandating states to charge incorporation fees that are sensitive to firms’ value will improve the states’ incentives to produce efficient corporate laws. Such regulation could be designed to align Delaware’s interests with shareholders’ interests. Such intervention, unlike other proposals, does not require activism on the part of shareholders in order to be effective in enhancing the quality of corporate law. Even if shareholders remain rationally uninformed about such new rule, Delaware would still be induced to maximize the value of its corporate law. Moreover, under the suggested intervention, Delaware would have incentives to improve its law even in the absence of competitive threats from other states.

The rest of this Article continues as follows. Part II reviews the existing theories of regulatory competition in American corporate law and assesses them in light of the evidence and the conventional wisdom that Delaware designs its law to maximize the volume of incorporations. Part III develops a new theory for the market for corporate law that incorporates price considerations. Part IV discusses the implications of a price considerations analysis for the assessment of the current system. Part V discusses the implications of a price considerations analysis for existing theories of regulatory competition. Part VI discusses the implications of the analysis for the desirability of federal intervention in corporate law. Part VII concludes.

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16 Choice enhancing federal intervention is one such option. See Bebchuk & Ferrell, New Approach, supra note 4.
II. THE STATE COMPETITION DEBATE

A. Factual Background

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

In this system, corporate law is said to emerge as a product of interstate competition in which states try to attract corporations with their corporate law and judicial and administrative system in order to get incorporation tax fees and revenues for the local bar. There has been a winner in this competition, Delaware, which has been the dominant state in the market for corporate law for almost a century. Delaware attracts more than 50% of all publicly traded companies, almost 60% of Fortune 500 companies, and more than 60% of companies that went public in the period 1996-2000.

Delaware has several competitive advantages that are difficult for other states to emulate. First, Delaware’s well developed case law ensures a relatively high certainty and predictability in litigated matters, which in turn reduces legal risk and facilitates business planning. Second, Delaware judges are required to handle a relatively high proportion of corporate cases and have a well-earned reputation for expertise and efficiency. Third, Delaware offers especially efficient

18 The internal affairs doctrine mandates that disputes regarding the internal affairs of a corporation be governed by the laws of the state of incorporation. See, e.g., McDermott Inc. v. Lewis, 531 A.2d 206, 217 (Del. 1987) (“Application of the internal affairs doctrine is mandated by constitutional principles”).
19 See Bebchuk, Desirable Limits, supra note 4, at 1458; Subramanian, Incorporation Choice, supra note 2, at 1803.
20 See ROBERT C. CLARK, CORPORATE LAW §10.2.4 at 416-417 (1986) (describing requirements for mergers under state law).
21 See Bebchuk & Cohen, supra note 2, at (reporting that Delaware attracts 51% of all publicly traded companies, 58% of Fortune 500 companies and 63% of companies that went public in the period 1996-2000). See also Bebchuk & Hamdani, supra note 5, at 576-578.
22 Kahan & Kamar, Price Discrimination, supra note 5, at 1213 (arguing that the extensive body of Delaware case law increases certainty and predictability, which in turn reinforces Delaware’s market share and power).
filing, registration and administrative services. Fourth, due to its large investment in its corporate law system and its prolonged dependence on franchise tax revenues Delaware possesses a credible commitment to remain responsive to corporate needs. Lastly, Delaware law, being the most widely used corporate law, exhibits network externalities which further reinforce its market power.

B. Current Views on the Market for Corporate Law

1. Race to the Bottom

The discussion over the merits of the current state competition structure was initiated by William Cary in one of the most cited and influential law review articles ever written. Cary forcefully argued that Delaware, the predominant state for incorporations of publicly traded companies, is leading a “race for the bottom” in producing rules that benefit managers at the expense of shareholders and social welfare. Cary advocated, therefore, that Congress adopt federal standards for corporate responsibility. Cary’s argument is now a benchmark for the future.

Future: The Role of Specialized Courts in Resolving Business Disputes, 61 BROOK. L. REV. 1, 5-8 (1995) (arguing that because corporate cases take up a significant portion of Delaware’s chancery court time “chancery's bench has developed the expertise in corporate matters”); Kahan & Kamar, Price Discrimination, supra note 5, at 1212 (arguing that Delaware courts provide the ability to resolve disputes quickly and sensibly).

See Kahan & Kamar, Price Discrimination, supra note 5, at 1213; Romano, The Need for Competition, supra note 3, at 509; The Delaware Division of Corporations has launched a web based filing system and is offering expedited incorporation and related services which include "24-hour", "Same Day" and "2-Hour" service. Delaware web based filing is available at http://ecorp2.state.de.us/default.sph/ecorpWeb.class. Rates for expedited services are available on http://www.state.de.us/corp/special.htm (last visited on March 2003).


This insight was raised and developed by Roberta Romano. See Romano, The Need for Competition, supra note 3, at 509; Romano, Empowering Investors, supra note 3, at 2391; ROMANO, THE GENIUS, supra note 3, at 38; Romano, Law as a Product, supra note 3, at 240-42. But see Black, supra note 23, at 586-587 (arguing that the costs of switching the state of incorporation are negligible and that a credible commitment to responsiveness is therefore not valuable).

Network externalities exist when the value of the product increases with the number of users. The insight that corporate law exhibits network externalities was developed by Michael Klausner in Klausner, supra note 5. For a detailed explanation on why Delaware law exhibits network externalities see discussion infra Section II. 3.

Cary, supra note 3. Cary's article is one of the most cited law review articles ever. See Fred R. Shapiro, The Most Cited Articles From the Yale Law Journal, 100 YALE L.J. 1449, 1462 (1991) (finding that Cary's article was the 14th most cited Yale Law Journal article).


Id. at 701.
spectrum of views on the market for corporate law, in which scholars largely differ over whether state competition is a “race to the bottom” or a “race to the top” and whether it should be replaced by federal legislation, either in whole or in part. 31

Cary was criticized for not taking into account market forces that work to align the interests of managers with those of shareholders. Recent race to the bottom theorists address this criticism by distinguishing between different kinds of corporate issues: Lucian Bebchuk has shown that although market forces do discipline managers to some extent, they cannot be counted on to perfectly align the interests of managers and shareholders with respect to all issues. 32 In particular, with respect to issues that involve large potential transfers to managers and issues that might themselves affect the strength of market forces, managers may seek inefficient rules that benefit themselves at the expense of shareholders. 33

In these issues, the race to the bottom argument goes, in order to attract and retain firms, Delaware must cater to managers’ interests. First, since board initiation is required for reincorporation, it is impossible to attract corporations from other states without catering to managers’ interest. 34 To be sure, reincorporation from one state to another requires shareholder approval. Yet, race to the bottom proponents also explain why, in their opinion, this requirement does not ensure an efficient outcome either. 35 First, with respect to many decisions, shareholders may remain rationally ignorant and uninformed. 36 For any shareholder who holds a small stake in the firm the expected value of acquiring and assessing information is most likely to be outweighed by the costs required to be expended in order to become informed. 37 More importantly, Delaware has many competitive advantages that compensate shareholders for possible differences between Delaware’s substantive corporate law and other states’ substantive corporate law. 38 Even if Delaware offers inefficient rules that cater to managers’ interests, shareholders might approve a move into Delaware because, due to its other advantages, the overall package that it offers is better than the one offered by other states. In other words, if the

31 See, e.g., Bebchuk, Desirable Limits, supra note 3, at 1499-1507 (arguing for federal rules or at least federal minimum standards for self-dealing transactions, the appropriation of corporate opportunities, freeze out mergers, takeover bids and proxy contests, and limitations on dividends); Winter, Shareholder Protection, supra note 3, at 252 (arguing for the desirability of state competition in corporate law); Romano, Empowering Investors, supra note 3, at 2386 (arguing for replacing federal securities regulation with state competition).
32 See Bebchuk, Desirable Limits, supra note 4, at 1458-1470.
33 Id.
34 See id. at 1460; Bar-Gill, Barzuza and Bebchuk, supra note 4, at 12-14 (showing formally that to lure firms from other states Delaware needs to cater to managers’ interests).
35 See Bebchuk, Desirable Limits, supra note 4, at 1470-1476.
36 See id. at 1472-1473.
37 Id.
38 Id. at 1471-1472.
benefits of its specialized judiciary, developed body of case law and network externalities associated with its corporate law system outweigh the costs incurred to shareholders due to Delaware’s pro-managerial bias as to particular substantive corporate law issues, shareholders would still approve a reincorporation to Delaware.

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

2. Race to the Top

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

Frank Easterbrook, Daniel Fischel and Roberta Romano join Winter in supporting the current system. They do not dispute that managers’ interests might diverge from those of shareholders neither that Delaware needs to cater to managers interests in order to attract them from other states. Like Winter, they stress that, in order to succeed in attracting incorporations, the leading state has to be superior to the other states,

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39 Id. at 1460.
40 See id. at 1459-1461.
41 See Winter, Shareholder Protection, supra note 3, at 256-266.
42 See id. at 256.
43 See id. at 264-266.
44 Id. at 256.
46 Race to the top proponents acknowledge that managerial opportunism may lead to managers favoring corporate law with inefficient redistributive rules. See Winter, Race for the Top Revisited, supra note 3, at 1528 (acknowledging that there are “cases in which management may seek legal rules allowing side payments where those payments outweigh the negative effects of the capital market”); Easterbrook & Fischel, Economic Structure, supra note 3, at 217 (“once they are ensconced, and have raised the capital the firm needs, managers may elect to behave opportunistically”); Fischel, supra note 3, at 918 (“In any agency relationship — such as the relationship between shareholders and managers — the interests of the agent will diverge from those of the principal”).
otherwise shareholders would not give their approval to reincorporation to that state.\textsuperscript{47} Indeed, they argue, Delaware offers better rules than the rest of the states.

In their view, if the leading state is also the superior one, then the current system benefits shareholders.\textsuperscript{48} Delaware's superiority is such an important building block in race to the top arguments that Roberta Romano, a prominent race to the top scholar, describes evidence on Delaware's superiority as "compelling evidence" that the current system benefits shareholders.\textsuperscript{49} Lastly, they argue, even if competition does not lead to optimal corporate rules, federal corporate law is almost certain to be worse.\textsuperscript{50}

\textbf{3. Weak Competition}

A third strain of research on the market for corporate law has moved from discussing demand side inefficiencies (the effects of the agency problem on corporations' choice of corporate law systems) to focus on supply side inefficiencies (the effects of the market structure on states' choice of corporate law). A major finding of this literature is that, for several reasons, which reasons include economic barriers to entry,\textsuperscript{51} network externalities,\textsuperscript{52} and political obstacles,\textsuperscript{53} Delaware does not face serious competitive threats. Hence, there is no race to the top or the bottom but, rather, the dominant state, Delaware takes a "leisurely walk" to a corporate law that protects its market power and enhances its revenues. The result of this "leisurely walk" is a corporate law of suboptimal quality and pro-managerial bias.

This literature also has important implications for the assessment of the market for corporate law. First, the race-to-the-bottom concerns do not disappear under the weak competition view. Scholars advancing this view argue that the corporate law of Delaware and the rest of the states at

\textsuperscript{47} See Romano, \textit{The Need for Competition}, supra note 3, at 493-494. See also Romano, \textit{Empowering Investors}, supra note 3, at 2416-2417 (arguing that a requirement of shareholder approval protects shareholders from a migration from a superior regime to an inferior one). See also Romano, \textit{Empowering Investors}, supra note 3, at 2415-2416 (suggesting that a requirement of voting approval by securities holders for a domicile change could protect investors under a regulatory competition system for securities law).

\textsuperscript{48} See Romano, \textit{The Need for Competition}, supra note 3, at 503 (arguing that "from the perspective of a corporate code and the efficacy of the output of competition, it is the net wealth effect of a code on investors that is important, and that effect is positive").

\textsuperscript{49} See Romano, \textit{The Need for Competition}, supra note 3, at 497 (Evaluating evidence on Delaware's superiority and concluding that "[t]hese uniformly positive findings, in my judgment, are compelling evidence that competition benefits shareholders").

\textsuperscript{50} See, e.g., ROMANO, \textit{THE GENIUS}, supra note 3, at 75 (arguing that "the track record of most states in takeover regulation raises serious questions concerning the efficacy of state competition does not imply that national regulation of takeovers is the solution to an imperfect federal system."); Romano, \textit{Empowering Investors}, supra note 3, at n. 77; Romano, \textit{The Need for Competition}, supra note 3, at 506.

\textsuperscript{51} See Bebchuk & Hamdani \textit{Leisurely Walk}, supra note 5, at 585-595.

\textsuperscript{52} See Klausner, \textit{supra} note 5; Bebchuk & Hamdani \textit{Leisurely Walk}, \textit{supra} note 5 , at 586-588.

\textsuperscript{53} See Kahan & Kamar, \textit{The Myth, supra} note 5, at 727-734.
equilibrium would not optimally protect shareholders from managerial opportunism. Some have even suggested that the managerial bias would be larger than under a market that was truly competitive.

In addition, given Delaware’s market power, some of the “weak competition” proponents have also expressed concerns for the quality of the corporate law that Delaware is expected to produce with respect to issues that do not involve conflicts of interest between managers and shareholders. In particular, it has been argued that, without competitive threats, Delaware has suboptimal incentives to invest in its corporate law and improve it.

This concern is especially important in light of the significant network externalities exhibited by Delaware law. Network externalities exist when the value of a product to consumers increases with the number of consumers who use that product. Outside the corporate law context, the telephone is a textbook example of the effects of network externalities. In an important paper Michael Klausner discussed the role of network and learning externalities in the production of corporate law. Corporate law, Klausner argues, exhibits network externalities for several different reasons. The likelihood of frequent judicial interpretation in the future reduces the uncertainty involved in corporate contract terms. Every firm that uses such terms imposes “interpretive network externalities” on its peers since its adoption of the same legal terms increases the likelihood that such a term would be litigated, and thus interpreted, in court. Such a firm also imposes “common practice network externalities” by increasing the quantity of future business practices, to be analyzed by courts, which in turn further reduces the

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54 See Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 599-601; Kahan & Kamar, The Myth, supra note 5, at 735-742.
55 See Kahan & Kamar, The Myth, supra note 5, at 735-742.
56 See Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 596-599. Inefficiencies might occur, Bebchuk and Hamdani argue, since a monopolist, in deciding which level of quality to produce, considers the preferences of the marginal consumer, which is rarely also the representative consumer. See also Michael A. Spence, Monopoly, Quality & Regulation, BELL J. OF ECON., Volume 6 Issue 2 (Autumn 1975) 417-429 (constructing a model that demonstrates this problem). See also TIROLE, supra note 10, 100-101 (1988) (describing Spence’s results). But see Kahan & Kamar, The Myth, supra note 5, at 742 (arguing that as a monopolist Delaware might invest in innovations more than a firm in a competitive market).
58 See Klausner, supra note 5.
59 See id. at 778-779. See also Marcel Kahan & Michael Klausner, Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate"), 83 VA. L. REV. 713, 750-51, 760-61 (1997) [hereinafter Kahan & Klausner, Economics of Boilerplate].
60 See Klausner, supra note 5 at 778-779; See also Kahan & Klausner, The Economics of Boilerplate, supra note 59, at 726.
uncertainty involved in such terms. Furthermore, a wide adoption of corporate law terms ensures familiarity with such terms by providers of legal and financial services, which in turn leads to lower costs associated with providing those services.

Network externalities ensure that even if another state were to replicate Delaware’s judicial system, its success in attracting corporations would be doubtful. To accumulate the network externalities associated with incorporation in Delaware, a competing state would have to attract a large number of firms from Delaware.67 Uncertainty and delay in a state’s ability to attract the critical mass of firms essential to produce network externalities may be detrimental and even prohibitive. As a result, at least according to the weak competition model, Delaware faces weak competitive threats of entry, and is likely to become lax in maintaining and improving the quality of its law.62

4. Race with the Federal Government

In a contemporaneous work, Mark Roe argues that Delaware’s real competition comes from the federal government rather than the rest of the states.63 As Roe demonstrates, federal authorities can displace, can inspire fear, and have displaced states corporate law on a set of important issues.64 To mention few of the examples, in the 1930s federal securities laws took voting from the states, in the 1960s Congress sought to limit takeovers with the Williams Act, states’ first generation antitakeover statutes were preempted by the federal court decision in Edgar v. Mite and, most recently, as a response to corporate scandals, Congress adopted the Sarbanes-Oxley Act that intrudes upon state corporate law.65

Delaware which has a lot to lose from federalization of corporate law, designs its law with that risk in mind. During the 1980s the federal government was pro-takeover and, correspondingly, Delaware did not adopt strong antitakeover rules as other states did. When the federal government authorities left the field in the 1990s Delaware’s decisions became more pro-managerial.66

According to this view the developments of Delaware law in the U.S. can not be explained by a race theory, neither to the top nor to the bottom. If it is shown that Delaware law is efficient, it is not necessarily a result of a race to the top. If it shown that Delaware law is inefficient, it

63 Id. at 846-847.
64 Id. at 850. In contrast to their assumption throughout the paper that Delaware designs its law to attract firms, with respect to this point, Kahan and Kamar appear to give, implicitly, some weight to price considerations by arguing that a monopolist might have incentives to innovate since it captures all of the benefits resulted from its innovations. See Kahan & Kamar, The Myth, supra note 5, at 742 (arguing that as a monopolist Delaware might invest in innovations more than a firm in a competitive market). They do not explain however, why network externalities would not impede these incentives.
65 Id. at 12-43.
66 Id. at 25-27.
is not necessarily a result of a race to the bottom. The development of corporate law in the U.S. is a result of a race with a threat of federal intervention.

C. Current Views and the Evidence

This subsection assesses the four views outlined above in light of the currently available evidence. The last decade has seen the emergence of empirical studies using statistical and quantitative methods to assess the desirability of the current system. As will be shown, although each theory is reconcilable with some of the empirical evidence, none of the theories fully accounts for the entire body of empirical evidence. Moreover, in light of existing theories, some of the evidence seems to be contradictory.

1. Race to the Top

Early empirical research supporting the race to the top view focused on stock price reactions to reincorporation decisions. Event studies demonstrated that reincorporation to Delaware usually resulted in a positive stock price reaction. If reincorporation benefits shareholders, race to the top proponents reasoned, then the current system that allows migrations must benefit shareholders. In addition, later studies show that companies incorporated in Delaware enjoy higher Tobin’s Q ratios and are more likely to be the target of takeover bids or acquisitions compared to companies incorporated elsewhere. If similar assets are worth more when governed by Delaware law, the argument continues, then Delaware corporate law must be superior and the race Delaware leads has to be to the top. Lastly, race to the top proponents stressed Delaware’s relatively mild antitakeover law as evidence for the good performance of the current system. Delaware did not enact extreme

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67 Id. at 43-48.
69 See, e.g., Romano, The Need for Competition, supra note 3, at 494-505; Romano, Empowering Investors, supra note 3, at 2383-2387.
70 Tobin’s Q ratio represents the ratio between firms market value and the book value of their assets. See Daines, Firm Value, supra note 2.
71 See Romano, The Need for Competition, supra note 3, at 530-537 (arguing that race to the bottom proponents have not adequately addressed the fact that “the state with the largest stake in the chartering business, stands out as an anomaly in the pattern of takeover legislation”); Romano, Competition for Corporate Charters, supra note 12, at 858-59 (emphasizing that Delaware’s antitakeover law is less draconian than the antitakeover law in some other states, such as Pennsylvania, and that Delaware was not
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antitakeover statutes, such as Pennsylvania’s,72 and Ohio’s disgorgement statute,73 or Massachusetts’ mandatory staggered board statute.74 Moreover, with respect to the statutes that it did enact, Delaware was only a follower rather than a leader.75

Thus, race to the top proponents view the empirical evidence as tilting the balance in the debate in their favor.76 Indeed, the fact that the state that produces relatively mild takeover law happens to attract most of the corporations in the market seems to indicate that the current system rewards states for, and provides them with the right incentives to, adopt efficient corporate laws.

At the same time, however, the current system produces laws which cannot be considered the result of a race to the top. Most notably, the proliferation of antitakeover statutes among states troubles race to the top scholars, since they believe that the market for corporate control is an important force that should not be limited.77 Moreover, empirical studies support the view that takeover laws are inefficient, in that such studies have found either no price reactions or negative price reactions to their adoption.78

Even more problematic for race to the top proponents, recent empirical studies show that states that offer strong antitakeover statutes are not penalized but rather rewarded, by attracting more incorporations in the market for corporate law. Two works, one by Lucian Bebchuk and Alma Cohen and the other by Guhan Subramanian, investigated the performance of several non-Delaware states in the market.79 They concluded that those states that adopted takeover rules hospitable to managers did better in terms of maintaining their in-state corporations

the leader but the follower in adopting antitakeover rules); EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, supra note 3, at 222-223 (stressing that Delaware antitakeover law is relatively mild); Winter, Shareholder Protection, supra note 3, at 289 (same).
75 See Romano, The Need for Competition, supra note 3, at 529-536.
76 See Romano, The Need for Competition, supra note 3, at 497 (concluding that the findings of the event studies “in my judgment, are compelling evidence that competition benefits shareholders”); Romano, Empowering Investors, supra note 3, at 2359 (“If a change in domicile increases firm value, it would be exceedingly difficult to maintain that charter competition is harmful to shareholders.”); Sanjai Bhagat & Roberta Romano, Event Studies & the Law: Part II – Empirical Studies of Corporate Law, 4 AM. LAW & ECON. R. 380 (2002) at 384. (“One certainly cannot read the event study literature and conclude that firms reincorporating are reducing their shareholders’ wealth, as critics of the “race to the top” theory contend”); EASTERBROOK & FISCHEL, ECONOMIC STRUCTURE, supra note 3, at 214-215 (“Empirical studies confirm the force of competition. These findings of the empirical literature fatally undermine the “race to the bottom” position . . . ”).
77 See, e.g., Winter, Shareholder Protection, supra note 3, at 288.
79 See Bebchuk & Cohen, supra note 2; Subramanian, Incorporation Choice, supra note 2.
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and attracting out-of-state incorporations. Puzzlingly, these results seem to indicate that the current system does not reward, but rather penalizes, states for adopting efficient rules, and that it, therefore, induces states to enact strong antitakeover laws.

2. Race to the Bottom

Following Cary, the race to the bottom literature addressed the empirical evidence analyzed by race to the top proponents. With regards to the findings about higher Tobin’s Q ratios for Delaware corporations, Bebchuk and Ferrell suggested that these differences could arise not from the superiority of Delaware's substantive corporate law but rather from competitive advantages Delaware's corporate law system enjoys over those of other states. The empirical evidence, they argue, merely shows that Delaware's corporate law system is better than that of the other states but does not prove its optimality. As discussed above, Delaware indeed enjoys substantial advantages over the other states, such as its specialized judiciary and network externalities. It could be, then, that competition drives all states to produce inefficient corporate laws, but that Delaware offers advantages that make it more attractive than other states. In a different article Bar-Gill, Bebchuk and I constructed a model which demonstrated formally how Delaware’s superiority might stem from its institutional advantages.

In addition, as mentioned above, recent empirical studies show that among states other than Delaware, states that adopt strong antitakeover laws are not penalized but rather rewarded in the market for corporate law. The stronger the antitakeover protections offered were, the more successful the state was both in retaining in-state corporations and in luring reincorporations.

Some data, however, is still inconsistent with this view. The first is Delaware’s takeover law. As explained above, according to conventional wisdom, Delaware's takeover law is quite moderate when compared to the law of the other states. Bebchuk, Cohen and Ferrell respond to these arguments by first claiming that Delaware's substantive corporate law is

80 There is one exception to this rule. The most extreme antitakeover statutes hurt the ability of states to retain firms in the Subramanian studies but not in Bebchuk and Cohen studies. See Subramanian, supra note 2, at 1857-1864; Bebchuk & Cohen, supra note 2, at 23-25. Bebchuk and Cohen get different results because, unlike Subramanian, they use separate dummies for the recapture and the staggered board statutes and also control for state characteristics. In addition, Robert Daines did not find that antitakeover rules affect firms decisions where to incorporate. Daines, however, focused only on IPO firms. See Daines, IPO Firms, supra note 2.
81 See Bebchuk & Ferrell, New Approach, supra note 4, at 137. See also Bebchuk, Cohen & Ferrell, supra note 4, at 1799 (suggesting that reincorporation to Delaware often provides additional value due to advantages not reflected in Delaware's substantive legal rules).
82 See Bar-Gill, Barzuza & Bebchuk, supra note 4.
83 See Bebchuk & Cohen, supra note 2, at 23-25
84 See discussion supra Section II. C.1. For a detailed discussion on the relative mildness of Delaware’s antitakeover law see infra Section IV.A.1.
in fact no better than the one in many other states.\textsuperscript{85} As to Daines’ findings, Bebchuk, Cohen and Ferrell suggest that they might be explained by self selection. In other words, Delaware does not facilitate acquisition but rather attracts firm that are subject to higher bid rates.\textsuperscript{86} They do not identify, however, the exact effect that self selection bears on Daines’ findings.\textsuperscript{85} Even if we accept their view about selection bias, there is still a need to explain why Daines’ studies suffer from it. Bebchuk, Cohen and Ferrell further argue that even if Delaware law were better than other states’ law, it would still not follow that competition is desirable.\textsuperscript{88} It might still be the case that competition pushes states to the bottom with the victorious states providing a slightly better law than the rest. They do not, however, provide a coherent theory to substantiate such a claim.

More importantly, none of the race to the bottom proponents explains why Delaware does not strengthen its antitakeover law in order to attract more incorporations.\textsuperscript{89} Such an explanation is needed, especially in light of the Bebchuk and Cohen’s and Subramanian’s findings that antitakeover laws help both in attracting reincorporations to Delaware and in retaining in-state corporations. If the race to the bottom proponents views as to Delaware’s motivations are complete, Delaware could increase the number of incorporations by strengthening its antitakeover law. First, by strengthening its antitakeover law Delaware may attract more firms from their home states. Second, 10% of public firms choose not to incorporate in Delaware or in their home state.\textsuperscript{90} Typically, such firms choose to incorporate in states with strong antitakeover protection. It seems plausible to contend therefore, that firms of this type prefer other states to Delaware because of the stronger antitakeover devices they offer. Delaware could attract these firms if it offered them comparable, more potent antitakeover law. It is not apparent, therefore, according to either Bebchuk and Cohen or Subramanian, why Delaware does not adopt at least some of these antitakeover devices.

3. Weak Competition

The first puzzle for the literature focusing on Delaware’s market power is Delaware’s market share. In particular, if so many firms find Delaware attractive, it is not clear why many other firms do not. As Bebchuk and Ferrell articulated, if Delaware law improves firm value, all firms are expected to move to Delaware. By doing so, firms could increase their value by as much as 5% in some years, which, in most

\textsuperscript{85} See Bebchuk, Cohen & Ferrell, \textit{supra} note 4, at 1803-1804.
\textsuperscript{86} \textit{Id.} at 29.
\textsuperscript{87} See \textit{id.} at 30.
\textsuperscript{88} \textit{Id.} at 26.
\textsuperscript{89} For a detailed discussion on the relative mildness of Delaware’s antitakeover law see \textit{infra} Section IV.A.1.
\textsuperscript{90} See Subramanian, \textit{supra} note 2, at 1816 fig. 3 (finding that 10% of the non-financial companies in his sample are incorporated neither in their home state nor in Delaware).
cases, substantially outweighs the incorporation and franchise tax they would pay in Delaware.

Since non-Delaware firms often choose to incorporate in their home-state, scholars have attempted to explain the special tie firms seem to have with their home states. Among the factors they have identified are the higher costs of incorporation in Delaware, the ability to have political influence in the home state and the influence of local law firms on the incorporation decisions. However, all studies indicate that the home state bias is stronger in states with strong antitakeover laws than in states with weaker ones. Why then does Delaware attract only part of the market? Assuming that the answer lies in its antitakeover law, why does it not strengthen it? These theories do not provide a conclusive explanation for the phenomenon of out-of-state incorporations in non-Delaware states.

A second puzzle relates to the argument that, as a result of significant market power and network externalities, Delaware has weak incentives to invest in the quality of its corporate law, which argument is not sustained by an examination of Delaware's behavior. In a seminal work, Roberta Romano found a correlation between the percentage of state franchise tax revenue to a state's total revenue and the responsiveness and speed of the state in designing and enacting legal innovations. Among all of the states, Delaware has the highest ratio and, accordingly, the highest responsiveness. Klausner found Delaware's high responsiveness puzzling in light of his analysis.

4. Race with the Federal Government

Mark Roe's theory provides a strong explanation as to why Delaware did not strengthen its antitakeover law during the 1980s. According to this explanation, pro-takeover federal environment kept Delaware on the mild side. During the 1990s, however, there was a shift in the federal government's view, and Delaware which could suddenly "breathe more freely" strengthened its antitakeover law in favor of managers. As some scholars argue, however, Delaware law remained mild relative to other states even during the 1990s. If there was no threat during these years one would expect Delaware to strengthen its antitakeover law further. It seems therefore, that the fear from federal intervention is not the only constraint that Delaware faces.

91 See Bebchuk & Cohen, supra note 4, at 8-14.
92 Id. at 14-26; see also Subramanian, supra note 2, at 1857-1864. Robert Daines did not find that antitakeover rules affect firms decisions where to incorporate. Daines' study, however, focused only on IPO firms, in which there is no conflict of interest between shareholders and managers. See Daines, IPO Firms, supra note 2.
93 In fact, Delaware lagged behind only with respect to changes that were not considered to add value to the firm, such as changes in antitakeover laws.
94 See Klausner, supra note 5, at 850 n. 283.
95 See Roe, Delaware's Competition, supra note 5, at 26.
96 See also discussion infra Section IV.A.1.
In addition, according to this theory we shall sometimes see Delaware being more pro managerial than other states. In discussing the choices and motivations of federal regulators Roe suggests that federal authorities are affected by two conflicting considerations. On the one hand, federal authorities are concerned with the management of the economy and the protection of shareholders. On the other hand, however, federal authorities are affected by pressure from interest groups. The fear from federalization of corporate law, therefore, could affect Delaware to race either to the top or to the bottom, either toward shareholders or toward managers. Yet, since Delaware pro-managerial tendency, as explained before, is consistently restrained relative to other states, there must be another factor, in addition to the fear from federal intervention, that restraint Delaware from catering to managers’ interests.

D. The Assumption that Delaware Maximizes the Volume of Incorporations

The previous sections have shown that, even though each of the current theories is sustained by some of the evidence, none of them seems to explain the body of empirical evidence as a whole. Even more puzzling, the evidence seems to include several contradictions. This section will describe the assumption that is common to all of these theories and, as will be argued later, is the source of the seeming incompatibility between theory and evidence.

While commentators continue to disagree about the desirability of the current system they all make one central assumption. All of the existing theories are premised, either explicitly or implicitly, on the assumption that Delaware designs its strategy with the goal of maximizing the number of incorporations. The common justification for this assumption is revenue maximization which is “thought to depend directly upon the volume of domestic incorporations.”

97 See Roe, Delaware’s Competition, supra note 5, at 8-10.
98 See id. at 43 (“…we cannot tell whether the big issues that remained with the states and are efficient were shaped by the federal government’s pernicious influence (because it the custodian of American economy) or whether the big ones that remained and are inefficient were shaped by the federal government’s pernicious influence (because it’s susceptible to error and interest group influence and, due to its overarching position can impose inefficient corporate rules).
99 See e.g., Subramanian, Incorporation Choice, supra note 2, at 1810 (stating that “[b]oth sides assume that states seek to maximize the number of companies incorporated within their boundaries”); Bebchuk & Cohen, supra note 2, at 1 (“In this debate most scholars have made similar assumptions about the supply side of the market. Namely, that states seek to attract incorporations.”).
100 Romano, Law as a Product, supra note 3, at 228. See also Bebchuk, Desirable Limits, supra note 4, at 1451 (arguing that states have an interest in increasing in-state incorporations because “[i]ncorporations bring with them franchise tax and fee revenues as well as patronage for in-state law firms, corporation service companies, and other businesses.”); Choi & Guzman, Portable Reciprocity, supra note 9, at 906 (stating that among other things “An increase in the number of market participants adopting a particular country’s regulatory regime leads to more tax revenue”).
To start with, this assumption is an important building block in the race to the bottom theory. For instance, Lucian Bebchuk, a prominent race to the bottom scholar asserts that states’ corporate “law is shaped by the desire to attract incorporations.”101 Building on this assumption he predicts that Delaware would cater to managers’ interests. In a later paper that further develops the race to the bottom view, Bebchuk and Ferrell similarly assume that “[s]tates are interested in maximizing the number of companies that are incorporated there.”102 The desire to maximize incorporations is a source of inefficiency under the race to the bottom view. To that end, given managers’ power over reincorporation decisions, Delaware must cater to managers interests. Indeed, they argue, this desire has led Delaware to offer strong antitakeover law that protects managers excessively.103

The recent literature on the market for corporate law, also does not consider the ways in which price considerations, as opposed to volume maximization, may affect Delaware’s choices in choosing between shareholders’ and managers’ interests. Since Delaware “aims to attract incorporations” Kahan and Kamar explain, “Delaware can benefit from designing its product to be attractive, if not equally so, to both shareholders and managers of as many corporations as possible.”104 Bebchuk and Hamdani, similarly suggest that Delaware cater to managers’ interests since this strategy minimizes the risk of loosing its firms.105

Interestingly, race to the top scholars also do not challenge the assumption that Delaware designs its law with the exclusive goal of attracting the maximum amount of incorporations. Roberta Romano, one of the most influential writers on the market for corporate law, states explicitly the common assumption that the “objective of states is revenue maximization, which is thought to depend directly upon the volume of domestic incorporations.”106 Unlike race to the bottom scholars, for race to the top scholars the desire to maximize the volume of incorporations is a source of efficiency. Since Delaware maximizes the number of incorporations, the mere fact that Delaware makes the volume of incorporations a state objective is not sufficient to explain its law. Given that Delaware maximizes incorporations, indeed Delaware’s choices with respect to its antitakeover law cannot be explained by either of the race theories, but, as shown in Part III, if one assumes that Delaware, when it designs its law, also takes into account how it will affect the price it can charge, its behavior is explainable even without the introduction of the threat of federal intervention.

101 See Bebchuk, Desirable Limits, supra note 4, at 1455.
102 See Bebchuk & Ferrell, New Approach, supra note 4, at 133.
103 See Bebchuk & Ferrell, The Race to Protect Managers, supra note 4.
104 Kahan & Kamar, The Myth, supra note 5, at 739-741.
105 See Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 559-600 (arguing that to retain and attract corporations Delaware has incentives to offer rules that favor managers). This assumption, though less important to its conclusions, also underlies implicitly the recent analysis that argues that Delaware designs its law in light of a concern that it could trigger federal intervention. In analyzing Delaware behavior during the 1980s, Mark Roe suggests that Delaware’s antitakeover law cannot be explained by race theories but only by the fear of federal intervention. Assuming that Delaware maximizes the volume of incorporations, indeed Delaware’s choices with respect to its antitakeover law cannot be explained by either of the race theories, but, as shown in Part III, if one assumes that Delaware, when it designs its law, also takes into account how it will affect the price it can charge, its behavior is explainable even without the introduction of the threat of federal intervention.
106 Romano, Law as a Product, supra note 3, at 228.
incorporations, the argument goes, it has incentives to produce an efficient corporate law rather than a pro-managerial one. Exploiting shareholders, whose approval is required for reincorporation, would decrease Delaware’s ability to attract firms.

Lastly, the analysis of the effects of network externalities on Delaware law also implicitly assumes that Delaware wishes to maximize only the number of incorporations that it attracts. From this premise of volume maximization, Klausner has proceeded to argue that Delaware has no incentives to invest in innovations and modifications to its corporate law. As a result of network externalities, he argues, Delaware does not need to make a significant effort to attract and retain firms, because a limited effort would suffice. According to this analysis, Delaware’s choices whether or not to invest in innovations and modifications depend solely on the potential contribution of such investment to the number of incorporations in Delaware.

Contrary to this widely held assumption, the following Part argues that Delaware’s choices are affected not only by volume considerations but also by price considerations. As shown below, the recognition of price considerations leads to a different analysis of the market for corporate law, one which helps in explaining the evidence, accounting for Delaware’s behavior and solving the puzzles described in this Part.

III. TOWARD A NEW THEORY: THE EFFECTS OF PRICE CONSIDERATIONS ON THE MARKET FOR CORPORATE LAW

This Part advances the view that price considerations affect Delaware’s choices in designing its corporate law and, therefore, that not taking them into account results in the competing theories being incomplete and unable to account for the empirical data in their totality. It develops an analysis that incorporates price considerations and generates testable predictions regarding the way these considerations affect Delaware’s behavior.

To develop the analysis, sections A, B and C of this Part present the assumptions that underlie the analysis. Section A argues that if price and quantity considerations conflict with each other Delaware will not simply maximize quantity but will also take into account price considerations, at least to a certain extent. Price is clearly important to Delaware, given that the franchise tax that Delaware charges is both significantly higher than its marginal costs and much higher than the franchise tax in any of the other jurisdictions, and that the annual taxes constitute a significant portion of Delaware’s annual revenue. Section B shows that other states, not being able to charge a positive price, do not take into account price considerations. These states, instead, will be either indifferent to their success in attracting incorporations or, if the local bar is strong enough, design their law to attract incorporations. Section C discusses the reasons for the divergence between shareholders’
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and managers' interests, and explains why managers are heterogeneous in their preferences toward extracting private benefits. Section D analyzes the way price considerations affect Delaware’s choices between shareholders and managers. It shows that in order to attract firms from other states and initial incorporations, Delaware must reduce its price to reflect the harm that is caused to shareholders from having inefficient pro-managerial rules. For Delaware, therefore, contrary to the common assumption in the literature, maximizing revenues is not equivalent to maximizing the volume of incorporations. When it observes demand from managers with varying preferences, Delaware faces a trade-off between quantity and price, with price considerations inducing Delaware to increase its corporate law quality, while at the same time quantity maximization considerations induce it to decrease its corporate law quality.

Section E discusses the ways in which price considerations affect Delaware's choices with respect to issues that do not involve conflicts of interest between managers and shareholders. It contends that price considerations could induce Delaware to improve the quality of its corporate law, notwithstanding the presence of network externalities. Section F explains why sub optimal quantity that typically results from monopolists’ price considerations is not a concern in our case. Finally, section G addresses possible objections and discusses limitations to the price considerations analysis.

A. What does Delaware Maximize?

The common justification for the assumption that Delaware maximizes the volume of incorporations is that revenue maximization is “thought to depend directly upon the volume of domestic incorporations.” However, as the discussion in the following subsections shows, the strategies that maximize the number of incorporations and the strategies that maximize the revenues from incorporations do not always overlap and sometimes even contradict each other.

This Part argues that in these cases Delaware would not maximize the volume of incorporations but would take price into account. The most simple and straightforward evidence that Delaware takes into account price considerations is its significant franchise tax. If Delaware cared only for the number of incorporations it could acquire, it would charge a price that does not exceed its marginal costs. Such a price, as shown below, would enable it to attract the greatest number of corporations. In addition, the major corporate law pressure group in Delaware, the local bar, would support a lower tax. Nevertheless, the

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107 Romano, Law as a Product, supra note 3, at 228
108 The bar would want Delaware to charge as low a tax as possible for two reasons: A lower tax would attract more corporations whose matters would be litigated in the Delaware courts and would leave a larger consumers’ surplus for the bar to extract
PRICE CONSIDERATIONS

franchise tax that Delaware charges is both significantly higher than its marginal costs and much higher than the franchise tax in any of the other jurisdictions.  

More importantly, the revenues that Delaware makes from incorporation serve as a strong incentive to invest in its corporate law system and improve it. Delaware’s revenues from its franchise tax amount to 20% of its total revenues. In per capita terms, Delaware’s franchise tax revenues constitute an annual income of $3,000 for every family of four.  

A current example demonstrates the importance of price considerations in setting Delaware’s strategy. According to current estimates, Delaware is expected to have a deficit of $300 million in its 2004 budget. After she consulted key leaders in the business community to find in how much Delaware could increase its tax rates without deterring firms from making Delaware their home state, Ruth Ann Myers, the governor of Delaware, decided, along with significant cuts, to balance the state budget by levying a 17% increase in franchise tax.  

This example, in addition to showing how important to Delaware are the tax revenues from incorporations, also demonstrates the trade-off that Delaware faces between price and quantity. If the governor had thought that Delaware could increase the tax further without losing firms, she would probably have proposed doing so instead of cutting government employment, reengineering programs and cutting health care costs.  

To be sure, that price is important for Delaware is still not enough to determine what exactly Delaware maximizes. If Delaware were a regular producer we would probably say that it attempts to maximize its revenues, i.e., the product of the number of firms it attracts and the price it charges each of them. However, Delaware is not a typical producer and hence is not necessarily motivated by a pure desire to maximize revenues. Unlike a typical producer, Delaware charges its price


109 See Romano, Empowering Investors, supra note 3, at 2429 tbl.1 (reporting that from 1966 to 1996 Delaware appropriated less than 3% of its revenues to its corporations division); Kahan & Kamar, The Myth, supra note 5, at 690 tbl. 1 (reporting that the maximal annual tax in Delaware is more than ten times larger than the annual tax in the next most costly state, Georgia, and more than hundred times larger than the annual tax in many of the other states).

110 See Bebchuk & Hamdani, Leisurably Walk, supra note 5, at 556.

111 This increase is expected to generate an additional $89 million of revenue in fiscal year 2004. In addition to increasing the franchise tax the governor intends to increase the state's revenues by increasing cigarette taxes, decoupling from the federal elimination of the estate tax and increasing revenues from lotteries. See Budget Address of Governor Ruth Ann Minner, January 30, 2003, State of Delaware, Office of the Budget. http://www.state.de.us/budget/fy/2004/2004-budget-speech.html

112 The plan includes cutting government employment and programs, cutting district school funds, consolidating departments (e.g. consolidating the Delaware State Police, Delaware Emergency Management Agency, Capitol Police, Office of Highway Safety, EMS Office and emergency communications staff to one department – the department of Safety and Homeland Security), and driving down health care costs. See id.
principally through its franchise tax law. The franchise tax law is not as flexible as a price in the market. In addition, for political reasons Delaware might want to keep its taxes relatively low.

Accordingly, the analysis in this Article will neither assume that Delaware maximizes revenues nor that it maximizes the volume of incorporations but rather that, in designing its corporate law, Delaware takes into account both the effects of its choices on the number of firms it attracts and on the price it charges each firm. At the very least, we could say that in the trade-off between price and quantity Delaware would not adopt rules that result in Delaware having to reduce the price that it currently charges, and might even adopt rules that enable it to increase this price.

B. What do other States Maximize?

States other than Delaware do not possess the market power that would enable them to charge a positive price for the incorporation of out-of-state firms. First, other states have not established a specialized court that could effectively compete with Delaware’s. Second, none of the other states attracts a portion of the market that is sufficiently large to create the network benefits associated with Delaware law. Political and economic barriers also make it unlikely that states would take steps in the near future to increase their market power. First, for many states the revenues that stem from incorporations would constitute only a negligible part of their annual budget even if they attracted a large number of incorporations. Second, for the small states that might be motivated by the prospect of revenues from incorporations, establishing an incorporation business requires an up front investment in a specialized court and administrative system that would not be recoverable if the state did not succeed in attracting firms from Delaware. Even if some other state managed to establish a similar infrastructure, in order to succeed in attracting firms from Delaware this state would need to offer law that is significantly superior to Delaware’s law. Assuming that this state overcame these hurdles and succeeded both in establishing a legal infrastructure and in offering a superior corporate law it is still far from clear that the endeavor would turn out to be profitable. During the time in which that state establishes its infrastructure and develops its corporate law, Delaware could retaliate by improving its own law to

113 See Kahan & Kamar, The Myth, supra note 5, at 708-715.
114 While Delaware attracts more than 50% of the publicly traded firms in the U.S., none of the other states attracts more than 5% of these firms. See Subramanian, Incorporation Choice, supra note 2, at 1815 figure 2.
115 See Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 588-589. But see Kahan & Kamar, The Myth, supra note 5, at 725-726 (arguing that a specialized court would not be expensive to establish).
match the other state's law or by reducing its price towards marginal cost.117

In the absence of special advantages, states cannot make significant financial revenues from out of state incorporations. If another state charged a positive non-negligible price it would lose its firms either to Delaware or other states. To be sure, states are expected to enjoy market power over some firms. In particular, each state is expected to have some market power on the firms that are headquartered in it. Yet, states have many reasons to not charge high taxes to firms based in their own state.118 Indeed, the price that the rest of the states charge is relatively nominal and certainly not a price that would generate any substantial revenue in excess of costs.119

Even though states do not hope to make revenues from incorporations, however, they might still design their rules to maximize the number of in-state incorporations. First, in many states the local bar, whose revenues increase with the number of firms, has significant influence on the design of corporate law. Second, managers, who in many states also have significant influence on the design of corporate law, press for rules that benefit them. These rules were found to have a positive effect on the number of incorporations in the state.120

To sum up, although states are not likely to attempt to attract firms from Delaware, states might design their law to retain incorporations as long as such strategy is supported by internal politics and does not require a significant investment.121 In particular, states in which the local bar and local managers influence state politics are likely to design their rules to maximize the number of incorporations. Other states might choose different rules even at the cost of losing corporations.

C. Managerial Opportunism

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

Both race to the top and race to the bottom theorists agree that managers’ interests are not, to a lesser or greater extent, respectively,

117 See Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 593-595. See also Bebchuk & Ferrell, New Approach, supra note 4, at 154-155. (relying on this argument to argue for the necessity of federal optional takeover law).

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

119 See Kahan & Kamar, The Myth, supra note 5, at 687-701 (finding that no state structures its taxes to gain significant revenues from incorporations); Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 580-581.

120 See Bebchuk & Cohen, supra note 4.

121 Even scholars with the most skeptical views about the incentives of other states to compete do not argue that states other than Delaware would not change their rules to retain incorporations if such a change does not require a significant investment and is not expected to raise political opposition. See Kahan and Kamar, The Myth, supra note 5, at 700 (stating that “states are unlikely to take measures to retain existing incorporations that generate political opposition or involve material fiscal outlays.”).
perfectly aligned with the interests of shareholders.\textsuperscript{122} To be sure, the markets for managerial labor, corporate control, capital, and products all work to align managers' and shareholders' interests.\textsuperscript{123} None of these markets, however, either singly or all of them together, can completely diminish these agency costs.

First, the disciplinary effects of the managerial labor market are limited. Since reduction in share value may have nothing to do with managerial performance, CEO compensation schemes are only partially sensitive to firm value and managers' future hiring and promotion does not depend significantly on firms' performance.\textsuperscript{124} Takeovers are costly and thus managers can extract significant private benefits before hostile takeovers become a real threat.\textsuperscript{125} Moreover, in choosing an incorporation venue, managers are expected to prefer regimes that provide them with strong antitakeover defenses.\textsuperscript{126} The market for products disciplines managers only to the extent that corporate law affects profitability and even then is weak for companies that retain monopolistic rents.\textsuperscript{127} Lastly, as to the market for capital, the costs it imposes are incurred mainly by existing shareholders rather than by managers.\textsuperscript{128} Private contracting which could reduce agency costs cannot be relied on to eliminate them completely. Contracting is costly, and the parties cannot always predict all future contingencies.\textsuperscript{129}

The following analysis correspondingly assumes that to some extent the interests of shareholders and managers diverge, so that managers

\textsuperscript{122} See Bebchuk, \textit{Desirable Limits}, supra note 4, at 1458-1468; Bar-Gill, Barzuza & Bebchuk, \textit{supra} note 4, at 7-9. Race to the top proponents also acknowledge that managerial opportunism may lead to managers favoring corporate law with inefficient redistributive rules. See Winter, \textit{Race for the Top Revisited}, \textit{supra} note 3, at 1528 (acknowledging that there are “cases in which management may seek legal rules allowing side payments where those payments outweigh the negative effects of the capital market”); \textit{Easterbrook \& Fischel, Economic Structure}, \textit{supra} note 3, at 217 (“once they are ensconced, and have raised the capital the firm needs, managers may elect to behave opportunistically”); Fischel, \textit{supra} note 3, at 918 (“In any agency relationship — such as the relationship between shareholders and managers — the interests of the agent will diverge from those of the principal”).


\textsuperscript{125} See Bebchuk, Fried & Walker, \textit{supra} note 124, at 777-778; Bebchuk, \textit{Desirable Limits}, \textit{supra} note 4, at 1462-1463.

\textsuperscript{126} See Bebchuk, \textit{Desirable Limits}, \textit{supra} note 4, at 1467-1470.

\textsuperscript{127} See Bebchuk, \textit{Desirable Limits}, \textit{supra} note 4, at 1466-1467; See Bebchuk, Fried & Walker, \textit{supra} note 124, at 778; Black, \textit{supra} note 23.

\textsuperscript{128} See Bebchuk, \textit{Desirable Limits}, \textit{supra} note 4, at 1465-1466; See Bebchuk, Fried & Walker, \textit{supra} note 124, at 778.

might seek inefficient rules that benefit them at the expense of shareholders.

2. Managers Differ in their Willingness and Ability to Extract Private Benefits of Control

Another assumption that is not discussed in the literature but is important for the purpose of this Article relates to differences among managers in their ability and willingness to extract private benefits of control. For many reasons managers are not identical but rather vary in their ability and willingness to extract private benefits and, accordingly, in their preferences with respect to the corporate laws that govern the firms they run.

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

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

D. Price Effects and Managerial Favoritism

A major question in the market for corporate law is how managers’ power over incorporation decisions affect states’ legislative incentives. In this section, I will illustrate the central role price considerations play in answering this question. To that end subsection 1 demonstrates how the price that Delaware charges for reincorporations and initial incorporations depends on the balance between shareholders’ and managers’ interests in its laws. Having analyzed the effects of price considerations, subsection 2 discusses Delaware’s expected choices in light of price considerations, and predicts how these choices are expected to change over time.

1. Delaware’s Trade-Off: Managerial Favoritism Requires

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

131 See Bebchuk, Desirable Limits, supra note 4, at 1476-1478 (analyzing agency problems in companies with a dominant shareholder); See also Kahan & Kamar, The Myth, supra note 5, at 740 (noting that the influence of managers and shareholder on reincorporation decisions varies across different ownership structures).

132 See Romano The Need for Competition, supra note 3, at 535-537 (arguing that institutional investors restrain managers from choosing regimes with strong antitakeover law); ROMANO, THE GENIUS, supra note 3, at 68-69 (describing how institutional investors forced managers to opt out of Pennsylvania’s disgorgement statute). See also Kahan & Kamar, The Myth, supra note 5, at 740 (suggesting that the influence of managers and shareholder on reincorporation decisions depends, among other things, on the amount of stock held by institutional investors).
Delaware to Reduce its Price

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

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

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

If, however, Delaware increases the agency costs of its rules to the point at which its overall quality just barely exceeds the next best state, it can no longer charge a higher price than its competitors, because it does shareholders will not approve managers’ reincorporation initiatives. To assure shareholder approval for reincorporation to Delaware, it would have to reduce the price it charges by an amount equal to the harm caused to shareholders from adopting inefficient redistributive corporate rules. Otherwise, some of the other states, in which the local bar is strong, will be able to lock in their firms by catering to the interests of shareholders, who would then not approve reincorporation to Delaware. The more pro-managerial Delaware law is, therefore, the less Delaware is able to charge each firm it attracts.

Recall however that to attract firms from other states Delaware needs to cater to the interests of managers, otherwise other states will be able to lock in their firms by catering to managers’ interests, which managers in turn would not initiate a move to Delaware. In addition, degrading its rules toward managers also helps Delaware in retaining its own corporations. Since managers have the power to initiate reincorporations, a useful way for Delaware to prevent its existing firms from leaving is to make sure that managers are satisfied. The more pro-

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133 See CARLTON & PERLOFF, supra note 10, at 87-92; TROLE, supra note 10, at 65-69.
134 See Bar-Gill, Barzuza & Bebchuk, supra note 4. The paper constructs a formal model of the market for corporate law. In equilibrium, the price that Delaware charges is bounded by three constraints, one of them is the value of its competitive advantages (e.g., legal infrastructure and network externalities), minus the harm caused to shareholders from the adoption of inefficient redistributive rules.
135 Some of the states will not adopt this strategy even though it helps them in retaining incorporations either because the local bar in these states is not sufficiently influential or because local managers have stronger influence than the local bar.
managerial Delaware's law is, therefore, the more managers it attracts and retains.

To demonstrate this point, assume that Delaware has to choose its corporate law from among three possibilities. X is the most pro-managerial structure, Z is the optimal structure maximizing shareholder value, and Y is in the middle; that is, a bit less pro-managerial and more efficient than X, but not as optimal as Z. Assume also that all of the managers prefer Y to Z, and that while some of them, the most opportunistic ones, prefer X to Y, the others do not.

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

If, instead of rule Z, Delaware adopted rule X, both the quantity of firms it could attract from other states and the price it could charge those firms would change. With the X rule, Delaware would be able to attract all the firms. Other states could not lock in their managers. Even if the other states offer the X rule, managers would prefer Delaware since it offers additional advantages. In addition, none of the managers in Delaware would want to migrate out of it. In order to secure shareholders approval, however, Delaware would now have to reduce its price to reflect the losses caused to shareholders by having rule X instead of rule Z. Otherwise, other states could lock in their corporations by offering Z to shareholders who in turn would not approve a move to Delaware. If, and only if, Delaware offers a price that reflects shareholders costs from having rule X relative to Z, will it be able to prevent other states from locking in their corporations.\footnote{It is worthwhile noticing that Delaware needs to reduce its price even if the other states eventually, in equilibrium, adopt X as well. If Delaware does not reduce its price to reflect shareholder costs, other states will be able to lock in their corporations by offering Z. See Bar Grill, Barzuza & Bebchuk, supra note 4.} If the harm that is caused by X is sufficiently large, Delaware would have to charge a zero or even negative price to get shareholder approval for reincorporation.

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

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

b. The Price that Enables Delaware to Attract Initial Incorporations

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

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

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

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

Since we know that firms in their initial incorporation stage choose Delaware rather than their home state even when their home state offers rules that are better for shareholders, it is clear that Delaware, in choosing its price, takes into account the effect of its rules on the value of the firms it attracts; that is, it charges a price that is not higher than the value of its specialized judiciary, developed body of case and administrative system minus the costs imposed by its pro-managerial rules.

2. The Results of Delaware’s Trade-Off

a. Static Effects

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

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

Since Delaware takes into account also the effects of its strategies on the price that it charges, however, its pro-managerial policy is

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137 See Subramanian, supra note 2, at 1854-1855.
140 See Subramanian, supra note 2, at 1820-1822, note 100 (Reporting that around 40% of the reincorporation of IPO firms to Delaware were from firms headquartered in California).
constrained. Delaware’s strategy, instead, is not to eliminate its advantages completely relative to other states. In particular, it will maintain a balance between managers and shareholders so that the costs imposed by its rules on the shareholders do not reduce the value of incorporation in Delaware to less than the tax it charges.  

b. Dynamic Effects

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

Since firms continue to incorporate in Delaware in large proportions, the advantage of a Delaware charter is constantly increasing. Firms that join Delaware increase the likelihood of judicial rulings on Delaware corporate law, and, therefore, impose interpretive network externalities on their peers that are also governed by Delaware law. Firms that join Delaware also increase the incentives for the financial and legal services industries to invest the fixed costs required to research Delaware law.

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141 Theoretically, Delaware could have chosen one of the following extreme options: First, Delaware could choose to attract all of the firms in the market even if that would require it to charge a zero price. Second, Delaware could choose the other extreme possibility which is to offer optimal rules, charge the highest price it can and as a result forgo luring firms from other states, and risk some of its existing firms – those firms whose managers have sufficient power to get shareholders approval for a migration to an inferior state. It is not likely, however, that such a corner solution would be more profitable than an intermediate one. More important, we know from reality that Delaware had chosen an intermediate path. First, Delaware has not chosen rules that cater to all of the managers in the market. Many managers choose to remain in their home state and use their influence on the state to adopt antitakeover rules that provide them with stronger protection than that provided by Delaware. Second, we know Delaware has not chosen the second extreme, namely, to forgo luring firms from other states, since Delaware attracts firms from states that are known for their pro-shareholder law, such as California. See Subramanian, Incorporation Choice, supra note 2, (reporting that over the period 1991-2000 out of the 208 firms that reincorporated in Delaware 84 came from California). Shareholders approve reincorporations in such numbers from California to Delaware probably because the price that Delaware charges does not exceeds the value that is generated by Delaware's corporate law system minus the inefficiency costs imposed by its rules.

142 See Klausner, supra note 5, at 844. One could argue that if every firm that joins Delaware also increases its network benefits maybe Delaware could raise the price with every firm that joins even if it caters to managers' interests. According to this approach, Delaware would have incentives to attract all of the firms in the market. This analysis is not likely to apply since the marginal network benefit of each firm that joins the group is decreasing. Whereas it is crucial for the network externality that Delaware's market share be much larger than the market share of other states, it is much less important whether Delaware attracts 50% or 60% of the market. Under both scenarios Delaware would have a developed body of case law, its judges would remain experienced and law firms in New York and other major corporate law markets would specialize in Delaware law. The marginal harm that results from catering to managers' interests, however, is expected to increase since the inefficiencies in enabling managers to extract private benefits are expected to increase. The more Delaware caters to managers' interests, therefore, the lower is the price it is able to charge.

143 See id. at 775-779.
Since these services involve economies of scale, by joining the group of Delaware corporations, firms reduce the marginal costs of these services to other group members. Accordingly, as the number of firms incorporated in Delaware increases the value of its charter increases.\footnote{\textit{See id.} at 782-785. To be sure, the number of incorporations also increases in states other than Delaware. However, in many of the states the number of firms has not reached a threshold necessary to exhibit network externalities. Moreover, it is not only the absolute number of Delaware firms that increases over time; Delaware’s market share is also increasing. As a result, even if incorporation in other states entails network benefits, Delaware is constantly increasing the gap between itself and other states.}

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

E. Price Effects and Quality

The role of price considerations is also important in analyzing Delaware’s willingness to invest in its corporate law and improve it as to issues that do not involve conflicts of interest between managers and shareholders. Recall that scholars were concerned that, given the presence of network externalities in the market for corporate law, Delaware’s market dominance reduces the competitive threats from other states and, in turn, weakens Delaware’s incentives to invest in innovation and modifications to its law. In addition, a general concern has been raised that, as a result of its monopolistic power, Delaware’s incentives to invest in the quality of its product are not optimal. I will discuss these two arguments in their order.

First, I would like to analyze how price considerations influence the adverse effects that network externalities might have on Delaware’s incentives. Assume, for example, that another state, say Nevada, offers better corporate law than Delaware offers. Since Delaware law exhibits network externalities, incorporating in Delaware is more valuable than incorporating in Nevada. If, however, all of the firms migrate to Nevada, so that network externalities could pass from Delaware law to Nevada law, all of the firms would have been better off. However, uncertainty and delay might prevent such migration from happening.\footnote{\textit{See Klausner, supra} note 5, at 850.} First, even if firm A prefers Nevada’s law to Delaware’s law it might not be certain that other firms prefer it as well. Since Nevada law is more valuable only if all of the firms move together none of the firms would take this risk. Second, even if firm A believes that after it moves other firms would progressively migrate to Nevada, the time that might pass until the migration of the rest might make it unprofitable for firm A to migrate.
During this time firm A would have to incur the costs of not having network externalities. For instance, it would have to pay extra hours for its lawyers that would need more time to learn Nevada’s law than Delaware law which they may already know. If none of the firms wants to be the first, migration might not occur even if it would have been profitable to the firms as a group to have it.

The purpose of this section is to argue that this analysis is applicable if Delaware only maximized the volume of incorporations. Yet price considerations incentivize Delaware to invest in innovations and modifications to its law notwithstanding the significant network externalities and the absence of competitive threats. Although network externalities do significantly impair the credibility of threats by other states to lure firms from Delaware, which in turn reduces Delaware’s incentives to invest in improving its corporate law, competitive forces are not the exclusive source for Delaware’s incentives. The ability of Delaware to extract, either partially or completely, the value generated by its law through the price that it charges may produce incentives for Delaware to increase this surplus. Price considerations, therefore, are likely to induce Delaware to invest in innovations and modifications notwithstanding the existence of network externalities and the absence of competitive threats.

In the economic literature, the analogous case is the one presented by Katz and Shapiro, which, as opposed to Farrell and Saloner, does not assume prices to be exogenous. Katz and Shapiro distinguish between two cases. In the first, free entry into supply of technology leads to marginal cost pricing. In that case, the basic intuition developed by Farrell and Saloner and adopted by Klausner applies. The technology that is superior today has a strategic advantage and can become, therefore, locked in as the standard. If, however, “a single firm controls the property rights to a given technology or if there are other entry barriers into the supply of that technology, then a supplier will be willing to make investments in the form of penetration pricing to establish the technology because such investments can later be recouped by pricing in excess of marginal costs.” Such a firm is defined to be a

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146 To be sure, firm A always has the option to hire a Nevada lawyer for that purpose. Yet, this might have costs as well. Firm A might have its headquarter located in New York and therefore prefers to work with a New York Law firm, or it might prefer to work with a national law firm or it might want to continue working with the firm which it usually uses.

147 See Michael L. Katz & Carl Shapiro, Technology Adoption in the Presence of Network Externalities, 94 J. POL. ECON. 822, 823 (1986) [hereinafter Katz & Shapiro, Technology Adoption] (constructing a model of the dynamics of industry evolution in a market with technological change). The Farrell & Saloner model, applied by Klausner to demonstrate the lock-in effect, produces different results because the Farrell & Saloner model treats prices as exogenous. See Farrell & Saloner, Installed Based, supra note 68, at 943 (stating that their analysis applies “if the technologies are competitively supplied”, which is not the case in the market for corporate law).

148 See Katz & Shapiro, Technology Adoption, supra note 147 at 825.

149 Id.
“sponsor”, since it sponsors the entrance of a new product in the first instance until all firms adopt the product.\textsuperscript{150}

The problems of uncertainty and delay described by Klausner are essentially coordination problems. In cases where it is efficient for firms to move to another product, Delaware can solve the coordination problem by changing the law for all the firms in its jurisdiction. The technique would be to apply the corporate rule as a default rule and let firms opt out of it. Such a technique was practically adopted with respect to the poison pill, and there is no reason to think the same technique could not be adopted with a more efficient term.\textsuperscript{151} Even if some firms would get smaller gains for few financial periods and, therefore, would only be willing to pay less for Delaware law, as in the case of the sponsor in Katz and Shapiro’s model, Delaware would find it profitable to extract smaller profits for a short while in order to increase price in the long run.

Here we encounter the second concern. As explained above, in general, a firm exercising monopolistic power does not necessarily produce an optimal level of quality. In particular, a monopolist might choose the quality preferable by the marginal consumer rather than the average one. The concern for suboptimal choices as to quality arises, however, only when the monopolist needs to charge the same price to all of its consumers.\textsuperscript{152} If the monopolist is able to price discriminate among consumers according to their willingness to pay for the product it would have the right incentives to produce optimal quality. As shown persuasively by Kahan and Kamar, Delaware price discriminates among firms according to the value they attach to Delaware’s product.\textsuperscript{153} Public firms pay more than non-public ones and, within the group of public firms, large firms pay more than small ones. Since Delaware is able to price discriminate it is not more sensitive to the marginal consumer but rather to the average one.

F. Price Effects and Quantity of Firms Delaware Attracts

Raising the issue of price considerations necessarily raises another inefficiency that might result in a concentrated market. Because a producer possessing monopoly power, unlike a firm in a competitive market, can raise its price above its marginal cost without losing all of its consumers it faces a downward sloping demand curve; that is, the more consumers it attracts the less it can charge for the product.\textsuperscript{154} A firm that wants to sell a small quantity can charge a price that only consumers who value its product highly would be willing to pay. If, however, it wants to sell a greater quantity it needs to lower its price so that consumers with lower valuations of the product will also find it

\begin{itemize}
\item \textsuperscript{150} Id.
\item \textsuperscript{151} See Bebchuk & Ferrell, \textit{New Approach}, supra note 3.
\item \textsuperscript{152} See Spence, supra note 56, at 419.
\item \textsuperscript{153} See Kahan & Kamar, \textit{Price Discrimination}, supra note 5.
\item \textsuperscript{154} See CARLTON & PERLOFF, supra note 10, at 87-92; TIROLE, supra note 10, at 65-69.
\end{itemize}
profitable to purchase it. If the producer needs to charge one price to all consumers it faces a trade-off; the more firms it attracts the less it is able to charge each firm. The monopolist will choose the price and quantity that maximizes its profits. Such price is likely to be a higher than the marginal cost of production and, accordingly, at a quantity that is likely to be socially suboptimal. This behavior creates a deadweight loss, since the product is not consumed by all consumers who value it in more than its cost of production.

This distortion, however, is less harmful in our context because it exists to the extent that the monopolist needs to charge a uniform price to all consumers. If, however, a monopolist is able to charge consumers different prices the problem is mitigated. In the extreme case in which the monopolist is able to charge each consumer exactly that consumer's valuation of the product the problem disappears completely. As shown persuasively by Kahan and Kamar, Delaware price discriminates among firms according to the value they attach to incorporation in Delaware. To be sure, Delaware does not charge each firm its exact valuation. By and large, however, smaller firms pay significantly less than larger firms. Thus, in the main, price considerations do not seem to cause Delaware to charge a price that is too high, and as a result to attract a suboptimal number of consumers.

G. Objections and Limitations

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

1. Shareholders’ Ignorance

At first glance, the price considerations theory seems to assume a significant role, maybe too significant, for shareholders. One might argue, however, that shareholders are many times rationally ignorant - they choose not to invest the time and the cost that are required in order to evaluate and compare corporate laws of different states. True, if absolutely all shareholders were to be rationally ignorant, Delaware would not have to lower its price so as to reflect the harm that is caused to shareholders by its pro-managerial rules. In such a world, Delaware's best strategy would be to adopt rules that cater to the interests of all types of managers, including the most opportunistic ones.

However, a reincorporation decision is one of the few in a firm's life in which shareholders are relatively informed about the firm's choices and their implications. Moreover, for price considerations to affect Delaware's choices, it does not have to be the case that all shareholders of all firms have the information that is required. In fact, even if in only a few firms there are such shareholders, Delaware is likely to take price considerations into account, at least to a certain extent.

More important, the decision to incorporate is taken many times at an initial stage, when the firm first decides to go public. Shareholders of
a firm that is looking to maximize its revenues from an initial public offering have considerable incentives to inform themselves of the added-value of different corporate law systems for incorporation. For one, as there are usually a smaller number of shareholders prior to the initial public offering, the shareholders do not face the collective action problem that arises when more than a few shareholders are involved. Second, even if shareholders are not necessarily aware of the difference in corporate law regimes, the firm's valuation in the market is determined, for purposes of determining the initial, market clearing, offering price, by investment banking professionals whose job is to make informed decisions about these matters.

2. The Delaware Bar Maximizes Incorporations not Revenues

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

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

3. Delaware Judges do not Consider Price

It might be argued that the analysis above, even though it describes the interests of the members of Delaware's legislative branch, does not apply to Delaware judges, who play a central role in designing Delaware's law. Judges are not at all expected to take into account the interests of the state, they don’t maximize anything but rather are true to their heart and to their understanding of the law.

155 See generally Macey & Miller, supra note 108; Carney, The Production, supra note 84.
156 See Macey & Miller, supra note 108, at 503-504.
157 See id.
158 See id.
159 See id.
For several reasons, there is ample ground to believe that Delaware judges decide cases is a way commensurate with the price considerations analysis described above, even if not deliberately so. For one, it is not at all clear that judges would ignore the state's interest in revenues. For several reasons, it is quite possible that they would take these interests into account.\footnote{See Bebchuk, Desirable Limits, supra note 4, at 1453 n. 74. (detailing the reasons for why Delaware judges design the law according to the state's goals, under the assumption that Delaware's goal is to maximize the volume of incorporations).} First, Delaware judges are certainly aware of the important role that the franchise tax has in the Delaware budget. Second, judges are not completely isolated from influence. To be sure, Delaware judges in the Supreme Court and the chancery court are appointed based on merit for a period of twelve years. However, they are appointed by the state governor, with the consent of the state senate, and might, as a matter of human nature, tend to satisfy those who appointed them.\footnote{Id.}

Lastly, they are aware of the fact that if they choose a direction which is not reconcilable with the state's goals the legislature might overturn it. For instance, the decision of the Delaware Supreme Court in \textit{Smith v. Van Gorkom},\footnote{Smith v. Van Gorkom, 488 A.2d 858, 874- 78, 881 (Del. 1985).} which increased directors liability and could have caused a migration of firms from the state, was followed promptly by the adoption by the legislature of section 102(b)(7) of the Delaware General Corporation Law,\footnote{Del. Code Ann. tit. 8, §102(b)(7) (1991).} which enables companies to limit directors' liability.\footnote{Id.}

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

Lastly, in our case, the approach that would maximize revenues for Delaware is reconcilable with a judicial view. Judges may see the goal of balancing between managers' and shareholders' interests as appropriate.

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

\footnote{Id.}
4. Other States do not Compete with Delaware

As mentioned at the outset, this analysis does not assume that other states are likely to compete with Delaware. Moreover, even if the other states are not strategic at all in their choices, meaning that they will continue to do what they do today no matter what Delaware does, price considerations analysis still applies.

In order to attract firms from other states and to maintain its own firms Delaware needs to cater to managers’ interests. Even if no other state behaves strategically or plans to attract incorporations, there are several states that offer pro-managerial rules. If Delaware does not protect managers, not only would it be impaired in its ability to attract incorporations but it also would risk a migration of managers to one of these other states.

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

5. The Tax that Delaware Charges is Low and therefore Negligible

There are two different versions to this argument. The first challenges the significance of price considerations on the basis that the tax that Delaware charges is bounded from above. The second questions the relevance of price considerations given that other states cannot compete with Delaware by cutting prices. These two will now be addressed in that order.

a. The Argument that the Tax is Bounded from Above

Unlike a typical supplier, Delaware charges its price, or at least a significant part of it, through a franchise tax, the amount of which is statutorily set. If, like the typical producer in the market, Delaware were to change its franchise tax to reflect changes in the market, such as the demand for the product or its quality, there would be no real significance to the fact that it uses a franchise tax to charge its price. It seems, however, that with respect to its price policy, Delaware does not act like the typical producer in the market. Delaware rarely increases it tax rates.
In fact, Delaware did not change its tax rates at all during the last ten years.

The fact that the franchise tax might be difficult to change does not at all refute the price considerations analysis or make it any less relevant. A rigid franchise tax simply means that Delaware will produce rules that are less pro-managerial than it would if it were charging a lower price and more pro-managerial than it would if it were charging a higher price. Hence, the conclusion that balancing price considerations with quantity considerations restrains the pro-managerial tendencies in Delaware corporate law holds even if Delaware's tax is rigid or constrained. By reason of the same principles, the extent to which Delaware will take care of shareholders' interests is affected by the structure of its franchise tax. If Delaware's ability to increase its tax rate is limited then its incentives to improve the quality of its corporate law are also limited by the upper bound of its franchise tax. Delaware is incentivized to protect shareholders' interests in order to be able to charge the current price that it has set. Delaware has no incentives, however, to protect shareholders beyond this limit because it cannot easily charge a higher price for that protection.

b. The Argument that Other States Cannot Challenge Delaware by Cutting Prices

One may argue that, because Delaware charges a relatively low price, and other states cannot challenge it by cutting prices, price considerations are not relevant. The fact that other states cannot compete with Delaware just by cutting prices, however, is reconcilable with the foregoing analysis. Since Delaware charges a price that is not higher than the value generated by its unique advantages, other states can challenge it by price cutting only if they charge a negative price. The value that arises from incorporation in Delaware depends, among other things, on the rules that Delaware chooses to adopt. The better these rules are, the higher the price that Delaware can charge is, such that other states would not be able to challenge Delaware other than by offering a negative price.

IV. IMPLICATIONS: PREDICTIONS AND ASSESSMENT IN LIGHT OF THE EVIDENCE

Part III developed a new analysis of the market for corporate law that incorporated price considerations. I now turn to analyze the implications of that analysis for the evaluation of the current system. Discussing the predictions of the theory, it will be shown that, unlike existing theories, the price considerations theory is able to account for recent developments in Delaware corporate law and that, in contrast to existing theories, it is fully in accord with and is able to explain all currently existing empirical evidence.
A. Delaware Law

1. Shareholder Protection

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

One area in which this trade-off is reflected is Delaware's antitakeover law, an area in which the conflicts of interest between shareholders and managers are expected to be most acute. Managers prefer rules that allow them to impede takeovers, regardless of the inefficiency costs these rules impose on the firms they run, because such rules help them retain their jobs and extract private benefits. Delaware’s policy on takeover law has been, on the one hand, to offer its managers substantial powers to resist hostile takeovers, but on the other, not to provide them with the most potent tools that exist in the market.

The antitakeover tools with which Delaware has equipped its managers are considered excessive by scholars from all sides of the debate. Race to the top proponents however, have emphasized that, with respect to its antitakeover law, Delaware stands as an anomaly in consistently keeping its antitakeover law relatively mild. Delaware enacted its first antitakeover statute seven years after similar statutes

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165 See Bebchuk, Desirable Limits, supra note 4, at 1468.
166 See Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 600-601; Bebchuk & Ferrell, The Race to Protect Managers, supra note 4, at 1178-1191 (analyzing the entrenching effects of Delaware takeover law); Lucian A. Bebchuk, John C. Coates IV & Guhan Subramanian, The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy, 54 Stan. L. Rev. 887 (2002) [hereinafter Bebchuk, Coates & Subramanian, Staggered Boards] (showing how the combination of classified boards and poison pills in some Delaware firms significantly impedes takeovers).
167 See Romano, The Need for Competition, supra note 3, at 531-537.
168 See, e.g., Bebchuk & Ferrell, The Race to Protect Managers, supra note 4, at 1193-1197 (citing race to the top scholars’ objections to states’ antitakeover laws); Easterbrook & Fischel, Economic Structure supra note 3, at 221-22 (1991).
169 See Romano, The Need for Competition, supra note 3, at 530-537 (arguing that race to the bottom proponents did not adequately addressed the fact that “the state with the largest stake in the chartering business, stands out as an anomaly in the pattern of takeover legislation”); Romano, Competition for Corporate Charters, supra note 12, at 858-59 (emphasizing that Delaware’s antitakeover law is less draconian than the antitakeover law in some other states, such as Pennsylvania, and that Delaware was not the leader but the follower in adopting antitakeover rules); Easterbrook & Fischel, Economic Structure, supra note 3, at 222-223 (stressing that Delaware's antitakeover law is relatively mild).
were introduced in other states.170 Delaware did not adopt a second generation statute before other statutes were upheld by the Supreme Court in CTS Corp. v. Dynamics Corp. of America171 even though twenty other states did so.172 Eventually, it adopted only one statute, which is relatively mild, while most other states adopted three, four and in some cases five antitakeover statutes.

The Delaware Court also did not write boards a blank check to block takeover bids, but instead adopted a moderated approach, in Unocal, limiting the use of the poison pill to a proportional response to a recognized threat.173 Furthermore, if there was still some doubt about it after Unocal the Chancery Court made it clear in Interco that managers could not use the pill arbitrarily, by forcing the board to redeem a pill in the face of a non-coercive takeover bid.174 The use of the pill by the incumbent board to block a non-coercive bid, the court ruled, is limited to a short time period in which the board could seek a higher offer.175 This approach was so moderate relative to other states that it triggered Martin Lipton’s famous memo recommending that his clients consider moving out of Delaware.176

To be sure, by the end of the 1980s Delaware case law empowered managers to resist takeovers vigorously. In Paramount Communications v. Time the Delaware Supreme Court rejected Chancellor Allen’s view in Interco.177 Scholars argued that the court’s reasoning suggested that “almost anything would be considered a legitimate threat justifying the use of potent defensive tactics.”178 Yet, if Delaware was racing to the bottom, why did it take it so long? Moreover, even today the protection that Delaware provides managers with is not as strong as that provided by many other states. As noted above, Delaware did not match Massachusetts’ staggered board statute or Pennsylvania’s or Ohio’s disgorgement statutes.179 More importantly, the protection that Delaware offers is not as certain and strong even when compared to many of the remaining states. Delaware neither adopted the statutes known as the “other constituency statutes” which permit management, in deciding whether to resist a bid, to take

170 See Romano, The Genius, supra note 3, at 59; Romano, The Need for Competition, supra note 3, at 531.
172 See Romano, The Need for Competition, supra note 3, at 531-532.
174 City Capital Associates Limited Partnership v Interco, 551 A2d 787 (Del Ch 1988).
175 Id. at 798.
176 See Martin Lipton, To Our Clients: The Interco Case, Nov. 3, 1988 (“private” mailing available to corporate America). Lipton mentioned specific states that provide stronger antitakeover defenses as possible destination states: “The Interco case and the failure of Delaware to enact an effective takeover statute, raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.” See id.
178 Bebchuk & Ferrell, New Approach, supra note 4, at 120.
179 See supra Section II.C.1.
into account interests other than those of shareholders, nor pill-validation statutes, which were adopted by the majority of the states.\textsuperscript{180}

With the fact specific approach of the Delaware Chancery Court, managers have no certainty that their defense will always be accepted, as the case would have been with a pill validation statute. Indeed, as vice chancellor Strine opined recently, the fullest possible availability of the poison pill defense is uncertain even following \textit{Paramount}.\textsuperscript{181} Generally, even today, as stated by Strine together with vice chancellors Jacobs and former chancellor Allen "[i]t is ... doubtful that courts would establish a 'bright line' precedent that gives boards a carte blanche to 'just say no'."\textsuperscript{182} Second, the Delaware court has rejected stronger defenses, such as the dead hand pill that is statutorily authorized in Virginia.\textsuperscript{183} Indeed, Robert Daines found that between the years 1980-1996 firms in Delaware were more likely to be the subject of a takeover bid and to be acquired. Third, Delaware's default law imposes the shortest delay on hostile bids among all states.\textsuperscript{184}

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

During the 1980s Delaware's market share increased by more than 20%.\textsuperscript{185} At the same time, its tax rates hardly even kept up with inflation rates. A few reasons may explain Delaware's abstention from raising its tax rates, among them pressure from the Delaware bar or a concern about triggering federal intervention. Instead of raising its tax, however,
Delaware used its increased market power to attract more corporations. With more features benefiting shareholders, Delaware could become more pro-managerial without having to lower its incorporation prices. And so it did. Delaware’s pro-managerial bias has increased in tandem with the increase in its market power.

2. Innovations and Modifications

The price considerations theory of regulatory competition illuminates Delaware’s incentives with respect to rules that do not involve conflicts of interest between shareholders and managers. If Delaware were only trying to maximize the number of incorporations, given that it faces no serious competitive threats, it would not be expected to invest in the quality of its law.

Since investing and improving its corporate law enables Delaware to charge a higher price to the firms it attracts, Delaware is incentivized to invest in its corporate law and improve it more than it would be if it were just maximizing the number of incorporations. Keeping price considerations in mind, Delaware’s interest in legal innovation becomes clear, even in the absence of any competitive threats.\(^{186}\)

The predictions of price considerations theory are consistent with Delaware’s actual behavior. Delaware is, and has consistently been, one of the first states to adopt major corporate law innovations.\(^{187}\) In fact, Delaware lagged behind other states only with respect to changes in antitakeover laws,\(^{188}\) which have been found to have adverse effects on firm value.\(^{189}\)

B. Other States’ Law

1. Shareholder Protection

The price considerations theory of the market for corporate law predicts that many states other than Delaware would tend to offer stronger protections for managers than those offered by Delaware. We have seen that Delaware prices its package in a way that ensures that it would be better for the managers of some of the firms in the market. Given Delaware’s strategy, the other states have no way to retain the firms Delaware chooses to attract, that is, the firms whose managers find Delaware’s law to be sufficiently protective. Offering rules that are more pro-managerial than the ones Delaware offers would not make much of a difference for the managers who either cannot or do not plan to extract

\(^{186}\) This result is consistent with Kahan and Kamar, though Kahan and Kamar do not explain how they overcome the network externalities problem. See Kahan & Kamar, The Myth, supra note 5.

\(^{187}\) See Romano, Law as a Product, Supra note 3, at 237-240.

\(^{188}\) See ROMANO, THE GENIUS, supra note 3, at 59; Romano, The Need for Competition, supra note 3 , at 531-532.

more private benefits than is currently possible in Delaware. Offering rules that benefit shareholders wouldn’t help either because, for the shareholders in these firms, Delaware offers unique advantages, in the form of a specialized judiciary and network externalities, which make its package better than the package any other state can offer.

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

To be sure, most states have no strong financial motives to attract and retain incorporations. As explained above, states other than Delaware cannot charge a significant price to out-of-state firms, and are not interested in charging a significant price to in-state firms.

In many states, however, the local bar significantly influences the design of state corporate law. In choosing between the interests of managers and shareholders, the local bar tends to prefer rules that are likely to maximize the number of in-state incorporations. Price considerations analysis suggests that, to that end, states will adopt antitakeover law that is more favorable to managers than that enacted by Delaware because, only by this means, can they prevent some firms, those with managers with a high preference for protection, from leaving.

Support from local management is likely to reinforce states’ tendency towards producing stronger pro-managerial rules than Delaware’s. Managers who prefer their home state over Delaware would likely desire strong antitakeover devices. Had they found Delaware’s protections sufficient, they most likely would have chosen Delaware. Lastly, it is worthwhile to note that choosing a strategy that caters to managers’ interests does not require a special investment from the states and is not more expensive than adopting a different strategy. For all of the reasons mentioned above, even though these states do not extract substantial financial benefits, they might still design their rules to retain as many corporations as possible.

The tendency to adopt rules that provide stronger protection to managers is manifested in the antitakeover rules of many states. Many states adopt rules that provide their managers with stronger antitakeover

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190 See Carney, The Production, supra note 84, at 737-49 (noting that many corporate law changes were initiated by lawyers).
191 See Macey & Miller, supra note 108, at 503.
192 Some firms might stay in their home states for reasons other than strong antitakeover law but evidence show that the choices of many firms are affected by the strength of antitakeover rules. See Bebchuk & Cohen, supra note (providing evidence that more firms tend to remain in their home states if these states have adopted antitakeover statutes)
devices than the ones offered by Delaware. Consistent with the price considerations analysis, in many cases the adoption of antitakeover devices was supported by local managers and the local bar.\footnote{See Carney, The Production, supra note 84, at 750-752 (noting that most of antitakeover rules were sponsored either by managers or by the local bar); Roberta Romano, The Future of Hostile Takeovers: Legislation and Public Opinion, 57 U. CIN. L. REV. 457, 461 N.11 (1988) [hereinafter Romano, The Future of Hostile Takeovers].}

To sum, states’ tendency to enact laws exhibiting greater pro-managerial bias than Delaware depends on the extent to which local interest-groups push in that direction. In-state politics may, in some cases, push the other way. If so, the analysis suggests, these states would end up losing many firms to Delaware. To be sure, these states may still retain some firms that prefer to remain in their home state for reasons other than corporate law provisions offered by their home state.\footnote{For example, firms might choose to remain in their home state in order to save the costs associated with incorporating out of state. See Bebchuk & Cohen, supra note 4 (finding that small firms, for whom the costs of incorporating out of state are relatively large, have a stronger tendency to remain in state).} Yet, the states that cater to managers’ interests will succeed both in retaining firms with home state bias and in retaining firms whose managers find Delaware law insufficiently protective. These predictions correspond to current evidence showing that enacting strong antitakeover protections is helpful in attracting both local and out-of-state firms.\footnote{See Bebchuk & Cohen, supra note 4, at 22-25.} In addition, the analysis is also consistent with evidence showing that antitakover rules do not help states attract firms in their IPO stage, when there is still no divergence of interests between managers and shareholders.\footnote{See Daines, IPO Firms, supra note 2, at 1589-1560 (finding little support for the argument that antitakeover law affects the domicile choices of IPO firms).}

It is worthwhile noting that, according to the analysis put forth in this Article, the success in attracting incorporations by states that offer strong protection to managers could never match the success in retaining incorporations by these same states. The reason is the requirement of shareholder approval for reincorporation: Managers would rather remain in a state that offers them strong protection than migrate. If however, they want to move to another state to increase their protection, they need shareholders’ approval. Shareholders would give their approval to a migration to a state that has no competitive advantages to compensate them for the efficiency loss due to stronger pro-managerial bias only if they are not informed about such consequences. Such ignorance can be reasonably assumed only in a small fraction of the cases. This analysis is consistent with the findings of empirical research.\footnote{See Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 568-569 (stating that “[o]verall, there is an enormous difference between states’ attractiveness to in-state and out-of-state companies”).} Indeed, as discussed in Section IV.D.2 below, firms that choose not to incorporate in Delaware, in most cases, remain in their home state.
2. Innovations and Modifications

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

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

According to price considerations analysis, since Delaware provides only intermediate protection to managers, the most effective tool that could help states in retaining and attracting incorporations is adopting rules that cater to managers’ interests. On this dimension, price considerations analysis reveals, states are expected to be entrepreneurial and innovative.

This prediction of the theory is also consistent with reality. The only field in which states other than Delaware do tend to innovate is that of antitakeover rules. According to price considerations analysis this is also one of the few fields that are worth the investment for states, since not all of the managers would find Delaware law to fit their preferences.

C. Delaware’s Superiority

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

Under this framework of analysis, firms incorporated in Delaware should have higher values because Delaware is expected to produce better corporate law than the law in the other states and to attract, as a result, firms with better managers (i.e., a lesser number of the most opportunistic managers). Managers who do not choose Delaware are most likely primarily motivated by a belief that Delaware’s law is not sufficiently protective of managers' interests; the most opportunistic managers, therefore, prefer to incorporate in other states. Interestingly, Robert Daines suggests that differences between managers who choose

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198 See Kahan & Kamar, The Myth, supra note 5, at 703-705 (stating that “[t]he single most important field for statutory innovation in corporate law … has been statutes designed to assist management in fending off unsolicited takeover bids”).

199 See Daines, Firm Value, supra note 3.
to incorporate in Delaware and managers who choose not to could drive his results.200

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

D.Patterns of Incorporations

1. Not All Firms are Expected to Move to Delaware

Price considerations analysis is also consistent with observed patterns of incorporations. As discussed throughout this Article, Delaware’s pro-managerial laws are sufficient to attract some but not all managers and, consequently, while some managers initiate reincorporation to Delaware, others do not. One of the puzzling issues in the market for corporate law relates to Delaware’s market share. Delaware attracts most of the market but not all of it. If Delaware is that good, why isn’t it good for everyone? What makes some firms choose to remain in their home state rather than incorporating in Delaware?

Since firms that do not choose Delaware choose to remain in their home state, it has been suggested that home state bias prevents firms from incorporating in Delaware. For example, it has been suggested that small firms that use local law firms might be advised by their law firms to incorporate in the home state. However, it has been shown that states that offer strong antitakeover protection succeed more in retaining in-state firms than the states that don’t.201

The prediction of the price considerations analysis adds another possible explanation for the fact that firms choose to remain out of Delaware -- Delaware deliberately targets only part of the market. Firms that reveal home state bias are not necessarily firms that Delaware could not attract under any possible strategy. If Delaware wanted to attract more firms it could have done so by adopting stronger antitakeover laws, but it would have had to reduce its price further. Price considerations analysis, therefore, provides an additional criterion to identify firms that will tend to remain in their home state instead of migrating to Delaware.

200 See Daines, Firm Value, supra note 3, at 553. (“Note that there is one endogeneity account that is consistent with the evidence. If Delaware law facilitates the sale of the firm, good managers might be more likely to incorporate there because they have less reasons to fear disciplinary takeovers. Poor managers, or those valuing private benefits would thus avoid Delaware incorporation because it would be more costly”).

201 See Subramanian, Incorporation Choice, supra note 2 (finding that, in general, adopting antitakeover rules helps states in attracting and retaining incorporations, except when these rules are especially draconian) Bebchuk & Cohen, supra note 2 (finding that adopting antitakeover rules helps states in attracting and retaining incorporations). According to one study, antitakeover laws do not make a difference for firms in their IPO stage. See Daines, IPO Firms, supra note 2, at 1589-1590.
The firms who do not choose Delaware are those whose managers find Delaware law insufficiently protective for them.

2. Home State Bias

Price considerations theory also provides an additional explanation to why firms that do not choose Delaware remain in their home state rather than incorporate in a third state. Some managers, according to the theory, find Delaware law to be insufficiently protective. If their home state provides them with the protection they desire these managers would choose to remain there. If their home states do not provide sufficiently strong protection these managers prefer to migrate to another state that offers stronger antitakeover protection. Yet, they may be unable to secure shareholders’ approval for such a migration. Since reincorporation requires shareholders’ approval, managers will succeed in advancing their reincorporation initiative only if (1) the other state compensates shareholders for the costs they are to suffer as a result of the stronger antitakeover laws, (2) the shareholders are not fully informed or (3) if the shareholders are induced to approve the move because the reincorporation referendum is bundled with another desirable decision. Because other states, unlike Delaware, do not have significant advantages with which they can compensate shareholders for suboptimal rules, managers would be able to reincorporate there only if one of the last two options occurs, that is, in relatively small number of cases.

The price considerations analysis, therefore, is consistent with evidence showing that firms incorporate either in their home state or in Delaware. In particular, it explains why the decision of where to incorporate is a choice between only two options, Delaware or a firm's home state. Firms that choose to remain in their home state are usually firms whose managers want stronger protection than Delaware provides and whose state provides them with such protection. Whereas managers in these firms could easily decide to use their veto power to remain in their states, it would be more difficult for them to succeed in moving their firms to a third state that they might prefer over Delaware or their home state.

E. The Incentives of Other States to Compete with Delaware

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

202 Obviously, this analysis also explains why states that offer strong antitakeover statutes succeed in retaining their firms more than states that offer weaker protection.
Even if a state other than Delaware offers rules that are optimal to shareholders it would not succeed in attracting firms in their IPO. Given Delaware strategy it would be more profitable for these firms to incorporate in Delaware. Moreover, even if another state changes its switching rules so that shareholders themselves would be able to initiate a move to another state it would still be more profitable for other firms to incorporate in Delaware. To be sure, if a state other than Delaware builds a judicial infrastructure similar to the one Delaware has and offers different switching rules, such a state might be more successful in attracting incorporations. Yet, once other state establishes such an infrastructure Delaware would reacting by cutting its prices and changing its laws.

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

F. Implications for Delaware’s Franchise Tax Law

An important implication of the recognition of price considerations is that it essentially creates a new focus on Delaware’s incorporation tax law. The discussion above has shown that the pricing mechanism provides a producer in such a market with strong incentives to invest in the quality of corporate law. Hence, if Delaware were a typical producer, these incentives would induce it to maintain the high quality of the corporate law it produces. Unlike the typical producer in the market, however, the incorporation price is implemented by a franchise tax law. If this tax is relatively rigid, i.e., if Delaware rarely changes it, the incentives to improve its corporate law are limited by the upper bound on the tax. This difference is important: unlike a typical producer, Delaware can strategically commit itself to a certain price structure that constraints its incentives to protect shareholders interests. Indeed, Delaware’s tax is relatively rigid. Unlike a typical producer Delaware doesn’t change its franchise tax rates frequently.

To be sure, at a level below the maximum rate, the franchise tax is sensitive to some extent to firm value and therefore might induce Delaware to improve its law. However, most of Delaware's franchise tax revenue comes from firms that pay the maximum franchise tax.203 With respect to these firms, an increase in the quality of the law would not lead to an increase in the price Delaware charges. In addition, firms that pay less than the maximum franchise tax would not be charged much more if Delaware increased the quality of its law. Delaware’s franchise tax is computed in two alternative ways. The first one is based solely on the number of authorized shares.204 Firms pay $90 for the first 10,000

203 See Kahan & Kamar, Price Discrimination, supra note 5, at 1251, tbl. 3.
authorized shares and $50 for every additional 10,000 shares. 205 A majority of the firms in Delaware pay according to this method, which method is generally not sensitive to firms’ performance. The second method is based on the product of the assets of the firm and the ratio of the authorized to issued shares, which is defined as the “assumed par value capital” (“APVC”) of the firm. Firms with an APVC above one million dollars pay $200 for each additional million dollars of APVC. Theoretically, this method could be sensitive to some extent to firms’ performance. However, because firms pay the lower of the above two as franchise tax, Delaware’s system is not sensitive to firms’ performance. With the option to choose between the two methods, firms that experience a substantial increase in firm assets do not necessarily have to incur an increased tax payment. Instead, they can transfer to the other method of paying the tax on the basis of the number of authorized shares.

The rigidity of Delaware’s franchise tax limits, to some extent Delaware’s incentives to improve the quality of its law and to protect shareholders. The price considerations analysis implies therefore that the structure of the tax has important implications for Delaware’s incentives. Accordingly, this analysis lends support for federal intervention in Delaware’s current tax structure. 206

V. IMPLICATIONS FOR THEORIES OF REGULATORY COMPETITION

During thirty years of literature the debate over the market for corporate law has not reached a conclusion. Evidence has been adduced to support each side of the debate. Price considerations analysis shows that, because all sides of the debate have overlooked an important dimension, the debate could not have been resolved. As this part shows, price considerations analysis has implications for every side of this debate as well as general implications for regulatory competition theory and its analysis.

A. Race to the Top

The superiority of Delaware law relative to other states' law has been one of the most important building blocks of the race to the top theory. Significant effort has been made to prove that Delaware law is better than the law in other states. Event studies have been conducted to show that a move into Delaware does not decrease and sometimes even increases the market value of firms that take such action. A study by Robert Daines showed that incorporation in Delaware is positively and significantly correlated with having a higher Tobin’s Q ratio. 207 Scholars have compared Delaware law to the law in other states and argued that

205 Id. Firms with less than 3000 shares pay $30, firms with more than 3000 but less than 5000 authorized shares pay $50, and firms with more than 5000 but less than 10,000 authorized shares pay $90.
206 See infra Section VI. C.
207 See Daines, Firm Value, supra note 3.
many other states provide stronger protection to managers than Delaware does.

As the price considerations analysis here reveals, however, Delaware is expected to produce better corporate law than the other states regardless of the direction in which the race is headed. This is so because, unlike other states, the higher the quality of Delaware's corporate law, the more Delaware can charge for it.

The evidence that was regarded by race to the top scholars as compelling is, in fact, of little relevance to the task of assessing the performance of the current system and determining its desirability. In that sense the analysis strengthens the view that the current system produces pro-managerial bias in the corporate law of Delaware and many other states.

B. Race to the Bottom

Price considerations analysis also has implications for the race to the bottom view. Price considerations analysis exposes an overlooked factor that induces Delaware to cater to shareholders’ interests. Race to the bottom proponents have underscored Delaware’s ability to compensate shareholders with its competitive advantages, but they have not recognized that Delaware pays a price for providing managers with protections. They have not, therefore, recognized that Delaware’s pro-managerial bias is constrained by price considerations and, accordingly, have not been able to explain why Delaware does not strengthen its antitakeover law.

C. Weak Competition

Price considerations analysis also has implications for the recent literature that focuses on the concentrated structure of the market for corporate law and its consequences. Contrary to the conventional wisdom, the analysis offered here suggests that Delaware’s market power benefits shareholders. In a competitive market no state could charge a positive price because if it did another state could immediately attract its firms by charging a positive price that is a bit lower. In such a market, none of the states would have incentives to protect shareholders. The analysis in this Article suggests, in contrast to conventional wisdom, that a concentrated market could protect shareholders better than a competitive market. In addition, the analysis suggests that Delaware’s market power induces it to invest in innovations to, and modifications of, its corporate law notwithstanding the network externalities in this market. Delaware's market power allows

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208 To be sure, this is not the only equilibrium that could emerge in a competitive market. If none of the states had market power in equilibrium they might choose to differentiate their products. The fact that the states that compete among themselves do not choose to differentiate their products in the current market indicates that such a scenario is unlikely to happen in a competitive market.
it to capture part of the firms’ surplus, which is higher when Delaware produces efficient rules.

In addition, the analysis developed here provides additional explanation as to why other states do not attempt to compete with Delaware neither by adopting better corporate law, nor by offering better switching rules. By reducing its price to reflect the harm that is caused to shareholders from the pro-managerial rules it adopts Delaware makes its overall package to be superior, for shareholders, to any possible deal offered by any of the other states, including a deal with different switching rules. The only group which other states might hope to retain is the group of firms with the more opportunistic managers and the only tools to achieve that is by rules that provide these managers with better protection than the one offered to them by Delaware.

The fact that other states seem to make efforts only with respect to their antitakeover law, therefore, does not indicate that states other than Delaware do not attempt to compete with Delaware but rather that they do so with the only tools that might make some difference.

D. Race with the Federal Government

The price considerations analysis also has implications to the thesis that Delaware real competition comes from the federal government. First, it suggests that, even when Delaware is not constrained by the fear of federal intervention, during the periods in which, in Roe’s words, Delaware could “breath more freely” there is another constraint on Delaware’s pro-managerial policy, which constraints arise from price considerations. The price consideration analysis therefore is reconcilable with and complements Roe’s theory.209

Second, Roe’s thesis that Delaware designs its law to minimize the risk of federal intervention suggests, as a practical matter, that even if the federal government does not intervene directly in Delaware law the deterrence effect on Delaware leads to similar results. Delaware is choosing the rules that the federal regulator would have chosen if it had to regulate.210 As shown in Part VI of this Article, federal intervention in the form of mandatory replacements of Delaware law is not the optimal form of intervention. Roe’s thesis therefore, strengthens the case for the intervention that is suggested in this Article -- intervention in the tax law.

Lastly, Roe’s thesis could be broadened to Delaware tax law. To minimize the risk of federal intervention in corporate law Delaware might choose to keep its price below a certain threshold. As this Article shows, the ability that Delaware has to increase its price creates incentives for Delaware to protect shareholders and to invest in the

209 For more examples as to how the theories complement each other see discussion supra note 11.
210 See Roe, Delaware’s Competition, supra note 5, at 13 ("I submit corporate law ...as 87.5% federal. Delaware gets to say some of the words, but only as long as the Federal authorities tolerate their script.")
quality of its corporate law. If the price is constrained these incentives are constrained as well. Therefore, another implication of our analysis for Roe’s theory is that the threat of federal intervention, if it applies to Delaware’s price as well, limits Delaware incentives to protect shareholders and invest in the quality of its corporate law.

VI. IMPLICATIONS FOR THE ROLE OF FEDERAL LAW

Having examined the implications of price considerations analysis for the assessment of the current system and for current schools of thought, this Part will analyze the implications of the analysis for the question of the desirability of federal intervention. Section A discusses the implications of the analysis for the question of the desirability of mandatory federal intervention in substantive corporate law. Section B discusses the implications of the analysis for the question of the desirability of federal intervention in rules governing changes to a corporation’s state of incorporation. Section C discusses a novel suggestion for federal intervention in the form of a requirement that the price charged for the corporate charter reflect the competitive value conferred by the corporate law system of the applicable state. Although this suggestion is fully developed in a different paper, I will briefly discuss its features here.

A. Mandatory Intervention in State Corporate Law

The debate over the market for corporate law has focused, in main part, on the choice between federal and state law.211 Opponents of the current system have suggested that federal intervention is required in corporate law, at least as to a certain set of corporate issues.212 Race to the top proponents have opposed any of these suggestions and have even called for expansion of regulatory competition in securities laws.213

The call for federal intervention is generally based on two different grounds. First, it is argued, as to some issues, that the bias in favor of managers is expected to be sufficiently significant to outweigh the

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

212 See, e.g., Bebchuk, Desirable Limits, supra note 4.

213 See Choi & Guzman, Portable Reciprocity, supra note 9; Romano, Empowering Investors, supra note 3. But see Merritt B. Fox, Securities Disclosure in a Globalizing Market: Who should Regulate Whom, 95 MICH. L. REV. 2498, 2501-2506 (1997) (arguing against regulatory choice and advocating instead that the home country of an issuer should regulate the disclosure regime for the issuer regardless of where investors are located or transactions take place).
disadvantages involved in federal regulation.\textsuperscript{214} The second argument is based on recent evidence purporting to cast doubt on the existence of vigorous competition among states.\textsuperscript{215} Because the competitive pressure from other states is actually weaker than has been previously recognized, it has been argued, the potential advantage of state law rules, compared with mandatory federal rules, is significantly smaller than has been suggested by race to the top scholars.\textsuperscript{216}

Indeed such intervention has been pursued several times by the federal government, as a response for presumed inefficiencies in states corporate law.\textsuperscript{217} Most recently, in response to corporate scandals at Enron and WorldCom, among others, Congress passed the Sarbanes-Oxley Act of 2002 which intervenes in issues such as the liability of gate-keepers (i.e., accountants and lawyers that provide services to an issuer) for breaches of fiduciary duty,\textsuperscript{218} audit committee independence,\textsuperscript{219} compensation,\textsuperscript{220} and other issues that were traditionally considered “internal affairs” of American firms.\textsuperscript{221} Moreover, even when such intervention does not occur, the rules that Delaware chooses might reflect the possibility of such intervention. Being aware of, and concerned about, the possibility of federal intervention if the federal government is not satisfied with Delaware's performance, Delaware designs its corporate law so that it does not diverge significantly from the corporate law that the federal regulator would have chosen.

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

\begin{itemize}
\item \textsuperscript{214} See Bebchuk, Desirable Limits, supra note 4, at 1499-1507.
\item \textsuperscript{215} See Bebchuk & Hamdani, Leisuredry Walk, supra note 5, at 608-610.
\item \textsuperscript{216} Id. But see Kahan & Kamar, The Myth, supra note 5, at 735-736 (“unlike Bebchuk and Hamdani … we do not share the assessment that the virtual lack of competition strengthens the case for a mandatory federal corporate law.”).
\item \textsuperscript{217} For a detailed description of all federal intrusions into states’ corporate law see Roe, supra note 5, at 20-40.
\item \textsuperscript{219} Id. § 301.
\item \textsuperscript{220} Id. § 304.
\item \textsuperscript{221} See Roe, Delaware’s Competition, supra note 5, at 39-40.
\end{itemize}
law toward managers’ benefits. Accordingly, over this period, the desirability of federal intervention increased significantly.

On the other hand, however, the analysis exposes an overlooked factor that induces Delaware to restrain its managerial favoritism to some extent and to invest in innovations to, and modifications of, its corporate law. Proponents of federal intervention in corporate law will need to take this into account when they assess the desirability of federal intervention in corporate law. Federal corporate law has several recognized disadvantages relative to state corporate law. State legislators have stronger incentives than federal officials to invest in and improve their corporate law. State legislatures face competitive forces that federal officials do not. Moreover, while revenues stemming from the incorporation business constitute a substantial portion of Delaware’s budget, they would only constitute a small portion of the national budget if a federal regime were chosen. State law makers also have better information than federal officials, simply because they get corrections from the market: a misperception as to the preferences of firms might lead to the migration of firms to other states. A more definitive determination, therefore, of whether federal intervention in corporate law is desirable or not requires further assessment in light of the new factors revealed by the analysis developed here.

B. Choice Enhancing Intervention

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

One suggestion that manages to preserve the benefits of the current system and potentially to improve on it is the proposition for “choice enhancing intervention” promoted by Lucian Bebchuk and Allen Ferrell. Choice enhancing intervention, which intends to increase the

222 See, e.g., Fischel, supra note 3, at 922.
223 See Winter, Shareholder Protection, supra note 3, at 291 (“Because federal legislation does not face direct competition with other legal systems, the behavior of investors under differing rules cannot be observed and we can only theorize about which rules optimize the underlying economic relationship.”). Cf. Romano, The Need for Competition, supra note 3, at 393 (relying on this argument to support regulatory competition in securities regulation).
224 Roberta Romano found that a responsiveness of a state to corporations’ needs is positively correlated to the percentage of state revenues contributed by the franchise tax. See Romano, Law as a Product, supra note 3, at 233.
225 See Winter, Shareholder Protection, supra note 3, at 290.
spectrum of choices that shareholders have and, as a result, also incentivize Delaware to take actions to improve shareholder value, consists of two components.

First, in order that more choices will have some meaning for shareholders, Bebchuk and Ferrell suggest that mandatory rules would create voting procedures that enable shareholders to initiate reincorporation in any state.\(^{227}\) Indeed, as the price considerations analysis shows, under the current switching rules, which provide managers with a veto power over incorporation decisions, all of the states, including Delaware, offer inefficient rules that benefit managers at the expense of shareholders. Giving shareholders power to initiate reincorporation could exert pressure on Delaware to improve shareholder value, or otherwise it would be at risk of losing all of its existing incorporations.

However, even if shareholders have the freedom to opt out of Delaware law other states have weak incentives to compete with Delaware. First, these states could not charge a positive price for out-of-state incorporations. Second, if they change their law to attract corporations, Delaware could match its law to theirs and by these means dissuade shareholders from leaving.\(^{228}\) The federal government, presumably, has better incentives to protect shareholders from expropriation of firm value by management.\(^{229}\) The price considerations analysis, therefore, also supports the second component of Bebchuk's and Ferrell's suggestion for “choice enhancing intervention”: optional federal takeover law. Under their suggestion, shareholders could opt in to (and out of) a federal takeover regime.\(^{230}\)

The effectiveness of Bebchuk's and Ferrell's suggestions, however, hinges on two main factors. First, its usefulness depends on the extent to which shareholders would find it profitable to get informed and to act upon the information they collect. Shareholders clearly invest the time and the costs in order to be informed in some cases, yet in many other cases they do not.\(^{231}\) The pressure on Delaware to improve its law exists only to the extent that shareholders get involved.

Second, an important component in Bebchuk's and Ferrell's suggestions is that it not only expands shareholder choice but also is

\supra\text{Regulatory Competition, 2002 Bus. Law. 1047 [hereinafter Bebchuk & Ferrell, Reply to Critics II] (replying to a critical response by Jonathan Macey); Bebchuk & Hamdani, Leisurely Walk, supra note 5 at 610-612 (grounding the case for such intervention in skepticism about the existence of vigorous competition).}\n
\supra\text{Bebchuk & Ferrell, New Approach, supra note 4, at 147-149.}\n
\supra\text{Id. at 154-155. See also Bebchuk & Hamdani, Leisurely Walk, supra note 5, at 612-614.}\n
\supra\text{Bebchuk & Ferrell, New Approach, supra note 4, at 154-155.}\n
\supra\text{Id. at 143-147.}\n
\supra\text{For a criticism on this aspect of Bebchuk and Ferrell’s proposal see Stephen J. Choi & Andrew T. Guzman, Choice and Federal Intervention in Corporate Law, 87 VA. L. Rev. 961, 989. Bebchuk and Ferrell also acknowledge that the problem of collective action and rational apathy affects shareholder voting. See Bebchuk & Ferrell, Reply to Critics I, supra note 240, at 995-996.}
expected, in turn, to put pressure on Delaware to pay more attention to shareholders’ interests. The more competition Delaware faces the more effective their suggestions would be. However, as we know, Delaware faces almost no competitive threats from other states. The possibility of a competitive threat from a federal incorporation choice is not currently in existence and it is unlikely to be adopted for the foreseeable future.

To be sure, the two arguments mentioned above do not impair at all the desirability of Bebchuk’s and Ferrell’s suggestion. They are intended to draw its limits.

C. Federal Intervention in the Franchise Tax Law

The analysis developed in this Article has examined the role that the price could play in improving the quality of Delaware corporate law. Based on this analysis, this Part suggests that a federal intervention in the incorporation tax system could induce Delaware to improve the quality of its corporate law. While the suggestion for intervention in the tax law is fully developed in a different article, I will discuss here why the analysis presented in this Article lends it support.

1. Federal Intervention in the Form of Pricing Regulation

As the analysis in this Article shows, price considerations restrain the bias in favor of managers in Delaware law and induce Delaware to take into account, at least to some extent, shareholder interests, even if doing so results in Delaware not attracting all of the firms in the market. At the same time, however, it has been shown that Delaware, at least to some extent, would cater to the interests of managers as well. Some form of intervention is required, therefore, in order to improve Delaware's incentives and to better align them with the interests of shareholders.

A federal intervention that could achieve this goal, suggested and elaborated upon by the author elsewhere, is intervention not in Delaware corporate law but rather in the price that Delaware charges, in its franchise tax law. In particular, tying the price that Delaware charges either to profits or to market value, by some measure, could induce Delaware to further improve the quality of its corporate law to enhance shareholders’ benefits.

Recall Winter’s strong argument that Delaware’s corporate law affects both the earnings and the share value of corporations governed by that law. If Delaware permits corporate management to profit at the expense of shareholders, the investment returns to shareholders of firms governed by Delaware law will decline. Inevitably, the prospect of low investment returns will lead to a decline in the value of the shares of those firms. This relation between the quality of corporate law and the performance of the firms could be used to improve Delaware incentives

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232 See Barzuza, Delaware’s Compensation, supra note 17.
233 See id.
234 See Winter, Shareholder Protection, supra note 3, at 256.
in producing its corporate law. With a tax that is sensitive to firm performance the revenues collected by Delaware could be strongly affected by the quality of corporate law it produces. Enticing managers with redistributive inefficient corporate rules might attract more managers, but, at the same time, would impair the economic performance of those firms it attracts and in turn the tax that is charged to each firm.

The effect of such an intervention is similar to the effects of price considerations described above. The virtue of such an intervention is that it could strengthen the importance of the price factor in the trade-off between price and quantity that Delaware already faces. The federal law would determine the tax in a way that enables Delaware to charge a relatively high tax if it produces efficient law but a low tax if it produces inefficient law.

As in the case of Bebchuk’s and Ferrell's suggestion, the proposal to intervene in the franchise tax law does not replace states legislating corporate law but rather is directed at improving their incentives. As a result, this limited intervention preserves the advantages of the current system.

An important virtue of the proposal for intervention in the franchise tax is that its effectiveness does not rely on any action or even awareness on the part of shareholders. As explained above, the suggestion promoted by Bebchuk and Ferrell to empower shareholders relies on activism by shareholders. Shareholders, however, are many times rationally ignorant, and hence might either not participate in a vote, or vote to support the managers’ position even when it is not in their interest.\(^{235}\) Intervention in the tax system is likely to improve the quality of the corporate law produced in the current system, even if shareholders are completely ignorant of such changes since it provides Delaware with independent incentives to invest in the quality of its corporate law.\(^{236}\)

Another virtue of intervention in the tax system is that it does not assume and does not rely on competitive forces. Even if Delaware faced no competition at all, and even if there were no chance that firms would ever migrate from Delaware, Delaware would still have incentives to invest in the quality of its law and to take into account shareholder interests. The reason for this is simple -- if the tax is correlated to firm

\(^{235}\) See Choi & Guzman, supra note 231; Bebchuk & Ferrell, Reply to Critics I, supra note 226, at 995.

\(^{236}\) See Barzuza, Delaware’s Compensation, supra note 17, at 32-44. The proposal for intervention in the franchise tax in fact works even when managers obtain shareholders’ approval for changes of corporate domicile that are not favorable to shareholders. Since all states will be required to enact a proportional tax, managers would not be incentivized to move to another state that offers more pro-managerial corporate law. Even if a state other than Delaware offers a body of corporate law that is more favorable for managers, with a proportional incorporation tax structure it is expected that once it attracts a sufficient number of firms the state will abandon its managerial favoritism policy and enact corporate law more favorable to shareholders.
performance, then tax collections are higher with a high quality law than with a low quality law.\footnote{See id. at 44-52.}

In fact, the way such compensation could incentivize Delaware or any other state with market power is similar to the way in which executive compensation schemes sometimes are designed to align managers’ incentives with shareholder interests. Tying Delaware's revenues to the performance of firms incorporated in Delaware, however, can achieve better results, on a relative basis, for shareholders than tying managers’ compensation to the performance of the firm.\footnote{See id. at 55-61.} Unlike managers, who are risk averse Delaware is diversified. The choices that Delaware makes affect not one firm but thousands of firms from a wide range of industries.\footnote{See Daines, Firm Value, supra note 3, Table 1.} Tying Delaware's compensation to the performance of firms incorporated in Delaware, therefore, would involve much lower costs of risk aversion than is the case for managers.

2. Possible Objections

The analysis below raises and analyzes possible objections to the suggested reform. It presents several criticisms that could be raised against the proposal, discusses the strengths and limits of each such criticism and attempts to provide solutions to the issues raised by each such criticism.

a. General Objections to Federal Intervention

Many legitimate concerns have been raised against federal intervention in corporate law. The current system, it has been argued, provides states, or at least Delaware, with strong incentives to invest in their corporate law,\footnote{See, e.g., Fischel, supra note 3, at 922.} and with information about corporations' needs.\footnote{See Winter, Shareholder Protection, supra note 3, at 291 (“Because federal legislation does not face direct competition with other legal systems, the behavior of investors under differing rules cannot be observed and we can only theorize about which rules optimize the underlying economic relationship.”) Cf. Romano, Need for Competition, supra note 3, at 393 (relying on this argument to support regulatory competition in securities regulation).} Even if the current system suffers from some shortcomings, with federal corporate law things might get worse.

Intervention in the incorporation tax law, however, preserves the benefits of the current system. Delaware has the same information as before, and its incentives are not at all impaired. In fact, under the suggested tax, Delaware would have stronger incentives to invest in the quality of its law than under the current tax, which is bounded from above. The suggested intervention does not require knowledge of corporate law and could reduce the necessity and justification for federal intervention in the substance of corporate law.
b. Political Economy

A number of commentators have pronounced skepticism about the prospect of federal legislation in providing better protection to shareholders than the laws offered by the states. Managers are better organized than shareholders, they argue, and therefore exert stronger political influence. Since, unlike with the states, federal legislation is immune from competitive threats, the asymmetry between managers’ and shareholders’ political influence is stronger and more influential on the federal level than on state level. Contrary to this perception, proponents of federal intervention, most notably Lucian Bebchuk and Allen Ferrell, argue that a federal regulator is likely to provide significantly stronger protection to shareholders than state regulators. In promoting federal intervention in corporate law, Lucian Bebchuk has argued that competitive forces actually push states to produce pro-managerial rules rather than rules that protect shareholders. The federal government, he argues, is at least insulated from these forces.

The argument that the incentives of the federal government are better aligned with those of shareholders is persuasive on few different levels. First, as Bebchuk and Ferrell recently pointed out, in many states, most notably Delaware, shareholders are not residents. Delaware, therefore, is not likely to take their interests into account as long as they agree to incorporate there. Moreover, there is an additional difference between federal and states legislatures. Federal corporate tax is more sensitive to firm performance than Delaware’s franchise tax. If the federal government can cause Delaware to produce more efficient corporate law its own corporate tax collection could be higher.

Lastly, even if federal legislation is more vulnerable to political pressure than state legislation it is not clear how much opposition such an intervention would trigger. As the analysis above has demonstrated, not all managers would oppose such a rule. For many managers in Delaware, Delaware could be less protective than it currently is. It is the marginal managers, the worse managers within the group that choose Delaware that might resist such a change. The marginal managers, however, have much more economic power than political power. A small group might cause Delaware to further degrade its law to attract more

242 See, e.g., Romano, Empowering Investors, supra note 3, at 2386-87; Romano, The Need for Competition, supra note 3, at 537-43; Choi & Guzman, Federal Intervention, supra note 231, at 972-978; Romano, The Future of Hostile Takeovers, supra note 193, at 468-485.
244 See Choi & Guzman, Federal Intervention, supra note 231, at 974.
245 See Bebchuk, Desirable Limits, supra note 4, at 1499-1508; Bebchuk & Ferrell, New Approach, supra note 4, at 157-159; Bebchuk & Ferrell, Federal Intervention, supra note 4, at 1002-1005.
246 See Bebchuk, Desirable Limits, supra note 4, at 1502-1504.
247 See Bebchuk & Ferrell, New Approach, supra note 4, at 155; Bebchuk & Ferrell, Federal Intervention, supra note 4, at 1002-1003.
incorporations. The same group however, is unlikely to have significant political power.

c. Franchise Tax is Negligible

At first glance the reader might doubt the effectiveness of the suggested intervention in light of the relatively low franchise tax rates. For many of the large firms the franchise tax is not significant enough to have a strong effect on their incentives. Yet, for the suggested intervention to be effective there is no requirement that the tax be significant on the firm level. Instead, the tax needs to be significant on the state level. Clearly, a potential increase of perhaps 20% in franchise tax revenues is significant for Delaware even if it is almost negligible on the firm level. The prospect of such an increase could induce Delaware to improve its corporate law, which is the exact goal of the suggested intervention.

d. It Might Incentivize Legislators but not Judges

It is not clear that a tax that is proportional to firm value would affect judges to the same extent that it affects legislatures. For judges, maximizing the volume of incorporations might still be more important than maximizing revenues. This does not refute, however, the potential effectiveness of such intervention. The concern that judges care less for revenues might induce Delaware to increase the determinacy of Delaware law and leave less discretion to judges to decide such issues on a case by case basis. Since currently Delaware has excessive incentives to produce indeterminacy intervention in the tax could also reduce inefficiencies in this area.

VII. CONCLUSION

In this Article, I have shown that price considerations play an important role in the market for corporate law. Specifically, I have shown that Delaware, in setting the quality of its law, takes into account also the effects it would have on the price it will be able to charge firms for it, rather than focus exclusively on attracting as many firms as it can, as conventional wisdom had it.

This Article exposed the trade-off Delaware faces between quality and price in designing its law: the more pro-managerial Delaware law is the more firms it attracts in equilibrium but the less it can charge each firm. It further showed that price consideration may induce Delaware to invest in innovations and modifications to its corporate law even in the absence of external competitive pressures. Thus, regardless of the current debate in the literature as to whether it leads a race to the top or a race to the bottom with other states, no race at all or one with the federal regulator, Delaware’s behavior is heavily guided by price considerations and they cannot be left out of the regulatory discussion.

248 See Kamar, supra note 5.
After presenting the significance of price considerations to the debate, and then offering the trade-off framework to analyze how it affects market dynamics, the Article turned to derive the following concrete implications for the debate. First, it offered new perspectives on the market. Although it reasoned that Delaware’s winning the race does not mean that the race is desirable, it exposed an overlooked factor that restrains Delaware’s managerial favoritism and induces it to invest in the quality of its law. It suggested that the concentrated market structure may lead to better protection for shareholders and to more investments in legal innovations than would be the case in a competitive market.

Second, if offered new perspectives on the role federal law should play in the market. It reasoned that the desirability of mandatory federal intervention of the kind manifested by the recent Sarbanes-Oxley Act can be determined only after its further assessment in light of the new factors revealed. Recognizing the importance of price considerations, the analysis called for a limited federal intervention which requires states to adopt an incorporation tax structure based on firm value. Such federal intervention would align Delaware’s incentives with shareholder interests and would induce Delaware to improve its law. This would be the case even in the absence of competitive pressures and even if shareholders were unaware of such improvements.

The debate has been going on for over thirty years now and has not reached firm conclusions as of yet. This Article suggests that this puzzling state of affairs is largely attributable to the neglect of the role price considerations play in the market. A major reason to incorporate price considerations into the debate is that doing so makes it possible, for the first time, to present a coherent explanation that account for the full body of empirical evidence available regarding patterns of incorporations nationwide, changes in Delaware corporate law, the frequency of takeover bids in Delaware and firm performance in it. It is my hope that exposing this element would lead the discussion to a better understanding of the market for corporate law.