



**MICHAL
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SEARCHING FOR THE RIGHT MIX OF FREEDOM AND REGULATION IN CORPORATE LAW

FOR more than thirty years, scholars have vigorously debated whether the interstate competition for incorporations is a “race to the top,” in which states work hard to offer value-maximizing corporate laws, or rather a “race to the bottom,” in which states lure managers—who affect incorporation decisions greatly—by offering them favorable protections at shareholders’ expense. The debate is well-developed; some might even say that the debate is stale. Michal Barzuza is still early in her career, but she has managed to refresh this debate by bringing new and important insights to the table. Barzuza has revealed overlooked variation among state corporate laws, collected surprising empirical data that cannot be easily explained by established understandings, raised new theoretical arguments regarding states’ incentives and firm heterogeneity, and exposed Nevada’s unnoticed strategy of market segmentation with lax law. Barzuza’s work is helping to create a new understanding of the market dynamics for corporate law—an understanding that has potential implications for other basic issues in corporate law.

Barzuza’s work on the interstate competition for corporate charters most recently led to her surprising findings about the state of Nevada. In two recent projects, “Market

Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction,” and the co-authored “What Happens in Nevada: Self Selecting into Lax Law?” (with David Smith), Barzuza argues that Nevada has embarked on a market segmentation strategy by offering strikingly lax law to corporations that seek protection from liability.

Conventional wisdom had it that Nevada imitates Delaware law and does not derive significant revenues from publicly traded corporations. Barzuza has found evidence to the contrary. Over the past decade, Nevada has raised its taxes on publicly traded corporations. It has also changed its law to protect managers at the expense of shareholders. Strikingly, officers and directors in Nevada face no liability for breach of duty of good faith, and no liability for breach of duty of loyalty except for intentional misconduct or knowing violations of law. In Delaware, by comparison, directors and officers are liable for any breach of duty of loyalty and good faith. Additionally, in Delaware, companies are subject to higher scrutiny when the corporation is subject to a takeover. Nevada, through its secretary of state’s website, also promotes itself as providing more protection from liability than Delaware.

Barzuza suggests that Nevada’s strategy of using lax law helps the state overcome significant barriers to entry in the market for corporate charters. By offering such law, Nevada caters to a group of corporations that are not served by Delaware law. Nevada has recognized what scholars have missed—not all firms are interested in the same type of corporate law. Some corporations have a stronger desire than others to free their officers and directors from liability for their acts. This variation in preferences among firms allows a state like Nevada to pursue a market segmentation strategy. Successfully attracting one segment of the market allows Nevada to charge supra-competitive prices and turn a profit.

Nevada’s lenient liability regime for corporate managers and directors mutes Delaware’s overwhelming market advantages in the competition for incorporations. First, Nevada’s law clearly spells out its no-liability regime, leaving little room for discretion in applying it. This means that

Delaware’s main advantages of having a developed body of case law and a specialized judiciary do not provide a significant advantage over the application of clearly defined (and manager-friendly) Nevada law. Moreover, Delaware cannot respond to Nevada by offering similar law because such a move could hurt Delaware’s brand, risk triggering federal intervention, and require Delaware to reduce its price for incorporation. Finally, building on its traditionally lax law in other fields, Nevada has more credibility than Delaware in offering lax law.

Perhaps not surprisingly, the legislative history of the Nevada legislation shows a pronounced concern for the kind of corporations that its recently amended law would attract. The bill’s opponents were concerned that dishonest corporate managers would choose to incorporate in Nevada—opponents predicted that the bill would attract “scoundrels” and make Nevada “the hole in the wall.” There is another perspective, however. Certain firms might appropriately choose Nevada because, for them, Nevada law is efficient.

Attempting to distinguish between these two accounts, Barzuza and Smith investigated differences between firms that choose Nevada and firms that choose Delaware. They found that Nevada corporations file accounting restatements at double the national rate, and at least 30 percent to 40 percent more than corporations in Delaware. Their findings control for firm characteristics, and they remain significant in a matched sample of Nevada and Delaware companies based on size and industry. Barzuza and Smith also found that incorporation in Nevada is not associated with the premium of incorporating in Delaware, though it is admittedly not associated with a discount relative to other states either. The negative market reaction to a filing of an accounting restatement by a Nevada company, however, is stronger than in other states. Barzuza and Smith interpret these findings as consistent with the explanation that firms go to Nevada for different reasons. Mere incorporation in Nevada is thus a mixed signal. Barzuza and Smith argue, however, that the comparatively strong negative market reaction to accounting restatements by Nevada corporations suggests that, when

they restate, Nevada corporations reveal themselves to be more likely to be the type of corporation that incorporated in Nevada in order to seek high private benefits.

Barzuza's work on Nevada thus focuses attention on firm self-selection in a regime where firms choose their state of incorporation. Barzuza argues that such choices are revealing in ways that may help shape policy. For example, if firms that need regulation most opt for the Nevada regime, as is the case for at least some of the firms, shareholders and policymakers should be concerned. On the other hand, Barzuza suggests that the current system where corporations can choose the state of incorporation has an overlooked but important benefit. This firm self-selection, Barzuza argues, could send a useful signal. By transparently choosing Nevada and its lax law, firms reveal information that would otherwise be unavailable about insiders' preferences. Because incorporating in Nevada sends a mixed signal, however, it is unclear whether investors will adequately deter companies that incorporate there for invidious reasons.

Barzuza has developed this last signaling theme rigorously in a related context, where the signal seems to be clearer: the cross-listing of foreign firms on U.S. exchanges. In "Lemon Signaling in Cross-Listing," Barzuza develops a model of signaling of private benefits of control. The model assumes that the market cannot fully observe the differences in manager and controlling-shareholder self-dealing across firms. Under these assumptions, cross-listing—and thereby bonding to a strict jurisdiction—is a signal that insiders do not seek private benefits. Because bonding is more costly to managers who extract high private benefits than to managers who extract low private benefits, cross-listing can separate good managers from bad managers: Managers with less interest in private benefits will choose to cross-list and managers with more interest in private benefits will choose to remain in their home market.

As Barzuza points out, this separation creates a unique signaling behavior in firms that have a controlling shareholder, as many foreign firms do. Unlike managers, controlling shareholders can sell their opportunity to extract private

benefits by selling their block of shares. The buyer pays a control premium that reflects, among other things, the potential to extract private benefits from the specific firm. Controlling shareholders may benefit from signaling that they extract high private benefits of control because that would increase the control premium a buyer would be willing to pay. The signaling of private benefits hypothesis thus predicts that managers and controlling shareholders would want to convey different signals. This distinction between two different types of "insiders"—managers and controlling shareholders—could be useful in understanding other choices corporate managers make, such as distributing dividends or raising capital.

Barzuza's recent work focusing on market segmentation is only one part of her contribution to the debate about the consequences of interstate competition for incorporation. In an earlier theoretical paper, "Price Considerations in the Market for Corporate Law," 26 *Cardozo L. Rev.* 127 (2004), Barzuza first develops the notion that, in the market for corporate law, there is more complexity than previously understood due to heterogeneity in the incentives of both the states that devise corporate law and the firms that choose that law by selecting their state of incorporation. Barzuza focuses first on the price that Delaware charges for incorporations, which she argues is wrongly ignored in the debate about the consequences of the interstate competition for incorporations. Price considerations constrain Delaware: The more pro-managerial Delaware law becomes, the less the state can charge for its incorporation services and still guarantee shareholders' approval. Price considerations thus prevent Delaware from catering to managers' whims exclusively; it must also attend to shareholders' interests. The price dimension, Barzuza argues, can explain why Delaware law is more protective of shareholders than the law of other states that do not have the market power to charge meaningful prices for incorporations.

In "Delaware's Compensation," 94 *Va. L. Rev.* 521 (2008), Barzuza continues to explore the significance of the price that a state can charge for incorporation. In this paper, she

argues that there is a connection between the structure of Delaware's franchise tax law—the way in which it determines firms' annual franchise tax liability—and Delaware's corporate law. The current structure of Delaware's tax is suboptimal because it is not sensitive to firm value or performance. If the value of firms in Delaware is rising, Delaware receives no additional tax benefit; if it is declining, Delaware's revenues do not decline. Delaware collections are instead affected only by the number of incorporations. A franchise tax that is sensitive to firm performance would be superior to Delaware's current franchise tax, Barzuza argues, because it would align Delaware's incentives with those of shareholders and induce the state to offer corporate law that maximizes shareholder value. Such a franchise tax would have this effect even if Delaware faced no competition from other states over incorporations and even if shareholders were passive. Finally, Barzuza argues that, despite this suboptimal situation, Delaware may not have sufficient incentives to reform its franchise tax law. The current tax law creates a commitment to managers, and assures that Delaware will continue to cater to their interests in the future.

Barzuza has emphasized the role that price plays in the interstate market for corporate charters, but she has also examined that market more generally. In the co-authored "The Market for Corporate Law," 162(1) *J. Institutional & Theoretical Econ.* 134 (2006), with Oren Bar-Gill and Lucian Bebchuk, Barzuza develops a formal model of the market for incorporations. It predicts that, in equilibrium, competition among states produces optimal rules with respect to issues that do not have a substantial effect on managers' private benefits, but such competition will not create optimal rules with respect to issues where managers' and shareholders' interests diverge. The model demonstrates that this may happen even where shareholders must approve reincorporation. Because Delaware has significant advantages that other states cannot replicate, shareholders may prefer Delaware over other states, even though its law is not optimal, and even where Delaware law disadvantages shareholders more than other states' laws. The paper analyzes why a dominant state such

as Delaware might emerge, the prices that it would set, and the profits it would make. It shows how Delaware's market power allows it to charge a high price, and also to respond to entry by cutting its price. Working on this project helped Barzuza understand the sources of Delaware's dominance in the market.

Barzuza's work has demonstrated that factors like the price states can obtain for incorporations and the heterogeneity of firm and state preferences help determine whether state corporate law is optimal. Through some of her research, Barzuza became convinced that Delaware has better incentives to protect shareholders than other states, and she recently decided to look closely into that question. In "The State of State Antitakeover Law," 95 *Va. Law Rev.* 1973 (2009), Barzuza examines differences among state takeover laws. Previous assessments of takeover law have taken Delaware law to be the relevant regime. In Delaware, managers who use defensive tactics in change-of-control situations must meet the enhanced fiduciary duties outlined in the famous cases of *Unocal*, *Revlon*, and *Blasius*. Conventional wisdom has largely assumed that all states follow Delaware's lead in applying this law. Barzuza, however, has shown that the limited available case law from the states actually tends to show considerable variation in courts' willingness to review managers' decisions in change-of-control situations. Some states do follow Delaware's enhanced duties, but others replace the Delaware duties with the lenient business judgment rule.

In this project, Barzuza first observed that Nevada law is significantly different from Delaware's. That finding took some digging, however. In *Hilton Hotels*, a federal judge applying Nevada law stated that Nevada follows Delaware standards of *Unocal* and *Revlon* to evaluate defensive tactics adopted by firms that are the target of a takeover. The case is often cited to show that Nevada follows Delaware law. But this piece of conventional wisdom missed the next development in Nevada. Following *Hilton Hotels*, Nevada's legislature stepped in to clarify that Nevada does not apply *Unocal* and *Revlon* to evaluate defensive tactics by takeover targets, but relies instead on the more deferential business judgment rule.

Barzuza's work has opened several themes that will occupy her in the coming years. She plans to explore how differences in the type and nature of agency costs among firms affect their choices about governing law. As part of this general theme, Barzuza is currently working on a project that challenges the commonly held assumption that in a world of private ordering, firms would sort optimally by choosing the appropriate law. She identifies several examples that illustrate the point that, when firms are able to choose the governing law, the firms that bond themselves to better regulation are the firms that least need that regulation because they already have a stronger shareholder base and their managers enjoy low private benefits.

Barzuza's project on lemon signaling in firms that cross-list highlights an overlooked difference between firms run by managers and those run by controlling shareholders. She will further compare the implications of this difference to other decisions that managers and controlling shareholders make.

Finally, the case of Nevada itself will require more study. Many papers have been written on Delaware, but very few have been written on Nevada, the only other state that attracts a significant number of out-of-state incorporations. Barzuza says that more research is required to understand the companies that choose Nevada, why they choose Nevada, and what we can learn from the Nevada case about firms' freedom to choose their governing law.

EXCERPTS

MARKET SEGMENTATION WITH LAX LAW: THE RISE OF NEVADA AS A LIABILITY-FREE JURISDICTION

WORKING PAPER (2011)

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A. OFFERING LAX LAW UNDERMINES DELAWARE'S ADVANTAGES

1. *The Clarity of Lax Law Undermines the Advantages of Specialized Judiciary and Network Externalities*

One of Delaware's primary advantages is that many public companies are already incorporated within the State—i.e., the size of Delaware's network. The expansive liability protections that Nevada provides, however, offer significant clarity. This clarity compensates for Nevada's lack of the amenities Delaware provides and contributes to the State's ability to segment the market. A rich body of case law, specialized judiciary, and network effects associated with a large number of companies are especially important when the law is indeterminate; they are less important when the law is clear. If law is clear, as Nevada law is, other advantages matter less.

2. *Nevada Has Competitive Advantages in Offering Lax Law*

While Delaware has so many advantages, lax law is perhaps the one field in which Nevada has a clear edge. Nevada has branded itself in other fields as consistently providing lax law. The State's political climate is generally hospitable to lax law. Offering lax corporate law is merely symptomatic of the State's broader approach. [...]

B. DELAWARE IS CONSTRAINED FROM RESPONDING EFFECTIVELY

Another reason that offering lax law is particularly effective is Delaware's incapacity to respond to Nevada's entry. As discussed above, Delaware's ability to respond to entry would deter most states from attempting to enter the market. In

response to market entry, Delaware could change its law and/or reduce the price it charges, making its overall package more desirable than that of any prospective entrant. [...]

1. *Delaware Is Constrained from Responding to Nevada's Entry by Degrading Its Law*

(A) THE RISK OF FEDERAL INTERVENTION IN CORPORATE LAW

First, in degrading its law, Delaware would increase the risk of federal intervention in corporate law. [...] If Delaware were to follow Nevada by degrading its corporate law, Congress might intervene. Since federal intervention could take many forms—even, in the most extreme scenario, the sweeping federalization of corporate law—Delaware could not afford to degrade its law as much as Nevada does.

To be sure, Nevada also stands to lose from federal intervention. But Nevada is less likely to trigger federalization than Delaware is. Nevada is still a relatively small player in the market. Because of the smaller number of companies that Nevada attracts, the State is much less likely to draw the attention of Congress. Because of its size, Nevada is able to externalize some of the risk of federal intervention onto Delaware. [...]

(B) DELAWARE'S HIGH FRANCHISE TAX

Delaware's franchise tax—the price that it charges for incorporations—further constrains its ability to respond to Nevada. In a previous work, I argue that Delaware is able to command a premium for incorporations due to the advantages that it offers shareholders. If the State were to degrade its law to favor managers, the value of its entire incorporation package, and concomitantly the premium it can charge for that package, should decline. In competing with Nevada, Delaware has to be careful not to risk diluting the surplus it offers to firms that incorporate there. Nevada's tax rate, while higher than the rates of many states, is still far lower than Delaware's.

(C) DELAWARE'S BRAND

Delaware has branded itself as providing efficient packages that do not rely on favoritism towards managers. Instead, Delaware's promoters stress its specialized judicial

system, the system's efficiency, the State's experienced judiciary, and the State's developed body of case law.

When Delaware has been criticized for being too protective of managers (in contrast to Nevada), its players have vigorously maintained that Delaware does not exhibit favoritism towards management. Rather, they have insisted that Delaware achieves a balance between shareholders' and managers' interests. If Delaware were to follow Nevada and degrade its own corporate law, its brand would suffer.

(D) THE TYPE OF FIRMS THAT DELAWARE ATTRACTS

Delaware may also have preferences regarding the types of firms it attracts; to wit, it may prefer to attract firms with lower agency costs. Indeed, Delaware players have pronounced their preference to attract the good firms in the market. To the extent that strict law attracts firms with lower agency costs and better corporate governance, Delaware may be reluctant to risk losing those firms.

2. *Can Delaware Respond with an Additional Menu?*

An alternative to degrading its corporate law would be for Delaware to offer firms a menu of corporate law forms with multiple options from which firms could choose. [...] For the following reasons, offering an additional menu would also impose costs on Delaware.

(A) INFORMATION TO INVESTORS

If Delaware were to provide a variegated menu, the signal that investors would receive when a firm incorporated in Delaware would become distorted. A firm's decision to incorporate in Delaware signals that its management believes in the superiority of the State's law, but it does not *ipso facto* explain why management arrived at that conclusion. For investors to ascertain why a firm chose to incorporate in Delaware would potentially require that they undertake costly investigations. This would diminish the benefit that managers presently realize from Delaware incorporation.

(B) SIGNAL EFFECT

Companies might choose to incorporate in Nevada for a variety of reasons. For instance, some companies might choose Nevada because it charges a lower franchise tax; oth-

ers might prefer Nevada because of the protections offered to directors and officers. Thus, while a firm's choice to incorporate in Nevada may suggest that it is seeking lax law, the signal is a noisy one. [...]

If, however, Delaware were to offer two distinct menus—a lax one and a strict one—firms choosing the lax option would broadcast a strong signal that they are interested in lax law. As a result, these firms would suffer more significant discounts in their valuations. [...]

(C) DELAWARE'S BRAND

As discussed above, Delaware's brand may constrain it from responding to Nevada's strategy. Offering a more management-friendly menu could also damage Delaware's brand as a provider of balanced corporate law, even if that menu would only be optional.

C. COMPARISON TO OTHER STRATEGIES

Having argued that market segmentation can be an effective strategy to overcoming significant barriers to entry, the question becomes, could segmentation be successful if attempted with strict, rather than lax, law? [...]

The following discusses a notable but thoroughly unsuccessful attempt to challenge Delaware by offering shareholder-friendly law. This example shows the challenges of these strategies.

1. *North Dakota—Why Segmentation with Strict Law Wouldn't Work*

A recent example has demonstrated the difficulties of attempting to enter the market from the top. North Dakota recently adopted a law that is more shareholder-friendly than Delaware's. However, North Dakota succeeded only in attracting a single out-of-state firm, American Railcar Industries Inc. Majority owner Carl Icahn lobbied strenuously for the North Dakota bill's adoption. In firms other than American Railcar, managers and shareholders alike have overwhelmingly opposed proposals to reincorporate in North Dakota.

Why has segmenting the market with strict law been so

unsuccessful? There are two main challenges that impede segmentation from the top. For one, firms in Delaware have the option to voluntarily opt out of Delaware law to adopt terms that are more shareholder-friendly. For example, Delaware firms can choose to have proxy access, not to have staggered boards or a poison pill, or to hold their directors liable for breaches of their duties of care. Thus, a state that offers strict law does not add much compared to Delaware. Yet opting out from existing law is not cost-free and is often a complicated affair. Thus, one could argue, a state that offers a comprehensive strict menu could have some advantages for firms interested in such a menu, even though it could theoretically be achieved under Delaware law.

There is another reason, however, for why Delaware provides a better alternative than North Dakota. This reason is related to Delaware's other advantages, apart from the law on its books. The added value of Delaware's other advantages makes the State attractive to firms that are interested in maximizing shareholder value, even as compared to a state that offers a somewhat better law.

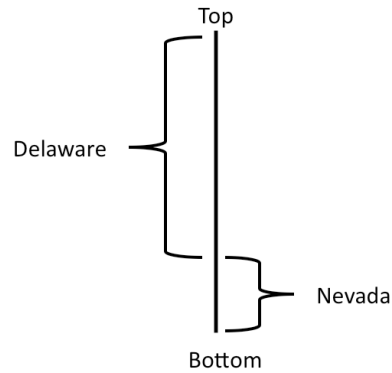
As a result of Delaware's advantages, its overall package may be worth more for shareholders than the package that North Dakota or any other state is capable of offering.

2. *Why There Are No Other States Along the Agency Costs Spectrum*

If not from the top, could another state emerge with a law that targets firms with agency costs greater than those of firms in Delaware but less than those of firms in Nevada? [...]

If there is any gap between Nevada and Delaware, it is probably quite a narrow one. It is still possible, however, that another state will attempt to bridge that gap. Such a state, for example, could offer Delaware law as a default with an option to opt into Nevada law. This would mean permitting companies to opt out of liability for duty of loyalty and duty of good-faith violations, as in Nevada, but conditioning this opting-out on shareholder approval. The question is whether this strategy caters to a sufficiently large segment to make it profitable.

FIGURE 1: Ranges of Firms' Preferences



3. Delaware Covers a Range of Preferences

Figure 1 illustrates the forgoing discussions in mapping the range of preferences that Nevada and Delaware cover. [...]

THE STATE OF STATE ANTITAKEOVER LAW

95 VA. L. REV. 1973 (2009)

Antitakeover law, which regulates what management can and cannot do in change-of-control situations, is one of the most heavily researched, debated, and litigated areas in corporate law. While the use of antitakeover devices may serve business purposes, it may also reflect conflicts of interest and weaken the disciplinary power of the market for corporate control.

Since half of all publicly held companies are incorporated in Delaware, the debate over antitakeover law has tended to focus almost exclusively on Delaware law. This law can be straightforwardly summarized. First, although management's conduct in running the day-to-day affairs of the company is subject to a deferential standard of judicial review under the business judgment rule ("BJR"), managers in

change-of-control situations are subject to enhanced fiduciary duties under the *Unocal*, *Revlon*, and *Blasius* standards. Second, while Delaware courts allow management to fight hostile takeovers by using the classic poison pill, they do not allow the use of extreme versions of the pill—the so-called "dead hand" and "slow hand" pills.

But what about non-Delaware antitakeover law, which controls the other half of publicly held companies? To date, no one has examined systematically whether other states follow Delaware standards. Other states have adopted some antitakeover statutes addressing management's use of defensive tactics, including pill endorsement and other constituency statutes, but conventional wisdom has been that since Delaware case law has allowed managers to use the pill vigorously, these statutes do not create a substantially different regime from Delaware law. To date, however, no one has examined how these statutes are actually applied. And in particular, whether they lead courts to apply similar or different fiduciary duty standards for management use of defensive tactics. This Article will document, for the first time, a systematic study of state antitakeover law. It focuses on one question: what are the standards that courts in states with and without antitakeover statutes—especially pill endorsement and other constituency/directors' duties statutes, which regulate management's use of defensive tactics ("Defensive Tactics Statutes" or "DTS")—apply to managers defending against a takeover? Do they follow Delaware enhanced fiduciary duties or do they impose weaker fiduciary duties?

The Article [...] will report the results of an examination of all available antitakeover case law [...] and a fifty-state survey of DTS.

The results are surprising and differ from common assumptions. The research finds that some states have rejected the *Unocal* and *Revlon* standards that impose enhanced managerial duties in Delaware, and shows that it is questionable whether these standards apply in other states. In particular, [this Article] finds that to the extent we can observe, courts in states with relatively strong (and sometimes even weak)

DTS have relied on these statutes to reject the imposition of enhanced duties and apply the BJR. States with no DTS follow Delaware standards. These results, by and large, are supported by comparison of cases before and after the passage of the statutes. Furthermore, in Nevada, where a court decided to follow *Unocal* and *Revlon* despite the state's relatively strong statutes, the legislature stepped in to correct the mistake. Finally, subject to a small number of observations, the findings suggest that extreme pills might be allowed in some other states.

PRICE CONSIDERATIONS IN THE MARKET FOR CORPORATE LAW

26 *CARDOZO L. REV.* 127 (2004)

Which system, of all possible ones, is likely to produce corporate law that maximizes shareholder value? One of the most fundamental questions in American corporate law is whether the current system, which allows firms to incorporate in a state of their choice, enhances shareholder value or should be replaced, either in whole or in part, by federal legislation. [...]

Notwithstanding the extensive theoretical and empirical literature on this question, there is no consensus as to the desirability of the current system. Although some believe that it creates competition for incorporations among states that induces them to produce efficient corporate laws, others doubt that such competition is desirable or that it even exists. While race to the top proponents point to the relative performance of Delaware, the dominant state in the market for corporate law, as an indication that the race is indeed one to the top, others argue that the current system provides incentives to produce corporate laws catering to the interests of managers. Puzzlingly, evidence exists to support all sides in the debate.

Although commentators hold opposing views regarding the desirability of the current system, they all share certain assumptions. Generally, they assume that Delaware designs

its law to maintain and enhance its incorporation-related revenues. In addition, they share the belief that Delaware derives significant revenues from attracting a great number of incorporations and from charging a price significantly higher than its marginal cost for those incorporations. Yet, in applying the assumption of revenue maximization to analyze Delaware's choices, commentators generally focus exclusively on Delaware's interest in attracting more firms, setting price considerations aside. Thus, during this three-decades-old debate, one dominant assumption on all sides of the debate has been that Delaware seeks to maximize the number of domestic incorporations.

By contrast, this article argues that Delaware revenues do not necessarily increase in quantity. Instead, it highlights the role that price, in addition to quantity, plays in determining Delaware revenues.

Unlike a producer in a competitive market that gets a competitive price from the market, Delaware, which enjoys substantial market power, can increase the price it charges for its law above its marginal cost of production. The extent to which Delaware can raise its price is affected by the two special characteristics of this market: the shareholder-manager agency problem on the demand side and the current American corporate law rule that requires manager initiation of and shareholder approval for any re-incorporation decision.

Given these characteristics, to induce managers to reincorporate to Delaware, Delaware must cater to their interests. To induce shareholders to approve reincorporation to Delaware, and to attract firms when they first go public, Delaware must ensure that firm-value will be greater in Delaware than in other states. Thus, it must not charge firms more for incorporation than the net value that Delaware incorporation confers upon them. This net value equals the value arising from Delaware's competitive advantages—such as its specialized judiciary, its developed body of case law, and the network externalities associated with its law—minus the harm to shareholders that is caused by its pro-managerial corporate laws.

Delaware revenues, therefore, do not necessarily increase

as the volume of incorporations increases. Instead, price considerations present Delaware with the following trade-off: the more pro-managerial its law is, the more managers it attracts but the less it can charge each firm. As managers have heterogeneous preferences toward the extraction of private benefits, the more Delaware offers corporate law that appeals to managers, the more managers it attracts. Yet, the more its law protects managers, the greater the decline in firm value and hence the less it can charge for incorporation.

As a result, if Delaware indeed maximizes its revenues as commentators assume, it necessarily designs its law taking into account not only its effect on the number of firms Delaware attracts but also its effect on the price Delaware charges. Moreover, price considerations are important even if Delaware cannot or is not interested in raising its price above a certain threshold, if it is merely interested in retaining its revenues rather than enhancing them, or if different constituencies in Delaware that have influence on Delaware law promote other interests. As long as Delaware charges a significant price, this price constrains the incentives of the legislative body and the incentives of other constituencies to cater to managers' interests, since doing so might cause Delaware to lose its leading position in the market. Lastly, the analysis is important even if Delaware adopts its law for reasons other than price considerations, as it can explain why Delaware does not have strong reasons to change its law.

The price considerations analysis has important implications for the corporate law that Delaware and the other states produce, the assessment of the current system of state corporate charters, and the determination of the desirable extent of federal intervention in the market for corporate law.

First, the analysis solves one of the main puzzles about Delaware's strategy. Conventional wisdom has it that Delaware provides managers with excessive hostile-takeover protection devices. At the same time, Delaware has traditionally been relatively mild on this front as compared to other states. As a recent work forcefully points out, since Delaware did not seem to be engaged in a race to the top or to the bottom, both sides of the debate could not fully account for its

behavior. The account put forward in this article is consistent with Delaware's behavior. To attract and retain managers, Delaware needs to cater to their interests by producing pro-managerial rules that reduce firms' value. To be able to charge a positive price, however, Delaware needs, simultaneously, to take into account the interests of shareholders. Racing to the top or to the bottom instead of choosing a middle ground could only impair Delaware revenues.

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