Theoretical Inquiries in Law 16.1 (2015)

Self-Selection and Heterogeneity in Firms' Choice of Corporate Law

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Firms' choice of legal regime is not uniform. Despite Delaware's significant advantages and success in attracting corporations, many firms still choose to incorporate in their home state, and some firms incorporate in a third state, most notably Nevada. Several factors — lawyers' advice, political influence in the home state, and relative costs of out of state incorporation — were identified as contributing to these patterns. Yet none of these factors neither their combination, fully account for firms' choices. This Article suggests that unidentified heterogeneity, potentially in managers' preferences for legal protection, might have contributed to, and could help in explaining, these patterns. Among other factors, this heterogeneity could result, for example, from variations in market forces and, in turn, private benefits that managers extract.

Introducing heterogeneity in managers' preferences, this Article suggests that managers that share a relatively strong preference for insider protection should be less inclined to incorporate in Delaware, and more inclined to incorporate in their home state where they have political clout, or in Nevada if their strong preference for protection is not satisfied in their home state. The analysis is too preliminary for normative implications to be derived, rather the Article suggests that more research into firms' heterogeneity and their choice of law could prove valuable.

Introduction

Firms' choice of corporate legal regime is not uniform. Even though Delaware offers significant advantages over other states, and attracts more than half of

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all publicly traded companies, not all firms choose Delaware. Rather, almost half of all public corporations choose to incorporate in their home states, in which their headquarters are located, rather than shop among the remaining states.[1] Furthermore, despite Delaware's significant advantages and dominant position in the market, and against all predictions, over the last two decades its tiny competitor, Nevada, has increased its incorporation tax rates, market share and revenues from out of state incorporations.[2]

What explains the observed variations in firms' choices? Different factors were identified as contributing to firms remaining in their home state: most notably costs of incorporation out of state, advice by local lawyers, political influence, and takeover law in the home state. Yet, none of these factors alone, nor all of them together, fully account for the observed patterns of incorporation. Consistent with these explanations, small firms and initial public offering (IPO) firms are more likely to remain in their home states. Some very large firms, however, also incorporate in their home state. And some small firms incorporate in Delaware and Nevada. More generally, in researching firms' choice whether to stay in their home state or incorporate in Delaware, Lucian Bebchuk and Alma Cohen found that while firms' characteristics such as size, industry or region matter, they "can explain only a very small part of the selection of firms that incorporate in Delaware."[3] Therefore, they argue, "some omitted variable with respect to firms . . . must have substantial influence."[4] Identifying this omitted variable that accounts for home state incorporation remains "an important task for future research."[5]

Firms also vary in how their choice of incorporation is affected by law. While takeover law may assist states in retaining some firms, it clearly does not affect all firms. Some firms prefer Delaware regardless of the takeover protection their state offers. Finally, extreme antitakeover rules do not help states *vis-à-vis* Delaware, but they do help them *vis-à-vis* Nevada, suggesting a difference in the preferences of firms that choose Delaware and firms that choose Nevada. Accordingly, Nevada's success is partly a result of offering

1 *See* Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & Econ. 383 (2002); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. Rev. 1559 (2002) [hereinafter Daines, *Incorporation Choices*].

2 *See* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 Va. L. Rev. 935 (2012); Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law*, 27 Rev. Fin. Stud. 3593 (2014).

3 Bebchuk & Cohen, *supra* note 1, at 404.

4 *Id.*

5 *Id.*

and marketing a differentiated product — lax corporate law — which some firms have found attractive and others have not.

This Article argues that some form of unidentified heterogeneity is needed to explain firms' choice of legal regime. An inquiry into this heterogeneity is needed to better understand the market for corporate law and its desirability. The Article also suggests one potential heterogeneity account that could help in explaining differences in firms' choice of legal regime — heterogeneity in management preferences for legal protection. Scholars have vigorously debated whether or not market forces sufficiently discipline all firms and, as a result, whether firms and states engage in a "race to the top"[6] or a "race to the bottom."[7] In reality, firms are disciplined by markets in a markedly unequal fashion. Given the focus on market forces in affecting managers' preferences, heterogeneity in these preferences is inherent to the debate. Similarly, in contrast to common assumptions on uniformity in corporate law, states offer varying levels of legal protection to management, and, more importantly, they also offer varying levels of commitment to protecting management interests.

Incorporating heterogeneity in management preferences, the Article argues that managers with a relatively strong preference for legal protection should be less inclined to incorporate in Delaware. As compared to many other states, Delaware faces several constraints in protecting managers such as the threat of federal intervention and the high price that it charges for incorporation. The home state, on the other hand, is superior not only to Delaware but also to many other states, for those managers who are interested in legal protection. In their home state, managers can employ their political clout in order to secure enactment of favorable legislation. In addition, whereas incorporating

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6 *See, e.g.*, Roberta Romano, *Law as a Product, Some Pieces of the Incorporation Puzzle*, 1 J.L. Econ. & Org. 225, 244-60 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. Legal Stud. 251 (1977) [hereinafter Winter, *Shareholder Protection*]; Ralph K. Winter, Jr., *The "Race for the Top" Revisited: A Comment on Eisenberg*, 89 Colum. L. Rev. 1526 (1989) [hereinafter Winter, *Race for the Top Revisited*].

7 *See, e.g.*, Lucian A. Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 Harv. L. Rev. 1435 (1992); William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 Yale L.J. 663 (1974). More recent literature has challenged the assumption that competition exists at all. *See* Lucian A. Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 Yale L.J. 553 (2002) (questioning whether a race exists at all, noting that only Delaware, which attracts sixty percent of all publicly traded corporations, actively attempts to attract incorporations); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 Stan. L. Rev. 679 (2002).

in a state that provides strong protections to managers requires shareholder approval, remaining in a firm's home state, where it typically starts, does not. Finally, remaining in-state can be rationalized by benign incorporation reasons that obscure management's self-serving motives. Not all home states are equal, though; some are less inclined to protect management, and also some managers might have an especially strong preference for legal protection. If the home state does not provide sufficient protection or if managers have a particularly strong preference for legal protection, they could choose Nevada that offers lax law as well as a commitment to a lax legal regime.

The heterogeneity in managers' preferences interacts with the other factors that predict choice of state of incorporation. For example, advised by local lawyers at their IPO, managers may choose to incorporate in their home state. When their firm grows and starts using the services of national law firms, they may consider reincorporating to Delaware. It is here that heterogeneity comes into play, since managers who have a strong preference for legal protection might choose not to follow the national law firm's advice to reincorporate in Delaware, despite significant advantages that the state offers to their growing company.

The heterogeneity account promoted here suggests that further research is required in order to better understand the market for corporate law and derive conclusions regarding the desirability of our system. For example, an important question that this account raises is who the managers are that have a preference for significant legal protection: managers who face strong market forces or managers who face weak market forces? Since normative implications will depend on this question, this project suggests that future research should focus on finding which firms tend to opt for lax law and which firms tend to opt for strict law.

Several scholars in the past have suggested some form of specialization among states. In a short note, Richard Posner and Kenneth Scott suggested that Delaware specializes in providing corporate law for large publicly traded firms.[8] Marcel Kahan and Ehud Kamar showed that in the past Nevada focused on a different segment — closely held corporations.[9] Barry Baysinger and Henry Butler have argued that firms with dispersed ownership will incorporate in states with lax law, while controlling shareholders would seek strict codes that allow them to exercise their voice.[10] This Article differs from previous

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8 *See* Richard A. Posner & Kenneth E. Scott, Economics of Corporation Law and Securities Regulation 111 (1980).

9 Kahan & Kamar, *supra* note 7, at 717.

10 Barry Baysinger & Henry N. Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. Corp. L. 431 (1985)

literature in suggesting that some managers have a clear preference for lax law and these managers might avoid Delaware law despite non-negligible benefits it may offer.[11]

Part I discusses incorporation patters and argues that some form of unidentified heterogeneity could help in explaining them. Part II discusses heterogeneity in market forces and as a result in management preferences. Part III incorporates heterogeneity in management preferences to the debate. The last Part concludes.

I. Incorporation Patterns — Unidentified Heterogeneity

By now it has become clear that firms' choice of state of incorporation is not uniform. Several explanations have been offered for the differences in firms' choices. Yet, some questions remain open. This Part argues that some form of unidentified heterogeneity is needed to explain firms' choice of legal regime.

To begin with, Delaware, the leading state, attracts more than half of the publicly traded corporations in the market.[12] Yet almost half of the companies incorporate in their home states, where their headquarters are located,[13] several hundred firms incorporate in Nevada, and some firms incorporate in several other states.[14] These patterns have yet to be fully explained. Delaware's success was attributed to significant advantages, such as a specialized judiciary, developed body of case law, and efficient administrative system and network externalities.[15] Yet, if sixty percent of publicly traded corporations find these advantages and Delaware package desirable, why do the other forty percent of firms choose not to incorporate there?[16] The puzzle is further underscored by Robert Daines's findings that between 1979 and 1996 Delaware firms showed a significantly higher Tobin's Q than firms in other states, which suggests that

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[hereinafter Baysinger & Butler, *Uniformity in Corporate Law*]; Barry Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & Econ. 179 (1985) [hereinafter Baysinger & Butler, *The Role of Corporate Law*].

11 *See also infra* notes 43-45 and accompanying text.

12 *See* Bebchuk & Hamdani, *supra* note 7; Kahan & Kamar, *supra* note 7.

13 *See* Bebchuk & Cohen, *supra* note 1; Daines, *Incorporation Choices*, *supra* note 1.

14 *See* Barzuza & Smith, *supra* note 2.

15 *See* Bebchuk & Hamdani, *supra* note 7.

16 *See, e.g.*, *id.* at 576-78 (finding that in 2000 fifty-eight percent of U.S. publicly traded companies, and fifty-nine percent of Fortune 500 companies were incorporated in Delaware); Kahan & Kamar, *supra* note 7.

Delaware's package might increase firm value or disproportionally attract high value companies.[17]

One potential explanation for why some firms forgo Delaware's advantages focuses on variations in the relative costs of out of state incorporations. Consistent with this explanation, small firms (for which the costs of out of state incorporation are relatively high) are less likely to incorporate in Delaware. Yet, while it is true that Delaware disproportionally attracts large firms, this factor by itself cannot fully account for home state incorporations, since there are large firms — S&P 500 and S&P 100 firms, for which incorporation fees are negligible — that choose to remain in their home states.[18]

Second, it is also unclear why, rather than take advantage of the U.S. system that allows for jurisdictional shopping, firms that do not incorporate in Delaware overwhelmingly incorporate in their home state.[19] Attempting to explain the home state bias scholars have focused on the type of legal advice that firms receive, or more specifically the identity of the advising law firm. While national law firms are more likely to recommend incorporation in Delaware, it has been argued, local law firms might be more inclined to recommend incorporation within the home state.[20] Local firms have a better understanding of their state law than of Delaware law (or that of other states that are not the home states), and they have a competitive advantage over national law firms with respect to the local law and the local courts.[21] Indeed, the higher inclination of small firms to remain in their home state is consistent

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17 *See* Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. Fin. Econ. 525 (2001) [hereinafter Daines, *Delaware Law*]; *cf.* Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. Econ. & Org. 32 (2004) (showing that this effect (1) existed only for small firms and (2) decreased and disappeared in subsequent years).

18 *See* Bebchuk & Cohen, *supra* note 1, at 398. Another potential explanation would suggest that firms choose to incorporate in Delaware since they use a national law firm. Evidence that supports this explanation is that East Coast firms who are more likely to use national law firms are also more likely to incorporate in Delaware. Yet, as explained below, this too does not account for all firms that do not choose Delaware.

19 *See id.*; Daines, *Incorporation Choices*, *supra* note 1 (finding that ninety-seven percent of the firms that went public between 1978 and 2000 incorporated either in Delaware or in their home state).

20 *See* Bebchuk & Cohen, *supra* note 1, at 397-99; Daines, *Incorporation Choices*, *supra* note 1.

21 *See, e.g.*, William J. Carney, *The Production of Corporate Law*, 71 S. Cal. L. Rev. 715, 722-28 (1998); Larry E. Ribstein, *Delaware, Lawyers, and Contractual Choice of Law*, 19 Del. J. Corp. L. 999 (1994).

with this explanation, as small firms are more likely to use a local law firm rather than a national one. Also consistent with this explanation, Delaware disproportionally attracts recent IPOs which are more likely to be advised by national firms and Northeast firms, whose lawyers are arguably more likely to recommend Delaware.[22] Yet this explanation too does not account for all firms' choice of incorporation.[23] Large firms that regularly use the services of national law firms sometimes incorporate in their home state, and small firms that are likely to be advised by local law firms sometimes incorporate in Delaware or Nevada.

Third, it was suggested that home state bias could be related to the political influence that managers have in their state. Consistent with this explanation, large firms' likelihood of incorporating in the home state is negatively related to the size of the state.[24] Also some evidence suggests that antitakeover statutes, which were the product of management lobbying, help states to maintain their own firms *vis-à-vis* Delaware.[25] Yet the state size is not statistically significant in explaining the home state bias of very large firms.[26] More importantly, while takeover protection and political influence may keep some firms from incorporating in Delaware, they clearly do not keep all of them. Many firms choose to incorporate in Delaware regardless of the takeover protection their home state offers and the state general responsiveness to management lobbying. The real question therefore is what attracts some firms to these takeover protections and not others.

Nevada's recent success in the market is also best explained by some form of firms' heterogeneity. For many years, Delaware was the only state that derived significant revenues from incorporations. Other states did not attempt to attract corporations and also did not stand to make any revenues from incorporations if they attracted any.[27] This state of affairs was not surprising,

22 *See* Daines, *Incorporation Choices*, *supra* note 1.

23 *See* Bebchuk & Cohen, *supra* note 1, at 403-04.

24 *See id.*

25 *See id.*; Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. Pa. L. Rev. 1795, (2002) [hereinafter Subramanian, *Antitakeover*]. *But see* Daines, *Incorporation Choices*, *supra* note 1 (finding that antitakeover law has no significant effect on incorporation choices of IPO firms); Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. Econ. & Org. 340 (2006) (finding that antitakeover laws have no significant effect on incorporation choices).

26 *See* Bebchuk & Cohen, *supra* note 1.

27 *See* Kahan & Kamar, *supra* note 7 (demonstrating that no state has made serious attempts to attract corporations and that the tax rates in other states

given Delaware's significant market power and the market's barriers to entry. As a result of the large number of firms in the state, Delaware was able to offer a well-developed body of case law, specialized, experienced judges, and other network externalities benefits.[28] Thus, to attract firms from Delaware another state would have to offer a significantly superior product. Furthermore, if another state entered the market, Delaware could respond by reducing its price.[29] Over the years Delaware's market power has grown, and its market share grew too. Thus, the likelihood that another state could enter the market and derive revenues from incorporations was even lower. However, since the beginning of the last decade Nevada has increased market share, tax rates, and revenues significantly. Nevada's success was assisted by changes to Nevada law and a vigorous campaign marketing Nevada as a lax law regime, which has proven attractive to some firms, but again not to all of them.[30]

Similarly, comparisons between Nevada and Delaware and their firms further support the heterogeneity account. For example, compare Nevada's and Delaware's success against states that offer significant legal protection — states with extreme antitakeover statutes. These states do not fare well *vis-à-vis* Delaware — extreme statutes do not prevent firms from incorporating in Delaware, and under some accounts maybe even push them to move out of their home state.[31] Conversely, these states fare very well *vis-à-vis* Nevada. Only a small portion of Nevada firms are from states with extreme statutes.[32] In other words, the typical candidate for incorporation in Nevada and the typical candidate for incorporation in Delaware are different. They respond differently to legal protection. Firms that consider Nevada as an option are hypersensitive to the level of protection their home state offers them.

Given the forgoing differences, it is likely that some form of heterogeneity is affecting firms' choice. Indeed, Bebchuk and Cohen find that firms' characteristics available from the Compustat database such as size, industry or region "can explain only a very small part of the selection of firms that

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are so negligible they would result in zero revenues if the states attracted any incorporations).

28 The association of network externalities with Delaware law is attributed to Michael Klausner. *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 Va. L. Rev. 757, 849-51 (1995).

29 *See id.* at 595.

30 *See* Barzuza, *Market Segmentation*, *supra* note 2.

31 *See* Bebchuk & Cohen, *supra* note 1; Subramanian, *Antitakeover*, *supra* note 25.

32 *See* Barzuza, *Market Segmentation*, *supra* note 2; Barzuza & Smith, *supra* note 2.

incorporate in Delaware."[33] Therefore, they argue, "some omitted variable with respect to firms . . . must have substantial influence."[34] "Identifying these omitted variables," they suggest, "is an important task for future research."[35]

The following Parts will suggest that heterogeneity in managers' preferences is one potential omitted variable that is both supported by evidence and could help in explaining firms' patterns of incorporation.

II. Heterogeneity in Market Forces and Management Preferences

The desirability of state competition for corporate charters has been debated for several decades.[36] In the piece that opened the debate, William Cary argued that Delaware is leading a race to the bottom by catering to managers' interests at the expense of shareholders.[37] Ralph Winter was quick to point out that managers who look for rules that benefit them at shareholders' expense will have a difficulty raising capital, face the risk of a hostile takeover, harm their reputation in the job market, and risk the ability of their firm to compete with others. In other words, managers are disciplined by markets.[38] At the end of the day, both schools agree that managers' interests sometimes diverge from shareholders' interests.[39] Also, both schools agree that market forces align managers' interests with those of shareholders to a certain extent. What they disagree on is the extent to which market forces mitigate agency costs, and in turn the magnitude of these costs relative to the costs and benefits of an alternative federal regulation of corporate law.

More recent scholarship has challenged the basic premise that states compete over incorporations.[40] Other than Delaware, most states are not interested in

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33 *See* Bebchuk & Cohen, *supra* note 1, at 404. Bebchuk and Cohen suggest the identity of the law firm as an example for an omitted variable. Yet, law firm identity is less likely to explain recent observed forms of heterogeneity, for example, why firms that choose Nevada are more responsive to management protection in their home state than firms that choose Delaware.

34 *Id.*

35 *Id.*

36 *See, e.g.*, Bebchuk, *supra* note 4. More recently scholars have shown that other states, or at least most of them, do not compete with Delaware. *See, e.g.*, Bebchuk & Hamdani, *supra* note 7; Kahan & Kamar, *supra* note 7.

37 *See* Cary, *supra* note 7.

38 *See* Winter, *Shareholder Protection*, *supra* note 6.

39 *See, e.g.*, Winter, *Race for the Top Revisited*, *supra* note 6, at 1528.

40 *See, e.g.*, Bebchuk & Hamdani, *supra* note 7; Kahan & Kamar, *supra* note 7.

or politically capable of entering the game.[41] Even if states are interested in entering the market, Delaware has accumulated such substantial market power that it is extremely difficult for another state to enter the market.[42] Several papers have considered the option that not all firms are looking for the same law and not all states offer uniform law. In a short note, Richard Posner and Kenneth Scott were the first to raise the possibility that the market for corporate law may lead to product differentiation.[43] In particular, they suggested that Delaware has tailored its law to attract large public corporations rather than small ones. Marcel Kahan and Ehud Kamar showed that in the past Nevada has attempted to attract closely held corporations.[44] In addition, several papers have assumed that firms differ in their appreciation of and willingness to pay for high-quality law. Because Delaware law is expensive, some firms will settle on the inferior laws of other states.[45] In an analysis closest to the one offered here, Barry Baysinger and Henry Butler have argued that while some firms could benefit from strict law, others would benefit from lax law.[46] As a result, they argue, Delaware is less likely to attract firms with concentrated ownership.[47]

The debate on whether firms race to the top or bottom has rightly focused on the strength and effectiveness of market forces — competition in the product market, the labor market, and the market for corporate control — in mitigating agency costs. A rich body of evidence is consistent with market forces mitigating agency costs and constraining private benefits. Not surprisingly, however, the evidence is also consistent with market forces varying across

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41 *See, e.g.*, Kahan & Kamar, *supra* note 7, at 739-41 (arguing that Delaware has more reason to protect shareholders than other states have).

42 *See, e.g.*, Bebchuk & Hamdani, *supra* note 7.

43 Posner & Scott, *supra* note 8, at 111.

44 *See* Kahan & Kamar, *supra* note 7, at 717.

45 *See* Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, *The Market for Corporate Law*, 162 J. Inst. & Theoretical Econ. 134 (2006); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 Colum. L. Rev 1908 (1998).

46 *See, e.g.*, Baysinger & Butler, *Uniformity in Corporate Law*, *supra* note 10, at 450 (stating generally that market mechanisms entail transaction costs, and as a result reliance upon market incentives will be appropriate only in some cases).

47 *Id.* Under their account, while some firms benefit from strict law, others would benefit more from lax law since they have substitute constraints. Their account, however, does not disturb the unidirectional theme in the "race" paradigm. Firms that are less disciplined by markets will supplement weaker external controls by selecting stricter law.

companies and accordingly also the agency costs and private benefits that insiders extract.

Take a long recognized constraint on agency costs, competition in the product market. Firms whose managers extract high agency costs and choose inefficient law, scholars have argued, could not compete with firms that choose efficient law.[48] Race-to-the-bottom scholars replied that competition, though an important force, does not diminish private benefits. Private benefits do not necessarily affect marginal costs of production.[49] Moreover, even if they do, competition is never perfect and thus firms have sufficient slack to extract from.[50] Both sides are right to a certain extent. Competitive forces discipline managers, but to a limited extent. More importantly, however, the exact level of competition that a firm is facing varies across industries, products, and firms. Some industries have more barriers to entry than others.[51] Some products have better substitutes than others. Insiders in firms with significant market power are less pressed to manage efficiently than insiders in firms that face fierce competition. Accordingly, a recent study found that a common indicator for extraction of private benefits — the control premium in sales of control blocks — is lower in competitive industries.[52] This evidence is not only consistent with variations in agency costs as a result of exogenous differences, but it also suggests that firms either could not or did not want to replace the weak market forces with other internal forces that would reduce private benefits of control.

A second market, the managerial labor market, arguably penalizes managers who do not perform well.[53] Managers' underperformance should be reflected in firms' market value. Consequently a low firm value should hurt managers' reputation. As was pointed out, this market force is also limited since firm performance is noisy. Many factors affect market performance, of which

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48 *See, e.g.*, Winter, *Shareholder Protection*, *supra* note 6.

49 *See* Bebchuk, *supra* note 7.

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

51 *See* Michael Porter, Competitive Strategy: Techniques for Analyzing Industries and Competitors (1980).

52 *See* Maria Guadalupe & Francisco Pérez-González, *The Impact of Product Market Competition on Private Benefits of Control* (Working Paper, 2010), *available at* http://ssrn.com/abstract=890814.

53 *See* Frank H. Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 Del. J. Corp. L. 540, 554-55 (1984); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 Nw. U. L. Rev. 913, 919 (1982).

managers' performance is only one. Indeed, consistent with these limitations, managers are not fired frequently due to poor performance.[54] The extent to which performance affects the hiring and firing of managers also varies across firms. Some industries are noisier than others. Thus, in some cases it would be easier to relate success or failure to managers, and managers aware of that would be more disciplined. Similarly, some firms are more transparent than others. Or, in some industries the managers' position is more competitive than in others, and there is less likelihood of finding a new job.

Finally, the market for corporate control is another important, if not the most important, disciplinary force for managers. If managers misperform the value of the shares should decrease to reflect it, and make a hostile bid more likely.[55] The disciplinary power of the market for corporate control is also firm-specific. Some firms are more difficult to acquire either because of their size, financial structure, or operations. Indeed, takeover bids vary across industries. Furthermore, the number of potential candidates for acquisition is often limited to a small number of firms that have synergies with the target firm, and the potential for synergies varies across firms.

III. Heterogeneity as an Explanation for Incorporation Patterns

If some managers are less exposed to market forces as the evidence suggests, that should affect their preference for legal protection. There are two primary ways in which weak market forces could affect managers' preferences. On the one hand, if we take the role of market forces in disciplining management's choice of law, with weak market forces managers could choose lax law without being penalized for that. Thus, under this account managers who face weak market forces would tend to choose lax law. On the other hand, in firms that face weak market forces legal constraints could add significant efficiency gains, and managers could opt for them as a substitute for the lack of market constraints.[56] Which direction this relationship is going and under what circumstances is beyond the scope of this Article. Rather, this Part will discuss, given management's specific preferences, which states they are more inclined to incorporate in. In particular, this Part will explain why managers

54 *See* Bebchuk, *supra* note 7, at 1463-64.

55 *See* Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. Pol. Econ. 110 (1965); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 Va. L. Rev. 259 (1967).

56 *See* Baysinger & Butler, *Uniformity in Corporate Law*, *supra* note 10.

with a relatively strong preference for lax law should be (a) less inclined to incorporate in Delaware, (b) more inclined to incorporate in their home state than in a third state, and (c) under some circumstances might incorporate in Nevada.

A. Managers with a Preference for Legal Protection Should Be Less Inclined to Incorporate in Delaware

Delaware offers significant advantages over other states. A rich body of case law, a specialized judiciary, familiarity with its law, and significant network externalities. Yet, while Delaware provides managers with protection, which according to some is excessive, Delaware faces more constraints in protecting managers than other states. First, as Mark Roe forcefully established, Delaware acts in the shadow of a threat of sweeping federalization of corporate law.[57] Federal law has regulated some portions of state corporate law, and if Delaware law becomes too problematic, Congress may step in and federalize corporate law partially or completely. Delaware lawmakers, Roe argues, have been responsive to this threat in their lawmaking, public speeches and writings. Why should the threat of Federal intervention constrain Delaware in catering to managers? Federal intervention typically kicks in at times of crisis: the Securities Act of 1933 and the Exchange Act of 1934, the pending shareholder access rule, Sarbanes-Oxley, Dodd-Frank, were all responses to scandal, crisis, and loss of trust.[58] Not surprisingly, historically federal intervention provided protection for shareholders from managers.[59] Thus, the threat of federal intervention requires Delaware to be protective, at least to a certain extent, of shareholders' interests. Other states are less affected by the threat of federal intervention — as they do not gain much from incorporations, they do not stand to lose from federal intervention in corporate law.

Second, despite the high number of companies it attracts, Delaware is significantly less susceptible to lobbying by management than other states are. To begin with, only a handful of companies reside in the state, thus practically none of the managers that are affected by Delaware law reside in Delaware. Moreover, Delaware derives significant revenues from incorporations that it would not want to risk.[60] Indeed, one field that involves significant tensions between managers and shareholders, antitakeover law, appears to be consistent

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57 *See* Mark J. Roe, *Delaware's Competition*, 177 Harv. L. Rev. 588 (2003).

58 *See id.*

59 *See* Lucian A. Bebchuk & Assaf Hamdani, *Federal Corporate Law: Lessons From History*, 106 Colum. L. Rev. 1793 (2006).

60 *See, e.g.*, Romano, *supra* note 6.

with this account. Unlike other states that have adopted up to five antitakeover statutes, Delaware has adopted only one mild antitakeover rule, and only after other states adopted up to five such rules.[61] Furthermore, in earlier paper I have argued that Delaware's antitakeover law is milder than other states' also in the standards it applies to management's use of defensive tactics.[62] Delaware has traditionally applied enhanced fiduciary duties to the use of defensive tactics. In Delaware, if managers resist a hostile bid in order to remain independent, they have to meet the *Unocal* test — requiring a showing that there was a cognizable threat to firm policy and that the defense was proportional to the threat.[63] If instead of resisting a hostile bid, the managers decide to sell to the white knight, under *Revlon*, the managers must act as auctioneers and maximize the sale price for shareholders.[64] When a defensive tactic interferes with shareholder voting rights, managers are required to meet the *Blaisus* test — to show a compelling justification for their acts.[65] In contrast, in their home states managers may receive the protection of the hands-off-business-judgment rule (BJR) instead of *Unocal*, *Revlon*, and even *Blasuis*.[66] As I find in some states clearly and in others with some likelihood, Delaware-style enhanced fiduciary duties do not apply.[67] Nevada has passed a rule that specifically applies BJR instead of *Unocal* and *Revlon*, and *Unocal* instead of *Blasius*.[68] Indeed Delaware has prohibited some potent defensive tactics that other states allow. In particular, unlike in Delaware — which allows only a regular poison pill — in some other states, extreme versions of the pill like the "dead hand pill" and the "slow hand pill" — which limit the power of a new board to redeem the pill — are allowed. Finally, consistent with these differences in law, Rob Daines found that firms in Delaware are more likely to receive takeover bids and to be bought by another firm.[69]

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61 *See, e.g.*, *id.*; *see also infra* Section III.B.

62 *See* Michal Barzuza*, Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127 (2004) [hereinafter Barzuza, *Price Considerations*].

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

64 Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

65 *See* Blasius Indus., Inc. v. Atlas Corp., 564 A.2d 651 (Del. Ch. 1988).

66 *See* Barzuza, *Price Considerations*, *supra* note 62.

67 *See id.* (showing that states that have strong antitakeover statutes also tend to apply the BJR to management's use of defensive tactics).

68 *See id.*

69 *See* Daines, *Delaware Law*, *supra* note 17.

B. For Managers Who Prefer Legal Protection the Home State Is Far Superior to Other States

For managers that are interested in legal protection, for several reasons, the home state is far superior not only to Delaware but to any other state in which they can incorporate. To begin with, in their home state managers can exert their political influence. This power is not only hypothetical. Managers have been successful in lobbying and getting protections from hostile takeovers, many times in the face of a hostile takeover. In fact, as Roberta Romano has shown, most of states' antitakeover statutes were adopted as a result of lobbying efforts from local interest groups.[70] Some of them were enacted in response to a pending threat of hostile takeover of a local company.[71] Also consistent with this account is the finding that a firm's tendency to stay in its home state is stronger when the firm is large and the state is small, namely when the managers are more likely to have political influence.[72]

Second, when they are small firms frequently incorporate in the state where they are originally located. When they grow more they decide whether to reincorporate, usually before a major event like going public or conducting a merger.[73] Since reincorporation requires managers' initiation, managers can choose their home state by simply not offering a reincorporation. If managers want to move to another state, however, that would be more difficult. Reincorporation also requires shareholder approval, in addition to management initiation.[74]

Lastly, there is another advantage in choosing your home state. Since firms choose their home states for different reasons, choosing the home state camouflages, to a certain extent, the reasons why some managers do not

70 *See, e.g.*, Roberta Romano, *The Political Economy of Takeover Statutes*, 73 Va. L. Rev. 111 (1987).

71 *See id.*

72 *See* Bebchuk & Cohen, *supra* note 1.

73 *See* Mark Roe, *Washington and Delaware as Corporate Law Makers*, 34 Del. J. Corp. L. 1 (2009). This usually happens when they have an idiosyncratic event like when they go public or seek financing. *See* Romano, *supra* note 6, at 244-60.

74 *See, e.g.*, Bar-Gill, Barzuza & Bebchuk, *supra* note 45. To be sure, shareholders are sometimes passive and uninformed and therefore may approve a move that is against their interests. Indeed, in these firms managers may be able to convince shareholders to approve a move to an exceptionally protective state, most notably Nevada. But in some firms shareholders are informed and wouldn't support a reincorporation proposal to a state with lax law, which requires an affirmative vote of the outstanding shares.

migrate to Delaware. In other words, if investors attach a discount factor to not choosing Delaware, this factor should be larger if managers choose to incorporate in a different state than if they picked their home state, since if they picked a different state it sends a clearer signal that they are seeking lax law.[75]

Evidence on the home state bias is consistent with some firms choosing the home state for the legal protection. Not all home states offer the same protection, and states are not equally inclined (politically) to offer protection in the future. Home state bias is stronger when the home state either offers stronger managerial protection or is inclined to do so in the future. Indeed, the evidence is consistent with this prediction.[76] First, larger firms are more likely to incorporate in the home state if the home state is small,[77] that is when they are more likely to have political influence.[78] Second, states that offer stronger protection fare better in retaining their own companies than states that offer no protection to managers. Yet all states lose some firms to Delaware regardless of the takeover rules they offer.

C. Managers with a Strong Preference for Legal Protection Might Choose Nevada

The heterogeneity account also explains Nevada's entrance to the market. As I argued in a recent paper, Nevada embarked on a market segmentation strategy, by offering a differentiated product with respect to which it has a competitive advantage — an exceptionally lax corporate law.[79] Why has this strategy been successful for Nevada? Nevada understood what the literature didn't — that some managers have an especially strong preference for lax law. These managers are not served by Delaware, and while some of them find a solution in their home states, for others, either because their home state is less protective or due to an especially strong preference for protection, the Nevada package is a better fit.

Since 2001, in Nevada officers and directors face no liability for breaches of the most basic fiduciary duties: duty of loyalty, duty of good faith, and duty of care. Rather, they face liability only with regard to a narrow category — only if they conducted intentional misconduct, fraud, or knowing violation of

75 *See* Michal Barzuza, *Noise Adopters in Corporate Governance*, 3 COLUM. BUS. L. REV. 627 (2013).

76 *See* Bebchuk & Cohen, *supra* note 1.

77 *See id.* at 402.

78 *See id.* ("There is one result that is clearly consistent with the local favoritism factor and does not appear explainable by any of the other stories.").

79 *See* Barzuza, *Market Segmentation*, *supra* note 2.

law.[80] Nevada also focused its marketing strategy on this feature. The Nevada Secretary of State website promotes "Nevada['s] stronger personal liability protection to directors and officers" relative to Delaware.[81]

Nevada amended its law in 2001 with the intention of offering a differentiated product. In support of the amendment, Michael J. Bonner, a Nevada attorney, argued that given Delaware's dominant market position, robust liability protection would be needed to attract firms to Nevada. Otherwise, he argued, "it is Delaware versus home state versus Nevada, if it is a tie, if the corporate laws of these jurisdictions are equally favorable . . . typically, they are going to select Delaware."[82] Opponents were concerned that the proposed liability protections were excessive and might attract the wrong kinds of companies to incorporate in Nevada. Senator Bob Coffin predicted that, as a result of the bill, "reputable companies [were] not going to want to come here to save a few dollars."[83] Nevada would become "the place where Butch Cassidy and Sundance Kid would go, the Hole in the Wall."[84] Yet the opponents eventually supported the passage of the law, as they were promised that the money raised from incorporations would be used to increase teachers' salaries.

By offering a differentiated package that focuses on its competitive advantage, a commitment to sustaining a lax legal environment, Nevada caters to a specific niche, managers with an interest in lax law that is not satisfied in their home states — either because they need especially strong protection or because they happen to reside in a home state that offers weaker protection than most states. Evidence on Nevada firms also supports the heterogeneity account. If Nevada attracts firms with a preference for strong protection, then one would expect Nevada to attract fewer firms from states with significant insider protection. Indeed, Nevada attracts only a few firms from states that offer significant protection to insiders. For instance, not even one company that resides in Maryland, a state that provides notably strong protection to management, incorporates in Nevada.[85]

Finally, evidence of firms' preference for protection can be found also in their choices to adopt legal protections in the charter bylaws and contracts. On

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80 *See id.*

81 *Id.*

82 Bill Draft Request 7-1547, introduced as Senate Bill 577, *Hearing on S.B. 277 Before the Senate Comm. on the Judiciary*, 2001 Leg., 71st Sess., at 13 (Nev. 2001).

83 *Id.*

84 *Id.*

85 *See* Barzuza, *Market Segmentation*, *supra* note 2. As explained above, states with extreme takeover statutes that fare well *vis-à-vis* Nevada are not particularly successful *vis-à-vis* Delaware. *See* Barzuza & Smith, *supra* note 2.

top of the protection the state law provides to insiders, firms are allowed to adopt — through charter bylaws and individual contracts — protections from liability and indemnification clauses. As the following Table shows, firms from states other than Delaware, which are primarily firms that are incorporated in their home states, adopt more protections and liability indemnification terms in their charters and bylaws. Thus, the *type* of firms that stay in home states has a preference for stronger protection. This effect is even more notable in Nevada where despite the strong protection insiders get from the state, as the Table shows, firms adopt protection and indemnification clauses and contracts in exceptionally high proportions.[86]

Table 1: Director Liability Protection (2001-2006)

The Table reports the proportions of firms with liability protection clauses and indemnification clauses and contracts as reported in RiskMetrics.

Director Liability Protection[87]	**Delaware**	**Nevada**	**Other States**
Director Indemnification	14.67%	30.16%	24.90%
Indemnification contracts	7.28%	32.54%	7.43%
Director liability	27.75%	45.24%	39.67%

86 The overall proportions of firms with protection and indemnification clauses are surprisingly low. *See also* Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *What Matters in Corporate Governance?*, 22 Rev. Fin. Stud. 783 (2009) (reporting the following average proportions across states for 2002: Director Indemnification 19.1%; Director Indemnification Contracts 8.1%; Director Liability 33.9%). These proportions used to be higher in the 1990s, but have decreased significantly over time. *See* Paul Gompers, Joy Ishii & Andrew Metrick, *Corporate Governance and Equity Prices*, 118 Q.J. Econ. 107 (2003) (reporting the following proportions: indemnification clauses and contracts (they bundle together two IRRC variables) 40.9% in 1990, and 24.4% in 1998; liability protection clauses: 72.3% in 1990 and 46.8% in 1998); *see also* Bebchuk, Cohen & Ferrell, *supra* (reporting higher proportions prior to 2002).

87 IRRC definitions: Director Indemnification: A charter or bylaw provision indemnifying the firm's officers and directors against certain legal expenses and judgments as a result of their conduct; Director Indemnification Contract: A contract with individual officers and directors promising indemnification against certain legal expenses and judgments as a result of their conduct; Limited Director Liability: A provision that limits the personal liability of its directors.

Conclusion

This Article argues that it is not necessarily the case that all managers are seeking either lax law or strict law, but rather market constraints and, accordingly, managers' preferences and states' offerings vary. Delaware is racing toward the top and other states are located closer to the bottom. More importantly, different states attract different firms. An essential question therefore is who the managers are that prefer strict law and therefore choose Delaware — managers that face significant discipline from the market or managers that face weak market discipline. While this question is beyond the scope of this Article and requires further research, it will have implications for the desirability of the market for corporate law.

This heterogeneity account promoted here helps to explain why we never reached any conclusion regarding the race to the top or race to the bottom debate. Reality is more complicated. The market consists not of one race but of niches. And these niches are segmented with respect to the heart of the debate — firms' agency costs. Some states offer stricter law and they attract firms with lower agency costs. Some states offer weaker law and they attract firms with higher agency costs.

Finally, the heterogeneity and self-selection discussed here could have broader applications for other choices, such as whether to adopt a corporate governance term, a takeover defense, etc. This Article suggests that looking into which firms adopt which terms could prove beneficial for future research.