



## NORTH CAROLINA LAW REVIEW

Volume 93 | Number 4

Article 3

5-1-2015

# The Delaware Delusion

Robert Anderson IV

Jeffery Manns

Follow this and additional works at: <http://scholarship.law.unc.edu/nclr>



Part of the [Law Commons](#)

### Recommended Citation

Robert Anderson IV & Jeffery Manns, *The Delaware Delusion*, 93 N.C. L. REV. 1049 (2015).

Available at: <http://scholarship.law.unc.edu/nclr/vol93/iss4/3>

This Article is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact [law\\_repository@unc.edu](mailto:law_repository@unc.edu).

## THE DELAWARE DELUSION\*

ROBERT ANDERSON IV\*\* & JEFFREY MANNS\*\*\*

*Delaware dominates the market for company incorporations, which places America's second smallest state in charge of determining the corporate governance framework for most public and private companies. The unresolved question is the basis for Delaware's appeal compared to other states. We set out to test empirically the two leading schools of thought, which hold that Delaware's appeal lies either in its superior legal regime that enhances shareholder value more than other states or in Delaware's protectionist appeal in adding "managerial value" by entrenching corporate managers at shareholders' expense. We apply an innovative technique to show empirically that both the "race to the top" and "race to the bottom" schools of thought are based on false assumptions because Delaware law neither adds nor subtracts significant value compared to other states.*

*Our "merger reincorporation" approach leverages the fact that each interstate merger is actually a reincorporation of the disappearing company's assets to the state of incorporation of the surviving company. This fact creates the opportunity to gauge the market's assessment of the value of Delaware law relative to that of other states by comparing the pre- and post-acquisition value of acquirers and targets in a cross-section of intra- and interstate mergers. We analyzed an eleven-year data set of mergers (from 2001 to 2011) and found that financial markets place no economically consequential value on Delaware law relative to that of other states, which contradicts both of the leading schools of thought.*

*This result suggests that lawyers are engaging in default decision making based on Delaware's past preeminence, rather than actively weighing the value added by Delaware compared to*

---

\* © 2015 Robert Anderson IV & Jeffrey Manns.

\*\* Associate Professor, Pepperdine University School of Law.

\*\*\* Associate Professor, George Washington University Law School. We would like to thank participants in the National Business Law Conference and the American Association of Law Schools' Section on Corporate and Securities Litigation, as well as workshop participants at the University of Toronto, George Mason University, and American University Law Schools, for their constructive comments.

*what other states could offer to their clients. Lawyers appear to turn to Delaware because it is the law they are most familiar with; they assume markets value Delaware law, and they regard Delaware as a safe default that does not trigger pushback from corporate managers. To break up herding effects among lawyers and spur lawyers to assess this opportunity to add value to transactions, we argue for a “shareholder say” on the state of incorporation. Empowering shareholders to vote on retaining or changing the state of incorporation would subject this decision to greater scrutiny and give shareholders the opportunity to address this principal-agent failure. This approach would dampen Delaware-centric herding and foster greater state competition.*

INTRODUCTION .....	1051
I. ASSESSING DELAWARE’S DOMINANCE OF CORPORATE LAW.....	1054
A. <i>The Debate on the Basis for Delaware’s Hegemony</i> .....	1054
B. <i>The Prior Literature on Delaware’s Appeal</i> .....	1060
II. EMPIRICALLY TESTING THE BASIS FOR DELAWARE’S APPEAL.....	1067
A. <i>The Merger Reincorporation Test</i> .....	1067
B. <i>Data and Methodology</i> .....	1070
III. RESULTS .....	1077
A. <i>Placing the Merger Data in Context</i> .....	1077
B. <i>Cross-Sectional Analysis</i> .....	1080
IV. DISCUSSION.....	1085
A. <i>The Interplay of Financial Markets and Legal     Decisions</i> .....	1086
B. <i>The Intertwining of Herding Effects and Path     Dependency</i> .....	1087
V. ADDRESSING THE PROBLEM AND EXPANDING COMPETITION .....	1092
A. <i>The Potential for a Federal Incorporation Option</i> .....	1094
B. <i>The Case for “Shareholder Say” on Incorporation</i> .....	1095
C. <i>Addressing Concerns About the “Shareholder Say”     Approach</i> .....	1098
VI. METHODOLOGICAL ISSUES .....	1100
A. <i>Assumptions Underpinning Analysis</i> .....	1100
B. <i>Potential Confounding Variables and Selection Effects</i> ...	1102
CONCLUSION .....	1104

## INTRODUCTION

The choice of where to incorporate a company should be one of the most significant decisions a company's managers and its lawyers make. This decision determines the corporate governance framework to which the company is subject. But the scandal of corporate governance is that this choice appears to be a default decision because of Delaware's dominance of the incorporation market. Corporate lawyers routinely embrace the widespread, yet unproven assumption that Delaware's corporate governance framework is better than that of other states and steer their clients towards Delaware.<sup>1</sup>

This core, unresolved question is the basis for Delaware's appeal, which has sparked two leading schools of thought. "Race to the top" advocates believe Delaware has won a competition among the states in producing a statutory framework and specialized court system that enhances shareholder value.<sup>2</sup> In contrast, "race to the bottom"

---

1. Approximately 60% of publicly traded companies in the United States are incorporated in Delaware, including 63% of the Fortune 500 companies. See DEL. DEP'T OF STATE, DIV. OF CORPS., 2009 ANNUAL REPORT 1 (2010) [hereinafter DEL. ANNUAL REPORT], available at <http://corp.delaware.gov/2009ar.pdf>. Over 90% of publicly traded companies that are incorporated in a state outside of their principal base of operations are incorporated in Delaware. See Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 391, 420 (2003).

2. See, e.g., RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW* 306-07 (2d ed. 1977) (arguing that Delaware's appetite for tax revenues from corporate charters incentivized it to develop efficient corporate law rules); RALPH K. WINTER, *GOVERNMENT AND THE CORPORATION* 28-42 (1978) (developing the "race to the top" argument in greater detail); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 184-90 (1985) (arguing that companies "will select their state of incorporation adaptively" leading to a "race to the top" among states); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 527-31 (2001) (analyzing the Tobin's Q of Delaware corporations versus non-Delaware corporations to argue that incorporation in Delaware adds value); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporate Law*, 76 NW. U. L. REV. 913, 919-20 (1982) (pointing to the greater market valuation of Delaware versus non-Delaware firms in arguing that Delaware "has achieved its prominent position because its permissive corporation law maximizes, rather than minimizes, shareholders' welfare"); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 265-73 (1985) (arguing that the positive market reaction to reincorporations in Delaware suggests that state competition results in a "race to the top"); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 35-38 (2004) (applying the Tobin's Q approach to show that Delaware law adds a modest, though declining amount of value compared to other states); Ralph K. Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 289-92 (1977) (arguing that state competition results in a "race to the top"); Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law* 24-25, 52 (Va. Law and Econ., Working Paper No. 2011-08), available at <http://ssrn.com/abstract=1644974> (finding there is a premium for Delaware incorporation based on a comparison of the Tobin's Q of Delaware and Nevada corporations).

advocates argue that Delaware law is best at adding managerial value and entrenching managers at the expense of shareholders.<sup>3</sup> This Article puts Delaware's appeal to the test. We apply an innovative empirical approach comparing the value added from merger incorporation decisions that allows us to examine and debunk the assumptions underpinning both of these viewpoints on Delaware's allure. We show that Delaware law does not add to or subtract significant value from publicly traded companies.

This empirical finding suggests that Delaware's appeal is driven by lawyers' default decision making based on Delaware's past preeminence and reflects lawyers' failure to assess the value added by Delaware compared to other states. Whatever Delaware's past advantages may have been, faith and path dependence, rather than actual value added, supports its current hegemony. This conclusion raises the question of how to incentivize managers and lawyers to

---

3. See, e.g., *Liggett Co. v. Lee*, 288 U.S. 517, 558–59 (1933) (Brandeis, J., dissenting) (framing the competition among states for incorporation revenues as a race “not of diligence but of laxity”); R. NADER, M. GREEN & J. SELIGMAN, *TAMING THE GIANT CORPORATION* 54–61 (1976) (framing Delaware's preeminence as a product of catering to management rather than shareholders); Oren Bar-Gill, Michal Barzuza & Lucian Bebchuk, *The Market for Corporate Law*, 162 J. INST. & THEOR. ECON. 134, 137–41 (2006) (developing a formal model that suggests that Delaware law systematically favors managers over shareholders in contexts where their interests conflict); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1437, 1440–45 (1992) [hereinafter *Bebchuk, Federalism and the Corporation*] (arguing that “state competition produces a race for the top with respect to some corporate issues but a race for the bottom with respect to others” in which managers' interests conflict with shareholders); Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775, 1820–21 (2002) [hereinafter *Bebchuk et al., Does the Evidence Favor State Competition in Corporate Law?*] (providing empirical evidence that state competition results in corporate governance rules that benefit managers but potentially at the expense of shareholders); William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 633, 665–66 (1974) (sparking the debate on the efficiency of Delaware law by arguing Delaware was leading a “race for the bottom”); Melvin Aron Eisenberg, *The Modernization of Corporate Law*, 37 U. MIAMI L. REV. 187, 209–11 (1983) (arguing for the need to reexamine corporate law to remedy rules that favor managers at the expense of shareholders); Richard W. Jennings, *Federalization of Corporation Law: Part Way or All the Way*, 31 BUS. LAW. 991, 993–94 (1976) (arguing Delaware favors managerial over shareholder interests); Stanley A. Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW. 883, 885–87 (1976) (framing Delaware as leading a “race of leniency” towards management); Donald E. Schwartz, *Federalism and Corporate Governance*, 45 OHIO ST. L.J. 545, 555–57 (1984) (arguing states compete in a “race to the bottom” because corporate law systematically favors management over shareholder interests and that reforms are unlikely because managers will “flee” to other states); Gordon G. Young, *Federal Corporate Law, Federalism and the Federal Courts*, 41 L. & CONTEMP. PROBS. 146, 151 (1977) (arguing Delaware's appeal lies in its leadership of the “race to the bottom”).

scrutinize the value added by Delaware's corporate governance framework compared to that of other states in order to create competition and accountability. The logic is that if corporate managers and lawyers have incentives to assess the merits of their incorporation choice, then Delaware and other states will be incentivized to compete to assess and enhance the quality of their corporate governance law.

We argue that policymakers should allow shareholders to decide on the state of incorporation to break up decades of path development and deference to Delaware. Empowering shareholders to have a say on the state of incorporation could be accomplished easily through a statutory change, a Securities and Exchange Commission ("SEC") regulatory mandate for public companies<sup>4</sup> or through stock-exchange listing rules.<sup>5</sup> This market-facilitating approach would let shareholders decide whether to keep the existing state of incorporation or to require the company to change. This strategy would incentivize proxy advisory firms to analyze the merits of states of incorporation and to recommend to shareholders to retain or change the state of incorporation.<sup>6</sup> This approach would also turn

---

4. The evolution of shareholder votes on executive compensation provides a road map of two potential strategies for a "shareholder say" on the state of incorporation. Advisory shareholder votes on executive compensation initially began at shareholders' prompting pursuant to SEC Rule 14a-8. See Jeffrey N. Gordon, "Say on Pay": *Cautionary Notes on the U.K. Experience and the Case for Shareholder Opt-in*, 46 HARV. J. ON LEGIS. 323, 337-40 (2009) (discussing the development of U.S. public company shareholder votes on executive compensation that gained momentum in 2006). The Dodd-Frank Act transformed optional shareholder votes into a mandate for public companies that must hold advisory shareholder votes on the top five executives' compensation at least every three years. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 951(b), 124 Stat. 1376, 1899-1900 (codified in scattered sections of 12 U.S.C., 15 U.S.C., and 22 U.S.C.); see also 17 C.F.R. § 240.14a-21(a) (2011) (containing the SEC rule implementing this provision).

5. One key issue for statutory and regulatory strategies is the question of whether shareholder "say on incorporation" would be binding on company management. For example, a state statutory solution could be crafted to empower shareholders to bind management on this issue, just as an exchange can make companies' adoption of provisions for binding shareholder votes a listing requirement. But a regulatory approach, such as an SEC rule, would be formally nonbinding on management, yet would likely have a similar impact because management would face strong pressure to comply with shareholders' wishes. See, e.g., Jeffrey N. Gordon, *Executive Compensation: If There is a Problem, What's the Remedy? The Case for "Compensation Discussion and Analysis"*, 30 J. CORP. L. 675, 698-99 (2005) (discussing stock-exchange-listing rule mandates for public companies to secure shareholder approval for stock option plans).

6. See, e.g., Randall S. Thomas, Alan R. Palmiter & James F. Cotter, *Dodd-Frank's Say on Pay: Will It Lead to a Greater Role for Shareholders in Corporate Governance?*, 97 CORNELL L. REV. 1213, 1216 (2012) (showing empirically that proxy advisory firm

on the market test of institutional investors who are weighing the benefits and costs of investing their energies in changing the state of incorporation.<sup>7</sup> Even simply the potential for shareholder votes on incorporation would force corporate managers and lawyers to think through the state of incorporation choice more thoroughly so that they can justify their decision.

This regulatory strategy would incentivize corporate lawyers to acquire legal fluency in multiple corporate governance jurisdictions, rather than to rely solely on their knowledge of the law of Delaware. The need to justify incorporation decisions to shareholders would force lawyers to actively assess the value added by Delaware law and the law of other states, and the acquired fluency has the added virtue of making it more likely that corporate lawyers will spearhead change in a proactive way to extract value for companies and their shareholders. Delaware may continue to serve as the dominant market for incorporations. The “shareholder say” strategy would create opportunities for states to compete to attract shareholder support and foster more robust competition among the states to enhance the quality of their corporate law.

Part I will provide an overview of the debate between the “race to the top” and “race to the bottom” schools of thought on Delaware law. Parts II and III will lay out the merger incorporation test for assessing the value added from Delaware law compared to other states and the results of our analysis. Parts IV and V will discuss the implications of our findings and offer our normative recommendation to empower shareholders to have a say on incorporation. Lastly, Part VI will discuss our methodological assumptions and address potential objections to our approach.

## I. ASSESSING DELAWARE’S DOMINANCE OF CORPORATE LAW

### A. *The Debate on the Basis for Delaware’s Hegemony*

Delaware’s dominance of corporate law is indisputable, although the reasons for its appeal are strongly contested. Delaware charters a clear majority of publicly traded companies in the United States, even though almost all publicly traded companies are headquartered in

---

Institutional Shareholder Services’ recommendations for shareholder votes on executive compensation had a twenty percent impact in swaying shareholder support or opposition).

7. See, e.g., Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1962–64 (2010) (discussing how the growth of institutional investors has increased the plausibility of shareholder activism because of the distinctive incentives institutional investors face compared to retail investors).

other states.<sup>8</sup> For example, thirteen times more public companies are incorporated in Delaware than in California, even though approximately forty-three times more public companies are headquartered in California than in Delaware.<sup>9</sup> Although less than half a percent of corporate assets are deployed in Delaware,<sup>10</sup> Delaware law ultimately undergirds the corporate governance of most American corporations operating throughout the world.<sup>11</sup>

But the reason for Delaware's enduring appeal is an open question that has divided most corporate law academics into two conflicting schools of thought. "Race to the top" advocates argue that lawyers advocate chartering large corporations in Delaware because it provides more efficient corporate law than other states and enhances shareholder value.<sup>12</sup> In contrast, "race to the bottom"

---

8. Delaware's dominance has been sustained for most of the past century as Delaware has consistently served as the incorporation home of a majority of large publicly traded companies. *See, e.g.*, Bar-Gill et al., *supra* note 3, at 135. For example, 97% of Fortune 500 companies are based outside of Delaware, *see* Bebchuk & Cohen, *supra* note 1, at 390–91 tbl.1, while 63% of Fortune 500 companies are incorporated in Delaware, *see* DEL. ANNUAL REPORT, *supra* note 1, at 1.

9. These figures are derived from the incorporation data from Bebchuk and Cohen's study. Bebchuk & Cohen, *supra* note 1, at 394–95.

10. Delaware accounted for merely 0.4% of the nation's GDP in 2011, which underscores the fact that it is an economic minnow, even though it functions as a corporate law whale. *See* Press Release, U.S. Dep't Commerce, Bureau of Econ. Analysis, Widespread Growth Across States in 2011 (June 5, 2012), *available at* [http://www.bea.gov/newsreleases/regional/gdp\\_state/2012/pdf/gsp0612.pdf](http://www.bea.gov/newsreleases/regional/gdp_state/2012/pdf/gsp0612.pdf). Many companies have no more than a nominal street address in Delaware, and many of America's largest companies literally share the *same* Delaware street address. *See* Leslie Wayne, *How Delaware Thrives as a Corporate Tax Haven*, N.Y. TIMES (June 30, 2012), <http://www.nytimes.com/2012/07/01/business/how-delaware-thrives-as-a-corporate-tax-haven.html?smid=pl-share>.

11. *See, e.g.*, STEPHEN M. BAINBRIDGE, *THE COMPLETE GUIDE TO SARBANES-OXLEY: UNDERSTANDING HOW SARBANES-OXLEY AFFECTS YOUR BUSINESS* 21 (2007) (describing Delaware as "the Michael Jordan" of corporate law); Jill E. Fisch, *Institutional Competition to Regulate Corporations: A Comment on Macey*, 55 CASE W. RES. L. REV. 617, 619 (2005) (describing Delaware as the "dominant supplier" of American corporate law); Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1969 (1991) ("As long as no other state grabs a substantial number of important corporations, the Delaware Supreme Court remains the national supreme court on corporate law.").

12. *See, e.g.*, POSNER, *supra* note 2, at 306–07 (arguing that Delaware's appetite for tax revenues from corporate charters incentivized it to develop efficient corporate law rules); Baysinger & Butler, *supra* note 2, at 184–90 (arguing that companies "will select their state of incorporation adaptively" leading to a "race to the top" among states); Daines, *supra* note 2, at 527–31 (analyzing the Tobin's Q of Delaware corporations versus non-Delaware corporations to argue that incorporation in Delaware adds value); Fischel, *supra* note 2, at 919–20 (pointing to the greater market valuation of Delaware versus non-Delaware firms in arguing that Delaware "has achieved its prominent position because its permissive corporation law maximizes, rather than minimizes, shareholders' welfare"); Romano, *supra* note 2, at 265–73 (arguing that the positive market reaction to



proponents argue that business lawyers embrace Delaware because its corporate law framework systematically favors managers at the expense of shareholders.<sup>13</sup>

The divide between the two schools of thought centers on conflicting premises about two key questions: (1) the corporate governance question of why managers incorporate in one state rather than another and (2) the empirical question of whether Delaware law increases or decreases firm value relative to the law of other states.<sup>14</sup>

---

reincorporations in Delaware suggests that state competition results in a “race to the top”); Subramanian, *supra* note 2, at 35–39 (applying the Tobin’s Q approach to show that Delaware law adds a modest, though declining amount of value compared to other states); Winter, *supra* note 2, at 289–92 (arguing that state competition results in a “race to the top”); Barzuza & Smith, *supra* note 2, at 24–25 (finding there is a premium for Delaware incorporation based on a comparison of the Tobin’s Q of Delaware and Nevada corporations).

13. See, e.g., *Liggett Co. v. Lee*, 288 U.S. 517, 558–59 (1933) (Brandeis, J., dissenting) (framing the competition among states for incorporation revenues as a race “not of diligence but of laxity”); NADER ET AL., *supra* note 3, at 54–61 (framing Delaware’s preeminence as a product of catering to management rather than shareholders); Bar-Gill et al., *supra* note 3, at 137–40 (developing a formal model that suggests that Delaware law systematically favors managers over shareholders in contexts where their interests conflict); Bebchuk, *Federalism and the Corporation*, *supra* note 3, at 1440–45 (arguing that “state competition produces a race for the top with respect to some corporate issues but a race for the bottom with respect to others” in which managers’ interests conflict with shareholders); Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, *supra* note 3, at 1820–21 (2002) (providing empirical evidence that state competition results in corporate governance rules that benefit managers but potentially at the expense of shareholders); Cary, *supra* note 3, at 665–66 (sparking the debate on the efficiency of Delaware law by arguing Delaware was leading a “race for the bottom”); Eisenberg, *supra* note 3, at 209–211 (arguing for the need to reexamine corporate law to remedy rules that favor managers at the expense of shareholders); Jennings, *supra* note 3, at 993–94 (arguing Delaware favors managerial over shareholder interests); Kaplan, *supra* note 3, at 885–87 (framing Delaware as leading a “race of leniency” towards management); Schwartz, *supra* note 3, at 555–57 (arguing states compete in a race to the bottom because corporate law systematically favors management over shareholder interests and that reforms are unlikely because managers will “flee” to other states); Young, *supra* note 3, at 151 (arguing Delaware’s appeal lies in its leadership of the “race to the bottom”).

14. In addition to these polar opposite positions, there are some alternative perspectives worth noting. One view rejects the idea that competition for incorporation exists on the grounds that other states are not attempting to attract charters. See, e.g., Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 685–87 (2002). This view is at least partly contradicted by the express efforts of states to compete, such as Nevada (however unsuccessfully). See, e.g., Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 938–40 (2012) (discussing Nevada’s efforts to attract out-of-state incorporations and its limited success); Stephen J. Choi & Andrew T. Guzman, *Choice and Federal Intervention in Corporate Law*, 87 VA. L. REV. 961, 961–62 (2001) (“The choice [of where to incorporate] available to corporations . . . has generated competition among states for incorporations.”). Another perspective argues that corporate law is made up primarily of default rules and is therefore “trivial.” See Bernard S. Black, *Is Corporate Law Trivial?*, 84

These two questions are distinct yet are inextricably intertwined. If Delaware law increases firm value, then the reason many companies incorporate there is straightforward, but the reason almost half of large companies do not incorporate there would be more complex. In contrast, if Delaware decreases firm value, then the incorporation decision reflects severe agency costs in corporate governance, and lawyers and corporate managers trade off a “Delaware discount” in exchange for securing managers greater autonomy from shareholders. Lastly, if Delaware is no better or worse than other states, factors other than the quality of corporate law likely underpin the incorporation decision, a fact which would take the Delaware debate in an entirely different direction. As a result, the stakes of this debate are far more important than the mere question of whether Delaware preeminence is a product of a “race to the top” or a “race to the bottom.” Understanding whether markets value Delaware law relative to that of other states is an important piece of evidence in resolving broader questions about agency problems in corporate law.

The fundamental disagreements between the two camps have masked a significant shared assumption—that Delaware law differs in economically consequential ways from that of other states.<sup>15</sup> As a result, both groups have largely skirted the more fundamental question of whether corporate law matters at all to financial

---

NW. U. L. REV. 542, 584–86 (1990). This view understates the role of institutions in mediating both the default corporate laws and adjudicating disputes. *See, e.g.*, Marcel Kahan & Edward Rock, *Symbiotic Federalism and the Structure of Corporate Law*, 58 VAND. L. REV. 1573, 1599–1600 (2005) (discussing the significance of the coordination between the Delaware judiciary and legislature in addressing corporate law issues); Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 594–95 (2003) (discussing the significance of Delaware’s legal decision-makers’ quick responses to trends and issues in corporate law); 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, 783–84 (2004) (discussing the appeal of Delaware’s judiciary in resolving corporate governance litigation issues). Lastly, William Carney has compiled survey data from underwriter and issuer lawyers that suggests that lawyers generally recommend either Delaware or their state of practice for incorporation because they only are familiar with the corporate law of Delaware and their state of practice. *See* William J. Carney, George B. Shepherd & Joanna Shepherd Bailey, *Lawyers, Ignorance, and the Dominance of Delaware Corporate Law*, 2 HARV. BUS. L. REV. 123, 124–25 (2012). Our analysis of market valuations of intra- and interstate mergers builds on this insight by arguing that Delaware’s dominance is not a product of markets placing any value on incorporating in Delaware, but rather reflects herding effects among lawyers coupled with path dependence from Delaware’s past preeminence.

15. *See, e.g.*, Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 471–72 (1987) (arguing that Delaware’s appeal lies both in “the present structure of its rules, and—perhaps more importantly—for the reliable promise it makes that rules adopted in the future will also be highly desired”).

markets.<sup>16</sup> In other words, do markets value the quality of corporate law in that they “price” the corporate law of states that firms choose? Do they apply a premium or discount to corporations simply for incorporating in a state whose corporate law is perceived to add or reduce value? Or is corporate law a matter of relative indifference to markets given the ability of corporations to contract around many rules?

Given the stakes (and potential arbitrage opportunities), one would expect that this debate would have been definitively resolved long ago. If simply reincorporating in Delaware could significantly increase the value of a firm, it would seem almost to verge on malpractice for corporate counsel not to push corporate managers to incorporate there. Or why would the firms that fail to reincorporate in Delaware not become appealing takeover targets or at least become comparatively more so on the margins? The opposite logic would apply to the extent that the “race to the bottom” advocates are correct. One would expect markets to impose a discount on companies incorporating in Delaware compared to those incorporating in stronger corporate law regimes.

The reason these questions remain unanswered is that both competing schools of thought have failed to produce definitive evidence about whether Delaware corporate law is better or worse than that of other states or even whether differences in state corporate law matter at all. Although scholars have conducted numerous empirical studies on the market value of state incorporation, the studies are almost completely inconclusive on the fundamental question of whether corporate law matters to financial markets.<sup>17</sup> The earliest papers conducted event studies around reincorporation transactions and had weak results, generally finding a small positive effect of reincorporating in Delaware.<sup>18</sup> More recent studies have taken a different approach, examining the Tobin’s Q of Delaware corporations versus non-Delaware corporations, with some

---

16. A notable exception is Bernard Black’s view that corporate law is made up primarily of default rules and is therefore “trivial.” See Black, *supra* note 14, at 584–86.

17. Compare Daines, *supra* note 2, at 527–31 (arguing that Delaware law enhances shareholder value), and Romano, *supra* note 2, at 265–73 (arguing that state competition results in a “race to the top”), with Bebchuck et al., *Does the Evidence Favor State Competition in Corporate Law?*, *supra* note 3, at 1820–21 (arguing that Delaware law is biased in favor of managers), and Subramanian, *supra* note 2, at 35–38 (showing that Delaware law adds a modest, though declining amount of value at best).

18. See, e.g., Romano, *supra* note 2, at 265–73 (finding that reincorporation is sometimes associated with positive abnormal returns for shareholders).

finding a strong positive effect from Delaware law<sup>19</sup> and others finding only evidence of a weak (or historical) positive effect.<sup>20</sup> Although the existing literature seems to have established that Delaware is not significantly *worse* than other states, it also has not produced much evidence that Delaware is better. Thus, the debate has “stalemated,”<sup>21</sup> largely because scholars have failed to move beyond the limitations of these two methodological techniques.

In this Article, we attempt to break this stalemate by using a new approach to assess the value added from incorporating in Delaware. Our technique, which we call the “merger reincorporation approach,” takes advantage of the fact that every merger between companies incorporated in different states is, in effect, a reincorporation of the target company. In these “merger reincorporations,” the target’s assets are redeployed from one legal regime (that of the target) to another (that of the acquirer), effectively reincorporating the target. If the new state of incorporation is more valuable than the old legal regime, then the reincorporation should create value in the merger relative to mergers in which the law stayed the same (or became worse due to migration to less efficient state regimes).

We collected over a decade’s worth of data on these merger reincorporations to determine whether value is created or destroyed when assets are brought under Delaware law relative to acquisitions when assets remain under the same legal regime or are brought under non-Delaware law. If markets place a higher value on Delaware law relative to non-Delaware law, then merger reincorporations should create more value (or destroy less) when a Delaware corporation acquires a non-Delaware corporation than when a non-Delaware corporation acquires a Delaware corporation. Our merger reincorporation approach provides a new test of the market value of Delaware law that will help to break the deadlock in the empirical literature.

We examine a sample of over 600 acquisition transactions from public companies (from eleven years of public company mergers from 2001 to 2011) and find that the conventional wisdom that Delaware corporate law is better than that of other states is a myth. We find

---

19. See, e.g., Daines, *supra* note 2, at 533 (finding that incorporating in Delaware added approximately five percent to firm value compared to incorporating in other states).

20. See, e.g., Subramanian, *supra* note 2, at 33–38 (applying the Tobin’s Q approach to show that Delaware law adds a modest, though declining, amount of value compared to other states).

21. See, e.g., Roe, *supra* note 14, at 634 (arguing that the longstanding debate between the “race to the top” and “race to the bottom” has devolved into a stalemate).

that the “excess returns”<sup>22</sup> when Delaware companies merge into non-Delaware companies are almost identical to those when non-Delaware companies merge into Delaware companies. The excess returns in both of these contexts are also roughly equal to cases in which Delaware companies merge with Delaware companies. Redeploying assets from a non-Delaware state to Delaware does not significantly increase the value of those assets, and redeploying assets from Delaware law to another state’s law does not significantly reduce the value of those assets. The empirical evidence shows that financial markets appear to place little to no value on Delaware law relative to that of other states and that both the “race to the top” and “race to the bottom” schools of thought rest on false assumptions.

The evidence leads us to consider explanations other than efficiency to explain Delaware’s dominance in the incorporation market. In contrast to the contentions of both the “race to the top” theorists and the “race to the bottom” theorists, we argue that the content of Delaware law—whether positive or negative—has little to do with most corporations’ choices to incorporate there. Instead, we argue that the empirical evidence suggests that legal herding and path dependence are at the heart of Delaware’s continued dominance in spite of Delaware law’s failure to add value. Lawyers appear to turn to Delaware because it is the law they know best and because it is a safe default to recommend without conducting due diligence since a majority of companies are based there. Lawyers assume markets value Delaware law, but lawyers’ recommendations appear to have nothing to do with whether Delaware law actually adds value compared to other states’ corporate frameworks.

### *B. The Prior Literature on Delaware’s Appeal*

The conventional wisdom among corporate scholars is that Delaware’s appeal to business lawyers and corporate managers stems from a century-long sorting process in which Delaware edged out all other states by competing with other states over corporate law.<sup>23</sup> This competition is made possible by the fact that corporate law in the United States is a state law matter. Corporations can choose to incorporate in any of the fifty states regardless of where their

---

22. “Excess returns” are the combined increase in value of the target and acquirer following the disclosure of a merger above the normal returns.

23. See CHRISTOPHER GRANDY, *NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW* 33–53 (1993) (discussing how New Jersey was initially the destination of choice for incorporations, yet was supplanted by Delaware due to a backlash to 1911 New Jersey legislation that placed limits on corporate management).

headquarters or principal place of operations is located.<sup>24</sup> Therefore, if one state provides a more attractive corporate law regime than another, companies would presumably choose the more favorable regime in the first place or reincorporate there later. According to the standard story, Delaware has won the “race” because it has provided more attractive corporate law than its competitors.<sup>25</sup>

The key dispute dividing scholars, however, is the question: “attractive to whom?”<sup>26</sup> Scholars embracing the “race to the top” view disagree with those advocating the “race to the bottom” perspective not on *whether* Delaware is better, but *for whom* Delaware is “better.” Both believe corporate law matters and that states compete in a “race” by providing law that is better for somebody, but disagree about the mechanism of competition and the beneficiary of the competition.<sup>27</sup> “Race to the top” theorists tend to believe that capital market discipline will lead companies to migrate to the most efficient law and that business lawyers and corporate managers naturally gravitate to the regime that maximizes shareholder value.<sup>28</sup> In contrast, “race to the bottom” theorists believe business lawyers look out for their clients—corporate managers—and, therefore, understandably choose the legal regime that benefits the managers the most.<sup>29</sup> The point of contention is whether Delaware’s preeminence is the result of a virtuous attempt to

---

24. The significance of corporate incorporation is due to the “internal affairs doctrine,” which specifies that the law of the state of incorporation applies to the “internal affairs” of the corporation, such as corporate governance. See William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 312–18 (1997).

25. Winning the race produces tangible benefits for Delaware. See, e.g., Kahan & Kamar, *supra* note 14, at 688–95 (discussing the range of benefits Delaware and Delaware lawyers derive from Delaware’s preeminence in corporate chartering). For example, in 2001, Delaware’s corporate franchise tax revenues amounted to \$750 per Delaware resident, which serves as a substantial tax revenue source. See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 583 (2002); see also DEL. ANNUAL REPORT, *supra* note 1, at 2 (detailing that in 2009, Delaware collected \$767 million in business-related fees accounting for twenty-five percent of the state’s budget).

26. See George W. Dent, Jr., *For Optional Federal Incorporation*, 35 J. CORP. L. 499, 505 (2010).

27. Compare Choi & Guzman, *supra* note 14, at 961 (arguing that states compete for corporate charters), with Kahan & Kamar, *supra* note 14, at 688–95 (arguing that Delaware’s preeminence means that states can no longer effectively compete for state incorporation).

28. See, e.g., Winter, *supra* note 2, at 254–58 (arguing that constraints imposed by capital markets make the “race to the bottom” argument implausible).

29. See, e.g., Kaplan, *supra* note 3, at 885; Schwartz, *supra* note 3, at 557; Young, *supra* note 3, at 151.

design law and governance institutions that seek to maximize firm value or the result of a defective market failure that promotes manager entrenchment and self-interest. The question is whether the race is a competition toward efficiency or a process that reflects and reinforces deep pathologies in corporate governance.<sup>30</sup>

The response of financial markets to Delaware corporate law is either explicitly or implicitly a central part of both sides' arguments. "Race to the top" proponents explicitly rely on the market as the mechanism that motivates lawyers and managers to embrace efficient corporate law.<sup>31</sup> The underlying logic is that markets will price corporate law, penalizing corporations that incorporate in suboptimal jurisdictions and rewarding firms that choose efficient corporate law frameworks. This capital markets penalty will create headwinds for firms that choose less efficient state law, causing the stock price to drop and making the company vulnerable to a takeover.<sup>32</sup> This view's logic holds that Delaware would have no interest in this fate befalling its corporations for fear of losing both prestige and its lucrative franchise tax revenue.<sup>33</sup> Therefore, Delaware would not have incentives to implement or keep law that favors management over shareholders. As a result, this school of thought argues that Delaware's dominance relies on market pricing of corporate law to stimulate regulatory competition toward the most efficient corporate rules.<sup>34</sup>

---

30. See Roberta Romano, *Is Regulatory Competition a Problem or Irrelevant for Corporate Governance?* 1–10 (Yale Law Sch. Ctr. for Law, Econ. & Pub. Pol'y, Working Paper No. 307, 2005), available at <http://ssrn.com/abstract=693484> (arguing that the current state of corporate law is still best explained by robust competition).

31. It is important to emphasize that "race to the top" proponents do not assume that managers are always acting as faithful agents of shareholders in maximizing shareholder value as they recognize the divergence between managers' and shareholders' interests. See Fischel, *supra* note 2, at 919. Instead, their notion of efficiency is a relative question and focuses on markets incentivizing managers to seek institutional arrangements, such as corporate law or corporate finance frameworks, that are superior to the alternatives and that the overall benefits exceed the costs. See *id.* (discussing how market pressures limit managers' ability to deviate from shareholders' interests and push them to maximize shareholder value); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. FIN. ECON. 305, 327–28 (1976) (discussing the role of markets in the choice of institutional frameworks).

32. See, e.g., WINTER, *supra* note 2, at 10–11 ("It is not in the interest of Delaware corporate management or the Delaware treasury for corporations chartered there to be at a disadvantage in raising debt or equity capital in relation to corporations chartered in other states.").

33. See Cary, *supra* note 3, at 684 (arguing that "there is no public policy left in Delaware corporate law except the objective of raising revenue").

34. See, e.g., Daines, *supra* note 2, at 532–35 (analyzing the Tobin's Q of Delaware corporations versus non-Delaware corporations to argue that incorporation in Delaware

“Race to the bottom” proponents often do not rely explicitly on the role of capital markets in facilitating the downward spiral.<sup>35</sup> However, they do rely on capital market valuation implicitly as a basis to assess the race.<sup>36</sup> The “race to the bottom” camp argues that corporate lawyers look out for corporate managers as both benefit from a regime that entrenches management at the expense of shareholders.<sup>37</sup> “Race to the bottom” proponents predict embracing Delaware corporate law will depress the stock price as the market applies a Delaware discount that reflects managerial entrenchment.<sup>38</sup> As a result, the “race to the bottom” approach also implies that financial markets price corporate law, a premise that can also be empirically tested.

Therefore, the debate largely boils down to whether Delaware actually has better corporate law than other states, where “better” is assessed by value in capital markets. A number of empirical studies have attempted to assess the value of Delaware law using stock price data.<sup>39</sup> The earliest studies took the most intuitive route, conducting event studies around reincorporations, transactions whose sole purpose was for a corporation to change its state of incorporation

---

adds value); Fischel, *supra* note 2, at 919–20 (pointing to the greater market valuation of Delaware versus non-Delaware firms in arguing that “Delaware has achieved its prominent position because its permissive corporation law maximizes, rather than minimizes, shareholders’ welfare”); Romano, *supra* note 2, at 265–73 (arguing that the positive market reaction to reincorporations in Delaware suggests that state competition results in a “race to the top”); Subramanian, *supra* note 2, at 33–38 (showing that Delaware law adds a modest, though declining amount of value at best).

35. See, e.g., Bar-Gill et al., *supra* note 3, at 137–40 (developing a formal model that suggests that Delaware law systematically favors managers over shareholders in contexts in which their interest conflict); Bebchuk, *Federalism and the Corporation*, *supra* note 3, at 1440–45 (arguing that state competition leads to rules biased in favor of managerial interests); Cary, *supra* note 3, at 665–66 (sparking the debate on the efficiency of Delaware law by arguing Delaware was leading a “race for the bottom”); Eisenberg, *supra* note 3, at 209–11 (arguing for the need to reexamine corporate law to remedy rules that favor managers at the expense of shareholders); Kaplan, *supra* note 3, at 885–87 (framing Delaware as leading a “race of leniency” towards management).

36. See, e.g., Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, *supra* note 3, at 1780–83 (providing empirical evidence that state competition results in corporate governance rules that benefit managers but potentially at the expense of shareholders).

37. See Schwartz, *supra* note 3, at 556–57.

38. See Romano, *supra* note 2, at 229–30.

39. See, e.g., Sanjai Bhagat & Roberta Romano, *Event Studies and the Law: Part II: Empirical Studies of Corporate Law*, 4 AM. L. & ECON. REV. 380, 385–87 (2002) (providing an overview of empirical studies that have sought to assess the value added by Delaware law).



from one state to another.<sup>40</sup> The premise of these studies was that if financial markets value Delaware law relative to the law of other states, not only would this fact motivate reincorporations in Delaware, but financial markets also should show positive stock price effects upon reincorporation in Delaware.<sup>41</sup> In contrast, if financial markets value other states' law over that of Delaware, the financial markets should show negative stock price effects upon reincorporation in Delaware.<sup>42</sup>

The reincorporation studies are mixed but generally show at least nonnegative market reaction to the decision to reincorporate in Delaware.<sup>43</sup> Some show small positive effects from reincorporating in Delaware.<sup>44</sup> Other studies show effects that depend on the motivation of the reincorporation, with reincorporations designed to erect takeover defenses producing negative returns and other types of reincorporations producing positive returns.<sup>45</sup> Overall, the results from the reincorporation studies suggest "modest" returns at best from reincorporation in Delaware.<sup>46</sup> But taken together with the large number of studies that show no effect or a mixed effect, the studies

---

40. See, e.g., ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 17–24 (1993) (providing an analysis of various event studies bearing on state competition).

41. See *id.* at 17.

42. See *id.*

43. Reincorporation studies often rely on the fact that the overwhelming majority of reincorporations are to Delaware to make their case that Delaware must be adding value. See, e.g., Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: 'Unhealthy Competition' Versus Federal Regulation*, 53 J. BUS. 59, 62–63 (1980) (documenting that 90% of reincorporating firms from 1927 to 1977 chose Delaware); Romano, *supra* note 2, at 244–45 (observing that 81% of reincorporations from 1961 to 1983 chose Delaware). But see Subramanian, *supra* note 2, at 34–37 (finding that during the 1990s, Delaware's share of reincorporations declined to only 56% of reincorporations).

44. See, e.g., Michael Bradley & Cindy A. Schipani, *The Relevance of the Duty of Care Standard in Corporate Governance*, 75 IOWA L. REV. 1, 66–67 (1989); Dodd & Leftwich, *supra* note 43, at 62–63 (showing that most of the abnormal returns for a reincorporating firm occurred before the reincorporation event date); Romano, *supra* note 2, at 240–43 (confirming this finding). Other studies show positive and negative results from reincorporations based on the managements' stated motives. See, e.g., Pamela Peterson, *Reincorporation Motives and Shareholder Wealth*, 23 FIN. REV. 151, 155–59 (1988) (showing that abnormal returns differed depending on the announced motivation for reincorporation with modestly negative returns for reincorporations that had an announced defensive purpose and positive returns for reincorporations that had an express purpose of enhancing shareholder value).

45. See Randall A. Heron & Wilbur G. Lewellen, *An Empirical Analysis of the Reincorporation Decision*, 33 J. FIN. & QUANTITATIVE ANALYSIS 549, 555–58 (1998).

46. See Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, *supra* note 3, at 1792 (arguing that "even if the positive abnormal stock price reaction [from reincorporations] is entirely due to the benefits of Delaware incorporation, these benefits appear to be rather modest").

provide mostly inconclusive results or no large effects of Delaware law.<sup>47</sup>

The reincorporation studies, in addition to providing weak evidence for Delaware's value, suffer from significant methodological drawbacks. The principal problem is that the reincorporation decision is itself the object of managerial choice, creating an endogeneity problem.<sup>48</sup> In other words, the decision to reincorporate may be interpreted by the market as positive news for reasons completely unrelated to any value placed on the legal regime. For example, corporations may reincorporate in anticipation of major transactions, such as a public offering, a major acquisition campaign, or defensive maneuvering as Roberta Romano's research showed.<sup>49</sup> Thus, the market might react to the potential signaling effects rather than the news that the legal regime will change, confounding the analysis of the value of Delaware law. Additionally, the small number of reincorporations is evidence against Delaware adding value. The fact that most non-Delaware corporations do not reincorporate into Delaware and yet continue to compete effectively suggests that Delaware's value is marginal at best in adding value to managers or shareholders.<sup>50</sup>

The recognition of problems with the reincorporation event study approach led to an alternative approach using Tobin's Q. Tobin's Q is a measure of the ratio of the market value of a firm's assets to the replacement cost of its assets.<sup>51</sup> The higher the Tobin's Q, the greater value that managers have created relative to firm assets, and the lower the Tobin's Q, the more ineffective the management has been in creating value from firm assets.<sup>52</sup> In 2001, Robert Daines

---

47. For an overview of event studies on reincorporation, see ROBERTA ROMANO, *THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION* 64–73 (2002).

48. See Yair Listokin, *Interpreting Empirical Estimates of the Effect of Corporate Governance*, 10 *AM. L. & ECON. REV.* 90, 94–97 (2008) (explaining how corporate governance analyses may be skewed due to the confounding effect of endogeneity problems).

49. See Romano, *supra* note 2, at 233–36.

50. See, e.g., Macey & Miller, *supra* note 15, at 478 (“Either Delaware reincorporation does not produce gains for all firms or firms refusing to relocate do not disappear, for though Delaware is successful in attracting and retaining corporate charters, many corporations continue to thrive under charters granted by other states . . .”).

51. See Kee H. Chung & Stephen W. Pruitt, *A Simple Approximation of Tobin's Q*, 23 *FIN. MGMT.* 70, 70 (1994).

52. See, e.g., Sanjai Bhagat & Bernard Black, *The Non-Correlation Between Board Independence and Long-Term Firm Performance*, 27 *J. CORP. L.* 231, 236 n.20 (2002).

employed this new approach to assess the value of Delaware law.<sup>53</sup> Daines found that Delaware companies had significantly larger values of Tobin's Q than companies incorporated in other states.<sup>54</sup> The effect was not just statistically significant but economically consequential as well, ranging from a 1% to 5% increase in market value, depending on the years chosen.<sup>55</sup>

The Daines article reinvigorated the debate over the value of Delaware law. But the fact that the value of Delaware law appeared to vary so much from year to year cast doubt on the robustness of the results themselves<sup>56</sup> and raised the question as to whether any Delaware effect that once existed had now "disappeared."<sup>57</sup> Moreover, the Tobin's Q studies may also suffer from a selection bias of their own, since incorporation decisions are not random, and Delaware corporations may vary from other corporations in systematic ways that cause the Tobin's Q result.<sup>58</sup> For example, if growing companies choose Delaware or if Delaware companies are more conservative with financial statements, their Tobin's Q could be higher, even though corporate law does not cause the increased value. Similarly, stronger management teams may tend to choose Delaware and therefore have higher performance that could account for results that have nothing to do with the substance of Delaware law.<sup>59</sup>

---

53. See Daines, *supra*, note 2, at 532–35. The new approach has caught on, as even critics of Daines' conclusions have used this framework in subsequent articles analyzing other governance issues. See, e.g., Lucian Bebchuk & Alma Cohen, *The Costs of Entrenched Boards*, 78 J. FIN. ECON. 409, 411–13 (2005) (using Tobin's Q as a measure of firm value in an analysis of the association between staggered boards and firm value).

54. See Daines, *supra* note 2, at 533–34.

55. See *id.*

56. See Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, *supra* note 3, at 1785–86 (documenting how Daines' "reported correlation between Tobin's Q and Delaware incorporation no longer exists").

57. See, e.g., Bebchuk & Cohen, *supra* note 1, at 391; Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1797–1802 (2002). See generally Martijn Cremers & Simone M. Sepe, *Whither Delaware? Limited Commitment and the Financial Value of Corporate Law* (Nov. 24, 2014) (unpublished manuscript), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2519238](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2519238) (using a Tobin's Q approach and finding that Delaware law has no positive value to the capital markets and may have a negative value).

58. See Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, *supra* note 3, at 1788–90 (discussing the influence of selection effects on the Daines results).

59. Indeed, Tobin's Q is often deployed in empirical research as a dependent variable assessing firm performance. See, e.g., Birger Wernerfelt & Cynthia A. Montgomery, *Tobin's Q and the Importance of Focus in Firm Performance*, 78 AM. ECON. REV. 246, 247 (1988).

The two existing methodologies for estimating the value of Delaware law each have their advantages and disadvantages. The reincorporation approach avoids the danger of selection effects from better management teams systematically choosing to incorporate in Delaware because the technique compares the same company and management before and after reincorporation. But reincorporation studies are subject to the criticism that other possibly confounding events typically accompany reincorporation, and those events could cause the price increases. The Tobin's Q studies do not have the problem of confounding events accompanying the reincorporation decision because there is no reincorporation decision. But the Tobin's Q studies compare one group of companies to another, and those companies may differ in systematic ways not caused by the law of the state of incorporation. In short, both of the leading methodologies suffer from significant methodological weaknesses and have produced results that are both conflicting and indeterminate.

## II. EMPIRICALLY TESTING THE BASIS FOR DELAWARE'S APPEAL

### A. *The Merger Reincorporation Test*

In light of the limitations of existing approaches, we developed a new approach for valuing Delaware law to shed light on the "race to the top" or "race to the bottom" debate in corporate law.<sup>60</sup> Our merger reincorporation test leverages the little-appreciated fact that every merger of companies incorporated in different states entails an "acquisition reincorporation" of the target company. In a merger, the assets and liabilities of the target corporation become the assets and liabilities of the acquiring corporation. As a result, the target corporation's assets are redeployed from the target corporation's regime of corporate law into the surviving corporation's regime of corporate law. In this sense, the business and assets of the target company are "reincorporated" in the state of incorporation of the acquiring company. If assets are redeployed from an inferior regime of corporate law to a superior one, this change should increase the value relative to mergers in which assets are redeployed from a

---

60. There are other approaches to evaluating the value of Delaware law, such as looking at market reactions to changes in law, *see, e.g.*, Elliott J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551, 554-58 (1987), as well as the performance of firms after reincorporation. For an overview of these approaches, *see* Sanjai Bhagat & Roberta Romano, *Empirical Studies of Corporate Law*, in 2 HANDBOOK OF LAW AND ECONOMICS 945, 946-51 (A. Mitchell Polinsky & Steven Shavell eds., 2007).

superior regime to an inferior regime, or mergers where the target and acquirer regimes are the same.

Our merger reincorporation approach makes it possible to harness some of the benefits of the reincorporation methodology while reducing the endogeneity problems inherent in the reincorporation studies. Previous studies focused on “freestanding” reincorporations in which the only (apparent) event was the corporate decision to change its state of incorporation.<sup>61</sup> As mentioned above, simply looking at the returns to companies reincorporating in Delaware raises significant confounding event problems, because companies that reincorporate often do so in anticipation of major corporate events, such as public offerings. Thus, one cannot determine whether the stock price reaction is a response to the reincorporation or to the major corporate events with which this change is inextricably intertwined. The problem could be greatly reduced if it were possible to reliably compare freestanding reincorporations into Delaware with freestanding reincorporations out of Delaware, but there are too few reincorporations out of Delaware to provide reliable results.<sup>62</sup> Our approach of using merger reincorporations, however, allows us to overcome this problem by comparing one acquisition against another acquisition. Because companies merge into and out of Delaware in roughly equal numbers, we are able to compare companies reincorporating into Delaware with those reincorporating out of Delaware.<sup>63</sup>

This approach yields four types of merger reincorporations, which we refer to as “merger counterparts,” that we can examine to find the relative value of Delaware law: (1) a non-Delaware corporation merges into a Delaware corporation, (2) a Delaware corporation merges into a Delaware corporation, (3) a non-Delaware corporation merges into a non-Delaware corporation, and (4) a Delaware corporation merges into a non-Delaware corporation.<sup>64</sup> If

---

61. See, e.g., Romano, *supra* note 2, at 265–73 (examining the role of state competition in reincorporations).

62. See Heron & Lewellen, *supra* note 45, at 553 (noting that only thirteen percent of reincorporations moved to a state other than Delaware). Even if there were sufficient numbers of companies leaving Delaware, the lopsided direction of reincorporation decisions would raise the risk that companies left Delaware for different reasons than those that entered Delaware, raising further confounding issues. The differing reasons of companies entering and leaving Delaware have been documented in the literature. See *id.* at 560 n.7.

63. See *infra* Table 2.

64. For each transaction, we located the original acquisition agreement (typically, an Agreement and Plan of Merger, even for tender offer deals) from the SEC’s EDGAR database. We used the first paragraph of the acquisition agreement to identify the states of

Delaware law increases firm value relative to the law of other states, we would expect that Case 1 should yield the highest returns, as assets under an inferior (non-Delaware) law would be reincorporated under the superior (Delaware) law. Case 4 should yield the lowest returns, because assets under the superior (Delaware) law would be reincorporated under the inferior (non-Delaware) law.

Cases 2 and 3, in which both merging companies are Delaware companies or non-Delaware companies, should fall in between Cases 1 and 4, but the expected returns need not be zero. When two Delaware companies merge, there is no “reincorporation” because all assets were deployed under Delaware law prior to the merger and after the merger. But if markets value Delaware law, there may be a positive element of value because the market “priced in” (i.e., had taken account of) the possibility that the target could be acquired by a non-Delaware company, and thus it is “relieved” that the assets remain in Delaware. The reverse might be true when two non-Delaware companies merge. There may be a negative element of value because the market priced in the possibility that the target could be acquired by a Delaware company, and thus the market is “disappointed.” Therefore, we would predict that if Delaware law has positive value, the Delaware into Delaware mergers should give a higher return than non-Delaware into non-Delaware mergers, yielding the following ranking hypothesis:

---

incorporation of the buyer, seller, and merger subsidiary (if applicable). We then identified the structure of the transaction from the recitals of the agreement or the body of the agreement itself. In some cases, multiple entities and multiple jurisdictions were involved, as in the case with real estate investment trust mergers, which often have a merger of the publicly traded holding company and a merger of the privately held operating subsidiary. We used the jurisdiction of the publicly traded holding company rather than the privately traded subsidiary.

**Table 1. Predictions for the Delaware Value Hypothesis.**

Direction of Merger	Expected Return
Case 1: Non-Delaware into Delaware	Highest
Case 2: Delaware into Delaware	Higher
Case 3: Non-Delaware into Non-Delaware	Lower
Case 4: Delaware into Non-Delaware	Lowest

To the extent that mergers follow the predicted pattern, one would conclude that Delaware law holds positive value relative to the law of other states (a “race to the top”). To the extent that mergers follow the reverse pattern, one would expect that Delaware law is worse than that of other states (a “race to the bottom”). If, however, the cases do not follow either pattern or there are no significant differences, one would conclude that Delaware is neither better nor worse than other states and that Delaware’s appeal to lawyers and corporate managers lies in something other than its ability to add value.

#### B. *Data and Methodology*

To examine the hypothesis that Delaware law creates value, we created a data set initially consisting of all announcements of mergers between public companies for the ten-year period between 2001 and 2011, inclusive with a “Total Invested Capital” of at least \$250 million.<sup>65</sup> We located these merger announcements using the Mergerstat database available through LexisNexis. For each transaction, we coded the state of incorporation of the acquiring company and the target.<sup>66</sup> The four merger counterparts (states of

65. The variable for “Total Invested Capital” in Mergerstat is a measure that takes into account not only the target’s implied market value of common equity, but also the face value of debt and the book value of preferred stock. *See Factset Mergerstat/BVR Control Premium Study FAQs*, BVR, <http://www.bvmarketdata.com/defaulttextonly.asp?f=CPS%20Faqs> (last updated Nov. 13, 2013). Thus, this is a proxy for the total “enterprise value” of the target company. *See id.*

66. In many cases, the transaction was structured as a triangular merger. In such cases, a merger subsidiary of the acquiring company is the entity that actually merges with the target. *See* Rev. Rul. 1990-95, 1990-2 C.B. 67–69. Because the merger subsidiary is a wholly owned subsidiary of the acquirer, corporate law is irrelevant to the merger

incorporation) are the key independent variables we test in the analysis.

The dependent variable of interest is the change in common stockholder wealth of the combined companies before and after the announcement date, i.e., the “excess returns” to common stock from the merger. This test calls for a standard event study analysis with one important change.<sup>67</sup> To assess the value of Delaware law in interstate mergers, we must measure the *combined* value of the two corporations before and after the merger.<sup>68</sup> We cannot merely look at the acquirer stock price and the target stock price separately because we do not know how the joint increase or decrease associated with the legal regime will be shared between the acquirer and the target.<sup>69</sup> If the surviving corporation’s state of incorporation is good or bad relative to that of the target, then that might affect the price paid in the merger.<sup>70</sup> As a result, we estimate three separate versions of our event study, one for the acquirer, one for the target, and one for a value-weighted portfolio of the acquirer and the target.<sup>71</sup> The results are presented in the next section.

---

subsidiary, so we treat the surviving corporation in such cases as the parent (acquiring) company. *Id.*

67. An event study is a statistical regression analysis that assesses the market’s reaction to an event, such as disclosure of information, by measuring the degree to which a security’s price diverged in response to an event from its typical correlation to the stock market. *See, e.g.,* Bhagat & Romano, *supra* note 39, at 382–85 (discussing the appeal of event studies in the securities law context because they provide a means to measure a specific event’s impact on individual stock prices); Elaine Buckberg & Frederick C. Dunbar, *Disgorgement: Punitive Demands and Remedial Offers*, 63 *BUS. LAW.* 347, 361 (2008) (noting that courts widely accept event studies in a broad array of contexts such as securities litigation); Madge S. Thorsen, Richard A. Kaplan & Scott Hakala, *Rediscovering the Economics of Loss Causation*, 6 *J. BUS. & SEC. L.* 93, 95 (2006) (observing that the event study method serves as “the gold standard” for loss causation for courts and economists).

68. Market capitalization of the acquirer and the target were computed by multiplying the share price of the relevant company on the fifth trading day prior to the announcement date by the number of shares of common stock outstanding on that date, each as reflected in the CRSP Daily Stock Files. The relative size of the target and acquirer was computed by taking the ratio of the target’s market capitalization to the acquirer’s market capitalization.

69. *See, e.g.,* Sanjai Bhagat et al., *Do Tender Offers Create Value? New Methods and Evidence*, 76 *J. FIN. ECON.* 4, 7 (2005) (explaining that most event studies of mergers estimate the effect on the acquirer and target separately, but that combined estimates are necessary because overall gains “depend on how this surplus is divided between bidder and target”).

70. *See* Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 *STAN. L. REV.* 127, 139–42 (1999).

71. *See* Michael Bradley, Anand Desai & E. Han Kim, *Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms*, 21 *J. FIN. ECON.* 3, 5–6 (1988) (conducting three separate versions of the



The “event” in our event study is the official announcement of the merger. We use the announcement date of the merger (which we denote as T) as the “event” and use a window extending from one trading day before the announcement date (T-1) to one trading day after the announcement date (T+1) to capture leakage of information before the announcement and errors in the reported announcement date.<sup>72</sup> We calculate the return for each of the targets and acquirers, and the combined returns for the two companies. The combined return for the portfolio of the two companies is based on a value-weighted portfolio of the two companies, following existing work in financial economics.<sup>73</sup> For example, if over the three-day event window the target stock price increased by 40%, the acquirer stock price decreased by 10%, and the target’s (pre-announcement) market capitalization was one-third the size of that of the acquirer, the combined return would be positive 2.5%.<sup>74</sup> This approach is designed to measure the net wealth percentage created or destroyed over the event window for the target and acquirer.

Following standard event study methodology, we subtract the estimated “normal” return over the period from the actual return calculated above. To estimate normal returns for the target, the acquirer, and the combined portfolio, we use the market model with the value-weighted market portfolio from the Center for Research in Securities Prices (“CRSP”)<sup>75</sup> serving as the “market.” We estimate normal returns over the trading days in the period T-201 to T-6 using the market model regression<sup>76</sup>:

---

event study for the target, acquirer, and both the target and acquirer to measure merger synergies).

72. In a number of cases, the announcement was made after the market’s close. In such cases, the price cannot react until the next trading day. Therefore, including one trading day after the announcement date ensures that the price reaction is captured in the event window.

73. See Bradley et al., *supra* note 71, at 9.

74. The calculation is performed by calculating the product of the acquirer’s market capitalization percentage of the combined company (here 75%) and the acquirer’s stock price reaction (here -10%) and adding that product to the product of the target company’s market capitalization percentage of the combined company (here 25%) and the target company’s stock price reaction (here +40%), which is  $-0.075 + 0.1 = 0.025$  or +2.5%. We calculate the value weights of each acquirer and target company as of five trading days prior to the announcement date (T-5).

75. *Wharton Research Data Services*, WHARTON UNIV. PENNSYLVANIA, <http://wrds-web.wharton.upenn.edu/wrds/> (last visited Feb. 20, 2015) (subscription required).

76. In this regression,  $R_{it}$  is the return for company  $i$  on day  $t$  and  $R_{mt}$  is the return to the value-weighted market portfolio.  $\epsilon_{it}$  is the disturbance term, which is a normal random variable with zero mean. See JOHN Y. CAMPBELL, ANDREW W. LO & A. CRAIG MACKINLAY, *THE ECONOMETRICS OF FINANCIAL MARKETS* 150–55 (1996) (describing the basics of the market model event study methodology).

$$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it}$$

The abnormal returns are therefore<sup>77</sup>:

$$AR_{it} = R_{it} - \hat{\alpha}_i - \hat{\beta}_i R_{mt}$$

We then regress these abnormal returns on our key independent variable of interest, the type of merger counterpart, which is given by dummy variables for Case 1, Case 2, and Case 3, with Case 4 constituting the baseline case. These Cases categorize the mergers according to whether a non-Delaware company merged into a Delaware company (Case 1), a Delaware company merged into another Delaware company (Case 2), a non-Delaware company merged into another non-Delaware company (Case 3), or a Delaware company merged into a non-Delaware company (Case 4). The coefficient for Case 1, Case 2, and Case 3 may therefore be thought of as the value created or destroyed in that case relative to the baseline case of a Delaware company merging into a non-Delaware company. If Delaware law is more valuable than that of other states, we would expect the coefficients on each of Case 1, Case 2, and Case 3 to be positive, because the baseline Case 4 is predicted to have the lowest returns under the Delaware value hypothesis.

We also collected a number of control variables for use in the regression analysis. The existing studies make it clear that we must distinguish between cash mergers and stock mergers.<sup>78</sup> These studies have documented that the bidder's returns are higher in cash deals than in stock deals. Other studies have documented that the target's returns are also higher in cash deals.<sup>79</sup> Thus, the existing literature has clearly shown that cash deals create more value for both acquirer and target, and therefore cash deals are a potential confounding effect in this study.<sup>80</sup> If companies incorporated in one state tend to use cash or

77. *See id.*

78. *See, e.g.,* Nikolaos G. Travlos, *Corporate Takeover Bids, Methods of Payment, and Bidding Firms' Stock Returns*, 4 J. FIN. 943, 946–51 (1987).

79. *See* Yen-Sheng Huang & Ralph A. Walkling, *Target Abnormal Returns Associated with Acquisition Announcements: Payment, Acquisition Form, and Managerial Resistance*, 19 J. FIN. ECON. 329, 332–34 (1987).

80. In addition, long-term performance seems to bear out the market's price reactions, as studies have found that cash deals outperform stock deals. *See, e.g.,* Tim Loughran & Anand M. Vijh, *Do Long-Term Shareholders Benefit from Corporate Acquisitions?*, 52 J. CORP. FIN. 1765, 1770–74 (1997) (finding that stock acquisitions and

stock more frequently than companies incorporated in another state, we might mistake the “cash effect” for an effect of the state of incorporation. We therefore include a variable to hold the cash component of the transactions constant.

However, the deals are not simply either pure cash or pure stock. There are a large number of transactions in which the consideration was mixed—both cash and stock, especially approximately half cash and half stock. We therefore include a variable for the proportion of the target consideration paid in cash.<sup>81</sup> The proportions of cash used in transactions are multi-modal rather than normal, with three distinct peaks near 0% cash (i.e., all stock), 50% cash, and 100% cash. We trichotomize this variable into dummy variables based on whether the cash consideration was less than one-third, between one-third and two-thirds, or greater than two-thirds. This approach reduces the distortion risk from the extreme non-normality of the variable.

We also include a control variable for the size of the target relative to the size of the acquirer, as well as the logged size of each of the target and acquirer. We use the market capitalization of the target and acquirer five trading days prior to the announcement date (T-5), where the market capitalization of each company is measured by the number of shares of common stock outstanding multiplied by the closing price on that date.<sup>82</sup> The variable for relative size of the target and acquirer included in the regression is the market capitalization of the target on T-5 as a proportion of the combined market capitalization of the combined companies on date T-5. The variables for the size of the target and acquirer individually are the logged market capitalizations of each company.

We also include one control for the type of industry. At least one recent study shows that mergers between high-tech companies produce significantly negative abnormal returns.<sup>83</sup> Because high-tech

---

acquisitions carried out via merger do not perform as well as cash acquisitions or acquisitions via a tender offer).

81. The data items for this calculation are taken from Mergerstat’s entries in the “Stock Payment” and “Cash Payment” fields, which allow computation of the fraction of stock used in the transaction. For information about the Mergerstat M&A Database, see *Source Information*, LEXISNEXIS, <http://w3.nexis.com/sources/scripts/info.pl?156282> (last visited Apr. 9, 2015).

82. Companies with multiple classes of common stock are excluded from the analysis. See *infra* note 88 and accompanying text.

83. See Cong Wang & Fei Xie, *Corporate Governance Transfer and Synergistic Gains from Mergers and Acquisitions*, 22 REV. FIN. STUD. 829, 840–41 (2008). We follow the authors’ characterization of “high-tech combinations” by using the classifications in Tim Loughran & Jay Ritter, *Why Has IPO Underpricing Changed over Time?*, 33 FIN. MGMT. 5, 35 (2004).

firms are disproportionately incorporated in Delaware compared to other types of firms, failure to include this variable could bias our results.<sup>84</sup> Thus, we include a dummy variable for “high-tech combinations” as defined in that study.<sup>85</sup>

Finally, we include variables encoding the legal structure of the transaction. We include a dummy variable indicating whether the transaction involved a tender offer acquisition structure, as some early studies have suggested greater returns from acquisitions structured as tender offers.<sup>86</sup> In our data, 105 deals (approximately 17%) were structured as tender offers. We also include a variable for whether the transaction is structured as a direct merger, reverse triangular merger, or forward triangular merger.<sup>87</sup> In our data, 415 deals (approximately 65%) were reverse triangular mergers, 100 (approximately 16%) were forward triangular mergers, and 100 (approximately 16%) were direct (statutory) mergers. The remaining handful had other structures or left the acquisition structure open.

In addition to including the control variables described above, we also excluded a number of transactions from the analysis. First, we included only deals involving an actual acquisition agreement, which excluded Mergerstat items described as rumors, letters of intent, mere proposals, or offers. In such cases, the date of “announcement” is often ambiguous, making it difficult to assess the market’s response to the announcement without a large event window. We excluded acquisitions of companies in bankruptcy and hostile acquisitions because in such cases, factors other than state of incorporation are likely to drive price fluctuations of the acquirer and target. We also excluded reorganizations of already related companies into a holding company structure because in such cases, multiple sister companies are simply being integrated into a single holding company.

We also excluded transactions involving certain categories of companies because of data limitations. We included only transactions

---

84. See Wang and Xie, *supra* note 83, at 856.

85. See *id.*

86. See, e.g., Travlos, *supra* note 78, at 18–21 (discussing the early studies suggesting tender offers had higher returns but demonstrating that the higher returns were attributable to the form of payment rather than the tender offer itself).

87. A reverse triangular merger is a process by which the acquiring corporation creates a subsidiary corporation, which is merged into the target corporation so that the target is the surviving corporation. See THOMAS LEE HAZEN & JERRY W. MARKHAM, *MERGERS, ACQUISITIONS AND OTHER BUSINESS CORPORATIONS* 5 (2003). A forward, or straight, triangular merger is a process by which the acquiring corporation creates a subsidiary corporation and the target corporation is merged into the subsidiary corporation so that the subsidiary is the surviving corporation. *Id.*

between a publicly traded acquirer and a publicly traded target when both companies were listed on a U.S. stock exchange and stock price data was available on CRSP. This approach allowed us to assess the impact of the announcement on the combined market value of the two companies. We excluded companies with multiple classes of common stock outstanding because such companies tend to have one or more of the classes of stock that is not publicly traded or otherwise not comparable with price data.<sup>88</sup> We also applied a floor of \$250 million to the target's enterprise value so that adequate price data would be available.<sup>89</sup> Finally, we also excluded a variety of other companies for which price or other relevant data was missing.

The exclusions narrowed the 1,887 total transactions in Mergerstat to 635 applicable deals.<sup>90</sup> The largest category of the excluded deals (666 total) was the category of deals in which stock price data was not available for the acquirer because it was private (e.g., private equity acquirers) or traded only on foreign exchanges. In such cases the market price reaction of the acquirer cannot be ascertained from our CRSP data.

The states of incorporation of the targets and acquirers for the deals retained in the data are set forth in Table 2 below. The Table shows that there are more Delaware than non-Delaware companies in the data, both among targets and acquirers. Moreover, Delaware companies tend to acquire other Delaware companies disproportionately to non-Delaware companies, whereas non-Delaware companies acquire Delaware and non-Delaware companies in roughly equal proportions. In the next Part, we analyze the results of our analysis for these 635 transactions.

---

88. See Lucian A. Bebchuk & Ehud Kamar, *Bundling and Entrenchment*, 123 HARV. L. REV. 1549, 1568–69 (2004) (explaining the rationale for excluding stock with multiple classes from analyses of mergers because of the problem of valuing dual-class shares with higher voting rights).

89. The use of this capital threshold was designed to ensure informational efficiency—i.e., the existence of a large enough market for the security such that prices fully reflect the publicly available information. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 387–88 (1970).

90. The largest exclusion was of private acquirers. The exclusion of transactions involving privately held firms is an unfortunate necessity for our empirical analysis due to the fact that we cannot determine the value of privately held entities due to the absence of public disclosures. But there is no reason to believe that any plausible value added (or lost) due to Delaware law would be any different for private rather than public companies.

**Table 2. States of Incorporation of Acquirers and Targets.**

	<b>Delaware Target</b>	<b>Non-Delaware Target</b>	<b>Total</b>
<b>Delaware Acquirer</b>	257	113	370
<b>Non-Delaware Acquirer</b>	140	125	265
<b>Total</b>	397	238	635

### III. RESULTS

In this Part, we present the results from our study. To provide necessary background and to situate our results within the existing literature, we first confirm and update the overall picture of merger price reactions documented in previous studies. We then analyze the key variable, the state of incorporation, to see whether the merger reincorporations might provide a missing piece of the puzzle in analyzing the wealth effects of mergers.

#### A. *Placing the Merger Data in Context*

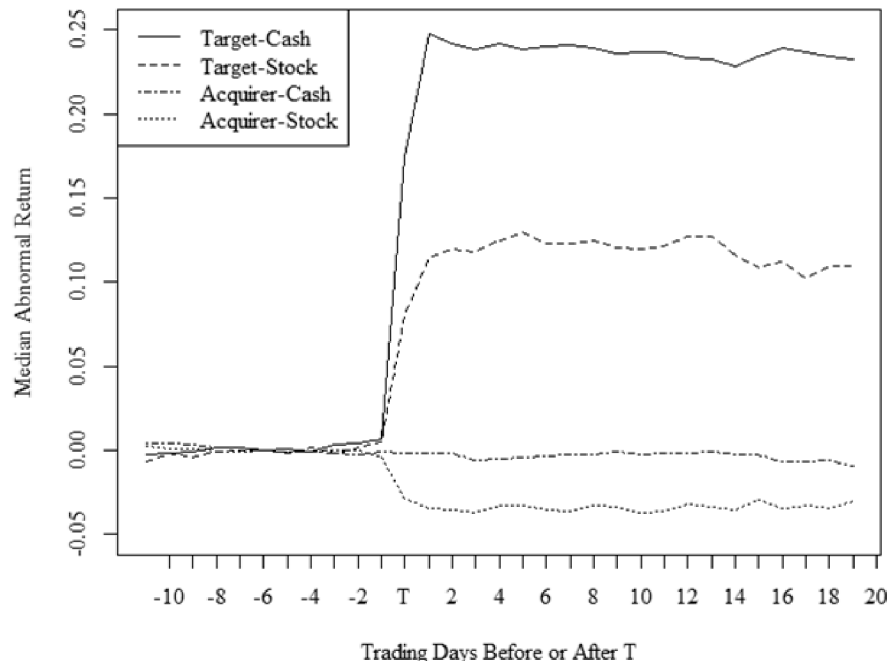
Our empirical findings on the broad brush of market reactions to mergers confirm and update many existing results within the law and finance literature. This point is important because it underscores that we are working with a representative cross-section of mergers and not a cherry-picked data set with potentially skewed results. For example, we find that target-stock prices rise, which the empirical literature has long established.<sup>91</sup> We also find that the acquirer usually has zero or negative returns,<sup>92</sup> which is consistent with what many (but not all) other studies have previously demonstrated.<sup>93</sup>

91. See Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 5, 7–8 (1983).

92. See Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 623–29 (1989) (discussing how acquirer managers may systematically overpay for mergers because of excessive optimism and ignorance about targets); Richard Roll, *The Hubris Hypothesis of Corporate Takeovers*, 59 J. BUS. 197, 200–06 (1986) (raising the hubris thesis

We also confirm that the returns for both acquirer and target depend greatly on the type of consideration offered in the deal, with cash acquisitions resulting in dramatically greater returns for both acquirer and target than stock acquisitions. We depict these results in Figure 1 below.

**Figure 1. Acquirer and Target Abnormal Returns.**



In Figure 1, each line plots the abnormal return for either the acquirer or target based on consideration paid in the merger over the thirty-one-day trading window from T-10 to T+20. The solid line is the return for the target in cash mergers; the dashed line is the return to the target in stock mergers; the dot-dash line is the return to the

to explain the empirical observation that acquiring companies' share prices tend to decline when mergers are announced, suggesting that acquiring companies systematically overpay). For an opposing view, see Mark Mitchell, Todd Pulvino & Erik Stafford, *Price Pressure Around Mergers*, 54 J. FIN. 31, 33-37 (2004) (arguing that a large portion of the declines in acquirers' price is attributable to short selling by merger arbitrageurs and that such declines tend to reverse themselves).

93. Compare Roll, *supra* note 92, at 200-01 (documenting that acquirers systematically overpay), with Bradley et al., *supra* note 71, at 7-9 (finding that both target and acquiring firms benefit from successful tender offers).

acquirer in cash mergers; and the dotted line is the return to the acquirer in stock mergers. Figure 1 makes it clear that the returns to the acquirer are much lower than those to the target and the returns to all parties are lower in stock mergers than in cash mergers. These results are qualitatively similar to what other studies have found, underscoring that we are working with a data set that is representative of conventional mergers.

The finding that target-stock prices rise and acquirer-stock prices often fall or remain flat following a merger announcement raises the more important question of whether there are “excess returns” to the combined portfolio of the two companies in the merger. In other words, is the aggregate, value-enhancing effect of the merger positive or do the acquirer’s losses outweigh the target’s gains? In conformity with prior results in other studies, we find that the overall return to the portfolio is very close to zero. The gains to the target companies almost exactly balance and cancel the losses to the acquiring companies depending on the type of consideration.

Figure 2 presents the results for the combined portfolio returns over the same time period as Figure 1. The fact that the acquirer and the target both have higher announcement returns in cash mergers than in stock mergers, as shown in Figure 1, translates into greater returns to the combined portfolio in cash mergers than in stock mergers. Combined returns are significantly negative for stock mergers and positive for cash mergers.<sup>94</sup> This insight intersects with another finance literature debate over the divergence in returns between cash and stock mergers.<sup>95</sup>

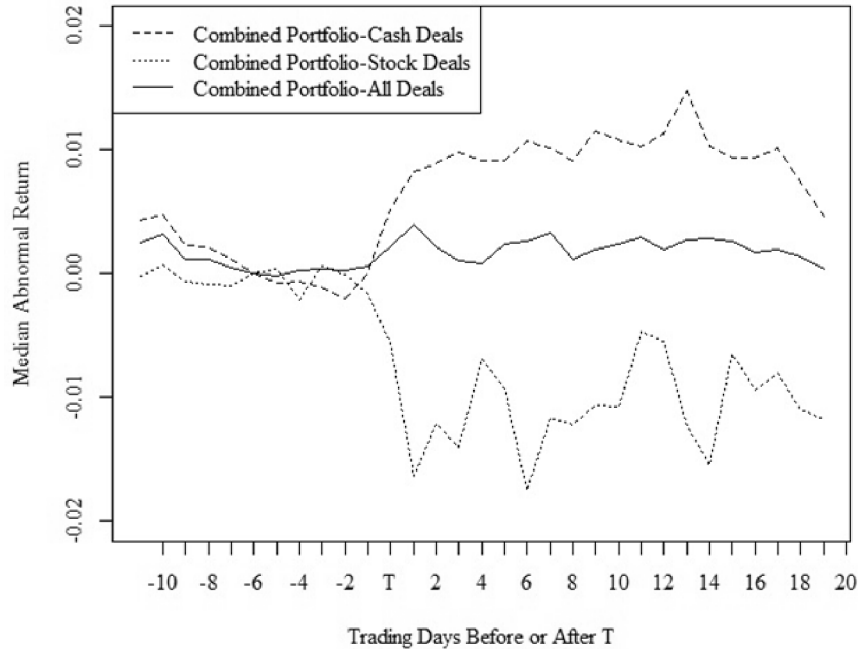
The results described above lay the foundation for our analysis of whether Delaware’s legal regime adds or detracts value from transactions. The dramatic differences between cash and stock mergers demonstrate that we must control for the type of consideration to determine whether there is any Delaware effect for each category or merger. In the next section, we conduct a cross-sectional analysis that takes the cash-stock split into account to determine the effect of Delaware law.

---

94. Our claims here approximate the relative combined gains for cash and stock transactions, and are not designed to estimate the overall gains to mergers. There are reasons why an event study approach such as ours might underestimate the overall gains. See, e.g., Bhagat et al., *supra* note 69, at 8 (arguing that traditional event study methods with short event windows will “estimate[] only a fraction of the full value effect of a successful transaction”).

95. See Pavel G. Savor & Qi Lu, *Do Stock Mergers Create Value for Acquirers?*, 64 J. FIN. 1061, 1068–72 (2009) (discussing the debate between stock and cash merger returns and making the case that stock mergers yield higher returns than cash mergers).



**Figure 2. Combined Portfolio Abnormal Returns.**

### B. Cross-Sectional Analysis

In this section, we turn to the main variable of interest in this study—the market value of the state of incorporation—and perform a cross-sectional comparison of the abnormal returns to assess whether reincorporating into Delaware law is valued by the financial markets. The cross-sectional analysis is designed to isolate any potential Delaware effect independent of the effects of cash versus stock consideration, the size of the target or acquirer, the type of industry of the companies involved, or the legal structure of the acquisition (tender offer, reverse triangular merger, forward triangular merger, etc.).

The results of our analysis are presented in Table 3, below. The first column presents the results for the combined portfolio, the second column presents the results for the acquirer, and the third column presents the results for the target.

**Table 3. Cross-Sectional Analysis of Delaware Law.**

	<b>Combined Portfolio CAR</b>	<b>Acquirer CAR</b>	<b>Target CAR</b>
<b>State of Incorporation Variables:</b>			
Case 1:  Delaware Acquiring Non-Delaware	-0.0020325  (-0.315)	-0.003937  (-0.499)	-0.010735  (-0.556)
Case 2:  Delaware Acquiring Delaware	-0.0093786  (-1.639)	-0.011432  (-1.547)	0.016014  (0.770)
Case 3:  Non-Delaware Acquiring Non-Delaware	-0.0035435  (-0.511)	-0.006865  (-0.840)	0.015924  (0.770)
<b>Consideration Variables:</b>			
Cash Consideration > 2/3	0.0205134*  (2.504)	0.028580**  (3.056)	0.017194  (0.644)
Cash Consideration < 1/3	-0.0170566*  (-2.480)	-0.003406  (-0.461)	-0.051304**  (-2.658)

<b>Size Variables:</b>			
Relative Size of Target	0.0284714* (2.420)	0.028333 (1.435)	-0.019515 (-0.766)
Log (Acquirer Market Cap)	-0.0046997** (-2.597)	0.006576* (2.557)	0.01894** (2.616)
Log (Target Market Cap)	0.0004065 (0.192)	-0.009389** (-3.055)	-0.039054*** (-4.210)
<b>Legal Structure Variables:</b>			
Tender Offer	0.0036771 (-0.625)	-0.007834 (-1.187)	0.064515** (3.193)
Direct Merger	0.0116249 (1.525)	0.019129* (2.464)	0.006413 (0.282)
Reverse Triangular Merger	0.0041549 (0.578)	0.010823 (1.367)	-0.019737 (-0.767)

<b>Industry Variable:</b>			
High-Tech Combination	-0.0205376*** (-3.662)	-0.02686*** (-3.823)	0.009380 (0.532)
Intercept	0.0992778* (2.216)	0.005990 (0.126)	0.558575** (2.907)
Adjusted R <sup>2</sup>	0.1156	0.1105	0.1361
Table based on 635 observations. Standard errors are heteroscedasticity-consistent based on the H3 adjustment. <sup>96</sup> T-statistics are provided in parentheses.			

The key figures for assessing the value of Delaware incorporation are those listed in the Table under the heading “State of Incorporation Variables.” The variable labeled “Case 1” is the estimate of the value created when a non-Delaware company merges into a Delaware company compared to the baseline case when a Delaware company merges into a non-Delaware company. This is probably the most important variable for assessing the Delaware value hypothesis as it directly compares reincorporation into and out of Delaware. As the entry in Column 1 suggests, the coefficient is very close to zero (actually slightly *negative*). This means that the value created in Case 1 (which was predicted to be the highest value) is estimated to be slightly lower than the value created in Case 4 (which was predicted to be the lowest value). The 95% confidence interval is -.0147 to 0.011. Thus, although we cannot completely reject

96. Heteroscedasticity-consistency refers to confirming that there is no technical defect in the degree of correlation between the size of errors and the size of the explanatory variable, which would cast doubt on the precision of the statistical tests used. See Michael O. Finkelstein, *Regression Models in Administrative Proceedings*, 86 HARV. L. REV. 1442, 1463–64 (1973).

the hypothesis that Delaware has the slightest bit of positive value at 95% confidence, we can reject the hypothesis that Delaware has a value greater than 1.11% (or less than -1.47%).

The other state of incorporation variables are similarly close to zero, suggesting that none of them have any significant effect. This lends further support to the conclusion that Delaware law does not have value because none of the hypotheses that would be implied by the “Delaware effect” is borne out. Indeed, none of the state of incorporation variables is statistically significant, and all three merger counterparts (Case 1, Case 2, and Case 3) are estimated to create less value than Case 4 (i.e., the merger of a Delaware firm into a non-Delaware firm), even though Case 4 was predicted to create the least value. Thus, although the state of incorporation coefficients are not statistically significant, it is clear that the analysis provides no evidence of capital markets valuing Delaware law. To the extent that the estimates provide evidence of any Delaware effect, they provide weak evidence of a *negative* effect.

The control variables for the combined company results in Column 1 are largely consistent with expectations from the previous literature, lending support to the robustness of our model and results. Deals in which more cash was paid relative to stock have higher returns for the combined companies and deals in which more stock was paid relative to cash have lower returns.<sup>97</sup> The size of the acquiring company is negatively related to the combined returns in the merger. The larger relative size of the acquirer compared to the target is associated with lower returns.<sup>98</sup> Combinations of high-tech companies are associated with lower returns, as another recent study also found.<sup>99</sup> The legal details of the combination (forward triangular merger, reverse triangular merger, direct merger, or tender offer) appear to have little, if any, significance to the overall returns.

The results for the returns to the acquirer and the target (Columns 2 and 3) also do not appear to have significant results depending on the state of incorporation. Neither the acquirer nor the target appears to capture larger gains when assets are shifted from non-Delaware law into Delaware law, consistent with the overall

---

97. The lower returns associated with stock mergers could also be the result of revelation of information about the bidder. *See, e.g.,* Bhagat et al., *supra* note 69, at 5–6 (finding that the lower returns in stock mergers are the result of revelation of negative information about the acquiring company).

98. *See id.* at 42 (finding that greater relative size of the acquiring company produces lower combined gains in the merger).

99. *See* Wang & Xie, *supra* note 83, at 841.

finding of no combined company value of Delaware law. At the same time, the value created by shifting from Delaware to non-Delaware law is not statistically significantly different from zero. In other words, we find no evidence that that the state of incorporation matters to financial markets either in terms of overall value created or in terms of the split between acquirer and target.

The control variables are more interesting in Columns 2 and 3 because they suggest that although the variables are a wash in terms of overall value creation, they may affect the split of the surplus between the target and acquirer. Column 3 suggests that tender offers imply significantly higher returns for the target company and may imply slightly lower returns for the acquiring company. This fact suggests that acquirers may overpay in such cases. Acquirers may have larger returns when the target is larger relative to the acquirer, as has been documented in existing research.<sup>100</sup> Column 2 suggests that the acquiring company has higher returns in the direct (statutory) merger case than in the other structures, which is one of the few legal details that appears significant in Table 3. Furthermore, in such cases the target company's returns are close to zero and the combined effect in Column 1 is positive and close to statistical significance, suggesting the possibility of some value creation in such cases. Finally, the results indicate that acquisitions with cash consideration are better for target, acquirer, and the combined companies, creating more value than acquisitions with stock consideration.

#### IV. DISCUSSION

Our results show that financial markets do not place a positive value on Delaware law. Companies constructively reincorporated into Delaware do not appear to systematically produce more or less value than companies constructively reincorporated out of Delaware, a finding that strongly suggests both the “race to the top” and “race to the bottom” views lack an empirical basis. Simply put, lawyers' recommendations to incorporate in Delaware do not appear to add value to either the corporations or the corporate managers the lawyers serve. We also do not find much evidence that the markets value the legal structure of the merger, except that tender offers appear to produce higher returns for targets and direct mergers may

---

100. See Paul Asquith, Robert F. Bruner & David W. Mullins, Jr., *The Gains to Bidding Firms from Merger*, 11 J. FIN. ECON. 121, 131–32 (1983) (documenting larger acquirer returns for greater target size relative to acquirer size).

produce higher combined returns. In this Part, we discuss the implications of our results and anticipate some possible objections.

A. *The Interplay of Financial Markets and Legal Decisions*

A skeptic may question the wisdom of using financial markets as the criteria for evaluating the legal decision of where to incorporate. However, we follow a long line of studies using the financial market reaction to the incorporation decision as the criterion for evaluating that decision.<sup>101</sup> A skeptic may still wonder whether the use of financial markets as the measuring stick was simply driven by the availability of financial market data. For this reason we need to explain why we focus on how legal decisions are based on perceptions of financial markets.

Part of the reason is that advocates and foes of Delaware have put the degree to which Delaware incorporations add or subtract value at the center of the debate for why lawyers and their corporate clients choose Delaware. As discussed above,<sup>102</sup> the dominant methods for assessing the value of corporate law have centered on market valuations of that law, and therefore our study uses the same basic criterion.

The more important reason for focusing on financial markets, however, is that lawyers themselves make an explicit causal link between Delaware incorporation and financial markets' reactions. For example, a recent article used surveys of lawyers to conclude that lawyers choose Delaware incorporation *because* of perceived financial market preferences.<sup>103</sup> Among the lawyers surveyed, the most common reason given for recommending Delaware incorporation was investors' familiarity with Delaware law, which mattered far more than most of the legal considerations.<sup>104</sup> Thus, it appears that lawyers are recommending Delaware incorporation because they believe the financial markets demand it, when in fact our study shows that financial markets are indifferent to the state of incorporation. In effect, we argue that corporate lawyers labor under a fundamentally

---

101. See, e.g., Bar-Gill et al., *supra* note 3, at 137–40; Bebchuk, *Federalism and the Corporation*, *supra* note 3, at 1440–45; Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, *supra* note 3, at 1780–83; Daines, *supra* note 2, at 527; Romano, *supra* note 2, at 265–73.

102. See *supra* Part II.

103. Carney et al., *supra* note 14, at 137 (arguing that “lawyers will choose Delaware because of their belief that investors’ ignorance of other states’ laws means that the investors will pay more for stock in Delaware companies”).

104. See *id.* at 143 tbl.4.

mistaken assumption about the preferences of capital markets, a potentially significant disconnect between law and finance.

This disconnect is possible because corporate lawyers appear to operate on faulty assumptions about financial markets, and financial market participants are abdicating the incorporation decision to lawyers. In other words, the incorporation decision slips through the cracks because financial market participants defer to lawyers, and lawyers assume financial market participants would push back if their assumptions about market reactions were flawed. The question of the valuation of legal regime is one that both sides appear to have assumed the other is responsible for. No professional is making a conscious comparison among the fifty states for incorporation decisions, and ironically, our data suggests it would not matter if they had! This fact raises questions about why Delaware has enjoyed enduring appeal as the default for incorporation. We will analyze the most plausible explanations: network benefits, herding behavior, and path dependency.<sup>105</sup>

#### *B. The Intertwining of Herding Effects and Path Dependency*

Because our empirical findings show that Delaware does not add value to public companies, it is important to understand what has led a majority of companies to incorporate in Delaware. Delaware's dominance appears best explained through herding effects that reflect the default decision-making of lawyers intertwined with path dependence from Delaware's past preeminence. Part of the problem lies in the fact that corporate managers routinely defer to lawyers' incorporation decisions in the context of IPOs, which suggests lawyers' logic or lawyers' false assumptions about the value of Delaware is at the heart of Delaware's appeal.<sup>106</sup> Empirical evidence suggests that markets focus almost exclusively on the financial terms rather than the legal terms of mergers.<sup>107</sup> A related point may help to explain why the choice of incorporation matters so little to managers

---

105. See, e.g., Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 761–63, 774–79 (1995) (making the case for the role of network benefits to incentivize firms to incorporate in Delaware).

106. Lawyers, rather than corporate management, generally choose the place of incorporation both at the time of the corporation's birth and the initial public offering stage, as this is one of many legal decisions companies routinely delegate to lawyers. See Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1579–80 (2002); see also Romano, *supra* note 2, at 274 (discussing how reincorporation decisions are typically motivated by lawyers rather than managers).

107. See Jeffrey Manns & Robert Anderson, *The Merger Agreement Myth*, 98 CORNELL L. REV. 1143, 1145–48 (2013).



that they allow their lawyers to choose the jurisdiction. The financial terms are foremost in the minds of managers during mergers, and the incorporation decision appears so insignificant to their bottom line (and to markets) that this decision is simply a matter for lawyers to resolve. Lawyers are naturally inclined to believe that this decision matters to both their clients and markets, but this decision ultimately does not add or subtract value for their clients.

Lawyers appear generally to follow a “herd mentality” in which Delaware serves as both the clear default (that lawyers and/or clients assume adds value) and the “safe choice,” which constitutes the path of least resistance and effort. Part of the herding story may reflect the intrinsic limits of corporate lawyers’ knowledge of state corporate law. Lawyers steer clients towards incorporating in Delaware or (to a lesser extent) towards the state in which the lawyers have their bar training and experience. Lawyers make recommendations based on their own limited knowledge or (as it has been put more bluntly) their “ignorance” of law outside of Delaware and the state in which they practice.<sup>108</sup> In fairness to lawyers, this outcome is not surprising. Elite law school students are primarily taught Delaware law in their corporations classes, which fosters Delaware-centrism. This fact may tip the scales even more towards choosing Delaware as a default for incorporation as lawyers understandably steer clients towards the law they know best. It would be surprising if lawyers frequently stepped outside of their knowledge and comfort zone and took on the challenge of understanding other states’ corporate governance laws when they can rely on the Delaware default.

The bias from lawyers’ training and backgrounds results in a landscape in which the overwhelming majority of incorporations are in Delaware or in the issuer’s principal state of business (if their lawyers are based in the same state).<sup>109</sup> If the issuers’ and/or underwriters’ counsel are local or regional firms, then their knowledge and experience may tilt them towards at least considering the state in which the company’s operations are primarily based. The more national the firm and its clients, presumably the more likely it is that lawyers may steer clients towards Delaware law as the de facto

---

108. See William J. Carney & George B. Shepherd, *The Mystery of Delaware Law’s Continuing Success*, 2009 U. ILL. L. REV. 1, 2–3 (making the case for “rational ignorance” among lawyers who are familiar only with Delaware law and the law of the state in which they practice).

109. See Bebchuk & Cohen, *supra* note 1, at 420 (discussing the fact that less than ten percent of publicly traded companies that are incorporated in a state outside of their principal base of operations are incorporated in a state other than Delaware).

national standard. This fact is understandable because most national lawyers' experience would entail dealing with Delaware corporate law and so they would be most comfortable working within that framework.<sup>110</sup>

The irony of the incorporation debate is that incorporation decisions may ultimately be a product of mutual abdication of lawyers and financial advisors. Lawyers may choose Delaware because they believe investors are more familiar with the law. But no one in the process is actually familiar with the strengths and weaknesses of Delaware law vis-à-vis the law of other states.<sup>111</sup> For example, a recent survey found that over ninety-five percent of underwriters' and issuers' counsel declared they were not comfortable incorporating in an issuer's home state unless the lawyers practiced law in that state.<sup>112</sup> This fact underscores the herding story that appears to lead to issuers primarily incorporating in Delaware or in their home state (if their legal counsel happens to be based in that state). But the question of whether Delaware actually adds or subtracts value for their client simply does not appear to factor into lawyers' analysis.

Part of the problem is that lawyers may receive no benefit from conducting the due diligence to figure out what state corporate governance framework (if any) is most favorable to their client. The costs of mastering multiple state corporate frameworks may far outweigh any prospective gains compared to falling back on the Delaware default they are most familiar with. That being said, lawyers may genuinely believe they are doing what is best for their

---

110. The best way to explain the divergence between companies that embrace Delaware and those that choose another state (generally their state of origin) is to examine the size and nature of corporations' outside counsel and their primary method of financing. Companies that choose to go the IPO route typically take on large national firms whose lawyers would push for the conventional default. Smaller firms would likely go with smaller, regional or local law firms who would push their comparative advantage in understanding the corporate law of the jurisdiction in which they are based. This decision would reinforce the lawyers' ties to the firm and raise (at least modest) barriers to entry to migrate to larger firms since the local lawyers could quite plausibly claim to be stronger experts on their state-of-operations' law. A related point is the nature of financing. Companies that focus on self-financing through free cash flow would have less of a need to rely on national firms as counsel. In contrast, companies reliant on capital markets would be more likely to use the white shoe law firms and in turn, receive pressure to follow the large law firm default of Delaware. It is possible that firms choose to incorporate outside of Delaware for other reasons, such as the desire to have favorable state regulators in other spheres that may be tied to the incorporation decision. For example, an insurance company may view its incorporation decision as a vehicle for choosing the most deferential state regulator, which may be of far more value to the company than any marginal gain (or loss) from choosing Delaware.

111. See Carney et al., *supra* note 14, at 134.

112. See *id.*

client in choosing Delaware. The perception that there are differences in the quality of Delaware law relative to other states likely exists in the present because of the high percentage of firms that have incorporated in Delaware. Therefore, lawyers may believe pushing their clients to follow the herd to Delaware is in their clients' interest. But like many actors in the financial world, lawyers may be taking the easy way out by embracing group-think. To them, Delaware is an appealing incorporation destination because many companies incorporate in Delaware, whether or not it actually enhances value.<sup>113</sup> Lawyers can and do routinely pitch Delaware as the default that markets would expect an IPO candidate to be in, and they can therefore sustain the self-fulfilling prophecy that Delaware is the state of choice.<sup>114</sup>

The choice to incorporate in Delaware also appears to be a product of risk aversion. Most lawyers offer the advice about incorporation that they believe other lawyers will offer. They have nothing to gain by risking their reputation for any alternative to the conventional wisdom.<sup>115</sup> In this way, Delaware's dominance is the product of ingrained path dependence as lawyers recommend Delaware because past lawyers have recommended incorporation in Delaware. Either lawyers believe the conventional wisdom must be right, or they trust that by opting for the conventional wisdom, they will not be blamed for making the wrong decision.<sup>116</sup>

The fallback story in defense of Delaware is that its role as a default jurisdiction creates positive network effects and benefits.<sup>117</sup> Just as companies converging on Blu-ray as the standard for movies or MP3s as the standard for music may make it easier to sell movies and music, having a primary default jurisdiction for corporate law can

---

113. For example, a recent survey found that over seventy percent of both underwriters' and issuers' counsel advised clients to incorporate in Delaware for initial public offerings. *See id.*

114. *See id.* at 132 (“[L]awyers may not offer a solution to the problem of Delaware’s puzzling persistence. They may be much of the cause.”).

115. *See* Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239, 290–91 (1984) (discussing lawyers’ roles as “reputational intermediaries,” which gives lawyers incentives to maintain a trustworthy reputation to keep and grow their business).

116. *See, e.g.,* Daines, *supra* note 106, at 1571 tbl.2 (noting that Delaware companies accounted for fifty-six percent of initial public offerings from 1978–2000).

117. *See* Klausner, *supra* note 105, at 761–63, 774–79 (discussing the role of network benefits in incentivizing firms to incorporate in Delaware); *see also* Bebchuk & Hamdani, *supra* note 25, at 568–75 (discussing the potential network benefits from Delaware); Larry E. Ribstein & Erin A. O’Hara, *Corporations and the Market for Law*, 2008 *U. ILL. L. REV.* 661, 663–64 (making the case for network benefits from Delaware incorporations).

have appeal to lawyers and investors. Markets may have stable expectations about what Delaware law does or does not bring to the table in terms of shareholder rights and management entrenchment. Lawyers may plausibly argue that choosing Delaware (especially at the IPO stage) makes it easier for investors to understand what they are getting into when they are deciding on whether to invest in the company.

For example, one recent study made the case for Delaware's appeal as "lingua franca" among lawyers and investors and showed parties are more likely to incorporate in Delaware when they are based in different states.<sup>118</sup> The logic is that Delaware's preeminence means that lawyers and investors are broadly familiar with the features of Delaware law and that lawyers turn to this common ground to establish clear expectations.<sup>119</sup> Lawyers assume that market participants will value Delaware and that this is a way to add value to the transaction. However, our empirical findings suggest that these network effects are marginal at best. Lawyers may tell each other (and academics) this story to justify herding clients into Delaware ostensibly for their clients' own good. But this story appears rooted in lawyers' false assumptions and is not borne out by the reality of market responses. Our study shows that network effects do not have a substantial effect in adding or subtracting value from Delaware versus non-Delaware companies. This fact suggests that herding among lawyers is a more powerful driver of incorporation decisions than lawyers' insights about the benefits from choosing Delaware as a default.

We concede that it is possible that Delaware once did offer a premium of value to shareholders (whether out of perceptions of adding value or the reality of maximizing shareholder or management returns). That conclusion is beyond the scope of our decade-long data set. Delaware may once have won a race to attract corporations, but it now rests on its laurels. Other jurisdictions have either converged with Delaware, or the distinctive aspects of Delaware have no impact on enhancing (or reducing) the value of corporations.<sup>120</sup> Alternatively, markets may have once discounted companies incorporating in

---

118. See Brian Broughman, Jesse M. Fried & Darian Ibrahim, *Delaware Law as Lingua Franca: Theory and Evidence* 2–4, 21 (July 8, 2014) (J.L. & Econ., Forthcoming), available at <http://ssrn.com/abstract=2117967> (finding that venture capital investors are five percent more likely to choose Delaware incorporation when investing out-of-state).

119. See *id.*

120. One possibility is that all states have converged to the same rules as Delaware and that the areas where they differ are not important to financial markets. It could be that corporate law is trivial. See Black, *supra* note 14, at 586.

Delaware in recognition of the corporate shenanigans of entrenchment that Delaware law permitted, but the reality of the last decade is that this premium (or discount) no longer applies. Instead, Delaware's dominance appears to stem primarily from its role as a default jurisdiction that lawyers instinctively recommend without having any empirical evidence or substantive reason for its appeal. Delaware's strength is the product of the intertwining of herding and path dependence based on its past preeminence.

In fairness to Delaware's proponents, we are not saying that Delaware corporate law may not have advantages over other states. For example, the speed with which Delaware courts resolve disputes is valuable.<sup>121</sup> Similarly, the specialized jurists in the Court of Chancery are clearly preferable in a dispute over a judge who heard a divorce yesterday, is hearing a corporate dispute today, and will hear a murder trial tomorrow.<sup>122</sup> Even if there are no benefits to Delaware's substantive law, it is still possible that there is a positive value to the network effects of Delaware law.<sup>123</sup> These advantages, however important to lawyers, do not appear to matter to financial markets that actually price companies' securities.

#### V. ADDRESSING THE PROBLEM AND EXPANDING COMPETITION

Our empirical findings raise the question of how to incentivize managers and lawyers to scrutinize the value added by Delaware's corporate governance framework compared to that of other states. The logic is that if companies or company shareholders have incentives to assess the merits of corporate incorporation choices, it will encourage Delaware and other states to compete to assess and enhance the quality of their corporate governance law.

The dilemma is how to spur competition in a legal world dominated by herding effects and default decision making while imposing minimal costs. Breaking up herding effects is one of the most daunting problems facing legal reform. Market participants have strong incentives for embracing the conventional wisdom for fear of the costs of being left behind or being exposed to greater scrutiny as

---

121. See Omari Scott Simmons, *Branding the Small Wonder: Delaware's Dominance and the Market for Corporate Law*, 42 U. RICH. L. REV. 1129, 1163–66 (2008) (discussing the speed with which the Delaware Chancery courts adjudicate corporate law cases).

122. See Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1077–78 (2000) (discussing the virtues of the distinctive specialization of the Delaware Chancery courts).

123. See, e.g., Klausner, *supra* note 105, at 761–63, 774–79.

an outlier.<sup>124</sup> Herding effects may drive lawyers towards Delaware precisely because lawyers perceive that Delaware adds value and that it is the “safe” choice. Although our paper shows empirically that whatever appeal Delaware may have had in the past, Delaware does not add value to companies in the present, so this fact may not be enough to dispel lawyers’ deeply entrenched belief in Delaware or even greater fear of making a mistake.<sup>125</sup> The stickiness of reputation and path dependence creates little incentive for Delaware law to do more than the bare minimum to remain an incorporation magnet.<sup>126</sup>

Delaware’s hegemony is so dominant that the system of state competition for corporate governance rules no longer functions in a meaningful way. Herding and path dependence have combined to create market failure, which requires extraordinary regulatory steps to restore competition and incentives for innovation. The best illustration of the extent of market failure is the shortcoming of existing state efforts at competing with Delaware.

In theory, other states could restore meaningful competition to Delaware simply by mimicking Delaware or creating more appealing alternatives.<sup>127</sup> Some states, such as Nevada, have tried to do just that in tailoring corporate governance frameworks that largely mimic Delaware.<sup>128</sup> But it is difficult to replicate fully Delaware’s legal institutions and their track record with which lawyers are familiar.<sup>129</sup> There is a chicken-and-egg problem in attracting enough high-profile corporations to establish a reputation of expertise and responsiveness to changing circumstances that can rival the Chancery courts and the Delaware legislature.<sup>130</sup> Additionally, the start-up costs of another

---

124. See, e.g., Thomas A. Piraino, Jr., *Regulating Oligopoly Conduct Under the Antitrust Laws*, 89 MINN. L. REV. 9, 12–15 (2004) (discussing the pervasiveness of conscious parallelism that facilitates coordination without express communication).

125. Delaware’s market power is underscored by the fact that its annual franchise fees are dramatically higher than those of other states. See Carney & Shepherd, *supra* note 108, at 63 (noting that franchise fees for comparable companies may be \$100,000 in Delaware compared to \$5,000 in Georgia or as low as \$40 in Kansas).

126. See *id.* at 4–6 (discussing Delaware’s longstanding dominance of incorporations in spite of erosion of the quality of Delaware corporate law).

127. One would expect that other states’ laws would converge with Delaware’s law to erode any advantage (leaving the stickiness of reputational capital as Delaware’s primary advantage).

128. See Barzuza, *supra* note 14, at 949–50 (discussing Nevada’s efforts to attract out-of-state incorporations by creating a more deferential regime to management but noting that Nevada has attracted less than seven percent of out-of-state incorporations).

129. See, e.g., Bar-Gill et al., *supra* note 3, at 151–56 (discussing Delaware’s first-mover advantage from investing in legal infrastructure).

130. See, e.g., Adam C. Pritchard, *London as Delaware?* 10 (Univ. Mich. L. Sch., John M. Olin Ctr. for L. & Econ., Working Paper No. 09-008, 2009), available at

state seriously attempting to take on Delaware's dominance would be high with a low probability of success at least for many years to come.<sup>131</sup>

A. *The Potential for a Federal Incorporation Option*

For this reason, there is a need for a more significant exogenous shock or regulatory shift to pave the way for more viable state competition with Delaware. The challenge is how to develop credible alternatives to Delaware.<sup>132</sup> One strategy that could undercut Delaware's default dominance would be to create a federal reincorporation option. Federal incorporation would create an instant rival to Delaware by creating a national standard, direct access to the federal courts, and a truly uniform common language among lawyers that would be an easy choice for lawyers both to consider and justify using.<sup>133</sup> These network benefits would arise from the existence of a federal incorporation statute regardless of whether an existing institution, such as the Securities and Exchange Commission, or a new agency oversaw corporate governance issues. The federal incorporation option would offer everything Delaware has to offer (with the exception of precedents on corporate governance at its inception) and would present lawyers with a credible alternative.

Politicians and policymakers have periodically flirted with the idea for over one hundred years as a response to concerns about the shortcomings of state corporate governance.<sup>134</sup> Legislative rumblings

---

<http://ssrn.com/abstract=1407610> (arguing that Delaware's appeal turns in part on the large number of precedents that Delaware Chancery courts and lawyers can rely upon).

131. See Dent, *supra* note 26, at 505.

132. See Bebchuk & Cohen, *supra* note 1, at 420 (noting that less than ten percent of publicly traded companies that incorporated in a "foreign" state, i.e., outside of their principal base of operations, incorporate in a state other than Delaware).

133. See Dent, *supra* note 26, at 507–11.

134. President Taft initiated calls for a federal incorporation statute over one hundred years ago as a response to concerns about excessive corporate power. See 48 CONG. REC. 21, 23–24 (1912) (President's Annual Message on Dec. 5, 1911 calling for a voluntary federal incorporation law); 45 CONG. REC. 378, 381–83 (1910) (Message from the President of the United States on Jan. 7, 1910 calling for a federal incorporation law); Franklin D. Jones, *Historical Development of the Law of Business Competition*, 36 YALE L.J. 207, 231 (1926) (discussing President Taft's calls for a voluntary federal incorporation law with "provisions against over-capitalization and holding companies"). Since that time, calls for a federal incorporation statute have resurfaced about once a generation. During the 1930s, the debate for federal incorporation was part of calls for greater federal power amidst the New Deal. See Harris Berlack, *Federal Incorporation and Securities Regulation*, 49 HARV. L. REV. 396, 397–98 (1936) (discussing the federal incorporation debate in the New Deal context); Note, *Federal Control over Corporate Distributions to Stockholders Under the Public Utility Holding Company Act*, 49 YALE L.J. 492, 493 n.3 (1940) (discussing SEC and Federal Trade Commission studies on the potential for a federal

about a potential federal incorporation statute have pushed Delaware to improve the quality of its corporate governance in the short run to forestall reform.<sup>135</sup> The creation of lasting federal competition would put pressure on Delaware continually to improve its corporate governance regime.<sup>136</sup>

But the danger of a federal option is that it may prove to be more than competition for Delaware and eventually swallow up the incorporation market. Critics may be concerned that a federal option would accelerate the creeping federalization of corporate governance, which would gradually squeeze the state role in corporate governance like a vine.<sup>137</sup> If the federal option supplanted Delaware as the default of choice, federal lawmakers may be tempted to tie an increasing amount of strings attached to corporate status, which may transform the corporate landscape far more than intended.

#### B. *The Case for “Shareholder Say” on Incorporation*

Because of the downsides from creating a federal incorporation option, we advocate an alternative strategy that would not unsettle

---

incorporation statute and related congressional bills that were proposed during the 1930s). In the 1970s, the corporate scandals that led to the Foreign Corrupt Practices Act also spurred debate about the potential creation of a federal incorporation statute. *See Protection of Shareholders’ Rights Act of 1980: Hearing on S. 2567 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing & Urban Affairs*, 96th Cong., 2d Sess. 395–412 (1980) (discussing the possibility of a federal incorporation statute and the preemption of state corporate governance laws); NADER ET AL., *supra* note 3, at 5–10; Cary, *supra* note 3, at 672–73. More recently, concerns about the structural shortcomings of corporate governance have led to renewed calls to consider a federal incorporation statute. *See, e.g.*, Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 163 (2001) (proposing the creation of an optional federal incorporation regime); Dent, *supra* note 26, at 507–12 (calling for optional federal incorporation to be chosen by shareholders); Steven A. Ramirez, *The End of Corporate Governance Law: Optimizing Regulatory Structures for a Race to the Top*, 24 YALE J. ON REG. 313, 347–58 (2007) (advocating the creation of a federal agency to oversee a federal incorporation statute and lay out governance standards that shareholders should be able to elect incorporation under a federal corporate law).

135. *See, e.g.*, Renee M. Jones, *Rethinking Corporate Federalism in the Era of Corporate Reform*, 29 J. CORP. L. 625, 629–31 (2004) (describing the debate over whether competition among states for corporate charters has resulted in good or bad corporate law).

136. The enactment of a federal incorporation statute would mark a significant departure from reactive congressional action to corporate governance crises that occurs in a piecemeal way, such as the Sarbanes-Oxley Act. *See* Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2530, 2541 (2005) (describing how Congress only reactively deals with corporate law issues when “constituents scream, fire alarms go off, and the media spots a big issue”).

137. *See, e.g.*, E. Norman Veasey, *What Would Madison Think? The Irony of the Twists and Turns of Federalism*, 34 DEL. J. CORP. L. 35, 53–55 (2009) (critiquing the increase in the federal role in corporate governance).



the longstanding balance between state corporate governance law and federal securities law. Introducing “shareholder say” on incorporation would seek to restore state competition to the incorporation market by focusing the attention of corporate stakeholders on the potential value added from changing the state of incorporation.<sup>138</sup>

Empowering shareholders to vote on affirming or rejecting the state of incorporation would build on existing public company mandates for shareholder votes on a range of corporate issues, such as executive compensation and stock option plans.<sup>139</sup> The potential for shareholder votes would force corporate managers and lawyers to justify the incorporation decisions they have made and to weigh the merits of the alternative states of incorporation. The appeal of this approach is that it is designed to mitigate an underlying principal-agent problem in corporate governance by making managers more accountable to shareholders about core corporate governance decisions.<sup>140</sup> It would empower the underlying owners to determine whether to keep the existing state of incorporation or to require the

---

138. A more aggressive alternative strategy would be to require companies to rotate their state of incorporation at periodic intervals (such as ten to twenty years). This mandatory rotation approach would gradually erode the dominance of Delaware and give states an immediate market to compete for. But the downside of this approach is that it would impose changes on managers and shareholders regardless of whether their current state of incorporation adds more value (or is perceived to add more value). While Delaware’s dominance may be a product of market failure, empowering shareholders to review and potentially veto the default decision making of managers and corporate lawyers offers a better remedy to this principal-agent problem. *Cf.* Barbara Arel, Richard G. Brody & Kurt Pany, *Audit Firm Rotation and Audit Quality*, 75 CPA J. 36, 38 (2005) (discussing the mandatory rotation of individual audit partners from individual clients and the broader arguments for and against audit firm rotation); Iris H-Y Chiu, *Regulatory Governance of Credit Ratings in the EU*, 2013 EUR. J. RISK REG. 209, 217–18 (discussing the merits of the European Union’s proposals for mandatory rotation of rating agencies).

139. As noted earlier, this approach could be achieved through a statutory change, SEC rule, or an exchange-listing requirement. A statutory change or exchange-listing requirement could be crafted to make shareholder say on incorporation binding on management. In contrast, an SEC rule could lead to a nonbinding shareholder vote, yet this approach would also place strong pressure on management to comply with the shareholders’ wishes. *See, e.g.*, Gordon, *supra* note 5, at 698–99 (discussing stock-exchange-listing rule mandates for public companies to secure shareholder approval for stock option plans); Dodd-Frank Wall Street Reform Act, Pub. L. No. 111-203, § 951(b), 124 Stat. 1899 (2010) (codified as amended at 15 U.S.C. § 78n-1 (2012)) (mandating public companies to hold advisory shareholder votes on the top five executives’ compensation at least every three years).

140. *See* Marcel Kahan & Edward B. Rock, *The Insignificance of Proxy Access*, 97 VA. L. REV. 1347, 1348–50 (2011) (discussing the potential for expanded shareholder voting rights on major corporate decisions); Mark J. Roe, *The Corporate Shareholder’s Vote and Its Political Economy, in Delaware and in Washington*, 2 HARV. BUS. L. REV. 1, 1 (2013) (describing the potential for proxy reform efforts to “revolutionize American corporate governance”).

company to change but would not mandate any changes if shareholders are satisfied with the status quo. Proxy votes on the state of incorporation would effectively function as a veto power, which shareholders could exercise to check decisions that serve managers' rather than shareholders' interests.<sup>141</sup>

Skeptics may be concerned that shareholder inertia may prove to be too strong to overcome.<sup>142</sup> The decision on where to incorporate typically occurs during the IPO process, which means that shareholders will face a default choice. Defaults, however suboptimal, have proven to be difficult to overcome in a range of legal contexts.<sup>143</sup> For this reason, the efficacy of this approach would turn on the participation of proxy advisory firms and institutional investors, who are positioned to overcome the collective action problems facing shareholders. Proxy advisory firms would add assessments of the merits of state incorporation choices to the range of issues on which they routinely make recommendations. Proxy advisory firms' advice on shareholder votes are widely followed by shareholders who often need direction and lack the economic incentive to invest in making informed choices on their own. Proxy advisory firms have well-established records in shaping shareholder votes on corporate governance issues, which gives this proposal plausibility as proxy advisory firms would be able to take the lead in assessing the value added by states of incorporation.

Institutional investors would similarly have incentives to consider whether the costs and benefits justify mobilizing shareholders to change the state of incorporation. Institutional investors have the economic stakes to invest in assessing the value added by a change in the state of incorporation. As significantly, they play a key signaling role to other investors to focus on this issue amidst the many other

---

141. See Michael S. Kang, *Shareholder Voting as Veto*, 88 IND. L.J. 1299, 1324–27 (2013) (discussing how shareholders can be expected to exercise negative vetoes more responsibly than to play a role in positive agenda setting for corporations); Robert B. Thompson & Paul H. Edelman, *Corporate Voting*, 62 VAND. L. REV. 129, 149–50 (2009) (discussing how shareholder voting should occur to correct managerial errors, which they define as decisions which diminish stock value).

142. See, e.g., Thompson & Edelman, *supra* note 141, at 130 (arguing that “[s]hareholders seldom seem to care much about the vote even when they have it” and often defer to the “Wall Street rule” even when they disagree with the management’s decision).

143. See, e.g., Cass R. Sunstein, *Deciding by Default*, 162 U. PA. L. REV. 1, 17–24 (2013) (discussing the role of inertia, endorsement, reference points, and loss aversion in the durability of defaults).

proxy votes that shareholders face.<sup>144</sup> The “shareholder say” approach would unlock the latent potential of these actors by giving them a low-cost way to shape this important corporate governance decision, while currently neither has a voice on this issue. Given the fact that the costs of transitioning from one corporate governance regime are low, this approach would provide a clear market-based test on whether the value added of changing incorporation regimes is worth it in the eyes of shareholders.

*C. Addressing Concerns About the “Shareholder Say” Approach*

One concern about this approach is that shareholders may not be sufficiently informed on how other substantive issues are intertwined with a state of incorporation.<sup>145</sup> For example, companies would balk at a shareholder mandate to change the state of incorporation in contexts in which the state of incorporation is tied to substantive state regulation, such as for state-chartered banks or insurers. That being said, these cases are the exception, rather than the rule, and proxy advisory firms and institutional investors would be unlikely to support changes in the state of incorporation when substantive regulatory concerns are at stake. A related concern is that empowering shareholders to change the state of incorporation would thwart the will of managers who genuinely believe Delaware (or some other state) is the optimal state of incorporation. While managers and their lawyers may paternalistically believe they know best,<sup>146</sup> the shareholder say approach would create greater accountability to the shareholder principals, and that power would presumably be tempered by the sobering advice of proxy advisory firms and shareholders’ self-interest as investors.<sup>147</sup>

Another critique is that there is currently no leading alternative to Delaware for shareholders to choose, which may limit the potential

---

144. See, e.g., Jill E. Fisch, *Rethinking the Regulation of Securities Intermediaries*, 158 U. PA. L. REV. 1961, 1962–64, 1970–72 (2010) (discussing the distinctive incentives institutional investors face compared to retail investors).

145. See, e.g., Stephen M. Bainbridge, *The Case for Limited Shareholder Voting Rights*, 53 UCLA L. REV. 601, 623–24 (2006) (discussing the concern that shareholders may not be informed enough to exercise shareholder voting rights responsibly).

146. See, e.g., Iman Anabtawi, *Some Skepticism About Increasing Shareholder Power*, 53 UCLA L. REV. 561, 565–69 (2006) (arguing that managers’ interests are actually better aligned than shareholders’ for maximizing firm value); Lynn A. Stout, *The Mythical Benefits of Shareholder Control*, 93 VA. L. REV. 789, 808–10 (2007) (questioning the assumption that shareholder democracy is a good thing).

147. See Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 711–14 (2007) (acknowledging the currently limited scope of shareholder voting but pointing to its potential).

of “shareholder say” to foster state competition. While Nevada attracts a modestly higher number of incorporations than the other states “competing” with Delaware,<sup>148</sup> every state is a “minnow” compared to the Delaware “whale” in terms of incorporations. This fact raises the specter of companies stumbling in the dark trying to figure out which state is their best option. At first glance, that might appear to be a significant concern because both corporations and their shareholders may be slow to recognize and adapt to the differences between corporate governance regimes. It is true that there is a potential cost due to these uncertainties, but this concern should not be overstated. The fact that almost half of American public companies are not Delaware companies suggests both that there are potentially viable alternatives worth consideration and that investors could process future shifts in states of incorporation.

A related concern is that proxy advisory firms and companies may rapidly cluster around a preferred alternative whose appeal is as baseless as Delaware’s. A rush to find an alternative may tempt lawyers to pick whichever state the first-mover leading law firms appear to congregate around regardless of the merits. This herding effect may swamp scrutiny of potential alternatives. There is no little irony in the danger that herding may potentially dampen the impact of a measure designed to mitigate herding effects. But the crucial difference is that “shareholder say” on the state of incorporation will focus more scrutiny on this decision by both insiders and outsiders and make it harder for default decision making to go unnoticed. At minimum, both company and proxy advisory firm lawyers would have incentives to analyze the merits of the leading candidates simply to explain the logic underpinning their decisions.

Another concern is that companies would face switching costs in adjusting to the demands of a new corporate governance regime if shareholders demanded a change in the state of incorporation. The literal switching costs would be token both in terms of money and time. Formally speaking, it is a simple process to incorporate from one jurisdiction to another and entails relatively modest fees and compliance with filing requirements. In fact, the premium that Delaware charges for companies incorporated in its jurisdiction is many times higher than its competitors, so in that sense there could

---

148. See Michal Barzuza, *supra* note 14, at 949 tbl.1 (noting that Nevada has attracted less than seven percent of out-of-state incorporations).

be substantial costs savings to transitions to another state.<sup>149</sup> But the real cost is more substantial both in terms of paying for lawyers to be informed in the jurisdiction and to adjust corporate governance institutions to an alternative regime. However, these costs could be overstated. In many cases, it would not be the first time that a company switched its state of incorporation, as companies frequently switch from the primary state of business operations to Delaware as part of the IPO process.<sup>150</sup> In particular, small companies are more likely to be non-Delaware companies, and many only become Delaware companies when corporate lawyers steer them towards Delaware during the IPO process based on the untested assumption that markets value Delaware law. But firms rarely raise concerns about the costs of reincorporation during the initial public offering process, and they are unlikely to do so in the face of a shareholder mandate for changing the state of incorporation.

## VI. METHODOLOGICAL ISSUES

### A. *Assumptions Underpinning Analysis*

Our study makes a number of assumptions in modeling stock price reaction to merger announcements, which merit explanation. Although most of our assumptions are standard in event studies and extensively discussed in the literature, we address a few methodological assumptions in this section and the reasons for those assumptions. We then address potential confounding variables and selection effects in the next section.

The first assumption is the event window, which is always an important methodological choice that can affect the results of an event study. There is a tradeoff in selecting the length of the event window because a shorter window reduces noise and increases statistical power, but it may not capture all of the effects that a longer window would.<sup>151</sup> Our study uses a short event window of three trading days surrounding the merger announcement in which to ascertain the market's response to the constructive reincorporations. One might argue that a longer event window would be preferable to

---

149. See Carney & Shepherd, *supra* note 108, at 63 (noting that franchise fees for comparable companies may be \$100,000 in Delaware compared to \$5,000 in Georgia or as low as \$40 in Kansas).

150. See Daines, *supra* note 106, at 1576; Subramanian, *supra* note 57, at 1825–26.

151. See, e.g., Bhagat et al., *supra* note 69, at 8 (noting that a short event window “minimizes . . . noise” but “estimates only a fraction of the full value effect of a successful transaction”).

capture all elements of value that might be related to the announcement. But with daily data and relatively clear identifiable event time (such as we have in our study), some scholars even recommend a one-day window.<sup>152</sup> Thus, we believe our three-day window strikes the right balance between statistical power and event date uncertainty. In fact, however, the exact choice of event window made little difference as we estimated the model using event windows of various lengths, and found some that gave positive estimates of the value of Delaware law, although not statistically significantly different from zero.

We believe that the three-day event window is appropriate for our study for several reasons. First, unlike prior studies that attempted to ascertain returns from both hostile and friendly offers, we have limited our analysis to friendly offers which allows us to pinpoint with much greater accuracy the date and time of announcement. Second, we are not attempting to capture or estimate all elements of value that arise from a merger as are most of the articles on which we build. Instead, we only seek to capture the market's response to the change in state of incorporation. In an efficient market, it is implausible that the market would take more than one day to digest such a simple and readily available piece of information.<sup>153</sup> Furthermore, because we are not concerned with estimating the magnitude or even directionality of overall combined gains from mergers, but only the relative gains from acquisition reincorporations, the fact that we may not capture the entire market reaction in a short window does not pose a problem.

One might also question our inclusion of acquisitions of all sizes instead of simply looking at mergers of equals or other acquisitions of target companies that are significant compared to the size of the acquirer. It is true that if the target company is very small compared

---

152. See Bhagat & Romano, *supra* note 60, at 956 (“If one is using daily return data, an announcement window of one day is quite feasible and the window that we recommend. However, in going from one to two or three days, the loss in statistical power is not serious.”).

153. Econometric practice broadly assumes that the semi-strong efficient market hypothesis applies to stock prices. This well-established framework asserts that stock prices immediately incorporate all publicly available information about the issuer, which implies that the information in an acquisition agreement is incorporated into the stock price on the trading day of the disclosure. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 384, 413–16 (1970) (concluding an empirical study with findings that the evidence supports the efficient markets model); see also Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 554–65, 642–43 (1984) (discussing the weak, semi-strong, and strong efficient market hypotheses as tools for understanding stock price behavior).

to the acquiring company, it would be much more difficult to detect changes in the combined wealth effects of the two companies attributable to the constructive reincorporation of the target. However, when we limit our analysis to target companies that are larger than ten percent of the combined target and acquirer, we find that the value of Delaware law is actually more negative. Thus, our modeling assumptions actually favor a finding of positive value in Delaware law, yet we find no such value, which underscores the significance of our findings.

*B. Potential Confounding Variables and Selection Effects*

Our analysis is also subject to potential objections on the grounds that selection effects or confounding variables or both could explain our null results even if Delaware law had positive value compared to the law of other states.<sup>154</sup> Both the existing studies and our study on Delaware law are bound to face challenges concerning potential selection effects, as would any empirical study of corporate governance.<sup>155</sup> One of the common selection issues is that the effects attributable to law may actually be attributable to new plans (e.g., the reincorporation studies) or systematic differences among firms incorporated in Delaware (e.g., Tobin's Q studies). In this section, we address some of the selection effects that might affect our study.

Any study that relates corporate governance variables with stock price changes runs the risk of confounding management performance with the variable of interest. Recall that one argument against the result from Daines' Tobin's Q approach is that if better managers choose Delaware and better managers also outperform the market, then Delaware law could appear to have positive value when in fact the positive value is attributable to better management teams. In our study, one might make the opposite argument; that worse management teams systematically choose Delaware companies and that our failure to find a positive value to Delaware law is because worse management offsets the value of the law. We find that

---

154. The concept of confounding variable is "[t]he presence of spurious association, due for example to the influence of extraneous variables," which may affect the variables that the study is focused on and bias the study's estimates and results. See JUDEA PEARL, CAUSALITY 269 (Cambridge University Press, 2d ed. 2009), available at [bayes.cs.ucla.edu/BOOK-2K/ch6-2.pdf](http://bayes.cs.ucla.edu/BOOK-2K/ch6-2.pdf).

155. See Yair Listokin, *Interpreting Empirical Estimates of the Effect of Corporate Governance*, 10 AM. L. & ECON. REV. 90, 94-96 (2008) (discussing how endogeneity problems pose challenges for corporate governance analyses).

explanation unlikely, especially given the criticism of Daines on the exact opposite ground.

Our study has other potential selection effects not present in the Daines study because of our use of mergers as our data set. The decision to use a database of mergers may tend to select some types of target (and acquirer<sup>156</sup>) management teams over others. For example, the target companies in this study might have better management than average, given that they did agree to the merger, a fact that shows less propensity for entrenchment. One might argue that conditioning on the fact of a takeover selects better, less entrenched target management, which if the market knew ahead of time, would reduce the return from the takeover. If one further assumes that good corporate law matters less for good managers (who do not need constraints of corporate law), and if target managers are disproportionately good, then the differences in corporate law could be hidden in a database of merger transactions.

On the other hand, conditioning on takeovers might bias in favor of *underperforming* targets, on the theory that a motivation for takeovers is “disciplinary” or to improve underperforming firms in the “market for corporate control.”<sup>157</sup> The evidence for this is far from uniform, however.<sup>158</sup> For example, target companies in *friendly* takeovers have similar characteristics to bidder companies in terms of Tobin’s Q.<sup>159</sup>

Our study focuses on companies that actually did receive a takeover proposal and accepted that proposal. Daines found that Delaware firms were more likely to receive a takeover bid, and interpreted that as at least part of the value added by Delaware.<sup>160</sup> Daines argued that the market includes that as value for Delaware companies.<sup>161</sup> But this fact, if true, does not affect our analysis. If non-

156. See Randall Morck, Andrei Shleifer & Robert W. Vishny, *Do Managerial Objectives Drive Bad Acquisitions?*, 45 J. FIN. 31, 33–34 (1990) (discussing how poor managerial decisions can reduce the value of firms).

157. Henry G. Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110, 118 (1965).

158. See Anup Agrawal & Jeffrey E. Jaffe, *Do Takeover Targets Underperform? Evidence from Operating and Stock Returns*, 38 J. FIN. & QUANTITATIVE ANALYSIS 721, 722 (2003) (showing that target firms do not systematically underperform when they are assessed in a multi-year time horizon).

159. See Larry H. P. Lang, Rene M. Stulz & Ralph A. Walkling, *Managerial Performance, Tobin’s Q, and the Gains from Successful Tender Offers*, 24 J. FIN. ECON. 137, 141–43 (1989) (presenting data suggesting that the Tobin’s Q was virtually identical for targets and bidders in a sample of acquisitions).

160. Daines, *supra* note 2, at 542–46.

161. See *id.*



Delaware companies are discounted because they are less likely to be takeover targets, then when they actually are targets, more value should accrue to those mergers than when Delaware companies are targets. In other words, under the “race to the top” view, a Delaware takeover should unlock additional value, but our results suggest this assumption is baseless.

Another objection is that one might expect the test to have low power because of the high variance around a merger announcement. Individual mergers may have a wide range of market reactions as some mergers may cause significant price spikes for targets (e.g., the Alpha Natural Resources-Massey Energy merger), while others may have minimal effects on targets (e.g., the Alcatel-Lucent or U.S. Airways-American Airlines mergers). As discussed above, we chose a large sample size and short event window specifically in order to address potentially low statistical power in this context.<sup>162</sup> But what is noteworthy is that the variance of the combined return of both the target and acquirer, however, is rather low, even for mergers of equals. This fact suggests that our conclusions from an over-decade-long data set of public company mergers have broad explanatory power.

#### CONCLUSION

It is indisputable that Delaware has won the race for corporate charters and enjoys a virtual monopoly on the out-of-state incorporation business.<sup>163</sup> But the irony is that the fierce debate about the “race to the top” versus “race to the bottom” has obscured the reality that financial markets place no value on Delaware law. Our innovative approach of analyzing the value added from Delaware and non-Delaware mergers presents strong evidence that any claim of a positive or negative effect from incorporating in Delaware is a myth perpetuated by lawyers’ herding effects and path dependence.

We argue Delaware’s dominance stems from the fact that lawyers largely choose the state of incorporation, which is generally a matter of indifference to businesspeople and financial markets. Lawyers appear to turn to Delaware because it is the law they know best and because it is a safe default to recommend since most companies are based there. Lawyers may assume Delaware adds value (or that their clients believe Delaware incorporation provides a

---

162. See Bhagat & Romano, *supra* note 60, at 955–56 (discussing sample sizes and event window lengths in the context of statistical power).

163. See Carney & Shepherd, *supra* note 108, at 2–3.

positive signal). But lawyers' recommendations appear to have nothing to do with whether Delaware law actually adds value compared to other states' corporate frameworks.

Delaware's preeminence may be the result of the superiority of Delaware law in the past, but our study shows that the markets place no greater value on Delaware than other states' law in the present. Our results do not imply that Delaware's virtual monopoly on out-of-state incorporations has no value. The fact that so many large corporations incorporate in Delaware may add marginal value due to network effects. There may be a very small benefit to having corporate lawyers cluster around a particular legal standard in creating a common language and stable expectations. But the key point is that Delaware does not need to be any better than any other state to provide that element of value since Delaware's dominance is a product of lawyer herding and path dependency.

For this reason, we suggest there is a need to break up these herding effects by creating "shareholder say" on the state of incorporation. This approach would unlock the potential for change by empowering shareholders to decide on whether to keep the existing state of incorporation or to require the company to change. This strategy offers a plausible way to address default decision making as proxy advisory firms and institutional investors possess the ability and the incentive to scrutinize managers' incorporation choice. As importantly, this regulatory strategy would spur lawyers to acquire legal fluency in multiple corporate governance jurisdictions to justify or challenge incorporation decisions and would incentivize proxy-advisory-firm and institutional-investor lawyers to cultivate this expertise. This "shareholder say" approach would create opportunities for states to compete to attract shareholder support and would dampen the dominance of Delaware by restoring greater competition among the states for incorporations.