THE INCORPORATION CHOICES OF IPO FIRMS

ROBERT DAINES*

This Article presents the first evidence about the choice of corporate law and the market for corporate charters at an initial public offering. Though firms are free to incorporate in any of the fifty states and are said to search for optimal legal rules, they appear to simply make a binary choice: Delaware or their home state. Federalism has thus resulted in a series of local markets with one national producer, rather than a nationwide "race to the top/bottom." This pattern raises questions about how firms choose a state of incorporation and suggests that there is a substantial home-state advantage (or home bias). Professor Daines explores reasons for this home bias and reports evidence that lawyers play a key role in determining state of incorporation and that agency costs may affect the advice they provide. Professor Daines also examines other factors that affect a firm's domicile, including variation in state law and firm characteristics. Takeover laws do not appear to be important and there is some mixed evidence that state law may have network qualities.

At the time of an initial public offering (IPO), entrepreneurs decide on the legal rights and governance protections they will offer investors in the firm. The entrepreneur must decide on the cash flow and voting rights to offer investors, the extent to which the firm's managers will be exposed to (or protected from) the threat of hostile takeover,[1] whether shareholders will have the right to sue managers for breach of duty of care,[2] whether to waive certain potential duty-of-

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* Professor of Law, New York University School of Law. J.D., 1992, Yale Law School.

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1 See Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J.L. Econ. & Org. 83, 86-88 (2001) (examining use of takeover defenses in IPO firms).

2 See, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (2001) (permitting charter provision eliminating or limiting directors' liability for breach of duty of care).

loyalty conflicts,[3] how the firm's executives will be compensated, and how the board of directors will be constituted. Typically, the entrepreneur is assumed to design these legal rights and governance features in a way that maximizes the value of the firm.[4] These rights and features are likely to be important because, on average, an IPO cuts managers' ownership by roughly 50%,[5] and managers therefore will have imperfect incentives to improve the value of the firm following the IPO.

One potentially important choice made at the IPO is the corporate law that will govern investors' rights and managers' duties. In the United States, each of the fifty states, plus the District of Columbia, enacts its own corporate law and maintains its own court system for resolving corporate disputes. Firms can elect to be governed by any of these regimes simply by incorporating in the state of their choice, without regard to where they operate.[6] Firms are thus free to choose their corporate law. How do they choose?

In an earlier study, I found that firms incorporated in Delaware were worth significantly more than firms incorporated elsewhere (perhaps by as much as 2% on average).[7] Delaware firms also received significantly more takeover bids and were more likely to be sold.[8] These findings are consistent with the theory that, relative to other states, Delaware better facilitates takeovers, thereby improving shareholder value. The findings received attention because they suggest that Delaware law is not, on balance, harmful to shareholders—something that has been long debated.[9] However, these findings are inter-

[3] See, e.g., § 122(17) (permitting corporations "to renounce . . . any interest or expectancy of the corporation in . . . specified business opportunities . . . that are presented to the corporation").

[4] See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 4-8 (1991) (explaining managerial efforts to create beneficial legal structures); Steven Kaplan & Per Stromberg, Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts 2 (Ctr. for Res. in Sec. Prices, Univ. of Chi. Graduate Sch. of Bus., Working Paper No. 513, 2000), http://papers.ssrn.com/sol3/delivery.cfm/000320302.pdf?abstractid=218175 (discussing this assumption in venture capital context).

[5] See Daines & Klausner, supra note 1, at 93 tbl.1.

[6] Under the long-standing "internal affairs" rule, investors' rights and managers' obligations are determined by the corporate law rules of the incorporating state and not the rules of the state in which the firm is headquartered.

[7] The sample included data on 4481 exchange-traded firms, including over 47,000 firm years between 1981 and 1996. Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. Fin. Econ. 525, 532 (2001).

[8] Id. at 541.

[9] See Roberta Romano, The State-Competition Debate in Corporate Law, 8 Cardozo L. Rev. 709, 710-17, 720-25 (1987) (summarizing classic positions on state competition and explaining why Delaware is destination state of choice); see also Easterbrook & Fischel, supra note 4, at 213-15 ("As a matter of theory, the 'race for the bottom' cannot exist."); Lucian A. Bebchuk, Federalism and the Corporation: The Desirable Limits on State Com-

esting for a second reason—they suggest that incorporation choices matter and that there is something unique about Delaware incorporation during this sample period. Delaware law either helps make firms more efficient or it attracts fundamentally different firms.[10] If incorporation state matters, the natural question is this: How do firms select a state of incorporation? My prior paper ended with this question and this Article is a first step towards an answer.[11]

One might expect that the question of where firms incorporate and how they choose would be well studied, especially given the vigorous debate over whether firms should be allowed to choose where to incorporate or whether mandatory federal law should govern.[12] Surprisingly, it is not. Legal scholars have examined the theoretical consequences of firms' choice of corporate law and have considered generally how firms *might* select a legal regime, but they largely have ignored what firms actually do.[13] Similarly, there has been little dis-

petition in Corporate Law, 105 Harv. L. Rev. 1435, 1441 (1992) (advocating greater federal regulation in various areas of corporate law); Lucian A. Bebchuk & Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, 99 Colum. L. Rev. 1168, 1172, 1190-91 (1999) (arguing that Delaware rules governing takeover defense tactics are "characterized by unnecessary ambiguity and unpredictability"); Ronald J. Daniels, Should Provinces Compete? The Case for a Competitive Corporate Law Market, 36 McGill L.J. 130, 138-40 (1991).

10 Many had considered corporate law trivial. See, e.g., Bernard S. Black, Is Corporate Law Trivial?: A Political and Economic Analysis, 84 Nw. U. L. Rev 542, 544 (1990) (arguing that "mandatory" corporate laws are actually trivial because they "do not prevent companies . . . from establishing any set of governance rules they want"). However, differences in valuation and takeovers in Delaware firms were durable and significant, even though firms incorporated elsewhere might have adopted (by contract) many provisions of Delaware law. This suggests that domicile matters in ways contract cannot replicate.

11 See Daines, supra note 7, at 555-56. An earlier draft of this paper in 1998 asked how firms choose a state of incorporation. After presenting the initial draft, however, it was clear that many believed corporate law was uniform and the choice of domicile therefore trivial, so I put the draft aside to finish the paper on Delaware firms. Now that it has become clear that Delaware incorporation matters, how firms decide where to incorporate is a more interesting question and I take it up again here.

12 More generally, the debate is over whether firms should be allowed to choose their own corporate law rules. See generally, Symposium, Contractual Freedom in Corporate Law, 89 Colum. L. Rev. 1395 (1989) (addressing mandatory role of corporate law); see also supra note 9 (surveying various positions in debate over whether state competition harms shareholders).

13 The exception is Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225 (1985). Her study, however, focuses only on the reincorporation decision and not the original incorporation choice. See id. at 226. Finance scholars have shown a greater interest in the actual governance choices of initial public offering (IPO) firms and how these choices may affect shareholders. Studies have examined their adoption of takeover defenses, see Daines & Klausner, supra note 1, at 95-110 (examing potential efficiency justifications for takeover defenses in IPO firms); Laura Casares Field & Jonathan M. Karpoff, Takeover Defenses at IPO Firms, 57 J. Fin. (forthcoming 2002), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=286923, and the composition of IPO boards, see Malcolm Baker & Paul A. Gompers, The Determinants of Board

cussion and no evidence about what states other than Delaware are doing and what qualities make a state's corporate law attractive.[14]

This Article is an initial attempt to fill this gap and answer questions posed by my earlier findings about Delaware firms. My primary goal is to describe the pattern of firm choice among IPO firms and to examine how firms choose among alternatives. Other papers will take up additional questions raised by these findings.

In some ways, my findings alter or are unexplained by popular conceptions of state competition. My central finding is that there is little evidence of a nationwide market in legal rules. In spite of all the debate about firms' freedom to incorporate *anywhere*, the importance of corporate law, and spirited state competition for charters, firms' actual choices are much more mundane: *97% of public firms incorporate either in their home state or Delaware.*[15] Firm choices are thus oddly "bimodal"—they operate as if there is no national market but a single choice: their home jurisdiction or Delaware. The nationwide search for attractive legal rules that Cary feared and Winter cheered[16] does not appear.[17] The nationwide race or market may be a heuristic for potential competition, but it does not describe firm choices during the period studied. Thus, the dominant metaphor of a national race between fifty states or a single market with fifty producers is incorrect and potentially misleading.

This bimodal character of firm choice and the "home-state" bias is unexplained by the literature on state competition, which emphasizes firm search for domicile based solely on legal rules.

Structure at the Initial Public Offering (May 2001), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=236035 (describing venture financing and CEO-shareholder bargain as determinants of board structure). These studies have not, however, examined the role of corporate law and legal protections for shareholders. This omission is striking as it is corporate law rules that will govern, interpret, and enforce the shareholder rights the entrepreneur designs. See also Barry D. Baysinger & Henry N. Butler, The Role of Corporate Law in the Theory of the Firm, 28 J.L. & Econ. 179, 179 (1985) ("[S]tate corporation laws . . . differ and . . . firms will select their state of incorporation adaptively."); 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).

14 But see Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. (forthcoming 2002) (manuscript on file with the *New York University Law Review*) (analyzing state efforts to attract incorporations of public companies).

15 See infra tbl.4, weighted by assets. Home state is defined as the location of the firm's executive offices.

16 See William L. Cary, Federalism and Corporate Law: Reflections Upon Delaware, 83 Yale L.J. 663 (1974); Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251 (1977).

17 Note that potential competition remains. That is, though Delaware currently may not face meaningful competition from other states, Delaware's behavior would be constrained by the possibility that other jurisdictions might begin to compete if Delaware neglected firm demands.

The evidence I find suggests that the question with which the state-competition literature has been primarily concerned—"are states racing to the top or bottom?"—may not be the right question at this point. Instead of offering theoretical accounts to believe that the race is up or down, we should also ask: (1) What explains the gravitational pull of the home state? (2) How do individual firms select a state of incorporation? (3) What factors lead to a state's success in attracting firms? (Do takeover laws attract firms? Does corporate law have network benefits? Is the Model Act[18] valuable?)

In this Article, I offer initial and tentative answers to these questions (see Table 1 below for a summary). But I take a central contribution of this Article to be that it begins to examine the "industrial organization" of the IPO market and firm demand for corporate law rules.[19]

TABLE 1

Standard assumptions about the race to the top/bottom	**The actual market For corporate law**
There is a nationwide race between states and entrepreneurs search out and choose between fifty alternatives.	Firms choose either Delaware or their home state. Delaware engages in serial competition in local markets but does not face actual competition in the market for national firms.
Delaware is winning the race with a roughly 50% market share.	Delaware's has a nearly 70% share of IPO firms and 95% share of firms incorporating outside their home state. Delaware's share is growing over time.
A state's market share depends solely on its laws and firms choose incorporation state based on law.	The location of a firm's executive offices greatly affects the firm's incorporation, probably because lawyers matter.
Managers or shareholders choose corporate law rules.	Lawyers influence incorporation choices and may seek their own welfare.

Part I describes the debate over the market for corporate law. Part II describes the Article's methodology and the sample of IPO firms. Part III presents the unique market structure for IPO firm charters that I observe. Part IV examines possible reasons for a home-state advantage. Part V tests several hypotheses about the demand for Delaware domicile, the type of laws that firms value, and why some firms incorporate in Delaware while others do not. I focus on the role of the lawyer in connection with the IPO firm's domicile choice. Note, however, that I can make only tentative claims as to the

[18] Model Bus. Corp. Act, at xxvii (1998/1999 Supp.).

[19] A separate paper will examine what these facts and serial competition imply for the state-competition debate generally and will present additional statistical evidence. This Article describes the market structure and presents preliminary regression results.

causes of a firm's choice of state of incorporation, as firm domicile is jointly determined with the firm's other financial and governance characteristics.

The Debate About the Market for Corporate Law

Perhaps the most basic debate in corporate law concerns firms' freedom to select their state of incorporation (and with it, the corporate law rules that govern the firm). This debate has generated intense disagreement and has influenced broader debates about federalism and state regulation in areas such as securities regulation, bankruptcy, environmental regulation, and banking regulation.[20] This Part argues that the state-competition debate has assumed a set of stylized facts about firm choice of law that, in material ways, do not correspond to observed behavior.

A. The State-Competition Debate

Critics of state regulation claim that, free to choose, self-interested managers seek lax or entrenching corporate laws in order to profit at shareholders' expense, leading states to provide promanager laws in order to attract incorporations.[21] Delaware, the most successful state on this score, is thus said to cater to managers by removing shareholder protections: "[A] pygmy among the 50 states prescribes, interprets, and indeed denigrates national corporate policy as an incentive to encourage incorporation within its borders."[22] Critics thus call for Congress to pass mandatory laws to regulate fiduciary duties, takeovers, and shareholder voting in order to protect investors.[23]

By contrast, supporters of state regulation argue that market forces (such as the capital, labor, and product markets) limit such op-

[20] The state-competition debate influences a wide variety of other areas. See, e.g., Henry N. Butler & Jonathan R. Macey, The Myth of Competition in the Dual Banking System, 73 Cornell L. Rev. 677 (1988) (discussing theory of competition between state and federal banking regulators); Robert Rasmussen, Resolving Transnational Insolvencies Through Private Ordering, 98 Mich. L. Rev. 2252, 2273 (2000) (arguing that regime of bankruptcy selection clauses would encourage competition among nations for bankruptcy business and "would lead to a general increase in the quality of extant law"); Richard L. Revesz, Rehabilitating Interstate Competition: Rethinking the "Race-to-the-Bottom" Rationale for Federal Environmental Regulation, 67 N.Y.U. L. Rev. 1210 (1992) (discussing state-competition debate with respect to environmental regulations); Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2365-2401 (1998) (advocating market-oriented approach that would expand role of states in securities regulation).

[21] See Cary, supra note 16 (advocating increased federal role in corporate law to address deteriorating corporate standards resulting from "race to the bottom").

[22] Id. at 701.

[23] See, e.g., Bebchuk, supra note 9.

portunism and that managers select, and states therefore compete to provide, rules that increase firm value.[24] Therefore, "entrepreneurs choosing a state of incorporation will search for legal rules that maximize investor's welfare," and state competition leads to a national "race to the top."[25] Because firms voluntarily seek out valuable investor protections and because they benefit from having a variety of legal regimes from which to choose, mandatory corporate law rules are likely to be harmful.[26]

B. *Common Assumptions About Firm Choice*

The two camps thus disagree about whether state competition benefits shareholders or managers—but these positions *are otherwise virtually indistinguishable*. Each camp adopts a common a priori view of the nature of state competition and the market for corporate law. First, each side agrees that a firm's choice of incorporation state is entirely decoupled from its operating decisions. Firms may, without cost or special permission, operate in State A and incorporate in State B. The choices are considered entirely independent.[27]

Second, each side agrees that legal rules affect the creation or distribution of the firm's value and that firms therefore search the array of fifty potential legal regimes and select the regime with the most favorable legal rules. Thus, Easterbrook and Fischel claim that managers and investors search out the best corporate law from among the fifty competing states.[28] They caution, however, that "[t]here are *only fifty states*, perhaps too few to offer the complete menu of terms needed for the thousands of different corporate ventures .... [W]ith only fifty jurisdictions, lots of (potentially desirable) combinations of [laws] will be missing."[29]

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24 See Winter, supra note 16 (rejecting "race for the bottom" theory and arguing that competition aligns management's interest with shareholders).

25 Easterbrook & Fischel, supra note 4, at 213.

26 Roberta Romano, The Genius of American Corporate Law 91-117 (1993) (examining impact of national laws regulating mandatory disclosure, insider trading, and federal criminalization of state fiduciary duty).

27 Under a long-standing "internal affairs" rule, the corporate law rules of the *incorporating* state govern the firm's internal disputes. See supra note 6. Thus, the only consequence of choosing a state of incorporation is the determination of the corporate law rules that will govern the firm.

28 Easterbrook & Fischel, supra note 4, at 213-15.

29 Id. at 216 (emphasis added). Macey and Miller note that "a decision about where to incorporate [is difficult because it] involves a comparison of legal rules across fifty jurisdictions." Jonathan R. Macey & Geoffrey P. Miller, Toward an Interest-Group Theory of Delaware Corporate Law, 65 Tex. L. Rev. 469, 487 (1987). Posner and Scott suggest that firms search out states that specialize in providing law for their particular type of firm. Richard A. Posner & Kenneth E. Scott, Economics of Corporation Law and Securities Regulation 111 (1980) (speculating that Delaware has tailored its law towards needs of

Third, both camps also agree that a state's market share is determined by the substance of its legal rules. In the words of one state-competition critic, "According to both the race for the bottom and race for the top theories, states' performance in the competition for incorporations *is determined by the substantive content of their legal rules*."[30] That is, both camps assume that State A will attract 10% of the nation's firms if its corporate law rules are offered at a price attractive to 10% of the nation's firms.

Fourth, both sides agree that states compete to provide legal rules that firms want because incorporation leads to incorporation fees and work for local service providers, such as lawyers.[31] Delaware, home to roughly 50% of the Fortune 500 firms, has proven so successful that fees from incorporations make up more than 20% of the state's revenues.[32] Other states are also said to compete for this incorporation business.[33] Nevada, for instance, is frequently described as trying to become the "Delaware of the West," and other states are thought to compete by adopting antitakeover measures that favor managers.[34]

The fact that firms have a choice have led many to analyze corporate law as a product or to conceive of this as a nationwide race to provide corporate law.[35] These analogies have proven exceedingly powerful and most scholars today either explicitly or implicitly accept a version of state competition that is described more generally as Tiebout[36] competition: Firms select valuable legal rules from a nationwide menu of alternatives.[37]

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large, public corporations, while other states have targeted small, closely held corporations).

30 Bebchuk, supra note 9, at 1446 (emphasis added).

31 See Kahan & Kamar, supra note 14 (manuscript at 11-35) (analyzing state incentives to compete for incorporations).

32 Marcel Kahan & Ehud Kamar, Price Discrimination in the Market for Corporate Law, 86 Cornell L. Rev. 1205, 1211, 1225, 1251 (2001).

33 Some scholars claim other states such as Maryland attract a substantial number of firms, suggesting success in competition with Delaware. See Subramanian, supra note 13 at 1816 (showing that Maryland holds second largest share of U.S. public company incorporations); see also Lucian Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate 3 (January 2002) (unpublished manuscript, on file with the *New York University Law Review*) (stating that Maryland has "significant toehold[ ] in the market for out-of-state incorporations").

34 Kahan & Kamar, supra note 14 (manuscript at 64). For summaries of state antitakeover statutes, see John H. Matheson & Brent A. Olson, Shareholder Rights and Legislative Wrongs: Toward Balanced Takeover Legislation, 59 Geo. Wash. L. Rev. 1425, 1519-69 (1991).

35 See, e.g., Cary, supra note 16; Winter, supra note 16.

36 See Charles M. Tiebout, A Pure Theory of Local Public Expenditures, 64 J. Pol. Econ. 416 (1956).

37 See, e.g., Daniels, supra note 9, at 138-40 (1991).

Given these assumptions, one would expect to find dispersion in firm incorporation choices. If State A offered a superior (inferior) set of rules, firms would migrate to State A, regardless of their headquarters. State B might respond by offering an even better (worse) set of rules, so firms would then move to State B. However, because both managers and shareholders have a veto power over reincorporations, their interests may diverge and presumably some firms would remain in State A. The result would be some national distribution of firm domicile where a state's market share reflected the past and current value of its legal rules.[38] A similar dispersion of firm incorporations would result if states specialized in providing laws for particular sorts of firms.

Because so little is known about the structure of this market and the degree to which reality matches the stylized facts, this Article investigates the market for IPO charters to examine what firms actually do.

C. *The Importance of Understanding the Market for Corporate Law*

In addition to shedding light on the state-competition debate, understanding how firms choose corporate law is valuable for other reasons. First, it affects our understanding of earlier findings that Delaware firms were more valuable. If valuable firms and future targets simply search out Delaware, this suggests that Delaware does not add value.[39] Second, choice of domicile is important as a practical matter. In the past twenty years, more than six thousand firms have gone public, at a rate of more than one a day, raising $488 billion (in

[38] This predicted pattern of flipping and national dispersion of domicile posed a problem for the original race-to-the-top/bottom debate. Romano noted that the standard account implies flipping and dispersion, supra note 13, at 228. Posner & Scott similarly suggest that the market is characterized by product differentiation: States offer different packages of investor protections, allowing firms to sort themselves into the appropriate domicile, supra note 29. Romano offers an alternative theory (and evidence) for Delaware's sustained lead and leaves the incorporation in other states unconstrained, which under the standard assumptions of the competition hypothesis may lead to dispersal. One possible explanation, explored here, is that there is a home state advantage or bias that is important relative to existing variation between state corporate laws. See text, infra at 1576 and 1602.

[39] If valuable firms and likely takeover targets simply prefer to incorporate in Delaware, this would raise interesting questions about why Delaware is attractive to these firms and it would help explain Delaware's advantage. But states would have no special reason to imitate Delaware law generally. On the other hand, if Delaware helps to create—rather than merely attract—valuable firms, this suggests that Delaware law is relatively valuable and that firms generally incorporate in a value-improving jurisdiction.

2001 dollars) in gross proceeds.[40] If IPO firms, on average, sell 30% of their stock at the IPO, the market value of these firms at the end of the first day's trading would exceed $1,900,000,000. If corporate law affects the value, productivity, or internal organization of these firms, the question of how firms select domicile is important.

Third, understanding how firms select corporate law rules may affect policy debates concerning the regulation of shareholder rights around the world. For instance, the European Union (EU) may adopt a similar U.S.-style rule that allows firms to choose the corporate law regime of any Member State.[41] The debate over whether the EU should open shareholder rights up to freedom of choice draws heavily on interpretations of the U.S. experience with regulatory competition.

II
METHODOLOGY AND SAMPLE

A. *Why Choices of IPO Firms Matter*

The few previous studies of domicile choice have examined the reincorporation choices of public firms (the canonical reference is Roberta Romano's classic study).[42] These studies are quite useful and highlight the reasons firms change domicile. However, by definition, studies of reincorporating firms do not focus on firms that stay put; many firms never reincorporate and the vast majority do not reincorporate after they are public.[43] Moreover, because the subset of reincorporating firms is not a random sample of public firms, it is hard to generalize the results. Domicile decisions of reincorporating may be fundamentally different than decisions of other firms. By examining the incorporation choices of all IPO firms (whether or not they

[40] This figure is obtained from Securities Data Corporation (SDC) data and includes the average increase in stock price of 18.8% on the first day of trading, which declines on average in following years. Jay Ritter & Ivo Welch, A Review of IPO Activity, Pricing, and Allocations, 57 J. Fin. 1795, 1797 tbl.1 (2002).

[41] A recent decision by the European Court of Justice has raised the possibility that the EU may abandon the "real seat rule"—the rule that firms are subject to the corporate law rules of the country in which they operate—in favor of something like the U.S. "internal affairs rule"—which is that firms are free to incorporate anywhere and their internal affairs are subject to the corporate law rules of the incorporating jurisdiction. See Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459, [1999] 2 C.M.L.R. 551 (finding contrary to European Communities Treaty Danish government's refusal to register branch of company which conducted no business in United Kingdom but was incorporated there in order to avoid Danish laws on minimum capital requirements). The ultimate effect of the *Centros* decision is uncertain. See e.g., Eddie Wymeersch, *Centros*: A Landmark Decision in European Company Law (Fin. Law Inst., Working Paper Series No. 1999015, 1999), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=190431.

[42] See Romano, supra note 13; Subramanian, supra note 13, at 1795.

[43] Daines, supra note 7, at 527.

reincorporate), I can examine all firms' domicile choices at a time that firms commonly evaluate and change their domicile.

IPO incorporation choices are also interesting because, in contrast to reincorporating public firms, they are relatively free from the agency costs. Managers of firms that are already public typically own little stock and therefore do not bear the full cost or benefit of the firm's legal rules. As a result, they may prefer either to remain in or move to a state with inefficient legal rules: A small increase in their perks or private benefits may outweigh their share of the resulting drop in the firm's stock price. Thus, agency costs may lead public firms reincorporating midstream to demand value-reducing legal rules.

However, while *public* firms may make suboptimal domicile decisions, it is less likely that firms *going public* will search out bad rules. IPO firms make domicile decisions before ownership is dispersed and before collective action problems and agency costs become severe. Before an IPO, managers own more than 50% of the firm's stock[44] and thus bear much of the cost of any suboptimal decision. Moreover, other pre-IPO investors (such as repeat players like venture capitalists) also have large pre-IPO holdings and have an incentive to monitor managers.

IPO domicile choices are also important because they are likely to shape the corporate law rules that states produce (and thus create the race to the bottom/top). More than six thousand firms went public between 1978 and 2000, and as part of this process were likely to evaluate their domicile with some care. These choices are typically permanent. By contrast, only roughly six hundred public firms reincorporated in the same period. Thus, if states compete to produce corporate law rules that firms value, they are likely to take the preferences of IPO firms into account.

Finally, incorporation decisions at the IPO stage shed light on how (and to what degree) entrepreneurs use corporate law rules to regulate investors' rights and limit agency costs at the firm's inception.[45]

Therefore, although there is evidence about how and why public firms *reincorporate*, it is useful to examine the charter market for IPO firms.

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44 See Daines & Klausner, supra note 1, at 93 tbl.1.

45 See generally Baker & Gompers, supra note 13; Daines & Klausner, supra note 1; Kaplan & Stromberg, supra note 4; Karpoff & Field, supra note 13.

B. Sample Description

I examine a sample of 6,671 IPOs between 1978 and 2000.[46] To select the sample, I begin with all domestic firms that completed a best-efforts IPO in the time period, according to Securities Data Corporation (SDC) records. I then exclude firms that do not have financial data available on Compustat. Mutual funds, financial firms and Real Estate Investment Trusts (REITs) are excluded from the sample because the law governing these firms differs substantially from those governing industrial firms. Moreover, the central issues that occupy corporate law scholarship—takeover law and fiduciary duty in public firms—are less important in these firms given the mandatory state and federal regulation to which they are subject.

Data on sample firms' current state of incorporation and the location of their headquarters come from Compustat.[47] Data on merger and acquisition activity, legal counsel, underwriters, auditors, and the firms' headquarters come from SDC. Data on underwriter reputation come from Carter and Manaster.[48]

The firms in the dataset represent a broad spectrum of firms from all parts of the country and a wide variety of industries. The dataset includes firms in 262 different three-digit Standard Industrial Classification (SIC) codes in each of the fifty states (and the District of Columbia). Roughly 40% of the sample firms are located in California, New York or Texas. Though many firms are taken public by families or entrepreneurs, 11% are spin-offs (that is, former subsidiaries of other companies) and roughly 42% had prior investment from venture capitalists.

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46 Regression estimates examine only firms that went public from 1978-1997, the last years for which Compustat data was available when I collected the data for the regressions.

47 Because Compustat only records a firm's current state of incorporation, it was necessary to identify firms that reincorporated since going public. Firms reincorporating since 1987 were identified by a LEXIS search of proxies and 10-K filings of all public firms. Data on reincorporations between 1978 and 1987 came from Moody's Annual Industrial Reports, as collected in Romano, supra note 13, at 242, and Robert Comment & G. William Schwert, Poison or Placebo?: Evidence on the Deterrence and Wealth Effects of Modern Antitakeover Measures, 39 J. Fin. Econ. 3, 11 (1995).

48 See Richard B. Carter & Steven Manaster, Initial Public Offerings and Underwriter Reputation, 45 J. Fin. 1045, 1056-66 (1990); Richard B. Carter, Frederick H. Dark & Ajai K. Singh, Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks, 53 J. Fin. 285 (1998).

III
The Market for Corporate Law

A. *Overview*

Consistent with the view of an active national market, corporate charters appear, at first glance, to be widely distributed among states. Sample firms are incorporated in all fifty states. Although Delaware had the largest market share (capturing over 50% of the IPOs, consistent with frequent reports that Delaware has a roughly 50% market share), firms still found other states' corporate laws attractive. California was home to roughly 8% of all IPOs, while New York, Massachusetts, Florida, Minnesota, and Texas collectively captured approximately 14% of the IPO market. This is summarized in Table 2 below and additional detail can be found in Appendix A.

Table 2
Market share of IPO charters

State	Market Share
Delaware	56.0%
California	8.4
New York	3.2
Minnesota	2.9
Florida	2.7
Massachusetts	2.7
Texas	2.6
New Jersey	1.8
Pennsylvania	1.6
Nevada	1.5
Washington	1.4
Ohio	1.3

By this measure, Delaware's share of the IPO market (and thus its advantage in producing legal rules) is large, but not overwhelming.[49] Buyers of corporate law appear to have alternative producers to choose from, and some states seem to have success competing for IPOs. This is consistent with the standard views of both the race-to-the-top and race-to-the-bottom advocates that there are numerous competitors, but Delaware leads with roughly 50% of the market.[50]

[49] The Herfindahl-Hirschman Index for the IPO market in the 1990s was roughly 3000 (Department of Justice (DOJ) guidelines for horizontal mergers suggest that an industry is highly concentrated when its index is about 1800). See U.S. Dep't. of Just. & Fed. Trade Comm'n, Horizontal Merger Guidelines § 1.51 (1992), available at http://www.usdoj.gov/atr/public/guidelines/horiz_book/15.html.

[50] Because SDC data on IPOs only goes back to 1978, I hand collected data on New York Stock Exchange (NYSE) IPOs between 1960-1978, though data for year 1966 is miss-

Delaware's share of New York Stock Exchange (NYSE) IPOs has increased (from approximately 30% during 1960 to 1978, to 54% between 1978 and 1998). See Table 3 below.

TABLE 3
DELAWARE'S SHARE OF ALL IPOs LISTED ON NYSE

Year	1960-1964	1965-1969	1970-1974	1975-1979	1980-1984	1985-1989	1990-1994	1995-1998
Delaware's share of IPOs	30%	30%	31%	36%	56%	75%	73%	77%
Total number of IPOs	265	279	331	140	95	160	307	217

B. *The Bimodal Market and Serial Competition*

The image of firms making unfettered choices from a nationwide menu of legal regimes disappears upon further examination. Firms essentially incorporate in one of only two places: their home state or Delaware. Roughly 95% of all firms that seek legal rules outside their state headquarters end up in Delaware—a market share that would make even Microsoft envious. Only a trivial fraction of firms seek out-of-state legal rules anywhere else: Delaware law governs more than 97% of assets of public firms incorporated outside of their home state, while *together*, Delaware's nearest four rivals split 0.6% of the market between them. See Table 4 and Figure 2 below and Appendix A for additional detail.[51]

ing. Though the increase appears dramatic, one must be cautious in interpreting any overall trend because data for the first half of the period come from a different source (NYSE) that may have had different data collection and sample criteria. I am grateful to Tara Benzinger for assistance in collecting these data.

[51] Subramanian reports a greater percentage of firms reincorporating in third states. Subramanian, supra note 13, at 1825-26. There are likely several reasons for this. First, his sample includes REITs and financial firms, which I also find are likely to incorporate in other states (typically Maryland, Massachusetts, or Minnesota). I however exclude these firms and focus on the industrial firms on which the state-competition debate has centered. The law governing REITs and investment companies is a specialized area of law and firm choice is not based on state regulations of the beneficiary-manager relationship, which is governed by federal law. See Kahan & Kamar, supra note 14 (manuscript at 61). Moreover, many firms that Compustat records as out-of-state firms incorporated in Massachusetts (or Maryland), for instance, are not companies at all, but business trusts organized to create mutual funds. Alternatively, it may also be that reincorporating firms are significantly different from IPO firms or that some of the firms reincorporate to a third state as part of a merger with another operating firm.

TABLE 4

LEADERS IN THE RACE TO ATTRACT OUT-OF-STATE FIRMS

State	Market Share (by number of firms)	Market Share (by total IPO firm assets)
Delaware	94.8%	97.0%
Nevada	1.5	0.3
California	0.7	0.2
New York	0.7	0.04
Minnesota	0.6	0.1

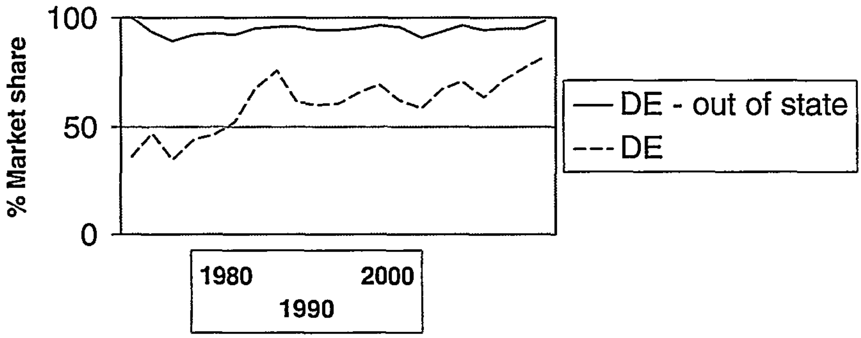

FIGURE 1

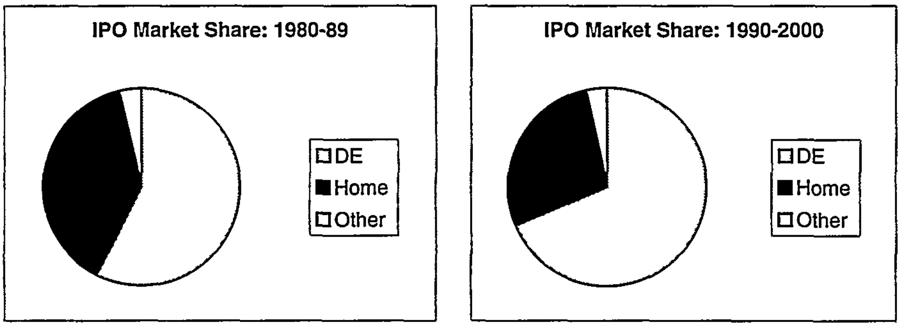

FIGURE 2

Thus, no state besides Delaware has had any meaningful success in attracting out-of-state firms going public. Other states attracted on average *only three* out-of-state firms and the median state attracted *only one* out-of-state firm over the sample period.[52] Even Nevada,

[52] In unreported tests, I find that the vast majority of Maryland incorporations are mutual funds, REITs, and investment companies. Maryland's ability to attract such firms is not related to its corporate law rules and regulation of the shareholder-manager relationship but is instead a function of its rules governing authorized shares. Kahan & Kamar, supra note 14 (manuscript at 70). Thus, Maryland does not provide an example of a state able to compete on the central aspect of corporate law—regulation of the fiduciary duties of managers and shareholder protection. Cf. Bebchuk & Cohen, supra note 33.

ostensibly the most aggressive competitor, has had only trivial success—attracting only thirty-four out-of-state firms of the roughly 3400 that went public between 1990 and 1997 (or 0.3% of assets).[53] Thus, while Delaware's share of IPOs is large, its share of firms that decide to go out of state for legal rules is overwhelming.[54]

Although the standard assumption is that legal domicile has no necessary connection to a firm's headquarters, the gravitational pull of a firm's home state is so strong that only about 5% of all firms that incorporate outside of Delaware make it anywhere else. The bimodal structure of firm choice is illustrated in Figure 2 above, which examines the market share of all IPOs between 1980-2000.

The financial consequences to states of attracting out-of-state firms are trivial: from each of the thirty-four out-of-state firms incorporated within its borders, Nevada collected annual franchise (or report) taxes of roughly $85 a year which totaled no more than $3000 annually. These firms also paid relatively minor one-time fees based on the aggregate authorized par value of capital stock. While a complete calculation of Nevada's gains would include legal fees paid by these firms and certain filing fees for recording corporate events, these are unlikely to be large.[55] Consequently, it is hard to see how Nevada's oft-cited effort to become the "Delaware of the West" has produced any financial gain, at least from public companies.[56] Other states most "successful" in attracting out-of-state firms—California, New York, and Minnesota—also had no meaningful financial gain from their success: They collect trivial initial fees and impose franchise taxes, based *not* on domicile but on the business done in-state. Thus the incorporations have no meaningful impact on the state's marginal revenue.[57]

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53 Nevada attracted only twenty-four nonfinancial firms over the whole decade of the 1990s.

54 Because California firms are such a big part of the IPO sample, I also examine California's market share. California fares poorly (retaining 20 to 30% of local firms), and some of Delaware's increase may simply be a mechanical relationship—as more firms from California go public, Delaware's share will improve.

55 See Kahan & Kamar, supra note 14 (manuscript at 21, 29-30).

56 Indeed, it appears that Nevada, to the extent it competes for incorporations, does not target the market for public firms. Nevada law firms and business-service firms emphasize qualities of Nevada law that are unlikely to appeal to public shareholders or underwriters, such as the fact that Nevada does not share tax information with the IRS. See, e.g., Incorporate in Nevada: Why Nevada Corporations Are Popular for Business, http://www.mycorporation.com/whynevada.htm (last visited Nov. 8, 2002); Fortress Protection: Nevada Corporations, http://www.angelfire.com/ca7/fortress/nevada.htm (last visited Nov. 8, 2002). Moreover, during this sample period Nevada did not even have a specialized corporate court, something one would expect from a jurisdiction intent on attracting public incorporations.

57 See Kahan & Kamar, supra note 14 (manuscript at 14-15).

C. Discussion

Free to incorporate anywhere, to search out exotic legal regimes, the *overwhelming* majority of firms select either their home state or Delaware. This bimodal pattern is perhaps the most basic characteristic of the market for corporate charters—it describes roughly 95% of domicile decisions. Any useful account of state competition or corporate law must explain this pattern.

These facts stand in marked contrast to the image of nationwide competition for firms evoked by the metaphor of a national race between fifty states. Firms do not act as if they are selecting from a nationwide menu of potential legal regimes. There is not nationwide Tiebout competition in any meaningful sense.[58] Rather, there are apparently forty-nine separate markets or linked duopolies in which Delaware engages in serial competition with local producers—competing with New York for New York firms, with California for California firms, and so on. Thus, the central metaphors for state production of corporate law – a nationwide race between 50 states or a single market with 50 producers – is inaccurate or inadequately specified.

The balance of this Article briefly addresses questions raised by the unusual, bimodal character of the market for corporate law rules: (1) What explains the strong gravitational pull of the home state and this odd equilibrium? The existing literature does not explain such a bias, although it is strong enough to account for roughly 95% of all incorporation choices. (2) How do individual firms select a legal regime? and (3) What explains variation in states' ability to compete with Delaware?

[58] A defender of Tiebout competition would argue that the sorting occurs a step earlier: Firms locate in the state with optimal legal rules. This explanation seems implausible. First, very few firms locate business facilities in Delaware, a state with obviously desirable laws. This is because there are cheaper ways to get the laws of State A than moving operations to State A—incorporating in State A. Second, there is evidence that even environmental regulation (which is likely to affect firm costs) does not affect decisions about where to locate plants. Instead, firms choose based on factors like labor costs and education. See Revesz, supra note 20, at 1235 (positing that firm-location decisions are based on multiple complex factors, only one of which is local environmental regulations); see also Adam B. Jaffe et al., Environmental Regulation and the Competitiveness of U.S. Manufacturing: What Does the Evidence Tell Us?, 33 J. Econ. Lit. 132, 158 (1995) (concluding that environmental regulations do not have significant effect on competitiveness of manufacturers and that "other factors would indeed overwhelm the environmental effect").

IV
THE HOME-STATE ADVANTAGE

A. *The Existence of a Home-State Bias or Advantage*

The pattern of choice is inconsistent with the idea that firms care only about corporate law rules. If firms care only about corporate law, and if there is vigorous competition and variation between states, one would expect more migration between non-Delaware states. For instance, California produces corporate law rules good enough to attract roughly 500 California-based IPOs—*but not a single firm from New York or Pennsylvania*. It is implausible that California corporate law rules are good enough to attract this many California firms but not good enough for outsiders. Consider also Oregon: Its record at retaining its own firms is excellent—tops in the nation for the past twenty years, retaining almost 70% of its IPO firms.[59] But Oregon is attractive *only to Oregon firms*. Only three out-of-state firms incorporated in Oregon during the two decades I examined.[60]

Why don't firms in Idaho (which retained *none* of the Idaho firms that went public—a 0% retention rate), New York (12% retention rate), or Illinois (12% retention rate) migrate to Oregon (69% retention rate), Minnesota (65% retention rate), or Louisiana (53% retention rate)?[61] In short, why don't firms migrate away from low-retention/bad-law states and into high-retention/good-law states? How can corporate law affect the domicile's value to *local* firms and thus a state's ability to retain local firms, and why doesn't this variation attract *foreign* firms? Note at the outset that it is no answer to reply that states do not compete – the question is why firms don't migrate, whatever the source of apparent variation in states.

One answer may be that local incorporation brings benefits other states cannot match. Imagine that states offer incorporating firms two things: corporate law rules (worth $2 if the state's law is good for the firm, and $2 if the law is bad) and the value of a home-state advantage (worth $10). Assume that Delaware law is uniquely valuable (worth $9). In this simple example, if home state law is good for a firm, the firm will incorporate at home (home incorporation will be worth $12,

[59] For more complete data on states' differing ability to retain local firms, see infra app.A tbl.A3.

[60] Interestingly, two of these three firms were from Oregon's next door neighbor, Washington This is an example of a general pattern, where firms incorporating outside of their own state or Delaware are more likely to incorporate in an adjacent state. See infra tbl.8 and accompanying text. This again suggests the importance of physical proximity.

[61] There appears to be meaningful variation in states' ability to attract their local firms. In the 1990s, ten states retained 50% or more of the IPO firms located in-state, while fourteen retained fewer than 15% and seven retained none. See infra app.A tbl.A2.

Delaware \$9, and all other states either \$2 or –\$2). If the home state law is bad, the firm will incorporate in Delaware (Delaware will be worth \$9, home state worth \$8, and all other states worth either \$2 or -\$2). Thus, in this simple example, if the home state advantage is very large (relative to the differences between states) variation in local law could affect the number of firms incorporated at home, but would not drive firms to jurisdictions other than Delaware. Other jurisdictions wouldn't be able offer corporate-law benefits to match Delaware and could not (by definition) offer a home-state advantage.

But what home benefits or biases might there be? The existing literature does not provide an explanation. This Section considers several possible explanations, including transaction costs, imperfect information, and agency costs.

Before considering these explanations, however, I note that the idea of a home bias may strike some as implausible: IPO entrepreneurs have incentives and freedom to select valuable rules and intermediaries can search legal rules of alternative states. Meaningful variation would thus be expected to produce migration. It is therefore useful to note that are similar biases have been found in other markets, whether information is even more transparent and the stakes are even higher. Though new in corporate law, such a home bias is "perhaps the least controversial stylized fact"[62] in international capital markets, where stakes are at least as high and actors are at least as well-informed as the legal market. In general, the home bias in the finance literature refers to the fact that equity investors overinvest in their local markets. If investors cared only about the risk and return of their portfolios, as theory suggests, they would hold the world portfolio and invest proportionally in each country. Instead, investors consistently invest too much in local markets. For example, U.S. investors have 91% of their equity investments in U.S. firms, even though U.S. firms represent only 49% of the world market portfolio.[63] This home bias persists even absent significant transaction costs, regulatory barriers or accounting differences and even though investors have strong incentives to seek optimal returns; thus, a large literature has not succeeded in providing an explanation for the phenomenon.[64] If such a bias persists in markets as thick and liquid as public equity

62 Lee Pinkowitz et al., Corporate Governance and the Home Bias, Social Science Research Network, at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=292835#Paper%20 Download (Nov. 2001).

63 Id. at 1.

64 A similar home bias occurs in a nation's consumption patterns. See generally Karen Lewis, Trying To Explain Home Bias in Equities and Consumption?, 37(2) J. Econ. Lit., 571 (1999).

markets, its seems reasonable to inquire if such a bias matters to incorporation decisions.

B. .What Explains the Home Bias?

A useful account of state competition or corporate law must explain the most basic features of firm choice of corporate law: the gravitational pull[65] of the home state and the bimodal character of firm choice. This Section takes initial steps at identifying two possible explanations for the observed home bias or home court advantage: The bias may be a function of regulatory benefits granted local firms and may be partly a function of the market for legal services. Each may identify benefits to local firms that are unrelated to the state's technical corporate law rules.

1. Political Influence

The only legal consequence of incorporation choice is that it specifies the corporate law that will apply. Zoning, environmental, labor, or tax benefits all apply to firms that do business in-state, regardless of whether the firm is incorporated.[66] The most plausible benefit from local incorporation is that *it allows managers to influence the firm's corporate law rules* by lobbying the legislature for particular corporate law reforms. When corporate rules constrain managerial action or affect the timing, cost, or feasibility of important transactions or governance changes, the firm's managers may lobby the legislature to change the rules.

The firm's ability to obtain this relief is likely to increase with the contacts between the firm and the state, which might lead to an observed home bias. A firm with local productive assets, a large employee base, and a traditional association between the firm and the community is better positioned to lobby for corporate law reform. If a

[65] Gravity may be an appropriate model for the flow of incorporation between states and has been used to model migration patterns and trade flow. Newton's Law of Universal Gravitation states that two bodies in the universe attract each other in proportion to the product of their masses and inversely to the square of the distance between them. Migration flows are sometimes analyzed with a gravity model—other things equal, there will be more migration to a city that is (1) close and (2) large. George Kingsley Zipf, The P_1P_2/D Hypothesis: On the Intercity Movement of Persons, 11 Am. Soc. Rev. 677 (1946). There is some evidence that firms act in this way: They are more likely to incorporate nearby and in a state that is larger (home to more corporations).

[66] Moreover, since franchise fees for a particular firm are typically trivial—and for most states unrelated to the firm's domicile—regulators are not likely to ask for local incorporation as a condition of granting some requests.

firm incorporates out of state, these assets and local connections are less valuable.[67]

Note, however, that the ability to influence corporate law rules is a double-edged sword: Managers deploy the firm's resources, including its political resources, but they may use their influence to benefit themselves rather than the firm generally. In state after state, managers have successfully lobbied for statutes that restrict takeovers and protect managers (and possibly employees) at the expense of shareholders.[68] For instance, faced with a takeover bid, Greyhound sought protective legislation from the Arizona state legislature. Given the firm's number of employees and the importance to the state, in the words of one legislator, "Greyhound said 'Jump' and we said, 'how high.'"[69]

Incorporation choice is thus one way to regulate the balance of power between managers and shareholders. Because managers have the ability and incentive to seek protective measures from the legislature, incorporating at home may be in some respects akin to a takeover defense – because the ability to lobby for reform is most likely to be important in the takeover context.[70]

By contrast, as I have argued elsewhere, when firms incorporate out of state, where managers and employees lack local political clout,

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67 Strictly speaking, managers might also influence legislators in states where they have no operations. They may simply use capital to obtain local clout (via campaign contributions and lobbyists). However, it will often be difficult to identify the state's interest in making the reform, given that for most states franchise fees (and the threat of the firm's exit) may be trivial. Moreover, local firms can also hire lobbyists and make contributions, plus they have the additional asset of a local employee base (future voters) and local contacts that may help secure legislators' attention. This alone may provide a reason to incorporate locally.

68 See Roberta Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 122-37 (1987) (discussing adoption of antitakeover statutes in Connecticut, Maine, Pennsylvania, Illinois, and Missouri driven by lobbying efforts of prominent local corporations under pressure of hostile bids). This does not require the assumption that such laws actually harmed shareholders but that legislatures respond typically to instate (potentially voting) organized employees more than out-of-state (nonvoting) dispersed shareholders. Currently forty-two states have adopted one or more antitakeover statutes. Investor Responsibility Research Ctr., State Takeover Laws 3 (1998); Lucian Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, at A-9 tbl.9 (John M. Olin Ctr. for L. Econ. & Bus., Harvard Law Sch., Discussion Paper No. 351, July 2002), http://papers.ssrn.com/abstract=296492.

69 See Mark J. Roe, Takeover Politics, in The Deal Decade: What Takeovers and Leveraged Buyouts Mean for Corporate Governance 321, 339 (Margaret M. Blair ed., 1993) (quoting Arizona representative Jim Shelly).

70 For example, to fight off an attempted takeover, Norton Industries was able to secure a law classifying the board of all publicly traded firms incorporated in Massachusetts. Norton was a large employer and rallied its employees to spirited protest meetings. See Robert Daines, Do Classified Boards Affect Firm Value?: Takeover Defenses After the Poison Pill 16-20 (2001) (unpublished manuscript, on file with author).

shareholders tie the hands of future managers and employees and make it harder for managers and employees to extract protective antitakeover legislation.[71]

2. *Legal Advice*

In considering incorporation decisions, we need to ask who makes the decision, what information they have as they make it, and what incentives they have to invest in additional information. These questions lead us to consider the role of lawyers and the possibility that the legal market influences incorporation choices and may help explain a home bias. This explanation is analogous to arguments that that imperfect information leads to a home bias in international capital markets.[72] If information about alternative legal regimes is costly to acquire, then a home bias may result: Lawyers may not learn the corporate law of other states, and entrepreneurs may not be able to monitor or verify their lawyer's recommendation about domicile, perhaps giving lawyers some slack to seek their own, rather than the clients' interest.

First, lawyers are likely to be influential in the firm's incorporation decision, as they possess specialized legal knowledge and may have more at stake in the decision than other advisors.[73] For instance, a survey by Roberta Romano found that lawyers initiated reincorporation decisions roughly 70% of the time and were almost four times as likely to suggest reincorporating to Delaware than were managers.[74]

Second, firms often hire local or in-state lawyers (more than 60% of sample firms did). This may be partly because the firm has already retained local counsel to represent them before local courts, and would incur switching costs if it changed legal counsel. Moreover, local lawyers have certain advantages. There is evidence that physical proximity reduces informational asymmetry in business settings, particularly "soft" information that is difficult to capture in written documents.[75] Firms also may have better information about the reputation

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71 See Daines, supra note 7 (noting that Delaware has adopted relatively mild barriers to hostile takeovers and that few of its incorporated firms are targets with local political clout).

72 See, e.g., Joshua Coval & Tobias Moskowitz, Home Bias at Home: Local Equity Preference in Domestic Portfolios, 1999 J. of Fin. 2045; Lewis,supra note 64.

73 See Romano, supra note 13, at 273 (noting lawyers' role in suggesting that firm reincorporate).

74 Id. at 274 tbl.13.

75 See, e.g., Coval & Moskowitz, supra note 72; Mitchell A. Petersen & Raghuram G. Rajan, Does Distance Still Matter? The Information Revolution in Small Business Lending, Social Science Research Networks, available at http://papers.ssrn.com/sol3/pa-

of lawyers that operate in the same community.[76] These sorts of locational and informational advantages are likely to be especially important for small (pre-IPO) firms, about which less is known and where information asymmetries may be greater. Finally, if social or informal connections are important in decisions about retaining counsel, these factors will lead firms to local lawyers.

If firms hire local lawyers, it is very likely that these lawyers, in turn, know local corporate law. State regulation requires lawyers to pass local bar exams, which include questions about a state's corporate law.[77] Thus, many firms will hire local lawyers who know the corporate law of the state in which they practice. Some lawyers also know Delaware law, as it is something of a national standard, frequently taught in law schools. In particular, lawyers specializing in large, complicated transactions (where precedent and certainty is especially valuable), or who have a multistate practice, are likely to know Delaware law. Focusing on one national standard allows them to economize on the need to keep up to date with developments in multiple jurisdictions.[78] Delaware is thus much like a common language and such lawyers are "bilingual," speaking Delaware law plus the local dialect.

Thus, lawyers will know the law of the state in which they practice, and some (particularly those with a multistate practice) will know Delaware law. This would reinforce the bimodal pattern we observed.

Of course, lawyers may also learn the law of a third state, like Nevada. Network effects are likely to make this difficult, however.[79] Learning another state's law is costly and a lawyer considering the investment will consider the expected return, which is partly a func-

pers.cfm?abstract_id=223461 (Oct. 2000); Michael Storper & Anthony Venables, Buzz: The Economic Force of the City, available at http://www.druid.dk/conferences/summer2002/Papers/STORPER.pdf (June 2002) (physical proximity can help overcome moral hazard problems and information flow and improve effort); Press the Flesh, Not the Keyboard, Economist, Aug. 24, 2002 (physical proximity improves information flow and facilitates trust and relationships necessary in deal making).

[76] This is consistent with the fact that law firms typically open an office in a geographical area in which they are likely to expand. Cumming and MacIntosh report that reincorporating firms in Canada prefer to have frequent face-to-face meetings with their counsel and hire local lawyers to facilitate this face-to-face interaction. See Douglas J. Cumming and Jeffrey G. MacIntosh, The Rationales Underlying Reincorporation and Implication for Canadian Corporations Int. Rev. Law & Econ. (forthcoming, 2002), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=218391).

[77] See, e.g., Jud. Ct. Acts § 478 (Consol. 2002); see also Romano, supra note 13, at 275-76 (describing survey results that local lawyers knew local law and therefore saw no advantage to incorporation in another state); infra Part V.A.1.

[78] Romano, supra note 13, at 274-75 (noting that outside counsel are likely to have cost-saving incentives for suggesting domicile relocation to Delaware).

[79] See infra text accompanying notes 93-95.

tion of the number of firms that adopt that state's law. If a lawyer expected many firms to move to Nevada, she would have incentives to learn Nevada law. However, since a large-scale shift to Nevada is difficult to coordinate, lawyers discount this possibility and have reduced incentives to learn Nevada law.[80] Thus, though this Section is largely speculative, in such a legal market where legal knowledge is costly to acquire, where lawyers know the law of their home state and some also know Delaware law, the observed bimodal pattern and paired competition may emerge, driven in part by the legal market and state bar regulations.

C. *Magnitudes*

Even if these effects lead to a home-state bias or advantage, before we could comment on their welfare effects, we would need to know the extent to which there is meaningful variation in the corporate law of states other than Delaware. If there is minimal variation between states other than Delaware, little would turn on the fact that firms rarely incorporate in third states.

There is reason to think there may be meaningful variation in state corporate law. First, Romano notes variation in states' substantive codes and the speed with which they update their statutes to respond to innovation.[81] Second, states vary considerably in their ability to retain local firms and these qualities appear to be durable over time and to be affected by legal rules that the state adopts.[82] For instance, several states appear to be consistently attractive to their local firms, while others appear to be consistently less attractive.

Also, to the degree that firms are influential in lobbying for particular reform, laws may vary somewhat between states. Thus, takeover statutes vary between states, though these are less likely to matter to IPO firms (who can freely opt into or out of the statute) than to public firms.

On the other hand, if the core of corporate law is fiduciary duty (as seems reasonable), state law outside of Delaware may be largely fungible. Delaware is uniquely attractive to firms, and its law and precedent are hard for other states to duplicate.[83] Fiduciary duty rules

80 See Romano, supra note 13, at 278.

81 See id. at 233-42. Moreover, other states may not be effective competitors, as others have also noted. See generally Kahan & Kramer, supra note 14.

82 See infra app.A tbl.A2 (providing retention rates and regression results). Thus, the very fact that the magnitude of the home-state advantage varies from state to state suggests that the value of corporate law rules similarly is not uniform among states other than Delaware.

83 Daines, supra note 7, at 540 (noting difficulty of replicating Delaware's courts and store of precedent); Kahan & Kamar, supra note 14 (manuscript at 81-83) (suggesting that

TABLE 5
STATE SUCCESS OR FAILURE IN ATTRACTING OUT-OF-STATE IPO FIRMS

This table examines a state's success in attracting incorporations among a sample of IPO firms between 1980-2000.

1980-1989

State	Out-of-state firms incorporated in state	%
DE	583	94.20
NV	4	0.65
NY	3	0.48
NJ	3	0.48
MD	3	0.48
PA	2	0.32
MN	2	0.32
IN	2	0.32
GA	2	0.32
CA	2	0.32
All others	13	2.08
Total	619	100%

1990-1999

State	Out-of-state firms incorporated in state	%
DE	2,293	95.38
NV	24	1.00
MD	14	0.58
CA	9	0.37
NY	8	0.33
MN	8	0.33
PA	5	0.21
GA	5	0.21
VA	4	0.17
IL	4	0.17
All others	28	1.16
Total	2,404	100%

are difficult to reduce to simple statutory rules (given the nature of opportunism and the difficulty of predicting and legislating to prevent future conflicts) and are instead regulated by a body of precedent. Other states, lacking Delaware's established precedent, unique case flow, and specialized courts, are likely less able to develop a distinctive and predictable body of case law. Thus, corporate law in other states may be largely uniform and the statutory differences relatively minor compared to Delaware. Moreover, one cannot exclude the possibility that variation in state retention levels is due to differences in the type of firms going public, rather than the substantive law. Thus, though we observe a home bias, even if we could discern its causes,

copying Delaware statutory law "would not deliver the exact same product that Delaware does" because of Delaware's unique court system and corporate case law); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908, 1932-35 (1998); Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757, 846 (1995) ("[W]ithout a base of corporate domiciliaries and hence a litigation flow comparable to Delaware's, it would be difficult for another state to offer a corporate law judiciary consistently as good as, let alone better than, Delaware's."); Romano, supra note 13, at 277 (noting that Delaware's "substantial body of case law cannot be easily replicated by a competitor"). Moreover, Delaware's record and reliance on fees provides firms and investors with assurance that, if Delaware courts make decisions that stray far from the expectations of business planners, legislative correction will quickly follow. See, e.g., Del. Code Ann. tit. 8, § 102(b)(7) (2001), which the Delaware legislature speedily passed in response to Smith v. van Gorkom, 488 A.2d 858 (Del. 1985).

the evidence I present here is still consistent with the idea that Delaware is unique, but that differences between other states are relatively small.

The next Part examines the role of lawyers and the need for political influence in the incorporation decisions of individual firms.

V
The Demand for Delaware Law

This Part examines the possibility that demand for Delaware incorporation is affected by (1) possible agency costs in the lawyer-client relationship; (2) the quality of legal rules in the home-state; (3) a firm's need for regulatory influence in its home state; and (4) firm-specific factors (such as firm characteristics or planned transactions). Note, however, that I can make only cautious claims about what actually causes a particular incorporation choice because firm domicile is likely endogenously determined with other firm characteristics such as ownership structure, takeover defenses, planned transactions, and the legal advisor. Below I try to account for the endogeneity of the domicile and legal advisor and to control for other firm-specific features. Section A of this Part describes possible theories of firm demand for Delaware law, and Section B presents regression results.

A. *Theories of Firm Demand: What Firms Want*

1. *Agency Costs*

Although keenly alert to agency costs that arise when firms hire managers, corporate law scholars are frequently silent about agency costs that arise when firms hire lawyers. Instead, the state-competition debate has generally assumed that managers get the law they prefer in a roughly Coasean world of low transaction costs and well-informed parties. In the classic Winter and Cary debate, managers sought (and got) either good or bad laws. However, managers do not choose domicile themselves but instead hire others (lawyers) to advise them.[84] Once we allow that managers rely on agents, it is natural to ask whether agents' self-interests might affect their advice.

One agency-cost hypothesis is that local lawyers encourage local incorporation because it is in their interest, while "national" law firms (i.e., those with clients in many states) encourage incorporation in Delaware. To see why this might be, imagine that Easterbrook wants

[84] Underwriters may also provide input, and subsequent regressions control for them. Anecdotal evidence from intereviews with underwriters suggests, however, that they do not typically make this decision or take an interest unless the suggested decision is "unusual."

to take his firm public. His current lawyer, Fischel, is influential in Illinois, knows Illinois law, and has a primarily local practice. What are Fischel's incentives when it comes to recommending a domicile for Easterbrook's firm? Other things equal, if Fischel recommends that Easterbrook incorporate in Illinois, Easterbrook will need to hire Illinois lawyers in the future for advice on transactions and for litigation and Fischel will face less competition for Easterbrook's corporate-law-related business from outsiders who are not allowed to practice Illinois law (specifically, local incorporators would exclude Wall Street or large out-of-state firms that specialize in Delaware law). Illinois incorporation also avoids the need for Easterbrook to hire (and Fischel to share fees with) Delaware lawyers in any litigated dispute. Thus, on the margin, because Illinois incorporation increases Easterbrook's demand for Fischel's services, Fischel may recommend local incorporation, which may or may not be in the Easterbrook's interests.

Imagine another lawyer, Cary, a New Yorker with a large national practice who knows Delaware but not Illinois law. Cary has the opposite incentives and may recommend that Easterbrook incorporate in Delaware. First, having his nationwide clients in a common jurisdiction (like Delaware) limits Cary's need to remain up to date on the laws of many other states, lowers his cost of doing business, and utilizes his investment in learning Delaware law.[85] By recommending a Delaware incorporation, Cary also reduces the expected value of knowing Illinois law and lawmakers, thus reducing the relevance of Illinois law, which is Fischel's comparative advantage in competing for Easterbrook's future business. Of course, Cary may also be better at providing advice regarding Delaware law and may recommend Delaware incorporation for that reason.

Thus, on the margin, it may be in the self-interest of local law firms to encourage local incorporation and national law firms to encourage Delaware incorporation. The important thing is to note the possibility that this may be a conflict of interest. Obviously, there are limits to the extent that such agency costs can determine a firm's domicile. Professional norms may help reduce these agency costs by reinforcing a lawyer's duty to seek her clients' welfare instead of her own. Competition between law firms will also reduce such agency costs, since lawyers who ignore their clients' interests will bear some cost. However, because clients have difficulty monitoring the quality of the legal advice they receive, norms and competition are likely to mitigate

[85] See Romano, supra note 13, at 275 (noting "the intuition that the interests of legal professionals have a significant impact on a Delaware domicile" and that outside counsel servicing clients in many different states have incentive to encourage Delaware incorporation).

but not erase residual conflicts of interest (just as competition in the labor market does not eliminate managerial agency costs).[86]

There are several important caveats to this: First, the choice of lawyer and domicile may be simultaneously determined. That is, Easterbrook may know that Delaware law is better for his firm and that Cary provides better advice on Delaware law. Thus, it is at least possible that Easterbrook searches out Cary in order to obtain Delaware law for his firm. I try to account for this possibility using regression techniques described below.[87] Nevertheless, there is other evidence that suggests that lawyers determine domicile. Romano found that reincorporation decisions were typically motivated by lawyers rather than managers.[88] Second, a large fraction of firms that do not incorporate either at home or in Delaware incorporate in a nearby state (e.g., a Connecticut firm incorporating in New York).[89] This is greater than the fraction that would occur if clients surveyed the national legal landscape by themselves and simply selected a lawyer to match. Rather, it is consistent with the idea that entrepreneurs know a local lawyer who practices in a nearby state, and therefore suggests incorporation in that state. Moreover, anecdotal evidence suggests that clients rely on legal advisors rather than independent preferences for legal regimes. In conversations with lawyers, underwriters, and entrepreneurs, IPO participants did not suggest this as a credible alternative. Thus, though this sort of lawyer selection is impossible to rule out, I consider it unlikely.

Second, there may also be more benign interpretations of the same behavior. If a client selects a local lawyer to advise on an IPO, the local lawyer may do a better job and provide better legal advice if the firm incorporates locally. The local lawyer's preference for local law may be the product of the lawyer's imperfect information rather than greed. Regression techniques will be unable to discern a lawyer's motivation. Therefore, though the welfare effects are indeterminate, if Delaware law really did improve firm value between 1981 and 1996 (perhaps by as much as 2% on average)[90] a local lawyer would have needed to add a great deal of value to make up for the mean reduction in firm value from incorporating outside Delaware.

86 See William J. Carney, The Production of Corporate Law, 71 S. Cal. L. Rev. 715, 721 (1998).

87 See infra notes 110-13 and accompanying text.

88 See Romano, supra note 13, at 274 tbl.13.

89 See infra tbl.8 and accompanying text.

90 See Daines, supra note 7, at 533; Subramanian, supra note 13, at 1809.

2. *Quality of State Law*

When a firm goes public, the quality of its state corporate laws may matter: If the state has high-quality corporate law, the firm may be more likely to stay home. If its laws are of poor quality, the firm may be more likely to incorporate in Delaware. Thus, good local corporate law may attract firms, whereas bad local corporate law may repel firms. The question of which laws attract or repel firms is at the center of the state-competition debate; examining which attract or repel firm incorporation will tell us what firms are looking for in corporate law. This will in turn suggest something about the laws states have an incentive to produce: If takeover laws of a certain sort increase the number of firms incorporated in a jurisdiction, then states may have marginally more incentives to pass such takeover laws.[91] The alternative hypothesis is that state law (outside of Delaware) is trivial and/or uniform and that variation in legal rules will not affect firms' domicile decisions.[92]

I examine four qualitative measures of a state's corporate laws. First, recent scholarship suggests that the value of corporate law rules is partly a function of the number of firms adopting them.[93] Just as the value of a particular operating system or a fax machine is partly a function of the number of users who adopt it, the value of a particular domicile may increase with the number of firms incorporated there. This is known as a network effect. For instance, as the number of firms incorporated in a state increases, the amount of litigation increases, which may clarify the law, provide valuable training to judges, and increase the availability of cheap legal advice. In addition, the more firms that incorporate in a given state, the more likely the legislature may be to update the state's corporate code. In this view, the overall value of a legal regime is the function of its inherent value (i.e., the value of a product standing alone) and its network value (its value, given that others use the product).

If corporate law has such network benefits, then the value of home-state law will increase (and the likelihood of Delaware incorpo-

[91] States, however, may have little financial interest in maximizing the number of firms incorporated within their borders. See generally, Kahan & Kamar, supra note 14 (manuscript at 11-30). It is, of course, true that Delaware is trying to increase the number of incorporations. Thus, if certain kinds of laws keep firms incorporated at home, this would affect Delaware's incentives if not other states' incentives.

[92] See, e.g., Black, supra note 10.

[93] Marcel Kahan & Michael Klausner, Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases, 74 Wash. U. L.Q. 347, 350-58 (1996); Klausner, supra note 83, at 843-44 ("[A]s the number of firms incorporated in a state increases, the value of its charter increases."); Romano, supra note 13, at 277-78 (analyzing effects of increased incorporations).

ration will decrease) with the number of firms domiciled in each firm's home state.[94] If network effects are economically insignificant, the likelihood of Delaware incorporation will be unaffected by the number of firms incorporated in the home state.[95]

A second, related measure of the quality of a state's corporate law is its adoption of the Model Act.[96] First, because roughly half of the states have adopted the Model Act, it may serve as a corporate law network. By adopting it, a state taps into a wide body of precedent and commentary, thus perhaps clarifying legal rules and reducing the cost of legal advice relative to a stand-alone legal regime. The Model Act also has, in some respects, different substantive rules than many states, and these substantive differences, rather than any network benefits, may also affect the value of the Act.[97]

As a third measure, I examine the degree to which the states' laws provide sufficient legal protection to allow the firm to sell to dispersed shareholders. If a state's legal rules allow managers and controlling shareholders to exploit investors, investors will require pre-IPO shareholders to retain a larger fraction of the firm's shares.[98] If managers begin to exploit investors, the price of the firm's shares will drop and managers will bear the cost. Thus, absent adequate legal protection, managers and entrepreneurs can credibly commit to taking

[94] This is an imperfect proxy as it may also capture something about the inherent quality of the law—as opposed to its network effects. In tests below, I try to distinguish between the network and inherent quality aspects. See infra note 115 and accompanying text.

[95] It may also be that incorporating in a jurisdiction with many other firms is valuable because it provides the firm with some assurance that there will be enough firms to lobby the legislature in case the state's code needs to be updated. See Romano, supra note 13, at 277 ("The more corporations there are, the more the state relies on their business and will respond with desired legislation."). This argument is similar to the network argument—numbers are valuable—but it describes the source of the advantages differently.

[96] Model Bus. Corp. Act, at xxvii (1998/1999 Supp.).

[97] Romano, supra note 13, at 278, argues that firms value a state's record in quickly updating its corporate code. Thus, states that respond quickly to legal innovations may fare better in the race against Delaware. I therefore examine the effect of a state's responsiveness (based on Romano's 1985 data) on the likelihood that a firm located in that state incorporates in Delaware, and expect responsiveness and Delaware incorporation to be negatively related. In regressions below, I find that the likelihood of local incorporation is generally increasing in state responsiveness, but the effect is dependent on the form of the regression, perhaps because of the different time periods in our studies. Romano's responsiveness index is based on corporate law developments though the 1970s, while I am primarily examining IPOs in the 1980s and 1990s.

[98] See Armando Gomes, Going Public Without Governance: Managerial Reputation Effects, 55 J. Fin. 615, 616 (2000). A similar result is obtained by Leland and Pyle, who show that managers will retain a large block of stock as a signal of the firm's quality. See Hayne E. Leland & David H. Pyle, Informational Asymmetries, Financial Structure, and Financial Intermediation, 32 J. Fin. 371, 384 (1977). However, such a signal is less valuable if legal protection reduces investors' uncertainty about investing in the firm.

valuable actions by retaining a large block of shares at the IPO. By contrast, if a state's legal rules reduce agency costs, entrepreneurs will be able to sell more stock to the public. Thus, other things being equal, firms subject to better governance may have more widely distributed share ownership. If Delaware law improves the value of holdings of dispersed shareholders, other things being equal, IPO firms that incorporate in Delaware will be more widely held. Therefore, in regressions below, I control for the percentage of the firm sold to the public in the IPO. Finally, I examine the impact of a state's adoption of antitakeover statutes. Antitakeover laws have received a great deal of attention from legal scholars who suggest that the adoption of these statutes may make a domicile more or less attractive.[99]

It is difficult to see, however, how these takeover statutes would affect the domicile choices of IPO or reincorporating firms. First, most antitakeover statutes are default only and allow IPO firms to costlessly opt into or out of important provisions. Given that firms going public can easily add or subtract these simple provisions in their charter without regard to whether the state has adopted such a statute, it is difficult to understand how these statutes might affect a firm's domicile choice.[100] Second, most statutes examined are, as a substantive matter, now trivial given the development of the poison pill. Most antitakeover statutes provide protection that is no better than (and often less effective than) a poison pill, which all firms may freely adopt on their own.[101] Thus, many of these protections are likely trivial as a substantive matter, and are easily replicated or avoided as a formal matter, regardless of the state's statute. For these reasons, it is hard to see how most antitakeover statutes would be relevant to a firm going public.

Several states have adopted statutes that may matter, however, because they contain provisions that firms are unable to create contractually, such as statutes authorizing the adoption of a poison pill, constituency statutes, control-share acquisition statutes, or disgorge-

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[99] See Bebchuk & Cohen, supra note 33, at 4 ("[A]ntitakeover protections are correlated with success in the incorporation market."); Subramanian, supra note 13, at 1826-64 (arguing that managers respond to antitakeover laws in choosing domicile).

[100] Bebchuk and Cohen suggest that the legislature's adoption of (or failure to adopt) a takeover statute sends a meaningful signal about the state's commitment to provide antitakeover protection in the future. See Bebchuk & Cohen, supra note 33, at 19. The value of such a signal is likely to degrade over time, however, and it seems unlikely that the adoption or non-adoption of particular statutes in the 1980s provides a meaningful signal of the state's corporate law more than a decade later. In most states, it seems likely that a large employer could lobby and win entrenching legislation if it were helpful.

[101] See James C. Coates IV, Takeover Defenses in the Shadow of the Pill: A Critique of the Scientific Evidence, 79 Tex. L. Rev. 271 (2000); Daines, supra note 70, at 4-5.

ment provisions.[102] In regressions below, I control for states that adopt these provisions.

3. *Home-Court Advantage*

Firms may incorporate at home in order to give managers influence over the firm's corporate law rules. If this ability to influence legislators and policymakers is useful, it is most likely used in takeovers—where the stakes for the firm are high and where firms have had success in lobbying state legislatures. If so, then home-state incorporation should be more likely when IPO firms are more likely to adopt takeover defenses. The likelihood of home-state incorporation would then increase along with the threat of takeover (as measured by the amount of takeovers in the firm's industry) and decrease along with research and development (R&D) intensity.[103] Firms may also incorporate at home to secure other regulatory benefits. If so, firms subject to important state regulation should be more likely to incorporate in-state. In regressions below I control for public utilities, which are subject to intense state regulation.[104]

4. *Firm Transactions and Conflicts*

The advantages of Delaware (or home-state) law may depend on a firm's business strategy. Romano argues that Delaware law will be valuable to firms that plan acquisitions.[105] In regressions below, I therefore control for the number of acquisitions each sample firm made following its IPO.[106]

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102 See generally Matheson & Olson, supra note 34.

103 Takeover defenses in IPOs are generally less frequent in industries where research and development expenses are large (relative to firm size). See Daines & Klausner, supra note 1, at 104-06.

104 See infra tbl.7. Initial results suggest that the number of employees is positively related to the likelihood of home-state incorporation, consistent in a crude way with the idea that firms incorporate at home when they have local political clout.

105 Romano, supra note 13, at 250. Delaware law is said to reduce acquisition costs for two reasons. First, a Delaware acquiror firm needs only the approval of a simple majority of its shareholders, rather than a supermajority. Second, Delaware's thicker precedent allows managers to plan acquisitions to avoid liability.

106 See infra tbl.7. The interpretation of this result is complicated by the fact that Delaware law may, in turn, affect the number of acquisitions a firm makes. To limit this concern, I count only the bids made during the first three years following the IPO. During this timeframe, shareholdings are relatively more concentrated and the shareholders, rather than formal corporate law, likely dictate the outcome and incidence of major transactions. Moreover, IPO firms presumably evaluate merger opportunities at the time they go public. Limiting the transactions to this timeframe limits, but does not eliminate, endogeniety concerns. Because the law of the *target's* domicile rather than the *acquiror's* governs most of the key questions in a transaction, I also examine the number of times each sample firm became the target of another bid in the three years following the IPO in unreported regressions without changing the basic results. The receipt of a quick bid is insignificantly related

Similarly, some firms may have greater need for fiduciary duty rules to constrain possible manager or shareholder opportunism. For instance, some firms go public with a controlling shareholder with whom the firm will continue to do business. Spin-offs fit this description. A spinoff occurs when a parent company (e.g., Ford) sells stock in a subsidiary (e.g., Hertz) to the public. In many cases, the parent controls the newly public subsidiary through its ownership and representation on SpinCo's board of directors. Often, the parent firm will continue to have dealings with SpinCo (Ford sells cars to Hertz), which raises the possibility that the parent will use these transactions to extract above-market prices from the subsidiary thereby harming shareholders of the sub. In such situations, conflict and litigation may be more likely. Thus Delaware's body of precedent, specialized chancery court, and tradition of interpreting fiduciary duty rules may be relatively more valuable. I therefore control for sample firms that are spin-offs.

Finally, Delaware may also attract firms with valuable growth opportunities. An earlier study found that Delaware firms are worth more than firms incorporated elsewhere between 1981 and 1996. One explanation of this finding is that Delaware attracts high-growth firms.[107] I attempt to control for this possibility in the regressions below by including the firm's sales growth in the three years following the IPO. In addition, on the grounds that firm quality and underwriter quality are likely to be correlated, I include two indirect measures of quality: the presence of venture capital investment, and the quality or reputation of the firm's underwriter, following a commonly used index.[108]

B. *Analysis and Regression Results*

Table 6 below summarizes some of the basic differences between firms that incorporate in Delaware and those that incorporate elsewhere. On average, Delaware firms are larger, more levered, and more likely to make acquisitions and receive takeover bids in the first few years following the IPO. These findings are consistent with the

to Delaware incorporation, suggesting that the greater frequency of bids for Delaware firms may not just be the product of an IPO selection bias.

107 Daines, supra note 7, at 551-53. This explanation is possible, but the theory behind such a selection bias is unclear.

108 Carter et al., supra note 48. Underwriters serve as reputational intermediaries and vouch for the quality of the firm's growth prospects, management team, and disclosures, as well as screen potential clients.

view that large firms that are likely to undergo complicated transactions find Delaware law valuable.[109]

Firms are more likely to stay "at home" if their home state has adopted the Model Act. Although Delaware's share has also increased over time—from roughly 40% to more than 70% over the sample period—its gain has largely come at the expense of states that do not adopt the Model Act, which lost roughly half their share to Delaware over the sample period (from 62% in 1980-1984 to 33% in

TABLE 6
DESCRIPTIVE STATISTICS

	1980-1989		1990-1999	
	Delaware Firms	Other Firms	Delaware Firms	Other Firms
Financial characteristics (in $millions)				
Assets	304.27**	62.93	456.63**	142.15
	(32.38)	(16.28)	(50.61)	(34.18)
Annual sales	150.03**	50.63	224.35**	102.54
	(33.52)	(17.36)	(41.07)	(30.33)
Market cap	126.87**	56.56	192.21**	112.07
	(47.04)	(23.45)	(90.39)	(57.70)
Debt/assets ratio	.16**	.12	.14**	.11
	(.08)	(.05)	(.03)	(.02)
Insider ownership after IPO	—	—	41.66**	45.78
			(42.8)	(47.8)
Transactions				
Average number of acquisitions	2.39**	1.79	2.19**	1.97
	(1)	(1)	(1)	(1)
Number of bids received	.90*	.81	.42**	.31
	(1)	(1)	(0)	(0)
Days firm remained independent	2,149**	2,484	983	1,044
	(1,933)	(2,484)	879	(928)
Law firm				
Number of states in which the firm has represented an IPO firm	6.15**	4.9	7.9**	5.4
	(5)	(2)	(6)	(3)
Other				
Underwriter quality	7.92**	7.39	8.12	7.41
	(8.75)	(7.88)	(8.75)	(8.5)
% of IPOs with VC investment	49.74%**	56.86	40.75	31.74
Big (5) auditing firm				
Number of firms incorporated in home state	154.45**	142.73	237.10	204.97
	(55)	(54)	(82)	(79)
Number of firms headquartered in home state	63.98**	58.64	88.40	77.33
	(127)	(107)	(164)	(140)

Differences in means are significant at the 1% (**) and 5% (*) levels, respectively.
Numbers in parenthesis represent medians.

[109] Another explanation is that Delaware law generates bids and acquisitions. To limit this concern, I examine only bids in the first three years of the IPO. During this time, the firm is usually still controlled by a small number of shareholders who own a controlling block. Corporate law will not have any impact on the acquisition decisions of such firms because the firm is not vulnerable (by reason of its ownership structure) to a hostile takeover attempt. Moreover, the control shareholders will determine whether or not to approve any transaction.

late the 1990s). By contrast, Model Act states retained roughly 50% of all their firms throughout the time period. This is consistent with the idea that state law matters and that firms find the Model Act valuable.

I use regression analysis to examine firms' incorporation decisions, controlling for a wide variety of factors identified above. Given the bimodal structure of the market for corporate law, I model the incorporation decision as a discrete choice whether or not to incorporate in Delaware (using a logit model). The model is complicated somewhat by the fact that the firm's domicile and legal advisor will likely be determined jointly or simultaneously, that is, we cannot understand a firm's domicile decision in isolation but need to consider the joint decision about domicile and lawyers.[110]

In order to clarify the relationship (and the potentially causal role of lawyers), I employ a technique known as two-stage or simultaneous-equations model. I first estimate a firm's demand for a national law firm, controlling for variables that might be correlated with a firm's need to retain a large firm with a national practice—some of which should be unrelated to the firm's demand for a particular domicile.[111] I then use the resulting estimate of the degree to which a firm will retain a "national" law firm as an independent variable in a sec-

[110] The domicile decision is of course endogenous to a wide variety of firm governance provisions, but for tractability I focus on the relationship between lawyer and domicile. It is also one of the strongest associations I find in initial and unreported regressions. While national lawyers may advise clients to incorporate in Delaware, one alternative interpretation is that some firms have plans or characteristics that make it desirable to have national lawyers and, for similar reasons, also find it desirable to be in Delaware. For instance, a firm that anticipated merger and acquisition activity may need both Delaware law and a large firm to advise it, because merger and acquisition work requires specialized legal talent possessed by large firms who also attract clients from across the country.

[111] I control for a wide variety of factors in this first stage. I attempt to control for a firm's ease of access to a large national law firm (e.g., entrepreneurs in New Jersey may be more likely to end up with a large New York law firm than entrepreneurs in South Dakota). Because firms in populous states may have easier access or more contacts with national lawyers, I also control for the number of firms headquartered in the IPO firm's state. Firms that plan complicated transactions after going public may retain a large law firm, so I also control for acquisitions that occur in the first three years following the IPO. Delaware law is relatively unimportant to acquirors and likely did not affect the probability of such transactions that could have been anticipated at the time of the IPO. In addition, I control for whether or not the firm received a bid in the three years following the IPO and a variable that measures the amount of takeover activity in the firm's industry during the three years surrounding the IPO. I also control for firm size (using log of sales or market value) because large firms may complete "bigger" deals and require bigger law firms. I control for venture capital investment, the firm's initial sales growth following the IPO, and the reputation of the underwriter, on the grounds that large firms or firms with growth opportunities may also require the advice of experienced transactional (national) lawyers. Finally, I include separate dummy variables for the firm's industry, the year of the IPO, and each of the fifty states in order to capture any state-specific effects. Although

TABLE 7
THE DEMAND FOR DELAWARE INCORPORATION

This table reports the results of discrete choice logit regressions estimating whether a firm incorporates in Delaware. A positive coefficient estimate indicates the variable is associated with a higher probability of Delaware incorporation.

	Logit	Logit	Logit	Logit	2 stage	2 stage	2 stage	2 stage stepwise
Legal advisor								
National law firm	0.07***	0.06***	0.06***	0.06***	0.34***	0.34***	0.21*	0.30***
						(0.05)		
State law								
Model Act		–0.66***	–0.61***	–0.00		–0.23*	0.02**	
						(0.13)		
Number of firms incorp. in state		–0.19***	–0.20***	–0.15		–.23***	–0.09	
						(0.05)		
Poison pill statute			0.30**	0.51**			0.52**	
Control share statute				0.66**			0.64*	
Constituency statute			–0.16	–0.22			–0.14	
Disgorgement statute			–0.35	–0.16			–0.02	
Fair price statute				0.31			–0.24	
Bus. combination statute				0.22			–0.27	
Firm and transaction variables								
% of shares sold in IPO		0.58**	0.62**	0.62**		0.73***	0.73***	0.63***
						(0.28)		
Spinoff		0.61***	0.61***	0.66***		0.74***	0.74***	0.82***
						(0.17)		
Regulated utility		1.71***	1.70***	1.86***		1.54***	1.82***	2.53***
						(0.53)		
Post-IPO acquisitions		0.10	0.11	0.08		0.01	0.00	
						(0.09)		
Industry merger activity		–0.00*	–0.00*	–0.00*		–0.01*	–0.01**	
						0.00		
Firm size (market value)		0.00	0.00	0.00		–0.00	0.00	
						(0.00)		
Underwriter ranking		0.18***	0.18***	0.18***		0.01	0.07	
						(0.03)		
Sales growth (first 3 years)		0.00*	0.00**	0.00**		0.00	0.00	
						(0.00)		
R&D		0.66*	0.66	0.90**		0.66*	0.97**	
						(0.40)		
Headquarter state dummies	No	No	No	Yes	1st stage	1st stage	Yes	
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	
correct					66.2		67.1	67.9
- 2 log likelihood	5,548	3,360		3,169	3,401	2,579	3,303	3,422
N	4,612	2,825	2,825	2,825	2,914	2,914	2,905	2,914

Significant at the 1% (***), 5% (**) and 10%(*) level.

ond regression that estimates the firm's state of incorporation. In addition to the variables described above, I control for the possibility that Delaware's relative attractiveness varies by industry (with controls for the firm's two-digit SIC code) and over time (with controls for the year of the IPO). I control for firm size by including the firm's market value, but similar results are obtained when I instead use the log of the firm's sales. I also include headquarter-state fixed effects, including separate dummy variables for a state's headquarters. This allows lawyer and domicile to be jointly and simultaneously determined, avoiding potential endogeneity concerns.[112] Regressions include fewer observations due to missing variables.

Results are summarized in Table 7 above. The first four columns in the table present results of one-stage logit regression estimates. Because the results of these regressions are very similar to the two-stage model, I primarily discuss the latter. I first control only for law firm, industry, and year of IPO. For robustness checks, I then successively add state-law variables, firm-specific variables, and finally takeover-statute variables and state-fixed effects.

In each model, the estimated effect of a national law firm is positive, which means that the likelihood of Delaware incorporation increases when the law firm has a more national practice. The effect of the law firm is generally highly significant, both statistically[113] (p-value typically = 0.0001—which means that there is less than one chance in 10,000 that the relationship is by chance) and economically (on average, an increase of five states in which the law firm has clients is associated with an approximately 50% greater likelihood of Delaware incorporation). Moreover, the addition of the law-firm variable does more to improve the fit of the model than any of the variables controlling for a state's law, more than the controls for a firm's characteristics, and more than *all other variables combined.* Thus local lawyers advise firms to incorporate locally, while national lawyers advise firms to incorporate in Delaware. This is consistent with the idea that lawyers act in their self-interest in providing this advice. An alternative interpretation is that lawyers provide their best advice but do not fully understand the advantages of Delaware (or home-state) law.[114]

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this technique deals with endogeneity concerns, it is impossible to conclusively rule them out.

112 If the domicile is jointly determined with the identity of the lawyer, estimates of firm domicile that ignore this endogeneity and the effect of the lawyer would be incorrectly specified and potentially misleading.

113 In all of the regressions I run, it is statistically the most significant of all relationships (p-values = 0.0001).

114 The two-stage regression attempts to deal with the possibility that certain firms (for whom Delaware is optimal) simply seek out national law firms.

There is some mixed evidence consistent with the theory that corporate law has network qualities. In columns B and C home states are more attractive when large numbers of public firms are already incorporated there. The relationship is highly significant (p-value = 0.0001). Thus, other things equal, it appears that the value of a state's law increases with the log of the number of firms incorporated there.[115] Moreover, firms are more likely to incorporate in home states that adopt the Model Act, which functions as something of a network of precedent and commentary. An alternative explanation is that firms value the Model Act's substantive rules, and I cannot discriminate econometrically between these two interpretations.[116]

This relationship, however, is sensitive to the form of the regression and the variables I include. I obtain inconsistent results when I instead use the absolute number of incorporated firms rather than the log, suggesting that the effect of the number of firms may be nonlinear. Controls for the number of firms incorporated in-state become insignificant in the presence of separate dummy variables for individual home states, and in OLS regressions estimating the proportion of local firms retained by each of the fifty states (in unreported regressions).

I find weak support for the idea that firms incorporate in-state in order to secure some regulatory advantage. Firms incorporate in-state when the threat of takeover is higher, which suggests that they may value the ability to lobby for takeover protection. Industry merger and aquisition activity is negatively related to Delaware incorporation

[115] An alternative explanation of this result is that states that adopt good substantive rules attract more incorporations. This is possible and cannot be excluded. However, there are several reasons to think we observe network—rather than inherent—benefits. First, I try to control for important substantive differences between states (such as the adoption of the Model Act or various takeover statutes), though there are likely unobservable differences. Second, in unreported regressions, I also include controls for a state's success in retaining locally headquartered firms (its retention rate)—as well as for the absolute number of firms headquartered in-state. If, in the presence of these controls, the number of firms incorporated became insignificant, but the retention rate *was* significant, this would suggest that the quality of the legal rules rather than the number of firms incorporated (and thus the network effects) was critical. However, the number of firms incorporated remains significant even in the presence of these controls, so I do not reject the networks explanation.

[116] If the substantive differences between the Model Act and states' corporate law regimes are relatively small, the better interpretation is that this suggests network effects. In unreported regressions, I find that there is some evidence that firms going public value a state's responsiveness in updating its corporate code, as Romano's measure of responsiveness is negatively related to the likelihood of Delaware incorporation (p-value = 0.001). In alternative specifications, the relationship is sometimes insignificant. This is not inconsistent with Romano, supra note 13, as I use her measure of responsiveness calculated through 1984, while it is possible that state responsiveness changes over the course of my sample period.

(the effect is significant at the 10% level). However, the effect of R&D intensity is insignificant and regulated public utilities are actually less likely to incorporate at home. I do not control for firm-level takeover defenses, however, so I cannot rule out the possibility that these firm-level defenses vary between Delaware and non-Delaware firms. However, in a separate sample of IPO firms drawn with Mike Klausner, I found no difference in the mean firm-level defenses adopted by Delaware or non-Delaware firms.

I find little support for the claim that antitakeover statutes affect the domicile choices of IPO firms. Poison pill or control share statutes make it more likely that firms will leave a state and incorporate in Delaware. However, this effect is not robust and is theoretically questionable given the ease with which firms can opt into or out of these provisions. In unreported regressions I examine alternative measures of a state's takeover laws and find that coefficient estimates are unstable and sensitive to the measure and choice of control variables. I therefore present results with and without these controls.

I also attempt to control for biases introduced by the fact that firms are not equally distributed across states, but are concentrated in a few large states (California, Illinois, New York, etc). Other studies of state takeover statutes, such as Bechuck and Cohen's,[117] have examined simply the choices of individual firms. However, because this method overweights the impact of large states, regression results say more about large states than about a system of relations between the fifty states. To correct for this bias, I estimate each state's success in retaining local firms, thus equally weighting each state. In these unreported regressions, takeover statutes are again insignificant or increase the likelihood of Delaware incorporation. This suggests that takeover statutes are not important in attracting incorporations and that takeover statutes do not provide evidence that states are "racing to the bottom."[118]

Spin-offs are more likely to incorporate in Delaware, consistent with the idea that firms incorporate in Delaware when they are likely to engage in transactions that may require rulings on managers' fiduciary duties. The fraction of the firm's shares owned by public shareholders is positively associated with the likelihood of Delaware incorporation. This is consistent with the idea that Delaware law reduces agency cost in public firms and protects investors. If investors

[117] See Bebchuck & Cohen, supra note 34.

[118] This is inconsistent with Bebchuk & Cohen, supra note 33, who examine the impact of takeover statutes on a different sample of firms. I further examine takeover statutes in another paper, but initial results indicate that my results are unchanged even using alternative models and measures of takeover statutes.

have fewer protections in other states, they would require a greater degree of concentration in order to provide entrepreneurs with the incentive to reduce agency costs. Another interpretation is that if Delaware law improves the value of the firm's shares, a firm's founders have greater incentives to sell shares to the public. Because the firm's ownership structure is also endogenous to the firm's incorporation, the interpretation of this relationship is uncertain.

To confirm these results and check their robustness, I also estimate a stepwise logit regression. Stepwise regressions add or subtract potentially important independent variables according to the variable's effect on the model's predictive strength. This resulting model includes the variables with the strongest effect on Delaware incorporation but has the limitation that it allows the data (rather than theory) to specify the ultimate model. I use it here to check on the robustness of the associations. Results are presented in Column H of Table 7. Consistent with prior results, the variables of theoretical interest (lawyers, networks/precedent, conflict transactions) are statistically significant and retain the expected sign.

C. Other Evidence

One way of examining how firms choose a domicile is to examine firms that do *not* fit the general pattern—i.e., firms that incorporate outside of their home state but not in Delaware. In particular, these firms can highlight the motivation for domicile choice and why firms leave the home state—whether these firms leave because they are searching for particular legal rules. I therefore separately examine all IPO firms between 1995 and 1997 that incorporated neither in Delaware nor in their home state. I then collected a copy of the prospectus from each firm's IPO. This produced a subsample of eighty-one firms.

Interestingly, many of these firms have a physical connection to their domicile: The domicile is an adjoining state (e.g., some Connecticut or New Jersey firms incorporated in New York), the state of the firm's parent company, or the state where the firm began major operations. Many firms began in the state, or have some original connection with the incorporating state (i.e., it being the location of the firm's parent company or founder) and some retain major operations in the domicile state.[119] See Table 8 below. Given their tangible, physical tie to the domicile state at the firm's inception, these firms are best seen

[119] In a spinoff, the parent firm sells shares in the subsidiary to the public. Of these spunoff firms, 38% of all firms not incorporated locally are incorporated in the home state of their parent firm.

as quasi-home-state incorporations, rather than firms that searched for and found a particular set of technical corporate law rules.

The fact that firms are often incorporated in a nearby state is consistent with the idea that lawyers influence incorporation decisions. An entrepreneur in Connecticut is more likely to know (and hire) a New York lawyer than a California lawyer. Therefore, if lawyers were important in domicile decisions, we would expect to see firms incorporating in nearby states. This is also consistent with the idea that lawyers matter and that lawyers suggest a local domicile at start-up.

I find additional evidence that lawyers affect incorporation decisions when I examine two different subsamples of firms. First, I examine only the subset of firms that incorporate locally. If local lawyers too frequently recommend local incorporation, firms represented by local lawyers will be less responsive to qualities that make Delaware attractive. That is, if the likelihood of Delaware incorporation generally increases with underwriter reputation, given local counsel, underwriters will need to be of higher reputation before local lawyers recommend Delaware incorporation. Conversely, if a given trait makes local law attractive, it will take more of that trait before national lawyers recommend local incorporation. I find some evidence of this: Firms represented by local lawyers come from smaller, less responsive states, that are more likely to have adopted the Model Act, sell a greater fraction of the firm's stock, and be taken public by an underwriter with a better reputation (variables, as explained above, are otherwise associated with Delaware incorporation). This is consistent with the idea that local lawyers recommend local incorporation to firms that would otherwise find Delaware attractive. Finally, to account for the possibility that sophisticated managers of relatively large

TABLE 8

WHY DO FIRMS INCORPORATE IN A THIRD STATE?

Type of firm	% of Total Firms in 3rd state	% of firms w/ known connection to 3rd state
Quasi-instate incorporations		
Former headquarters, major manufacturing facilities, or regulated sales within the state of incorporation	43.2%	50.0%
Firm was spunoff from parent corporation headquartered or incorporated in the state of incorporation	9.9	11.4
Firm was founded in the state of incorporation	6.2	7.1
Adjacent state	18.5	24.4
Director links to the state of incorporation	2.5	2.9
Other	6.1	7.1
Unknown	13.6	N/A

firms may select national lawyers and independently prefer Delaware law, while other firms incorporate locally, I examine only the subset of firms with prior venture capital investment. Results are essentially unchanged in unreported regressions.

Conclusion

The debate over state corporate law has focused almost exclusively on theoretical reasons for believing that Delaware is racing to the top or the bottom and on evaluating Delaware's prominence. There is, however, surprisingly little evidence about how firms actually make incorporation choices at the IPO stage, how the market for corporate charters is organized, or how other states or regulatory schemes fare.

In this Article, I examine the incorporation choices made at the IPO, the starting line of any corporate law race and before ownership is dispersed and agency costs arise. I document the death of Tiebout competition. Though firms are free to incorporate in any of the 50 states, they rarely do: Firms incorporate either at home or in Delaware. No other state has been able to attract out-of-state incorporations and no state attracts more than ½ of 1 percent of the assets of firms seeking legal rules out of state.

Thus, a primary finding of this Article is that the dominant metaphor for state corporate law - a national race to the top or the bottom or a market with 50 producers–is incorrect and potentially misleading. Instead, the market looks more like a series of 49 paired-duopolies (or run-offs) between Delaware and other states.[120] There is simply no meaningful actual competition for national firms outside of Delaware; its lead in the national market is overwhelming. This suggests that the crucial question at this point is not simply whether states are racing to the top or the bottom-but what kind of race or market this is and what factors or barriers to entry sustain the equilibrium I observe.

One implication of these facts is that there is a home bias or home-court advantage in incorporation decisions. I examine two potential explanations for this home bias: a local firm's ability to lobby for corporate law reform (particularly antitakeover statutes) and the role and possible agency costs of lawyers. I find evidence more consistent with the idea that lawyers matter. Lawyer identity appears to explain more of the variation in firm decisions than any other factor, including the substance of the state's legal rules. Local lawyers appear to suggest local incorporation, and lawyers with multi-state practice suggest Delaware incorporation. One potentially troubling aspect of

120 Any national market is potential only.

this is that the advice matches their own self-interest, although I cannot exclude other interpretations.[121] However, given evidence that Delaware firms were more valuable and more likely to receive takeover bids in this sample period, it seems reasonable to suspect that this affects shareholder welfare.

With these facts on the table, future work will examine the implications of these findings for corporate law. A few areas of inquiry appear profitable, however. First, one must ask how much of a race there is. Delaware's lead is enormous and growing (its share of IPOs rose from about 40% to 80% in the sample period). Other states' complete failure to attract out-of-state firms (including Nevada's failure) suggests the difficulty of competing with Delaware and may discourage other states from attempting to compete in the long run. Moreover, if each state's market is effectively limited to local firms, states (especially small states) have relatively little incentive to "compete" for charter fees or to invest in innovations. Thus, although Delaware's small size and industrial base is an advantage and allows it to become dependent on franchise taxes and limits the political influence of takeover targets,[122] for other states, being small is a disadvantage. In the alternative, the absence of a meaningful number of firms incorporating outside their own boundaries anywhere but Delaware, may be taken as evidence consistent with the idea that other states are not competing for incorporations. Thus, Delaware may face few actual competitors and enjoy considerable slack in the race to the top/bottom and market power in the market for corporate charters. In the words of Ralph Winter, it may be a "leisurely walk" rather than a vigorous national competition.[123] This would be relatively good news if competition's critics are generally correct, as Delaware would face fewer incentives to quickly race to the bottom. However, this would be relatively bad news if competition's supporters are generally correct, as Delaware and other states would have fewer incentives to race to the top.

This data also raises questions about the direction of any race between states. If lawyers affect the demand for corporate law (as

121 Though I do not evaluate the welfare effects of this conflict in detail, evidence suggests that unless the local lawyer was dramatically less expensive, on average firms may have been better off in Delaware. This is, of course, only an average and there is no reason to think that Delaware incorporation was optimal for every firm.

122 See Daines, supra note 7, at 540.

123 Ralph K. Winter, The "Race for the Top" Revisited: A Comment on Eisenberg, 89 Colum. L. Rev. 1526, 1529 (1989).

they do its supply),[124] any race is not driven only by manager-shareholder conflict and, at least in this respect, is neither to the top nor the bottom. That is, even if states are trying to increase incorporations, they would not simply craft laws to suit managers' preferences, but would rationally cater to lawyers (whose interests may or may not coincide with the firms' interests).

One key question is whether this market structure (and home bias) affects shareholder welfare. Given the valuation and transaction consequences of Delaware incorporation, it seems that the choice between Delaware and home state incorporation matters. However, it is less clear that much turns on the choice between a firm's home state and, say, Oregon. If non-Delaware states produce largely similar corporate law, the fact that firms ignore third states is unsurprising and the home bias is untroubling. If corporate law outside of Delaware is largely fungible, even a small in-state benefit would be sufficient to produce a home state bias. Differences may or may not be meaningful. Given that lawyers appear to affect the choice between home state and Delaware where there is apparently variation, it is not implausible that potentially meaningful variation is overlooked or o\avoided by the parties or lawyers. It is not obvious that serial (or pair-wise) competition generates a different or less efficient laws than national head-to-head competition with 50 states. Even given this market structure, Delaware would still compete in New York for New York firms, and in California for California firms. Thus, Delaware may adopt similar legal rules regardless of whether it competes in one legal market or 49 distinct legal markets. One potential implication of these findings, however, is that Delaware may focus on potential competition from populous states where most of their potential customers are located. Moreover, the threat of potential competition constrains Delaware.[125] Thus, the market structure suggests that Delaware enjoys meaningful market power, but does not without more compel the conclusion that the resulting corporate law rules are inefficient.

I find some mixed evidence that network benefits may explain both individual firm decisions and Delaware's large and sustained

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[124] See Carney, supra note 86, at 720-21 (1998) (arguing that corporate lawyers can influence production of corporate laws); Macey & Miller, supra note 30, at 473 (arguing that Delaware lawyers shape Delaware law with their own interests in mind).

[125] Even absent a nationwide competitor with substantial share, there are three likely sources of competition: (a) home states, which by default would become more attractive; (b) the federal government (which has sometimes intervened in state corporate law matters, such as the Williams Act, 15 U.S.C. § 78(a)-(mm), and the recent Sarbanes-Oxley Act of 2002, Pub. L. No. 107-214, 116 Stat. 745 (codified in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); or (c) states adopting the Model Act.

lead.[126] The welfare implications of this one unclear. If network effects are important, there is reason to be less optimistic about the constraining effect of potential competition from other states. It would be extremely difficult for a state to gain share by developing particular statutory schemes for the simple reason that legal rules cannot be copyrighted. If a state adopted a legal rule valuable enough to entice existing firms, Delaware could simply imitate the rule, making it optional. Thus, firms would have no incentive to leave Delaware for the other state's substantive law. This could discourage states from innovating in corporate law reform.[127] As a result, a state interested in gaining market share would only be able to compete over network benefits-which is highly unlikely to be successful given Delaware's enormous installed base.[128] Small states would likely be ineffective competitors, given the small number of firms located there (even though a limited revenue stream might otherwise lead to a dependence on charter revenues and thus make the state a good competitor).[129] Thus, network effects and the ability to copy corporate law rules may help explain Delaware's persistent lead. If so, then one cannot conclude that the observed outcome is the optimal one. On the other hand, even if individual states cannot provide network benefits to compete with Delaware, they can effectively band together and provide a competing network by adopting the Model Act. Moreover, large states may attract sufficient numbers of local firms that they begin to create network benefits of their own. Thus, even recognizing network effects does not mean that Delaware faces no competition.

Finally, whatever its problems, firms' preference for Delaware does not appear to be pathological or the result of managerial agency costs. During this sample period, Delaware attracted the most firms and appears to have offered valuable legal rules and to be relatively

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[126] Network effects may also explain why lawyers do not more frequently learn the law of a third state. See supra text accompanying notes 79-80.

[127] In fact, this is one way to interpret the evidence that Delaware typically does not innovate in corporate law reform, but rather is an early adopter of other states' innovations See Romano, supra note 13, at 260.

[128] States might also compete on price, perhaps even offering a subsidy (negative price) to incorporating firms. States have not done this to date. Another potential method of competition would be to provide a specialized chancery court.

[129] See Romano, supra note 13, at 278 (

> [O]nly if a substantial number of firms could agree to move to a state other than Delaware in a coordinated fashion, could that state begin to compete with Delaware. It is the existence of a large pool of resident corporations that . . . allows [Delaware] to develop a legal system that promotes the sale of charters by reducing the costs of doing business to firms.).

unlikely to entrench incumbent managers.[130] Delaware IPO firms were also more widely held, consistent with theories that Delaware improves governance and reduces agency costs in public firms. Finally, firms with reputable underwriters, venture capital or leveraged-buyout investment were also more likely to end up in Delaware, suggesting that it is not just chosen by the ill-advised. Given this, it is at least as important to examine the actions of other states and firms that do not incorporate in Delaware. This article is a first step in examining these choices.

130 Daines, supra note 7, at 541-42 (noting that Delaware's political economy limits managers' ability to obtain entrenching laws).

APPENDIX

TABLE A1
STATE SUCCESS OR FAILURE IN ATTRACTING OUT-OF-STATE PUBLIC FIRMS

This table examines a state's success in attracting incorporations among a sample of publicly traded firms.

1985

	Out-of-state firms incorporated in state	%
DE	1155	83.57
NY	51	3.69
NV	29	2.10
NJ	22	1.59
MD	16	1.16
VA	12	0.87
PA	10	0.72
MA	10	0.72
OH	9	0.65
TX	6	0.43
N	1382	100.00

1995

	Out-of-state firms incorporated in state	%
DE	1963	87.79
NY	51	2.28
NV	50	2.24
NJ	18	0.81
MD	17	0.76
PA	14	0.63
MN	11	0.49
MA	11	0.49
VA	10	0.45
IN	10	0.45
N	2236	100.00

TABLE A2
STATE SUCCESS OR FAILURE IN RETAINING IPO FIRMS

This table examines a state's success in attracting incorporations of locally headquartered firms among a sample of [ ] IPO firms between 1980-2000.

1980-1989			1990-1999		
States with best retention rates	Local firms incorporated in-state %	Firms HQ'd in-state		Local firms incorporated in-state %	Firms HQ'd in-state
DE	100	4	DE	100	5
WA	67	24	OR	69	36
MI	67	15	NV	67	21
OR	64	11	MN	65	72
NV	63	8	LA	53	17
MN	63	19	WA	52	77
AR	60	5	WV	50	2
WI	59	17	SD	50	4
IN	57	7	ND	50	2
NC	53	15	MT	50	4
GA	50	26	GA	48	100
OK	50	4	FL	47	143
NM	50	2	TN	47	58
CA	49	260	MI	47	38
OH	45	31	IN	46	28
MA	45	66	OH	45	78
States with worst retention rates					
AK	0	1	AK	0	3
HI	0	1	AR	0	7
ID	0	2	HI	0	3
RI	0	2	ID	0	5
WV	0	3	NM	0	3
DC	0	3	VI	0	1
CT	4	24	WY	0	1
AZ	10	10	CT	4	74
LA	11	9	DC	7	15
IL	12	41	NH	8	13
MO	13	16	AZ	12	41
UT	17	6	IL	12	118
NH	20	5	NY	12	208
VA	21	24	CO	13	80
FL	23	22	MO	15	33

Table A3
State success or failure in retaining public firms

This table examines a state's success in retaining incorporations among a sample of [ ] IPO firms in 1985 and 1995.

1985			1995		
States with best retention rates	Local firms incorporated in-state %	Firms HQ'd in-state		Local firms incorporated in-state %	Firms HQ'd in-state
VT	100	2	DE	100	11
NV	93	14	NV	81	32
DE	86	7	MN	74	136
OR	83	18	IN	71	49
IN	78	41	OR	68	38
WI	76	37	SD	67	6
HI	75	4	ME	67	3
MN	73	90	WI	66	65
ME	67	3	OH	55	139
OH	60	119	WA	55	51
SC	60	10	MI	55	78
PA	58	111	IA	50	18
GA	58	65	HI	50	4
IO	58	12	AK	50	2
MA	57	117	PA	49	156
States with worst retention rates					
MT	0	1	MT	0	4
WV	0	2	DC	0	6
DC	0	4	NH	0	18
IL	7	122	IL	9	164
NH	9	11	ID	11	9
ID	13	8	CT	13	103
AR	15	13	AL	14	29
AL	18	17	AZ	15	39
AZ	19	16	AR	16	19
CT	20	85	VT	20	5
CA	25	325	WV	20	5
OK	26	23	TX	23	338
KY	27	11	MD	24	49
MO	28	43	NM	25	4
TX	28	209	CA	25	551

TABLE A4
THE MARKET FOR IPO CHARTERS: 1990-2000

	A	B	C	D	E	F
State	Number of firms incorporated instate	Market Share %	Out-of-state firms incorporated in-state	Market share of all firms that incorporate out of state	Number of firms headquartered in state	Retention rate %
AK	0	0	0	0	3	0
AL	4	.12	0	0	16	.25
AR	0	0	0	0	7	0
AZ	5	.15	0	0	41	.12
CA	223	6.66	9	.37	899	.24
CO	13	.39	3	.12	80	.13
CT	4	.12	1	.04	74	.04
DC	2	.06	1	.04	15	.07
DE	2298	68.66	2293	95.3	5	1.00
FL	71	2.12	4	.17	143	.47
GA	53	1.58	5	.21	100	.48
HI	0	0	0	0	3	0
IA	5	.15	2	.08	12	.25
ID	0	0	0	0	5	0
IL	18	.54	4	.17	118	.12
IN	16	.48	3	.12	21	.46
KS	5	.15	0	0	14	.36
KY	2	.06	0	0	12	.17
LA	10	.30	1	.04	17	.53
MA	64	1.91	0	0	247	.26
MD	32	.96	14	.58	64	.28
ME	2	.06	0	0	5	.40
MI	20	.60	2	.08	38	.47
MN	55	1.64	8	.33	72	.65
MO	5	.15	0	0	33	.15
MS	3	.09	0	0	13	.23
MT	2	.06	0	0	4	.50
NC	24	.72	1	.04	52	.44
ND	1	.03	0	0	2	.50
NE	4	.12	1	.04	12	.25
NH	1	.03	0	0	13	.08
NJ	26	.78	3	.12	99	.23
NM	0	0	0	0	3	0
NV	38	1.14	24	1.00	21	.67

State	Number of firms incorporated instate	Market Share %	Out-of-state firms incorporated in-state	Market share of all firms that incorporate out of state	Number of firms headquartered in state	Retention rate %
NY	32	.96	8	.33	208	.12
OH	36	1.08	1	.04	78	.45
OK	7	.21	0	0	24	.29
OR	27	.81	2	.08	36	.69
PA	47	1.4	5	.21	119	.35
RI	2	.06	0	0	10	.20
SC	3	.09	0	0	15	.20
SD	2	.06	0	0	4	.50
TN	29	.87	2	.08	58	.47
TX	65	1.94	0	0	306	.21
UT	11	.33	1	.04	23	.43
VA	21	.63	4	.17	80	.21
VT	1	.03	0	0	6	.17
WA	42	1.25	2	.08	77	.53
WI	13	.39	0	0	29	.45
WV	1	.03	0	0	2	.5
WY	0	0	0	0	1	0
N	3347	100	2406	100	3347	—

TABLE A5
THE MARKET FOR CORPORATE CHARTERS IN PUBLIC FIRMS: 1995

	A	B	C	D	E	F
State	Number of firms incorporated in-state	Market Share	Out-of-state firms incorporated in-state	Market share of firms incorporating out of state	Number of firms headquartered in-state	Retention rate %
AK	1	.03	0	0	2	.50
AL	4	.11	0	0	29	.14
AR	3	.09	0	0	19	.16
AZ	6	.17	0	0	39	.15
CA	142	4.03	3	0.13	551	.25
CO	31	.88	6	0.27	82	.30
CT	15	.43	2	0.09	103	.13
DC	1	.03	1	0.04	6	0
DE	1974	55.98	1963	87.79	11	1.00
FL	78	2.21	10	0.45	147	.46
GA	52	1.47	6	0.27	103	.45
HI	3	0.09	1	0.04	4	.50
IA	10	.28	1	.04	18	.50
ID	2	.06	1	.04	9	.11
IL	18	0.51	3	.13	164	.09
IN	45	1.28	10	.45	49	.71
KS	11	0.31	2	.09	22	.41
KY	7	0.20	2	.09	14	.36
LA	11	0.31	3	.13	22	.36
MA	100	2.84	11	.49	193	.46
MD	29	0.82	17	.76	49	.24
ME	2	0.06	0	0	3	.67
MI	45	1.28	2	.09	78	.55
MN	111	3.15	11	.49	136	.74
MO	23	0.65	4	.18	70	.27
MS	4	0.11	0	0	14	.29
MT	0	0.00	0	0	4	0
NC	31	0.88	3	.13	58	.48
ND	31	0	0	0	0	.31
NE	5	0.14	1	.04	13	.06
NH	1	0.03	0	0	18	.26
NJ	57	1.62	18	.81	149	.25
NM	1	0.03	0	0	4	.81
NV	76	2.16	50	2.24	32	.34

State	Number of firms incorporated in-state	Market Share	Out-of-state firms incorporated in-state	Market share of firms incorporating out of state	Number of firms headquartered in-state	Retention rate %
NY	147	4.17	51	2.28	281	.55
OH	85	2.41	8	.36	139	.35
OK	13	0.37	2	.09	31	.68
OR	28	0.79	2	.09	38	.49
PA	90	2.55	14	.63	156	.36
RI	4	0.11	0	0	11	.47
SC	9	0.26	0	0	19	.67
SD	4	0.11	0	0	6	.43
TN	26	0.74	2	.09	56	.23
TX	82	2.33	5	.22	338	.46
UT	16	0.45	3	.13	28	.39
VA	42	1.19	10	.45	82	.20
VT	1	0.03	0	0	5	.55
WA	30	0.85	2	.09	51	.66
WI	47	1.33	4	.18	65	.20
WV	1	0.03	0	0	5	0
WY	2	0.06	2	.09	0	0
N	3526	100	2236	100	3526	—