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DELAWARE'S SHRINKING HALF-LIFE

Mark J. Roe

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A revisionist consensus among corporate law academics has begun to coalesce that, after a century of academic thinking to the contrary, states do not compete head-to-head on an ongoing basis for chartering revenues, leaving Delaware alone in the ongoing interstate charter market. The revisionist view pushes us to consider how free Delaware is to act. Where and when would it come up against boundaries, punishments, and adverse consequences? When do other states (and Washington) constrain Delaware? Recent state corporate lawmaking helps us to define those boundaries in terms of potential state competition and to see that the critical actors are not other states' lawmakers directly, but Delaware's own corporate constituents who, if disgruntled, can induce other states to enact new laws. Moreover, analysis of previously unassembled chartering revenue data from Delaware's Secretary of State's office displays a vital dimension of state competition, once thought to be relatively unimportant, but that's becoming increasingly powerful: Delaware's tax base is eroding, and it's eroding faster in the past decade or so than ever.

Delaware must move ever faster to replenish that erosion. The dynamism of American business interacts with even a lackluster state-based corporate chartering market to put powerful pressure on Delaware, whose business base is persistently eroding as firms merge, close, and restructure.

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INTRODUCTION

Corporate law academics have long sought to fully understand the process of state corporate lawmaking. Do states compete to issue corporate charters? Do they compete in a race to the top that hones an efficient law, or one to the bottom, by states currying favor with corporate insiders? For decades the debate was premised upon strong, ongoing state-to-state competition, with sharp disagreement on the directionality of that competition. In this decade, however, a powerful revisionist perspective has emerged that states do not compete, leaving Delaware alone with a monopoly in the interstate charter market. Marcel Kahan and Ehud Kamar showed in their influential *The Myth of*

State Competition in Corporate Law in the Stanford Law Review that no state other than Delaware actively seeks chartering revenues and concluded, as the title indicates, that states just do not compete.[1] Their perspective has proven to be convincing. Ronald Gilson said in describing the coalescing consensus to a European corporate audience, "Kahan and Kamar ha[ve] demonstrated [that] there is no[] competition for corporate charters in the U.S. [and] no competition among states for the revenue from incorporation . . . ."[2] Others offer similar views, sometimes with differing analytics.[3]

Now that we know that ongoing franchise tax competition is weak, we need to reframe the inquiry to examine the constraints that Delaware does face. No state is poised to take franchise revenues away from Delaware. If that kind of state competition just isn't in play, does Delaware have unlimited discretion? If not, where do those limits come from?

First, Delaware faces a unique constraint that hasn't yet been analyzed, perhaps because it historically was weak. Even if no *other* state actively competes for chartering revenue, Delaware itself must vie to sell new charters because it needs to draw reincorporations from other states, as its own charters disappear as firms merge and disappear. Conceptually, this is clear. The question, then, is one of degree. When business turnover was slow, this competitive channel was not particularly important. But as corporate restructurings, spin-offs, mergers, and turnover have accelerated, this competitive channel has become increasingly important for Delaware. Indeed, it has squeezed the half-life of its tax base down from a quarter century to a decade.

Second, another state, North Dakota, actively entered the market for

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1. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 684-85 (2002) ("The thesis of this Article is that the very notion that states compete for incorporations is a myth. . . . Modern state competition scholars have misconstrued the incentives of states to attract incorporations, misinterpreted their actions, misunderstood the economic and political barriers that states face, and arrived at mistaken conclusions about the market for incorporations.").

2. Ronald Gilson, Professor, Columbia & Stanford Univ., Address at the Transatlantic Corporate Governance Dialogue: Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective (July 12, 2004), *available at* http://www.ecgi.org/tcgd/launch/gilson_speech.php.

3. Mark J. Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2498 (2005); Robert B. Thompson, *Delaware, the Feds, and the Stock Exchange: Challenges to the First State as First in Corporate Law*, 29 DEL. J. CORP. L. 779, 779 (2004) ("[Delaware's] reign is not imperiled by the other states . . . ."); Melvin Eisenberg, Professor, Univ. of Cal., Berkeley, Address at the Transatlantic Corporate Governance Dialogue: Regulatory Competition and Subsidiarity in Corporate Governance in a Transatlantic Perspective (July 12, 2004), *available at* http://ecgi.org/tcgd/launch/eisenberg_speech.php ("The race is over. Delaware has won."); *cf.* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 588 (2002); Bernard S. Black, *Is Corporate Law Trivial?*, 84 NW. U. L. REV. 542, 586 (1990) ("The chartermongering race . . . is essentially over.").

corporate charters, drawing intense attention from Delaware and increasing attention from corporate dealmakers and corporate law academic analyses. It's captured few reincorporations yet—and, hence, little in franchise fees—but the potential can constrain Delaware.

And, third, Washington, D.C. has always been a corporate governance player. Moreover, in the scandals of the early part of this decade and the economic turmoil of the latter part, its persistent role, and its potential to displace and sometimes affect state lawmaking, has become increasingly vivid.

The first channel deserves further attention. Typically, we lack data on the intensity of any competition and its growth or decline. But below I describe data the Delaware Secretary of State's office provided that show flow and turnover of Delaware's tax base to be substantial in the past decade. Although ongoing state-to-state competition for chartering revenues is somnolent, as has been shown, competition in American business—*in the real economy*—is not. The dynamism of the real economy interacts with the structure of the chartering market to create a major arena where Delaware must continually vie for charters.

The data reveal another trend: just as we corporate law academics were concluding that state chartering competition wasn't happening, this pressure on Delaware to maintain flow has *increased.* Briefly put: only a couple of decades ago, the half-life of Delaware's tax base was on the order of a quarter century. That posed a real consideration for Delaware, but was long enough not to be of immediate concern to the typical career state official, legislator, or Delaware lawyer. This pressure on Delaware has intensified, however—due to increasing pressures coming from the real economy interacting with the structure of Delaware's tax rules—to reduce the half-life of Delaware's tax base from a quarter century down to a decade.

Delaware must continually provide enough value to new firms arising in other states (and to their controlling decisionmakers) to induce them to reincorporate into Delaware. The current focus on whether *state lawmakers* are sufficiently dynamic and competitive is certainly warranted, but it's not the whole story.[4] Even if states are insufficiently dynamic and competitive, *American business* is dynamic. Firms arise, prosper, and merge; others arise, fail, and disappear. For Delaware's importance to persist over the decades, it must convince new and growing firms to reincorporate away from their home states.

Delaware faces other constraints. We can call those constraints competitive ones, if we expand our concept beyond ongoing competition for chartering revenue. Or we might just think of them as pressures and constraints on Delaware from being a fully free agent in its corporate decisionmaking.

4. *E.g.*, Kahan & Kamar, *supra* note 1, at 686 ("Delaware's potential competitors are state bureaucracies that pursue political goals and operate under political constraints.").

Delaware must be wary of making a major mistake, one that would not just induce the inflow to dry up, but that could induce a previously inactive state to enter the market, conceivably in a way that could irreversibly erode Delaware's existing base of charters if corporate America becomes unhappy with Delaware. Even states not actively seeking charters can potentially compete in this limited sense with Delaware. Such a concept has a parallel in the industrial organization literature on contestable markets: a single producer can putatively dominate a market, but it could lose its market share overnight. Hence, it acts like a competitor on some matters, or knows it must provide an overall package that is attractive to its primary customers. It has slack, but that slack is not unlimited, because its market, like Delaware's, is contestable.

In this dimension as well, the focus on slow state bureaucracies and uninterested state legislatures is justified but easy to overemphasize. The relevant actors are interests *already in Delaware* who become unhappy with Delaware corporate policy. These interests are not passive consumers, forced by the absence of another state purveying its own corporate law to accept whatever Delaware decides to offer. They can approach another state's lawmakers, ask for new law, offer that state the tax benefits of the law, and even do the needed legal drafting; they are the ones who would motivate and press Delaware to change. And, as if to demonstrate this possibility, shareholder activists, unhappy with Delaware law, went shopping for a friendly state in the past couple of years and found one—North Dakota—to put competitive pressure on Delaware. I discuss this entry and its precursors below.

Delaware, despite not facing the intense Economics 101 competition of many competing producers of corporate law, faces a contestable market, and that contestability limits the breadth of Delaware's discretion. Its position, hence, is contestable horizontally, subject to several powerful interstate pressures. And it is contestable vertically, subject to pressures from Washington. For example, Delaware legislation passed in March 2009 could change core parts of corporate law dealing with election contests and access to the company's proxy statement. That legislation is best understood as motivated by one or both of these dimensions to competition.

That Delaware competes in some (albeit possibly weak) sense seems indisputable: its principal lawmakers are active, involved, and energetic. A simple conversation with a Delaware judge or corporate lawyer, or an hour spent reading recent court opinions, would disabuse one of the notion that Delaware players are sloppy monopolists unconcerned about the professionalism of their product. Indeed, an astute inside commentator tells us that even if Delaware has won some race or another, "no one in Delaware is willing to play hare while some other state tortoise gains ground."[5]

5. Lawrence A. Hamermesh, *The Policy Foundations of Delaware Corporate Law*, 106 COLUM. L. REV. 1749, 1765 (2006).

Delaware players worry. The task I set out to accomplish in this Article is to better understand what they have to be worried about.

I. OUTLINE OF THE CASE THAT DELAWARE IS A MONOPOLY

Consider first the raw numbers at the heart of the currently emerging consensus. Half of American public firms have Delaware charters.[6] Of those firms reincorporating from one state to another, 85%, the overwhelming majority, move to Delaware.[7] And recent analyses tell us that 97% of America's public firms obtain their charter from either Delaware or their home state.[8] In general, firms either stay put in their home state or move to Delaware. There's no third state that corporate players regularly consider.

A study of 3800 firms going public in the past dozen years showed that 2600, or about 70%, moved their state of incorporation from their home state. Of those that moved, 94% chose to go to Delaware.[9] This generates more than $500 million in chartering fees annually for Delaware, about 17% of the state budget. No other state is close.[10]

Behind these numbers, however, there's more to see. For quite some time, Delaware's dominance was viewed as Delaware having won a race among the states, either one to the top, or one to the bottom. Those interpreting the race as one to the top emphasized that Delaware had to provide a corporate law with which shareholders would be happy;[11] those who thought the race to be one to the bottom argued that, as managers were the prime actors in the reincorporation decision, Delaware won by catering more to them than to shareholders.[12]

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6. Delaware Division of Corporations, Home Page, http://www.corp.delaware.gov/default.html (last visited Aug. 29, 2009).

7. Bebchuk & Hamdani, *supra* note 3, at 555-56.

8. Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1562 (2002); *see also* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where To Incorporate*, 46 J.L. & ECON. 383, 396 (2003).

9. Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 340, 352 tbl.2 (2006).

10. Kahan & Kamar, *supra* note 1, at 689, 724; Randall Chase, *Delaware Governor Signs $3 Billion Budget Bill*, USA TODAY, July 1, 2009, *available at* http://content.usatoday.net/dist/custom/gci/InsidePage.aspx?cId=delmarvanow&sParam=31084559.story.

11. *See* Ralph K. Winter, Jr., *State Law, Shareholder Protection and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 251-52 (1977); *see also* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 12, 16-17 (1993); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 915 (1982).

12. The iconic article is William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663 (1974). Updating, deepening, and expansion can be found in Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State*

New analysis is more nuanced and differs in ways that convince me and others.[13] Professors Kahan and Kamar showed that other states just do not try to garner franchise tax revenue.[14] No other state invests enough in building up solid business courts and corporate support services, makes the formal corporate law that managers and shareholders want, or charges enough in franchise fees for the result to be interesting financially if they attracted more firms. Delaware, in this new view, is alone in competing day-to-day for corporate charters and the franchise tax.[15]

Other states, the new thinking runs, are not entrepreneurial enough. For a state to set up a dedicated business court as the foundation for servicing a future reincorporation stream, someone in-state would lose, as litigation would move from one locale to another. Those who would lose due to the litigation displacement have the political clout to stymie the effort. And, for large states like California or Pennsylvania, the revenue from the incorporation business isn't enough to justify a determined effort that would take years before garnering much of a return.[16] Only smaller states are potential competitors, and they are few enough that internal politics could stymie each of them from emerging as effective ongoing competitors.

Economic reasons are also in play. For a state to start competing with Delaware, the noticeable start-up costs of getting a good corporate law passed, staffing up high-quality courts (which need a flow of cases to work with, to be at the top of their game), and so on, would seriously impede it from competing. Since only small states are likely to play, even modest costs could stymie them from starting up. And a state that began to compete despite these barriers would have reason to fear it'd just serve as a stalking horse: if it started taking corporate chartering business away from Delaware, then Delaware could react by matching its advantage and thereby stopping the erosion. As Bebchuk and Hamdani emphasize, potential upstart states, anticipating that Delaware would strike back, have reason not to incur the costs of starting up.[17] They'd eventually be no more than hapless stalking horses, left on the sidelines. And, fearing that Delaware would quickly match them, they have little incentive to compete in the first place.

Moreover, start-up costs interact with political time horizons to further

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Competition in Corporate Law, 105 HARV. L. REV. 1435 (1992).

13. See sources cited *supra* note 3.

14. *See* Kahan & Kamar, *supra* note 1, at 724-35.

15. *See id.* at 724. Roughly contemporaneously, Lucian Bebchuk and Assaf Hamdani came to a similar conclusion through a complementary route. Bebchuk & Hamdani, *supra* note 3, at 585-95 (finding that other states face economic and structural barriers to entry). Melvin Eisenberg briefly made a similar observation years ago. Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1511-12 (1989).

16. Bebchuk & Hamdani, *supra* note 3, at 584.

17. *Id.* at 594-95.

dampen state-to-state competitive efforts. The time horizon most vivid for a typical state governor extends to the next election, often via a two-year or four-year cycle. While the start-up costs for the state to compete would be incurred before the next election, any benefits that might be derived if the effort succeeds would come further in the future. Hence, politicians, wary that the unrealized state profits of the effort will be unrecognized by their constituents when the next election rolls around, will hesitate to support start-up endeavors.

Whatever the underlying explanation, the bottom line in the new view is clear: no state *has* a tax structure that would make it profitable to take a slice of Delaware's chartering business, few if any states *try* to get it, and no state other than Delaware *gets* a big tax boost from a corporate chartering business.

Hence, the consensus is now running that states do not compete for corporate chartering revenue. Hardly any state other than Delaware is trying. No other state is succeeding. Delaware has a monopoly.

II. DELAWARE'S CONSTRAINTS I: BUSINESS DYNAMISM AND DELAWARE'S HALF-LIFE

But Delaware faces constraints, and we should reframe the analysis to see clearly where those constraints come from. Even if no other state effectively competes for franchising fees, Delaware cannot act without consequence. And not only do these constraints exist, but they appear to be increasing.

Consider first the importance to Delaware of inflow. An American business is founded in, say, a garage in California. It grows and incorporates, with the local lawyer getting a California charter for the founders. Most such small firms eventually fail and close, but some survive and grow; they then consider whether they want a Delaware charter. Meanwhile, older, established, Delaware-incorporated firms decline and disappear, sometimes in mergers, sometimes otherwise. For Delaware to make money in the chartering business, it must continually capture an inflow of new, growing firms from other states to offset the regular erosion of its market. It must do so even if *no* other state actively tries to attract reincorporations by selling charters to enhance its own tax revenue. Hence, Delaware must compete in this alternative sense, even if no other state does.

American business is dynamic and competitive, even if state tax-based corporate chartering competition is not. Delaware must deal with both the potential threat of competition from other states and the dynamism of American business. The two interact. We next see the extent, which was once small but is now large.

A. *Inflow and Expiration*

1. *The incorporation rate*

Consider the flow of corporate chartering business into Delaware. The year 2005 began and ended for Delaware with about 300,000 companies chartered there. But intrayear turnover was substantial. More than 35,000 firms incorporated in Delaware during the year 2005—about 10% of its total.[18] And, we can deduce that about the same number left, closed up, or were absorbed into other firms. New firms arise and move into Delaware. Preexisting Delaware-chartered firms merge, go bankrupt, or close, eliminating in each case one source of Delaware's franchise fees. The question is how much this motion undermines Delaware's tax base.

2. *Data on changing rates of reincorporation*

Table 1 shows that the 10% annual turnover rate in Delaware in 2008 was about the same as the rate for each year during the period 1997-2008. For the decade, there's a steady annual entry and then exit of about one-tenth or more of Delaware's firms.

Inflow of firms going public is similarly dynamic during the decade: nearly 65% of the American firms that went public in the dozen years ending in 2002 were incorporated or reincorporated into Delaware.[19] This amounted to 2600 firms, about two-thirds of the total number of Delaware-chartered *public* firms at the end of the period. Overall, Delaware firms are younger and riskier than their counterparts incorporated elsewhere,[20] further suggesting that flow into Delaware is important to the state's tax base and its corporate structural interests (such as the Delaware law firms and governmental agencies that service its corporations).

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18. INT'L ASS'N OF COMMERCIAL ADM'RS, ANNUAL REPORT OF THE JURISDICTIONS 39 (2006), http://www.iaca.org/node/80.

19. Kahan, *supra* note 9, at 352 tbl.2. Delaware charters approximately 3700 publicly traded companies. Bebchuk & Cohen, *supra* note 8, at 391 tbl.2.

20. Feng Chen, Kenton K. Yee, & Yong Keun Yoo, Are Delaware Firms Oranges? Fundamental Attributes and the Delaware Effect 1 (Dec. 18, 2006) (unpublished manuscript), *available at* http://www.ssrn.com/abstract=912942.

Table 1 Exit from and entry into Delaware[21]

	Charters on January 1	Entry	Entry percentage*	Exit	Exit percentage**	Charters at year-end
1997		53,030				291,511
1998	291,511	48,885	14.36%	42,682	12.54%	297,714
1999	297,714	54,585	15.49%	43,807	12.44%	308,492
2000	308,492	59,949	16.27%	45,470	12.34%	322,971
2001	322,971	40,043	11.03%	44,330	12.21%	318,684
2002	318,684	37,160	10.44%	47,937	13.47%	307,907
2003	307,907	33,023	9.69%	36,609	10.74%	304,321
2004	304,321	33,865	10.01%	38,524	11.39%	299,662
2005	299,662	35,245	10.52%	36,406	10.87%	298,501
2006	298,501	34,384	10.33%	56,565	16.99%	276,320
2007	276,320	35,139	10.50%	33,886	10.12%	300,915
2008	300,915	28,785	8.73%	34,455	10.45%	295,245

* (New charters issued during the year / (Charters at start of year + New charters issued))

** (Charters cancelled during the year / (Charters at start of year + New charters issued))

In the summer of 2006 there were 292,000 active Delaware firms. Of these, about 10% had incorporated in Delaware in the prior year. More interesting, however, are the five-year and ten-year cumulative numbers: 47% of Delaware's active firms had incorporated in Delaware within the prior five years, and 70% had incorporated in Delaware in the prior ten years.[22]

21. The information included in Table 1 is drawn from the International Association of Commercial Administrators. The data for years 1997-2007 is derived from the Association's *Annual Report of the Jurisdictions*. The 2003-2007 reports are available at http://www.iaca.org/node/80. The 1999-2002 reports are on file with the author. For the 2008 data, see INT'L ASS'N OF COMMERCIAL ADM'RS, ANNUAL REPORT OF DELAWARE (2008), http://www.gavinm.com/iaca/?country=USA&state=DE&section=BOS&print=true. Entry includes all firms receiving a Delaware charter, whether by incorporation, reincorporation, spin-off, or new formation.

22. Delaware Secretary of State's Office, Spreadsheet calculations, available from the author.

Table 2. Examples of major reincorporations into Delaware[23]

Company	Year company moved to Delaware	State from which firm reincorporated
Northrop	1985	California
Sun Microsystems	1986	California
The Gap	1988	California
Intel	1989	California
Waste Management	1995	Oklahoma
Amazon.com	1996	Washington
Ebay	1998	California
Google	2003	California
Coors	2003	Colorado
Banknorth Group	2005	Maine
J.Crew	2005	New York
Sotheby's Holdings	2006	Michigan
Iptimize	2007	Minnesota
Idaho General Mines	2007	Idaho
Synthetic Blood Int'l	2008	New Jersey

Tables 3 and 4 show the tax consequences to Delaware of turnover. Delaware's tax base is precarious *even* if Delaware faces no active competitor, as can be seen by decomposing Delaware's 2008 franchise tax revenue of $543 million. Of that $543 million, $294 million, or 54%, came from firms that had incorporated in Delaware in the prior ten years, and $428 million, or 80%, came from firms incorporating in Delaware within the prior twenty years. In 1996, the distribution was similar: total franchise revenue was $333 million, with $180 million, or 54%, coming from firms that came to Delaware in the prior ten years.

A similar effect can be seen by examining the structure of the maximum payers in Delaware in 2008. As Table 5 shows, 1668 firms paid the maximum franchise fee in 2008, providing about one-half of Delaware's $543 million total franchise fee. Of those, half had incorporated in Delaware in the prior ten years.

23. Information in Table 2 is drawn from annual Form 10-K reports submitted to the SEC. See for example, Northrop Grumman Corp., Annual Report (Form 10-K) (Mar. 24, 2003), *available at* http://sec.edgar-online.com/northrop-grumman-systems-corp/10-k-annual-report/2003/ 03/24/Section2.aspx.

Table 3. Franchise tax payments in Delaware in 2008, by year incorporated into Delaware

Year of Delaware incorporation	Number of firms	Franchise fees paid	Year of Delaware incorporation	Number of firms	Franchise fees paid
pre-1983	19,158	64,489,994	1996	7,638	23,056,647
1983	1,770	6,844,745	1997	8,700	24,466,362
1984	1,961	5,099,958	1998	9,600	26,097,225
1985	2,361	6,898,241	1999	10,722	29,374,820
1986	3,025	14,872,437	2000	11,935	28,868,536
1987	3,181	13,691,615	2001	10,089	19,448,175
1988	3,265	9,282,855	2002	10,546	19,323,870
1989	3,534	8,441,962	2003	11,193	22,750,747
1990	3,476	7,408,853	2004	13,060	28,824,130
1991	3,663	10,781,159	2005	15,200	38,404,654
1992	4,136	10,653,384	2006	17,148	36,520,095
1993	5,142	15,239,595	2007	20,133	36,500,390
1994	5,857	13,924,065	2008	17,715	7,596,339
1995	6,540	14,375,732			

	Total 2008 Fees		**543,236,586**
2008 revenue coming from entrants in prior 20, 15, and 10 years	**20-year total**	**0.79**	**431,339,596**
	15-year total	**0.71**	**384,771,382**
	10-year total	**0.54**	**293,708,981**

Even if no firm *ever* leaves Delaware for another state and even if no *other* state actively seeks to sell corporate charters, Delaware still must keep itself attractive enough to keep reincorporations of newer and reorganizing firms flowing in. Otherwise, the tax base will erode. It will erode because over time, Delaware firms will merge, decline, and reorganize.

Table 4. Franchise tax payments in Delaware in 1996, by year incorporated into Delaware

Year of Delaware incorporation	Number of firms	Franchise fees paid	Year of Delaware incorporation	Number of firms	Franchise fees paid
pre-1983	41,631	97,802,636	1990	10,511	11,260,250
1983	4,688	10,813,562	1991	11,448	16,228,944
1984	5,091	8,362,813	1992	14,321	15,709,549
1985	5,947	11,123,523	1993	19,173	24,225,987
1986	7,994	24,049,635	1994	24,383	20,778,753
1987	8,631	23,569,823	1995	31,013	22,492,417
1988	9,457	16,626,021	1996	39,931	13,919,047
1989	10,215	15,598,866			

	Total 1996 Fees		**332,563,069**
1996 revenue coming from entrants in prior 10 years:	**10-year total**	**0.54**	**180,409,655**

Some considerations: If the qualitative gap between the home states' corporate law and Delaware's was huge, such that home states just could not service the large public firm, then the pressure on Delaware to maintain an ongoing inflow would be negligible. Firms would move to Delaware because big firms in such a setting have no real choice: once they got big enough, they'd have to move, even if Delaware did not keep polishing its corporate law; the reincorporation decision would not be a marginal one. But the flip side of the refrain that Delaware has about half of the big company charters is that the *other* forty-nine states *have the other half*. Many states now presumably *do* provide a serviceable, even if imperfect, corporate law for large firms. For example, one of Delaware's prime advantages is its highly-praised courts. One reason to incorporate in Delaware is to get better access to the courts when there's a corporate law dispute. However, there's relative judicial *exit* from Delaware of firms in merger agreements, as Delaware firms often choose another state to be the forum for any resulting litigation. Hence, firms have a choice even in this dimension. Delaware must actively draw firms out from their home states; because enough other states provide a usable, satisfactory corporate law and judiciary for the public firm, Delaware needs to try harder.[24]

24. Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements*, 59 VAND. L. REV. 1975, 1982 (2006) ("The outflow [of merger contract choice of forum] from Delaware is not trivial. . . . only [a fraction of Delaware-oriented merger contracts] specified Delaware as the litigation forum."); Matthew Cain & Steven M. Davidoff, Delaware's Competitive Reach: An

Table 5. Aging of Delaware's 1679 maximum franchise tax payers in 2008

Number of maximum payers that incorporated in Delaware *after* the beginning of year	Year	Percentage that incorporated in Delaware *after* the beginning of year
73	2007	0.04
155	2006	0.09
262	2005	0.16
339	2004	0.20
393	2003	0.24
447	2002	0.27
499	2001	0.30
560	2000	0.34
641	1999	0.38
727	1998	0.44
812	1997	0.49
885	1996	0.53
936	1995	0.56
1147	1990	0.69
1361	1985	0.82
1441	1980	0.86
1513	1970	0.91
1577	1960	0.95
1601	1950	0.96
1615	1940	0.97
1631	1930	0.98
1658	1920	0.99
1667	1910	1.00
1668	1900	1

Note: Of the 1668 firms paying the maximum franchise tax in 2008, 885 (approximately half) incorporated in Delaware after January 1, 1996.

The data indicate that pressure on Delaware due to the precariousness of its tax base has *increased* during the past quarter century. Table 6 shows the "half-life" pattern—the number of years needed for half of the tax base to decay and disappear from the state if there were no inflow—during the prior quarter century for Delaware's maximum franchise fee payers. (I use the maximum

Empirical Analysis of Public Company Merger Agreements 4 (Aug. 18, 2009) (unpublished manuscript), *available at* http://ssrn.com/abstract=1431625 (finding "flight to both Delaware and New York from other jurisdictions[,]" but without the Delaware outflow that Eisenberg and Miller found for a differing period).

franchise fee payers and the 1983 cutoff because that's the data available from the Delaware Secretary of State's office.) In 1983, the half-life of this part of Delaware's tax base was a quarter century. In the past fifteen years, the half-life has been squeezed down to about a decade, increasing the pressure on Delaware.

Table 6. The shortening half-life of Delaware's franchise tax base

Year	Number of Maximum Franchise Tax Payers	Maximum Franchise Tax	Total Franchise Tax	Percentage of Total Paid by Maximum Payers	Half of Maximum Payers Became Delaware Corporations within How Many Years?
2008	1668	$165,000	$543,000,000	0.51	12 (after January 1, 1996)
2003	1510	$165,000	$485,000,000	0.52	11 (after January 1, 1992)
1998	1182	$150,000	$400,000,000	0.44	11 (after January 1, 1987)
1993	736	$150,000	$262,000,000	0.42	11 (after January 1, 1982)
1988	496	$150,000	$176,000,000	0.37	17 (after January 1, 1978)
1983	246	$110,000	$80,000,000	0.34	25 (after January 1, 1958)

The portion of the revenue provided by maximum payers is steady but rising. In 2008, maximum payers provided half; in 1983, one-third. But the half-life is *shorter* now (about ten years) than it was in 1983, when it was a quarter of a century. Some shortening is probably due to the dot-com boom and the stock market bubble of the late 1990s, some to the accelerating pace of change in American business. Things may change in the future, but this source of competitive pressure increased in the last quarter century and seems substantial enough to affect those who depend on the corporate franchise fee revenue stream in Delaware.

3. *Mergers as a source of flow*

A related competitive pressure exists. When firms merge, one firm survives. If a Delaware firm merges with a non-Delaware firm, the firms must decide whether the Delaware or the non-Delaware firm survives. In that moment of decision, Delaware competes to get the business. Even if both firms are Delaware corporations, the merger is a moment for the parties and their attorneys to assess whether they want the survivor to be a Delaware corporation or not.[25] Since mergers often require the approval of shareholders of one or the other (or both) of the constituent corporations, shareholders can turn down the merger if they are deeply unhappy with the state in which the survivor would

25. The merger of two Delaware firms paying the maximum franchise tax rate reduces Delaware's revenue, creating an interesting incentive for the state's corporate apparatus.

be incorporated.[26] While it's unlikely that the survivor's domicile would itself induce shareholders to reject a merger, if the surviving state was seen to be a very poor one for shareholders, that should affect pricing. Mergers and restructurings increased in the United States in recent decades, making this arena for pressure not small.[27]

4. *The composition of Delaware's inflow*

I decomposed Delaware's recently acquired tax base, first identifying the firms paying Delaware's maximum franchise fee in 2006 that originally appeared on Delaware's franchise tax roll ten years previously, in 1996. There were ninety-one such firms. (Remember, Delaware's maximum franchise fee is reached by not-very-large companies.) Next, we identified the reason for the firms' entry into Delaware, from the firms' 10-Ks, their websites, or news reports. (Ambiguous or no information was available for seven of the ninety-one, yielding eighty-four firms whose reason for Delaware incorporation could be identified.) Nearly half (38/84) were new companies. Reincorporations from another jurisdiction and companies going public accounted for nineteen of the eighty-four; mergers, reorganizations, and spin-offs accounted for twenty-seven of eighty-four. (Details are available in an unpublished appendix.)

The pressure here on Delaware results from the accelerating pace of business change. In 1938, the average life of a Standard & Poor's 500 company was said to be about a century. By 2007, it was only twenty years. Of the ten largest American companies by market capitalization in 1965, only one non-oil company was on that list in 2006.[28]

B. *Structural Implications of Increasing Flow While the Installed Base Shrinks*

This mechanism of increasing pressure on Delaware can affect the nature

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26. That is, the approving shareholders have reason to put the state of incorporation into the decision-making mix as long as they will not be cashed out.

Some mechanics on the Delaware Secretary of State's office coding for mergers: The office codes each company in the data underlying Tables 3, 4, 5, and 6 with a unique number upon incorporation. If a Delaware firm is the survivor in a merger, the office does not record the resulting firm as a new Delaware entity. Similarly, a name change for a corporation does not yield a new entity for tax-data tracking purposes, as the identification number remains constant. Hence, the data underlying the tables should not be picking up simple mergers of Delaware firms.

27. About one-third of Fortune 500 firms received takeover bids during the 1980s. *See* John C. Coates IV, *Measuring the Domain of Mediating Hierarchy: How Contestable Are U.S. Public Corporations?*, 24 J. CORP. L. 837, 851 (1999); Gerald F. Davis & Suzanne K. Stout, *Organization Theory and the Market for Corporate Control: A Dynamic Analysis of the Characteristics of Large Takeover Targets, 1980-1990*, 37 ADMIN. SCI. Q. 605, 608 (1992).

28. ADVANCED VENTURE CAPITAL 14 (Dror Futter & Curtis L. Mo eds., 2007).

of competition and affect whether it's more a race to the top, or to the bottom. Pressure from inflow increases pressure on Delaware to satisfy both of its core corporate constituencies, boards and shareholders.[29] A larger, stable installed base of firms already present in Delaware enables the state to favor one over the other, because both must approve a reincorporation out from Delaware; i.e., one alone can veto exit. Since the board, which has been historically tied to managers, must move first for reincorporation away from Delaware, boards have conventionally held the upper hand in controlling outflow.[30] Hence, if Delaware relied only on a stable installed base, it need not compete and it can more easily favor one corporate player over another.[31]

When Delaware must rely for revenue more on inflow than its already installed base, both corporate parties must approve (in contrast to exit, which one alone can block). But an empirical difficulty in assessing the directionality of the pressure on Delaware is due to *both* inflow and the installed base vitally affecting Delaware's franchise fee stream. Over ten years, about half of its tax base in the final year comes from the new entrants.[32] That turnover rate *is* fast enough for Delaware to know that it cannot sit on its corporate laurels, but slow enough that it knows that with its installed base of larger firms, it can be profitable for several years, even if it attracts no new entry.

This indeterminacy of the relative importance of inflow versus retention to Delaware helps to explain why the bottom versus top race debate has proven inconclusive to many of the debate's observers. Delaware faces two structural pushes here, the inflow-based one to favor managers and shareholders jointly, and its installed base option to favor one over the other. The compressing half-life of the franchise fees points to a weakening of its option to satisfy just one corporate player and an increase in its need to satisfy both.

C. *The Tax Rate*

The structure of Delaware's franchise tax increases inflow's importance, compared to what its importance would be under other imaginable rate structures. The annual rate tops out quickly, at $165,000 in recent years for a corporation with assets of $660 million (or 26.4 million authorized shares).[33]

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29. If no state protects shareholders, then Delaware need only provide shareholders a little extra value—from, say, network advantages—to win reincorporation business. *Cf.* Michal Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127, 135-36 (2004); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 843-47 (1995) (analyzing Delaware's network advantages).

30. Bebchuk forcefully makes this point. Bebchuk, *supra* note 12, at 1460.

31. *See id.* at 1459-60.

32. Based on 1996 and 2006 data. *See supra* Tables 3 and 4.

33. Barzuza, *supra* note 29, at 186-87. Delaware recently raised the annual fee to $180,000.

General Motors, for many decades America's largest industrial corporation, pays the same franchise tax as, say, Datameg, a newcomer.[34]

Hence, the density in Delaware of its midcap firms is more important to its total tax revenues than the overall market capitalization of its firms. One $660 million firm is as good as any other for the tax coffers and, in 2008, 1668 firms paid the maximum franchise fee. They provided half of Delaware's franchise fees.[35]

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Delaware has reason to focus not just on its installed base, but also on inflow. Density of firms, not just density of capital, is the essential character of Delaware's revenue base.

III. CONSTRAINT II: CHARTERING COMPETITION AS A CONTESTABLE MARKET

Contestable market theory—which describes how a new, aggressive entrant can at times swiftly replace an incumbent monopolist—shows how Delaware faces another competitive challenge. Day-to-day, its installed base will not move en masse. But over the long run, Delaware's installed base conceivably *could* move en masse, or a dormant state *could* enter the chartering market. To preclude that movement or entry, the incumbent must, in contestable market theory, compete.

A. *What Is a Contestable Market?*

The industrial organization concept of a contestable market, which William Baumol analyzed, is relevant here.[36] As Scherer summarizes:

> When potential entrants have access to the same technology as incumbents, when there are no sunk costs, and when a firm can enter and exit the market before incumbents can respond, the market is said by Baumol et al. to be *perfectly contestable*. The only sustainable price available to incumbents under these conditions is one that just covers average cost.[37]

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34. *Cf. id.* at 187-88 (explaining that although the larger firms would likely be willing to pay more, Delaware retains this taxing formula because of a trade-off between prices charged and the quantity of firms willing to incorporate in Delaware). For Datameg, see SEC Info, Datameg, http://www.secinfo.com/d11A75.1Aa.d.htm (last visited Aug. 29, 2009).

35. The bracket creep apparent in Table 6 deepens this effect, making Delaware somewhat more dependent today than before on midcap firms.

36. WILLIAM J. BAUMOL, JOHN C. PANZAR & ROBERT D. WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE 5 (rev. ed. 1988); WILLIAM J. BAUMOL, THE FREE-MARKET INNOVATION MACHINE 163-65 (2002); ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 82-83 (2002).

37. F.M. SCHERER & DAVID ROSS, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC

Thus even incumbents without current competitors face constraints in contestable markets. True, Delaware does not face a perfectly contestable market. Although all states have access to the same technology of making corporate law, none is actively waiting in the wings, and Delaware in principle could respond to a new entrant quickly by changing its own law,[38] thereby devaluing that competing state's investment. Because the potential entrant knows that Delaware could react, that potential competitor has reason not to compete, an illustration of the stalking horse problem.[39]

But the relevant actors who could make state chartering contestable are not primarily state governmental players—whether they be local legislatures or even local lawyers lobbying the legislature—or even parties traditionally thought of as competitors. Rather, they are Delaware's own corporate constituents, those who would benefit from the outside competition. They would benefit from even stalking horse competition and, as we shall see, already are benefitting. Hence, they could be willing to bear the costs of state innovation. It's not just that another state's *legislature* could contest Delaware's supremacy,[40] but that Delaware's primary interest groups could motivate another state to enter the market for Delaware's installed base. Delaware's own customers can create a contestable market for Delaware—not just, and maybe not even primarily, other states' bureaucracies, legislatures, and lawyers. Delaware's own corporate players and their organizations, like the Business Roundtable or the Council of Institutional Investors, are well-positioned to instigate another state to act and can even pay the initial setup cost.

B. *Who Would Instigate?*

Imagine that Delaware fumbled, but didn't recover. Both managers and shareholders are, let's posit, outraged at Delaware's *Van Gorkom* decision, or another line of decisions, or some statutory misfeasance. And they're annoyed and disappointed that Rhode Island, South Dakota, and Nevada do nothing to improve the situation. No state is waiting in the wings, as Kahan and Kamar have shown, watching for a Delaware fumble so that it can rush to pick up the ball.[41]

PERFORMANCE 375-76 (3d ed. 1990) (footnotes omitted).

38. Delaware's response capability corresponds to the stalking horse impediment to state competition that Bebchuk and Hamdani demonstrate. Bebchuk & Hamdani, *supra* note 3, at 593-95.

39. *See id.* at 595.

40. *Cf.* ROMANO, *supra* note 36, at 82-83.

41. Or imagine something more threatening to Delaware: Business changes in some way that half of the firms prefer rule X, and the other half not X, and there's no good way to

But that doesn't mean that competition is absent. It may be weak, but weak does not mean it's nonexistent. State competition might start up—after the incumbent missteps—if a sleeping competitor sees an opportunity and acts before Delaware recovers. Delaware might then recover to fully mitigate the threat; that's one reason, as Bebchuk and Hamdani have said,[42] why other states don't have much of an interest in being a stalking horse that would just induce Delaware to change its law over the long run rather than yield the new competitor much in the way of corporate chartering revenue.

But the offended Delaware *interests* could themselves go to Rhode Island or South Dakota or Nevada and make them an offer. Give us, they say, Delaware law, but without the offending provisions, and then we just might give you Delaware's tax revenues, $500 million per year.

That states aren't actively competing for chartering revenue doesn't necessarily mean that they couldn't compete, doesn't mean that if Delaware fumbled and didn't recover another state wouldn't pick up the ball, and doesn't mean that the offended players in Delaware wouldn't and couldn't themselves act to *create* a competitive state. Nor does current absence of an active competing state mean that Delaware is unaware of the potential for a viable competitor to emerge. The offended *interest groups* have reason to devote resources to starting up a competitor—*even* a stalking horse competitor that Delaware would co-opt. The interest groups that benefit from changing corporate law win either way under this scenario: either Delaware changes, or a new more favorable competitor arises. They have reason—if they can coordinate to overcome their own collective action problem—to instigate a state to compete, even if the state has little reason to invest its own resources. Chambers of Commerce, the American Bar Association, and Business Roundtable committees, some financed by the relevant corporations, could provide much of the start-up costs and could be the means of coordination.

Without multiple states shadowing Delaware for decades and competing closely, Delaware obviously has freedom to maneuver, but contestable markets theory tells us that that band of freedom, though perhaps wide, is not unlimited.

C. *Contestable Markets for 1980s Merger Law*

The hostile takeover was the overarching corporate transaction of the 1980s. Its treatment then was an issue that could affect a firm's state chartering decision. Many states responded to their local firms' managers' goals by passing tough antitakeover laws. Yet, Delaware did little in the mid-1980s.

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compromise. Delaware, no matter what it does in the competency arena, could find itself facing unrest from half of its installed base.

42. Bebchuk & Hamdani, *supra* note 3, at 594-95.

Then, when its Chancery Court issued a strong pro-takeover opinion[43] and its legislature ignored calls to pass antitakeover laws, Delaware faced the threat of exit, as evidenced by Martin Lipton's then-famous public proposal for firms to reincorporate out of Delaware. The demands of the race were as plain as could be for Delaware. In Lipton's words:

> The *Interco* case and the failure of Delaware to enact an effective takeover statute, raise a very serious question as to Delaware incorporation. New Jersey, Ohio and Pennsylvania, among others, are far more desirable states for incorporation than Delaware in this takeover era. Perhaps it is time to migrate out of Delaware.[44]

How much of this was threat and how much was bluff—both managers and shareholders would have had to approve firms going through the reincorporation exit—is hard to assess. Whether Lipton and, say, the Business Roundtable would have geared up to show Rhode Island how to make corporate law for them is hard to say. But law firms frequently do undertake such public service ventures, some of which coincide with their clients' interests.

Such interests had the resources to do so. And for a time, they had the motivation. Then Delaware passed an antitakeover law, its Supreme Court wrote antitakeover decisions, most prominently that in *Time-Warner*,[45] which explicitly rejected *Interco* (Lipton's bête noir), hostile takeovers declined in frequency perhaps because of economic reasons, and talk of firms exiting Delaware stopped.

Lipton's threat suggests the plausibility of contestable market competition: even if other state legislatures and bureaucracies do not *sua sponte* pursue the opportunity, corporate interests could and, if their ox was being gored, would.

Two more examples are available, both from the Dakotas.

D. *Contestable Markets in the Dakotas: Credit Cards and Corporate Charters*

When decades ago Citibank wanted to escape state law interest rate limits

43. City Capital Assocs. v. Interco, Inc., 551 A.2d 787, 797 (Del. Ch. 1988).

44. Letter from Martin Lipton, Partner, Wachtell, Lipton, Rosen & Katz, To Our Clients: The Interco Case (Nov. 3, 1988) (on file with author); *see also* Tim Smart, *For Managers, Delaware Isn't the Haven It Used to Be*, BUS. WK., Dec. 19, 1988, at 33 ("[L]egal advisers to worried managers already are suggesting that companies should consider playing elsewhere . . . ."); Charles Storch, *As Company, Time Focusing on 1 Newsmaker*, CHI. TRIB., July 9, 1989, at 8 (Delaware's blocking Interco management from using the pill "so enraged Martin Lipton, the lawyer . . . credited with inventing the poison pill defense, that he urged his Delaware-incorporated clients to consider reincorporating elsewhere").

45. Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1142 (Del. 1989).

on its credit card operation, it sought out South Dakota, which then had a high limit. Then South Dakota, to make itself even more attractive to the top credit-card-issuing banks, fully repealed its interest rate lid.[46] If corporate America showed up on the steps of the statehouse in South Dakota, one imagines that the state lawmakers would be even more solicitous when they saw Delaware's $500 million franchise fee dangling in front of them.

Lawyers associated with activist investors asked North Dakota in 2007 to pass a corporate law attuned to institutional investors' current agenda, which the lawyers outlined for the state legislature, which then enacted the law.[47] Its passage of a competing corporate law shows how state-to-state competition comes about: it's not the state bureaucracy, the state legislature, or the in-state lawyers who innovate, but entrepreneurial corporate interests who want a change in Delaware law.

Activist investors, unhappy with Delaware legislation and case law, which did not give shareholders the voice and authority that the activists thought proper, sought to set up a state to compete with Delaware. They approached Vermont, which demurred, before approaching North Dakota, which did not. The activists' lawyers, *not* the state, drafted the proposed corporate law.[48]

Consider first the stalking horse consideration—cost. The North Dakota legislator who sponsored the law said, "If no one ever used [the law,] it didn't cost us anything[.]"[49] Consider next the benefit to the activist corporate law entrepreneurs—the stalking horse possibility that Delaware matches the new entrant. Even before any major firm takes up the North Dakota offer, the competitive risk from North Dakota has seemed more vivid in Delaware than in the corporate world generally, with meetings and news reports analyzing the North Dakota challenge[50] and national news media reminders when

46. LYNN M. LOPUCKI, COURTING FAILURE: HOW COMPETITION FOR BIG CASES IS CORRUPTING THE BANKRUPTCY COURTS 53-54 (2005).

47. Publicly Traded Corporations Act, ch. 102, 2007 N.D. Laws 497 (codified at N.D. CENT. CODE § 10-35-01 (2007)).

48. Elizabeth Lopatto, *'Virgin' North Dakota Draws Billionaire Icahn in Raider Quest*, BLOOMBERG.COM, Feb. 20, 2009, http://www.bloomberg.com/apps/news?pid=20601109&sid=aXgfseyKwJmI ("The legislation came into being after Icahn rounded up a group of like-minded investors, including New York-based hedge funds Jana Partners LLC and Steel Partners II LP, and hired Philadelphia attorney William H. Clark Jr. to draft a bill . . . .").

49. *Id.*

50. Martha Graybow, *Delaware Beware: North Dakota Wants Your Business*, REUTERS, Apr. 25, 2007, *available at* http://www.reuters.com/article/domesticNews/idUSN2543618020070425; Maureen Milford, *Del. Legal Academic Sees Time for a Change*, THE NEWS J., Mar. 2, 2008, *available at* http://www.delawareonline.com/apps/pbcs.dll/article?AID=/20080302/BUSINESS/803020379/1003 (reporting a Delaware meeting on the impact of North Dakota's new statute).

For North Dakota to compete seriously, it must provide a strong commercial court or a viable dispute resolution process, which it has not yet tried to do. It could finesse the judicial problem by facilitating dispute resolution of internal corporate affairs via arbitration panels shareholder activists have sought to induce specific companies to reincorporate to North Dakota. The media reports and the occasional related litigation remind Delaware of its vulnerability even without much corporate charter flow to North Dakota.

Activist investors have pressed well-known companies, like Oshkosh, Whole Foods, and PG&E, as well as lesser-known biotech firms like Amylin and Biogen, to reincorporate to North Dakota. These are the same activists who successfully lobbied North Dakota to set up a new corporate regime and who hired lawyers to draft legislation for the state. As the lawyer who spearheaded the drafting of the North Dakota law said, "Delaware will initially scoff at North Dakota . . . [b]ut it will eventually feel the pressure."[51] Hence, for the activist investors, Delaware's matching of the stalking horse is a goal, not a cost.

A corporate activist announced in the *Wall Street Journal* that the North Dakota development is more "a wake-up call for Delaware to modernize [and account for activist shareholders] than . . . [an effort] to attract business in North Dakota."[52] Hence, students of corporate law have to reassess how competition for state chartering can arise. As we've seen, it can break out without a motivated, actively competing *state administration* looking for taxing opportunities.

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of three members chosen, say (since the North Dakota pitch is a proshareholder one), from the Council of Institutional Investors.

51. Rachel Beck, *Goal of North Dakota's New Shareholder Law Could Be to Soften Delaware Law*, The Associated Press, Apr. 24, 2007.

52. Cari Tuna, *Shareholders Ponder North Dakota Law*, WALL ST. J., Dec. 8, 2008, at B6 ("A new front in the battle over corporate governance is emerging in an unlikely place: North Dakota." And: "The North Dakota law is part of an effort by shareholder advocates to generate competition among states for company incorporations based on governance rules."); *cf.* Robert Daniel, *Amylin: 2 Holders to Propose Director Nominees*, MARKETWATCH, Feb. 1, 2009, http://www.marketwatch.com/story/amylin-pharma-icahn-black-bear-fund-to-propose-directors ("[Icahn] also plans to propose that the company reincorporate in North Dakota, Amylin said. The company currently is incorporated in Delaware."); Selena Maranjian, *Should We All Move to North Dakota?*, THE MOTLEY FOOL, May 29, 2009, http://www.fool.com/investing/general/2009/05/29/should-we-all-move-to-north-dakota.aspx?source=iseitlnk0000001&mrr=1.00 ("[P]ublic companies like . . . Delaware. . . . [but] North Dakota is now offering an intriguing alternative . . . .").

As a formal matter of corporate law, reincorporating to North Dakota is no easier than winning a proxy contest to replace a target firm's board or to change a Delaware firm's bylaws to embed the substance of North Dakota's corporate law. Activists upset with a firm would go for the latter. Delaware, though, may worry that North Dakota could get the "brand" name for being proshareholder; shorthand decisionmaking from investors who aren't lawyers could lead them to prefer North Dakota because they don't want to, or cannot, read bylaws to see how they allocate authority inside the firm. North Dakota also promises to update its laws to stay proshareholder in the face of new transactional developments.

E. *Toeholds*

These developments can be conceptualized in antitrust competition terms. The current thinking that there's no ongoing state chartering competition is insightful and correct. So, to understand what constraints Delaware does face, we can think in this dimension of the potential for franchise tax competition.

Multiple states have "toeholds"—holds on an important element for state competition, despite the fact that the state lacks the full panoply of what's needed to compete. North Dakota has a competitive corporate law—a different product—in place, but it lacks both a base of North Dakota corporations and well-developed corporate law courts. Other states lack what North Dakota has, but can find themselves with toeholds from the explosion of alternative business entities, such as limited partnerships, business trusts, and other noncorporate business forms that provide another toehold.[53] A state that gets a toehold in an alternative business entity is positioned to expand into corporate chartering.

Other states, such as New York, have been developing commercial courts. A state with a vibrant, capable commercial court has a toehold that could also be the base from which to launch franchise competition. Courts that serve as the forum for business litigation other than core corporate litigation could become the springboard asset for eroding one of Delaware's prime assets: its judiciary.[54] A state with a strong presence in commercial litigation or in chartering alternative business entities would be well positioned to compete for corporate charters if Delaware stumbled. Delaware players are presumably more aware of that possibility than others, as that process—toehold and an incumbent's stumble—was how Delaware obtained the corporate chartering business from New Jersey early in the twentieth century.

Conceptually, we now have two state-based interactions that could upset the Delaware status quo, even without active, entrepreneurial state corporate administrations outside of Delaware. First, we've seen that dynamism in the real economy renders Delaware dependent on inflow, because entrepreneurial activity in the real economy persistently erodes Delaware's installed base of existing firms. And, even if there's no entrepreneurial heartbeat in the other forty-nine *state administrations*, entrepreneurial *lawyers* can and do upset the Delaware status quo by pitching the franchising fee opportunity on behalf of their clients—disgruntled Delaware players—to otherwise passive state legislatures.

IV. CONSTRAINT III: IT'S NOT JUST STATES THAT CAN CONTEST

53. *See* Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183, 185 (2004).

54. *See* Geoffrey P. Miller & Theodore Eisenberg, *The Market for Contracts*, 30 CARDOZO L. REV. 2073, 2073 (2009).

DELAWARE'S MARKET

There's another dimension that constrains Delaware—one that is probably just as, or more, salient than another state taking away Delaware's installed base. American corporate law could be made in Washington. Much already is. During the past century, every decade has seen the threat or the reality of large batches of American corporate law moving from Delaware to Washington.[55] The threat to Delaware isn't that Washington would take away the right to charter corporations (that's possible, but unlikely), but that if Washington makes much of what's important to corporate law, there's less reason for firms to move to Delaware, since it couldn't provide enough distinctive value.

A. *The Federal Overlay*

Federal authorities—Congress, the SEC, the Second Circuit Court of Appeals, the New York Stock Exchange acting after SEC prodding—have often made corporate rules that displaced Delaware's rules. At one level, they check Delaware. At another level, they just displace it. If all corporate law were made at the federal level, then even if the chartering were local, the franchise tax couldn't be very high, because no state—not even Delaware—would have much to sell corporate America.

1. *Regulatory competence*

What most worries Delaware—or what should most worry it—are two types of actions. One type would be to display incompetence in regulating corporate America. If persistent and widespread, they'd face not just a Sarbanes-Oxley-style incursion into parts of corporate lawmaking, but ouster from controlling wide areas of corporate law.[56]

2. *Actions that annoy its two major interest groups*

Second, Delaware cannot simultaneously offend both of its major interest groups, managers and institutional shareholders, without risking major erosion via reincorporations into a newly found corporate-friendly state. As one observant Delaware player pointed out recently, when the two primary groups agree, Delaware has an easy time making corporate law.[57] If it misstepped,

55. Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003).

56. *Cf.* Roberta S. Karmel, *Realizing the Dream of William O. Douglas—The Securities and Exchange Commission Takes Charge of Corporate Governance*, 30 DEL. J. CORP. L. 79, 79 (2005).

57. Leo E. Strine, Jr., *Delaware's Corporate-Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough?*, 86 CORNELL L. REV. 1257, 1268-70

however, and annoyed both of its primary interest groups simultaneously, the two would have reason to ask Washington or another state to step in, significantly threatening Delaware's position.

B. *Delaware Moves: Shareholder Access and Contestability in Two Dimensions*

Thus, properly understood, Delaware's chartering monopoly is contestable in two dimensions: horizontally, if Delaware stumbles, another state could enter, take away market share, and displace Delaware; and vertically, as Washington could displace it, in whole or in part.

Consider shareholder access to the company's proxy statement. As is well known, the incumbent board must solicit proxies for votes from shareholders in the annual board election, and it does so at the company's expense. But, although shareholders who want to nominate their own directors separately instead of voting for the incumbent-endorsed nominees can solicit votes, they must pay for their own solicitation. That solicitation is sufficiently expensive to deter most elections from being contested.

After the Enron scandals and the passage of Sarbanes-Oxley, the SEC took up the issue of giving activist shareholders ready access to the *company's* proxy statement as a reform to lower the costs of activism toward the end of making managers and boards more accountable.[58] It was considered a potentially major reform when SEC Chair William Donaldson first put it on the modern SEC agenda in 2003. But the access issue proved controversial, and it didn't become law, dropping off the SEC agenda briefly,[59] until the next SEC Chair, Chairman Cox, put it back on the agenda. But his Commission also did not act on it. The subsequent and current SEC Chair, Mary Schapiro, quickly announced shareholder proxy access as a high item on the new Commission's agenda[60] and the economic and political atmosphere today makes the proposal more plausible than before for the SEC to move on.

During the same time span (from 2003 until 2009), Delaware law was seen as barring activists from either seeking such access to the company's proxy statement directly or even getting access to propose such a bylaw. Activists sought bylaws that would enable shareholder access, and Delaware lawyers

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(2001). Leo Strine is a sitting Vice Chancellor of the Delaware Chancery Court.

58. Proposed Rule: Security Holder Director Nominations, Exchange Act Release No. 34-48626, 68 Fed. Reg. 60,783 (proposed Oct. 14, 2003), *available at* http://sec.gov/rules/proposed/34-48626.htm.

59. *SEC To Consider Changes to Director Nominations Rules*, CORP. COUNS. WKLY. (BNA), Sept. 13, 2006, at 276; Deborah Solomon & John D. McKinnon, *Donaldson Ends an SEC Tenure Marked by Active Regulation*, WALL ST. J., June 2, 2005, at A1.

60. *Schapiro, Carrying Through on Promises, Directs Staff to Draft Proxy Access Proposals*, SEC. REG. & L. REP. (BNA), Mar. 16, 2009, at 448. The SEC formally proposed shareholder access in May 2009.

opined that Delaware law barred access, so boards refused to include such proposals in the companies' proxy statements.[61] Towards the end of this five-year period, a state competitive reaction also arose. The activist investors who induced North Dakota to pass an activist-friendly corporate law had the issue high on their agenda: the North Dakota law makes shareholder access the automatic default rule for all new North Dakota-incorporated public companies.[62] Thereafter, activists such as Carl Icahn made reincorporation in North Dakota an issue in multiple recent corporate control contests, proposing that troubled firms reincorporate to North Dakota, where shareholders would have access to the company's proxy solicitation.[63]

Next, Delaware's competitive reaction: In March 2009, the Delaware legislature amended the state's corporate law to allow shareholders access to the company's proxy solicitation. Facing vertical pressure on access from the SEC, as well as horizontal pressure from an insurgent competitor, the Delaware Corporate Law Council—the body that initiates the state's corporate law reforms—recommended that the legislature authorize access.[64] The business press reported that "the most significant change [of the year's proposed corporate law updates] is the amendment allowing investors to include their director nominees in the same proxy document mailed by companies to shareholders, making it easier for them and less expensive."[65] It was the lead

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61. See lawyers' opinions filed in connection with 14a-8 applications for no-action letters. The letters are summarized in Brett H. McDonnell, *Shareholder Bylaws, Shareholder Nominations, and Poison Pills*, 3 BERKELEY BUS. L.J. 205, 260 (2005).

62. Publicly Traded Corporations Act, ch. 102, 2007 N.D. Laws 497 (codified at N.D. CENT. CODE § 10-35-01 (2007)).

63. *Id.* (requiring access in North Dakota); Ronald Grover, *Icahn Is on the Attack*, BUS. WK., Mar. 9, 2009, at 32 (reporting that activists seek reincorporation to North Dakota); Lopatto, *supra* note 48 (reporting similar activist efforts).

64. Act of Apr. 10, 2009, 77 Del. Laws ch. 14 § 1 (to be codified at DEL. CODE tit. 8, § 112), *available at* http://delcode.delaware.gov/sessionlaws/ga145/chp014.shtml.

65. Joseph A. Giannone, *Proposed Delaware Law Changes Expand Proxy Access*, REUTERS, Feb. 27, 2009, http://www.reuters.com/article/reutersINCOnlineReport /idUSTRE51Q5RT20090227. The press sees Delaware as acting positively in enacting shareholder access, with its proposal resonating with the SEC's agenda and North Dakota's required access. But I see Delaware in the text above as positioning itself a big step short of that, because the statute only authorizes Delaware firms to *allow* bylaws that permit stockholder nominees in the company's proxy solicitation. To get the bylaw, shareholders seeking access to the company's proxy statement must first convince managers to add the bylaw or get an approving vote, which itself would require proxy access to be viable. In other words, for shareholders to avoid a full-scale proxy solicitation to elect a short slate, they must first engage in a full-scale proxy solicitation for a new bylaw. But, regardless of whether this is strategic, Delaware is reacting and competing, even if not replicating its competition.

Delaware players may be setting up to battle the SEC. If the SEC promulgates wider shareholder access regulation than Delaware's statute, then, with Delaware having acted, the federal displacement of state law would be made more vivid.

section in the Delaware March 2009 bill to amend Delaware corporate law.[66] In April 2009, the Delaware legislature passed the bill, and its Governor signed it into law.

Delaware faces pressures. Whether they come from other states, acting in concert with corporate dealmakers, or from the federal government, Delaware faces serious constraints. It's acquiescence to some, even weakened form of shareholder access, seems to illustrate the constraints and pressures it faces.

V. YARDSTICK COMPETITION AND PROFESSIONALISM

Delaware faces still other constraints and pressures. First, there's yardstick competition. And there's basic professionalism to consider.

Consider yardstick competition, which although not tight for Delaware, is real. As Albert Hirschman famously wrote in *Exit, Voice, and Loyalty*,[67] when customers cannot exit easily, they can raise their voices to complain. Delaware constituents, if disgruntled, can complain inside Delaware, and their leverage from internal complaint is stronger when they can show Delaware lawmakers that other states' corporate lawmakers are acting differently. Delaware, they can assert, is not keeping up.

People use benchmarks and yardsticks to see how they are doing. Officials who take their positions seriously look at how others handle similar problems. Delaware's constituents can then point out to them discrepancies in performance and results.[68]

Delaware players have opportunities to benchmark their corporate law. There's a Model Business Corporation Act against which to check their work. Major states reconsider corporate lawmaking from time to time. The American Law Institute studied corporate law for about a decade and produced its *Principles of Corporate Governance*, against which Delaware players could measure their rules. Law professors and student law reviews are always ready to lend a helping, often critical, hand when they examine any new Delaware action. *The Business Lawyer* provides Delaware players with practicing lawyers' views. Delaware players can often be found on Practicing Law Institute and American Bar Association panels: they're not just marketing

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66. *See* 77 Del. Laws ch. 14 § 1.

67. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 30 (1970).

68. Timothy Besley & Anne Case, *Incumbent Behavior: Vote-Seeking, Tax-Setting, and Yardstick Competition*, 85 AM. ECON. REV. 25, 25 (1995); Pierre Salmon, *Assigning Powers in the European Union in the Light of Yardstick Competition Among Governments*, *in* 22 JAHRBUCH FÜR NEUE POLITISCHE ÖKONOMIE, EUROPEAN GOVERNANCE 197, 197 (Manfred J. Holler et al. eds., 2003); Jack L. Walker, *The Diffusion of Innovations Among the American States*, 63 AM. POL. SCI. REV. 880 (1969); *cf.* Andrei Shleifer, *A Theory of Yardstick Competition*, 16 RAND J. ECON. 319, 319-20 (1985).

Delaware, but gaining feedback, observing current practice, and learning about current problems.

Indeed, one could imagine cross-national checking for innovation and competency. London now provides securities market competition for U.S. issuers as a haven from, say, Sarbanes-Oxley regulation.[69] In the future, London might seek to provide a total package of listing, trading, and chartering.[70]

Basic professionalism can also be a source of competitive pride, as officeholders (judges, regulators, legislators) want to do a good job for its own sake. Similarly, governmental Weberian bureaucracies simply seek to be relevant.[71] True, this goal could disguise competition for chartering revenue, with even the actors unaware that their professionalism is a veneer. But professionalism need not be just a veneer and could be a separate dimension.

Professionalism could also be political competition on another level: officeholders want re-election, reappointment, or success at reaching higher office;[72] these goals give officeholders an impetus to innovate, or at least to keep up. Lynn LoPucki found bankruptcy courts competing for the big, prestigious cases. Yet bankruptcy courts' competition cannot be motivated by franchise fees[73]—there are none in bankruptcy—and such a nonfee pressure could be in play for basic corporate law too, obscured by our traditional analyses of state competition for franchise fees.

Political scientists model interjurisdictional learning, as policymakers observe what others do and adapt their observations to their own environment.[74] This isn't classic incentive-based economic competition, but it

69. *Cf.* Larry E. Ribstein, *Cross-Listing and Regulatory Competition*, 1 REV. L. & ECON. 97, 128 (2005) (focusing, though, on loss of business, not just feedback from voice).

70. Donald Langevoort made this point when commenting on a related paper.

71. WILLIAM A. NISKANEN, JR., BUREAUCRACY AND REPRESENTATIVE GOVERNMENT 28-29 (1971).

72. *Cf.* Peter Bernholz & Roland Vaubel, *The Effect of Interjurisdictional Competition on Regulation: Theory and Overview*, *in* POLITICAL COMPETITION AND ECONOMIC REGULATION 1, 2-3 (Peter Bernholz & Roland Vaubel eds., 2007); Pierre Salmon, *How Can a Country Like Canada Be Inhospitable to an Influence of Yardstick Competition on Regulation?*, *in* POLITICAL COMPETITION AND ECONOMIC REGULATION, *supra*, at 103, 104.

73. LOPUCKI, *supra* note 46, at 16-17, 254-55. There's been an analogous competition for trust business, which franchise fees cannot drive, since the tax rate there is zero. Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 416 (2005). True, lawyers' and processors' fee-based goals (instead of officeholders' professionalism or bureaucracies' drive for relevance) could drive that competition.

74. *See* William D. Berry & Brady Baybeck, *Using Geographic Information Systems to Study Interstate Competition*, 99 AM. POL. SCI. REV. 505, 505 (2005); Chang Kil Lee & David Strang, *The International Diffusion of Public-Sector Downsizing: Network Emulation and Theory-Driven Learning*, 60 INT'L ORG. 883, 883 (2006); Kurt Weyland, *Theories of Policy Diffusion*, 57 WORLD POL. 262, 262 (2005); Katerina Linos, Social Learning and the Development of Corporate Law 1 (Apr. 24, 2006) (unpublished paper on file with The

is diffusion of innovation. And there's no reason to think Delaware doesn't keep an eye on what others do, with information and technique flowing into (and out from) the jurisdiction.

At a minimum, these yardstick-type considerations constrain professionals from acting badly. They may not propel Delaware to innovate, but they give it reason to keep up, to adopt innovations that occur elsewhere and, sometimes, to stay ahead of the game.

CONCLUSION

Today, only Delaware actively and successfully gets chartering revenues. But that does not mean it is not competing in other dimensions. The dynamism and turnover of American business interact with even static state governments to prod Delaware. Even if Delaware had all of the *current* incorporation business in America and even if no firm would ever move out from Delaware, firms fail, merge, and go out of business. Products erode, and new technologies bring forth new firms. Delaware must attract these new firms and sell them Delaware charters. Hence, it must compete. It must convince enough of the new winners that it's worth their while to pay Delaware's highest-in-the-nation annual franchise fee and reincorporate away from their home state into Delaware.

This dimension is conceptually real, and its importance becomes particularly vivid when we analyze the source of Delaware's franchise fees. Several decades ago, the half-life of its installed base of franchise fees was about a quarter of a century. By 2009, that half-life has become a decade.

Not only must Delaware pull new firms away from their home states, but contestable market theory tells us that in some markets, although one competitor does all the business, it can lose its market dominance overnight. Aware of the risk, the incumbent could even be forced to act as if it faced an immediate competitor. That isn't the classic competition of many strong producers, but it's still real competition.

The market for corporate charters resembles such a contestable market. If Delaware simultaneously offended its two central players—directors and shareholders—it would create an instantaneous competitive opportunity for another small state. Either a state could gear up to compete, or the offended players could go to the state to show it what it needed to do to gain the chartering revenue bonanza. Moreover, while internal state politics and stalking-horse economics are relevant, they can be overemphasized. Other

Harvard Law School Program on Corporate Governance), *available at* http://www.law.harvard.edu/programs/olin_center/corporate_governance/papers/Brudney2006_Linos.pdf; *cf.* Gerald F. Davis & Henrich R. Greve, *Corporate Elite Networks and Governance Changes in the 1980s*, 103 AM. J. SOC. 1, 1 (1997).

states' bureaucracies and legislatures need not be competitive innovators for state competition to arise. The players who would induce a state to compete with Delaware are the *corporate* players who would profit from a competitor state—Delaware's own constituents. That's about how it happened when New Jersey lost to Delaware at the beginning of the twentieth century. And that's happening in 2009, as activist shareholders, unhappy with Delaware's corporate law, have sought, successfully, to get another corporate law in play.

Likewise, the potential contestable market nature of state competition in this dimension—with a punctuated, possibly even once-and-for-all result—resembles how federal authorities interact with Delaware. It's possible that if Delaware were to offend its primary interest groups, or offend federal lawmakers, larger swathes of corporate law could go national. Delaware has reasons to be on its toes, even if no other state is now looking for chartering revenues. It needs to be on its toes because it cannot afford to instigate federal actors who could displace Delaware corporate law, in whole or in part. It needs to be on its toes because its primary interest groups have the capacity to set up a new state competitor. And it needs to be on its toes because its revenue base is always eroding—more quickly now than ever before.