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## Delaware's Familiarity

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# Delaware's Familiarity

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## I. INTRODUCTION

We all type on the “QWERTY” keyboard, even though it is inefficient.<sup>1</sup> Microsoft advertises that its BING search engine is superior to Google in a side by side comparison,<sup>2</sup> yet when the Authors, and probably our readers, do an Internet search, we use Google. Even closer to home for lawyers is when a form document includes a boilerplate provision. We rarely question or change it, we have seen the provision a hundred times and understand its consequences—so why fix what is not broken?

These examples and countless others illustrate the central theme in this Article—that sometimes a product, in our case a body of law, is chosen not necessarily for its superiority, but rather because we are *familiar* with it. There may be more efficient computer keyboards, search engines, and boilerplate provisions at hand; however, we like the tried and true methods—the ones we are familiar with. This is true in everyday life, and as we attempt to show in this Article, it is also true when corporations choose to be governed by one body of law over another, with potentially millions of dollars on the line.<sup>3</sup>

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1. See generally Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332, 332–33 (1985) (discussing the development of the QWERTY typewriter keyboard and the more efficient typewriter keyboards developed after it). See also Brett H. McDonnell, *Getting Stuck Between Bottom and Top: State Competition for Corporate Charters in the Presence of Network Effects*, 31 HOFSTRA L. REV. 681, 705 (2003) (citing Paul David’s work for the proposition that QWERTY was initially adopted precisely because it was slower, which helped early typewriters avoid jamming). But see S.J. Liebowitz & Stephen E. Margolis, *The Fable of the Keys*, 33 J.L. & ECON. 1, 2 (1990) (disputing the idea that QWERTY is inefficient).

2. Mike Nichols, *Take the Bing It On Challenge!*, BING BLOGS (Sept. 6, 2012), <http://blogs.bing.com/search/2012/09/06/take-the-bing-it-on-challenge/> [<http://perma.cc/D5VN-XTX7>].

3. *Market Capitalization of Listed Companies*, WORLD BANK, <http://data.worldbank.org/indicator/CM.MKT.LCAP.CD> [<http://perma.cc/L2AD-YBJ8>] (showing the market capitalization of public corporations in the United States in 2012 was over \$18 trillion) (last visited May 20, 2015).

One of the enduring topics of interest in corporate law is why the tiny state of Delaware dominates the market for incorporations, especially incorporations of the most powerful and profitable firms.<sup>4</sup> The “internal affairs” rule allows corporations to choose which state’s law will govern their corporate affairs, whether or not the corporation has ties to that state.<sup>5</sup> Voluminous literature on the topic largely credits Delaware’s dominance in attracting incorporations to factors relating to the inherent quality of its corporate law and the business expertise of its judges who hear corporate law disputes. Another strand of literature credits Delaware’s network effects. Either way, Delaware is no doubt winning the “race” for incorporations, long beating other states,<sup>6</sup> and holding the federal government at bay as well.<sup>7</sup>

The cause and normative implications of Delaware’s success, however, are hotly debated. Under the “race-to-the-top” view, Delaware prevails because it provides a body of corporate law that maximizes shareholder value.<sup>8</sup> In comparison, under the “race-to-the-bottom” view, Delaware dominates the market for corporate charters by offering laws that favor senior management and other insiders at shareholders’ expense.<sup>9</sup> Both

4. Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 578 (2002) (reporting that 58% of public companies are incorporated in Delaware); Lucian Arye Bebchuk & Alma Cohen, *Firms’ Decisions Where To Incorporate*, 46 J.L. & ECON. 383, 391 tbl.2 (2003).

5. ERIN A. O’HARA & LARRY E. RIBSTEIN, *THE LAW MARKET* 107 (2009).

6. See Mark J. Roe, *Is Delaware’s Corporate Law Too Big to Fail?*, 74 BROOK. L. REV. 75, 77 (2008) (“[T]he idea of the race [between states] being a strong one has worn thin in recent academic work.”).

7. See generally Mark J. Roe, *Delaware’s Politics*, 118 HARV. L. REV. 2491, 2494 (2005) [hereinafter Roe, *Delaware’s Politics*] (analyzing Delaware’s autonomy in structuring its corporate law with regards to potential federal intervention); Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588, 592 (2003) [hereinafter Roe, *Delaware’s Competition*] (arguing that any “race” is between Delaware and the federal government rather than Delaware and other states).

8. The classical race-to-the-top works include Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254–66 (1977); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 212–27 (1991); and ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 14–31 (1993).

9. The classical race-to-the-bottom works include William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663–68 (1974); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Oren Bar-Gill et al., *The Market for Corporate Law*, 162 J. INST. & THEORETICAL ECON. 134 (2006).

sides of the debate focus on the substantive features of Delaware corporate law, the difference being whether Delaware law is thought to benefit shareholders or benefit management at shareholders' expense.

This Article is not another race-to-the-top versus race-to-the-bottom story. Instead, it demonstrates something new—while Delaware may have begun its ascent to the top of the corporate law hierarchy by offering more desirable law than its leading competitor,<sup>10</sup> it stays there as much because it is *familiar* to business parties as for its substantive virtues.<sup>11</sup> In this respect, we attempt to show Delaware's resemblance to the aforementioned QWERTY keyboard, Google search engine, and form document's boilerplate provision.

This Article builds on our prior empirical research showing that, everything else equal, start-up firms<sup>12</sup> financed by out-of-state investors are more likely to incorporate in Delaware.<sup>13</sup> We argue that this finding is due to out-of-state investors' familiarity with Delaware corporate law, and relative lack of familiarity with the corporate law of the start-up's

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10. New Jersey led the state race for incorporations until 1913, when Woodrow Wilson (then New Jersey's Governor) advocated the "Seven Sisters Act," which prohibited corporations from owning stock in other corporations. These new restrictions in New Jersey's corporate law—not found in Delaware's corporate law—led to Delaware taking the lead in the incorporations race—a lead it has never relinquished. See Christopher Grandy, *New Jersey Corporate Chartermongering, 1875–1929*, 49 J. ECON. HIST. 677, 677–78 (1989) (recounting these historical events in New Jersey); McDonnell, *supra* note 1, at 727–32.

11. An important work related to our own is William J. Carney, George B. Shepherd & Joanna Shepherd Bailey, *Lawyers, Ignorance, and the Dominance of Delaware Corporate Law*, 2 HARV. BUS. L. REV. 123 (2012). Professors Carney, Shepherd & Bailey survey corporate attorneys regarding factors influencing choice of domicile and find that that lawyers believe one advantage of Delaware relative to their home state corporate law is that more investors across the country are familiar with Delaware than with their home-state corporate law. *Id.* at 137–38. Our contribution is consistent with their results, but in addition provides a theory to distinguish familiarity from network externalities, and reports empirical data showing that investor familiarity can influence choice of domicile. *Id.* at 677–78.

12. For a better idea of what we mean by "start-ups," as opposed to so-called "lifestyle" small businesses, see Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1406 (2008) (noting start-ups are "high-risk, high-growth" companies funded by angel investors and venture capitalists).

13. Brian J. Broughman, Jesse M. Fried & Darian M. Ibrahim, *Delaware Law as Lingua Franca: Theory and Evidence*, 57 J.L. & ECON. 865, 868 (2014). Our prior study used two statistical techniques, VC fixed-effect analysis and a first-differences analysis of reincorporation, to isolate a causal relationship between out-of-state financing and choice of domicile. See *id.* at 869. We refer interested readers to our prior article for questions about the statistical analysis. The primary contributions of our current article are to develop a model of investor familiarity, distinguishing it from network and learning effects, and to explore in greater detail the normative implications of investor familiarity for the competition for corporate charters.

home state. In the current project, we extend our prior research by (i) developing an informal model distinguishing investor familiarity from related economic theories of network effects and learning effects, (ii) showing that our data are more consistent with familiarity than with these alternative explanations, and (iii) discussing normative implications of the familiarity effect for corporate choice of domicile. Since our prior work was written primarily for economists, this Article publicizes our empirical findings to legal scholars and practitioners. In addition, the normative implications of our findings should be of great interest to scholars following the corporate federalism debate.

The remainder of the Article proceeds as follows. In Part II, the Article provides a theory for how investor familiarity impacts a private firm's choice of domicile and uses a numeric example to distinguish familiarity from related economic theories of network effects and learning effects. Part III discusses the results of our prior study testing for a familiarity effect and recaps those findings, including new regression results showing familiarity's role as a dominant explanation for Delaware's dominance, contrasting familiarity's effect with that of substantive law quality and network effects. Part IV explores normatively what our familiarity findings might mean for state competition and the overall quality of Delaware law. Part V offers a brief conclusion.

## II. THEORETICAL ASPECTS OF FAMILIARITY

What does it mean to suggest that Delaware law is "familiar" to investors? We have already given some examples that attempt to illustrate familiarity's role in decisions we all make on a day-to-day basis, for example, the QWERTY keyboard. Perhaps a closer analogy is the use of English as a common language, or *lingua franca*, in international business deals.<sup>14</sup> For instance, if a party from Japan wants to contract with a party from France and neither speaks the other's language, this could present a hurdle to closing the deal. It would at least increase the deal's transaction costs as one party would have to hire a translator to help overcome the language barrier. However, the ability to settle on English as a language familiar to both parties, even though it is neither party's native tongue, can

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14. See Broughman, Fried & Ibrahim, *supra* note 13, at 866; John F. Coyle, *Rethinking the Commercial Law Treaty*, 45 GA. L. REV. 343, 366 (2011) (showing substantive treaties reduce transaction costs because of a wide variety of individuals from different nationalities are familiar with them).

overcome that hurdle and allow for the contract's execution.<sup>15</sup> English, being a universal language, serves as a lingua franca for the Japanese and French investors.<sup>16</sup> As demonstrated in this Article, we believe that Delaware law serves the same lingua franca function for investors from different American states. Delaware is the universal language of corporate law.<sup>17</sup>

#### *A. Theory: Familiarity Versus Network Externalities*

Our theory of familiarity is straightforward. Business parties are familiar with a body of law if they have studied it and used it in the past. Familiarity relates to a party's *own* knowledge and comfort with a particular body of law.

Familiarity with a particular body of law can impact contract negotiations by lowering transaction costs. For example, if an entrepreneur seeking external financing incorporates in a state that provides corporate law familiar to her prospective investors, this will make it easier for such investors to evaluate the terms of financing. By contrast, investors may be reluctant to negotiate a financing contract if they are unfamiliar with the relevant body of corporate law. If asked to do so, the investors are likely to demand a lower price for the firm's shares (i) to protect them from potential opportunism<sup>18</sup> or (ii) to compensate for the cost of learning

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15. ANNA MAURANEN & ELINA RANTA, ENGLISH AS A LINGUA FRANCA: STUDIES AND FINDINGS, 1 (2009) ("English has established its position as the global *lingua franca* beyond any doubt . . ."); Coyle, *supra* note 14, at 367 ("There is no doubt that a substantive treaty is capable of serving as a common language to persons from different legal backgrounds."); Tsedal Neeley, *Global Business Speaks English: Why You Need Language Strategy Now*, HARV. BUS. REV. 117, 117 (May 2012) ("Ready or not, English is now the global language of business.").

16. Hyejin Ku & Asaf Zussman, *Lingua Franca: The Role of English in International Trade*, 75 J. ECON. BEHAV. & ORG. 250, 258–59 (2010); Julie M. Spanbauer & Katerina P. Lewinbuk, *Embracing Diversity Through a Multicultural Approach to Legal Education*, 1 CHARLOTTE L. REV. 223, 223 (2009) ("As a result of globalization, the English language is fast becoming 'a global lingua franca.'). See also Coyle, *supra* note 14, at 367 ("It is possible, in other words, for the national law of a particular state to serve as a *lingua franca* that reduces transaction costs in transactions touching on multiple jurisdictions.").

17. Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1581 (2002) ("Delaware is . . . much like a common language and such lawyers are 'bilingual,' speaking Delaware law plus the local dialect.").

18. Investors may be especially concerned if an entrepreneur incorporates in a state that the entrepreneur (or her legal advisor) is familiar with but the investors are not. In this case, the entrepreneur could use her informational advantage to take advantage of the investors. See *infra* note 85 and accompanying text.

a new body of law.<sup>19</sup> Everything else equal, by selecting a familiar body of corporate law an entrepreneur can lower her cost of capital.

Concepts related to familiarity in the economics literature need to be distinguished. For example, “network effects” and “learning effects,” collectively thought of as “network externalities,” can also enhance the value of a product beyond that product’s substantive merits.<sup>20</sup> In our case the “product” is Delaware corporate law.<sup>21</sup> Delaware law benefits from learning effects due to the sheer number of firms previously incorporated in Delaware and the body of law that has resulted.<sup>22</sup> Delaware law also benefits from network effects because the more incorporations it attracts now and in the future, the more corporate law it will produce going forward. Like the telephone, the more that parties use Delaware corporate law, the more value it has.<sup>23</sup>

Network effects and learning effects are closely related, the difference being temporal.<sup>24</sup> Learning effects focus on past use, while network effects focus on contemporaneous and future use.<sup>25</sup> If we do attempt to parse them out, learning effects may be the easiest to see in the incorporations context. For decades, Delaware has attracted the majority of public incorporations and as a result had developed substantial legal precedent.<sup>26</sup>

19. See, e.g., Ola Bengtsson & Dan Bernhardt, *Different Problem, Same Solution: Contract-Specialization in Venture Capital*, 23 J. ECON. & MGMT. STRATEGY 396, 416 (2014). In many cases this cost may simply represent heightened legal fees. The investor’s lawyer will charge more to do legal work using an unfamiliar body of corporate law.

20. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 763 (1995) (“When a product exhibits network externalities, the basic market model of microeconomics does not apply. That model, which links individual value-maximizing behavior with social optimality, does not take account of the interdependence in value that network externalities create.”).

21. *Id.* at 775 (noting that a body of law can be a product).

22. In another illustration of learning effects, Charles Goetz and Robert Scott have examined implied versus express contract terms. Because judicial precedents have incorporated implied terms into contracts over the years, future parties benefit from the learning effects of those terms. The parties, in fact, favor those implicit terms over terms that are explicit but less often used. Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 289 (1985).

23. See Klausner, *supra* note 20, at 772 (noting that the telephone’s value as a product increases with each new user).

24. See Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CALIF. L. REV. 479, 569 (1998).

25. See *id.*

26. See, e.g., Klausner, *supra* note 20, at 844 n.263.



For these reasons it is likely that investors have previous experience with Delaware corporate law. This predictability enhances Delaware's attractiveness to business parties regardless of its substantive virtues.<sup>27</sup> Simply knowing what the law is, and how to plan in accordance with that law, adds value above the content of that law.<sup>28</sup>

Network effects are perhaps less obvious. Michael Klausner observes that the "quality of a state's future case law depends on the number and diversity of lawsuits brought before its courts. These factors in turn depend on the number of firms incorporated in a state."<sup>29</sup> Thus, it is not simply what Delaware has done in the past, but what it will continue to do in the future. Because a new firm knows that Delaware is where most firms incorporate, it expects "ex ante to benefit from judicial interpretations involving other firms, and from the development of legal expertise in the future."<sup>30</sup>

By contrast, an explanation of a particular firm's choice of domicile, our familiarity, or lingua franca, does not consider the total number of firms incorporated in Delaware, or even the total number of business parties familiar with Delaware law. Rather, our focus is only on the parties at the bargaining table. If a private firm is receiving financing from a group of investors who are unfamiliar with the firm's home-state corporate law, but are familiar with Delaware law, then this firm will be relatively more likely to domicile in Delaware. The key issue is the relative familiarity of the parties at the bargaining table.

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27. See, e.g., McDonnell, *supra* note 1, at 681, 686, 701.

28. Brett McDonnell believes that learning effects help Delaware but do not pose a substantial barrier to competing states. He observes that other states can promise to copy Delaware precedents wholesale, thus negating Delaware's learning effects advantage. McDonnell, *supra* note 1, at 702 ("[S]tates can match the learning effects gained by a leading state's case law by adopting wholesale the existing case law of that state."). This is debatable, however, as other courts without Delaware's expert judges might not get the copying right. For example, in *Hilton Hotels Corp. v. ITT Corp.*, 978 F. Supp. 1342 (D. Nev. 1997), Nevada courts attempted to apply the *Unocal* standard of Delaware takeover law, and held that the target company did not have reasonable grounds for believing a threat to corporate policy existed. *Id.* at 1348 (citing *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953, 955 (Del. 1985)) (but holding that "ITT has shown no real harm to corporate policy or effectiveness"). But that *Unocal* prong is almost always satisfied when Delaware courts hear a *Unocal* case. Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 293 n.160 (2001) (citing *Hilton Hotels* for the proposition that "[i]nterestingly, courts outside Delaware that adopt the *Unocal* standards seem more inclined to take the first prong seriously"); Troy A. Paredes, *The Firm and the Nature of Control: Toward a Theory of Takeover Law*, 29 J. CORP. L. 103, 167 (2003) ("There is almost no meaningful judicial review under *Unocal*'s threat prong [in Delaware].").

29. Klausner, *supra* note 20, at 845.

30. *Id.* at 762.

To be sure, the reason investors and their lawyers are familiar with Delaware law may be driven in large part by network and learning effects. To illustrate, a law school professor may choose to emphasize Delaware law in her corporations class not because of its inherent quality, but rather because so many firms are already incorporated there. Put another way, the professor wants her students to be able to take advantage of the positive network externalities associated with Delaware incorporation.<sup>31</sup> Similarly, the fact that a large number of firms are already incorporated in Delaware increases the likelihood that that an investor or lawyer will gain familiarity with Delaware simply through practice.<sup>32</sup> In this respect, familiarity is at least to some extent derivative of learning and network effects.<sup>33</sup> In the current project, we do not address why Delaware became the lingua franca for corporate law. Rather, our claim here is that widespread investor and lawyer familiarity with Delaware law has an independent effect on choice of domicile apart from any network benefits associated with Delaware incorporation.

The following numeric example illustrates the impact of investor familiarity on choice of domicile. We use this example to clarify our distinction between investor familiarity and network and learning effects.

### *B. Numeric Example: Familiarity Versus Network Externalities*

Consider an entrepreneur seeking external financing for a new business (*Startup*) located in Virginia. *Startup* will be structured as a corporate entity. To attract financing, *Startup* must provide terms, including state of domicile, acceptable to an investor. Consistent with numerous empirical studies, we assume that *Startup* will incorporate either in its home state of Virginia or in Delaware.<sup>34</sup>

Indeed, *Startup*'s choice of domicile can be understood as a term in the financing contract. Investors sometimes explicitly bargain over legal domicile by including it in the financing term sheet negotiated with the

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31. See *id.* at 840, 851.

32. See McDonnell, *supra* note 1, at 704; Broughman, Ibrahim & Fried, *supra* note 13, at 866–67.

33. See Broughman, Fried & Ibrahim, *supra* note 13, at 867.

34. Virtually all firms, public and private, incorporate in either their home state or in Delaware. See Bebchuk & Hamdani, *supra* note 4, at 578; Broughman, Ibrahim & Fried, *supra* note 13, at 872; Daines, *supra* note 17, at 1562; Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J. L. ECON. & ORG. 79, 79 (2011).

entrepreneur,<sup>35</sup> or by requesting that the firm reincorporate to a jurisdiction that is more acceptable to the investor.<sup>36</sup> Even if domicile is not explicitly bargained over, perhaps because the entrepreneur incorporated the business prior to financing, the entrepreneur is likely to consider the interests of prospective investors when choosing where to incorporate.

Since it arises out of a voluntary contract, the parties have an incentive to choose the body of corporate law which provides the greatest net benefit to all contracting parties.<sup>37</sup> Proponents of the race-to-the-top view may argue this “contractarian” understanding of choice of domicile reinforces the view that Delaware’s success is due to the high quality of its substantive law.<sup>38</sup> Everything else equal, we agree the higher quality corporate law is more likely to be selected. It should be noted, however, that the “net benefit” of a given body of corporate law is not based solely on the quality of the substantive law, but also includes other factors such as: (i) the franchise tax charged by the state, (ii) the investors’ relative familiarity with the law, and (iii) network externalities created by other firms domiciling in the state.<sup>39</sup>

Putting this altogether suggests the entrepreneur and prospective investors will select the body of corporate law that maximizes the following equation:

$$\text{Net benefit} = \text{law quality} - \text{franchise tax} - \text{unfamiliarity cost} + \text{network ext.} + \varepsilon$$

“Unfamiliarity cost” represents the aggregate cost for all contract parties, including investors, to adequately inform themselves regarding the relevant state’s corporate law. If parties are already familiar with the state’s corporate law, then unfamiliarity cost equals zero. “Network externalities” represents various benefits that arise based on the number of other firms incorporated in the state. The term “ $\varepsilon$ ” is a random error term that is meant to capture idiosyncratic reasons parties sometimes choose one state over another. This error term effectively transforms the above equation into a predicted likelihood that Delaware, as opposed to the home

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35. To illustrate, the state of incorporation is one of the first terms listed in the National Venture Capital Association (NVCA) model term sheet. *Model Legal Documents, Term Sheet*, NAT’L VENTURE CAPITAL ASS’N, <http://nvca.org/resources/model-legal-documents/> [<http://perma.cc/WJ4M-Y393>] (last visited May 20, 2015).

36. Reincorporation is fairly inexpensive for a small, private firm. It is more costly for larger businesses and for firms that have already gone public. See, e.g., Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 558, 586–87 (1990).

37. See Klausner, *supra* note 20, at 758.

38. See Winter, *supra* note 8, at 256, 290; Romano, *Law as a Product*, *supra* note 8, at 279–81.

39. See Broughman, Ibrahim & Fried, *supra* note 13, at 867–68, 880.

state, will be selected as the state of incorporation. Thus, even if all defined terms in the above equation suggest that Delaware will provide higher net benefit for a particular firm, the error term implies that there is still some chance that the firm may nonetheless domicile in its home state.

To give some content to unfamiliarity cost, we make three foundational assumptions. First, we assume each investor is familiar, either directly or through their legal counsel,<sup>40</sup> with the investor's home-state corporate law. Given the prevalence of home-state incorporation for small businesses,<sup>41</sup> local investors and their legal counsel will likely have at least some experience with the corporate law of their home state. This is especially true if, as is typically the case, the investor is represented by an in-state attorney.<sup>42</sup> Lawyers have several avenues for becoming familiar with their home-state law. In chronological order, lawyers become familiar with home-state law through some combination of the following: 1) they studied home-state corporate law in law school—if they attended an in-state school; 2) they passed the home state bar exam, which tests corporate law; and 3) they have practical experience counseling clients on home-state law. For all of these reasons, we believe business parties located in a particular state will be familiar with that state's corporate law.

Our second foundational assumption is investors and their lawyers are familiar with Delaware corporate law. The majority of publicly traded firms are incorporated in Delaware,<sup>43</sup> and consequently investors are likely to have had experience investing in Delaware firms. Indeed, in a recent

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40. Lawyers are likely to handle legal issues associated with an equity investment, and thus an investor's lawyer may be more involved in negotiating the state of incorporation issue than the investor itself. See Teresa A. Sullivan, Elizabeth Warren & Jay Lawrence Westbrook, *The Persistence of Local Legal Culture: Twenty Years of Evidence from the Federal Bankruptcy Courts*, 17 HARV. J.L. & PUB. POL'Y. 801, 840 (1994) (finding that a debtor's choice of Chapter 7 or Chapter 13 bankruptcy is clearly influenced by her attorney's preference). By talking to lawyers at national law firms who counsel VCs, we found that the sophisticated VCs were as involved in the domicile decision as the lawyers. It stands to reason that the non-sophisticated VCs may defer to their attorneys more, although we have no proof of this.

41. See Dammann & Schundeln, *supra* note 28, at 84.

42. In connection with our empirical paper, we interviewed several VCs about their choice of attorney in start-up financing matters. We asked them whether they used an in-state and out-of-state attorney, and from those who responded, the answer was unanimously in-state attorney. Admittedly this is a small sample size, less than ten VCs, but nonetheless offers support for the assumption that VCs use in-state attorneys to counsel them in connection with start-up financings.

43. See Bebchuk & Hamdani, *supra* note 4, at 572.

survey, lawyers involved in initial public offerings (IPOs) overwhelmingly report that one benefit of Delaware relative to the issuer's home-state corporate law is that investors are familiar with Delaware law.<sup>44</sup> Equally importantly, lawyers in all states become familiar with Delaware law. Regardless of school attended, most American law students study Delaware corporate law in law school.<sup>45</sup> Furthermore, it is rational for a business lawyer to focus on Delaware law.<sup>46</sup> As Rob Daines observes, business "lawyers . . . are likely to know Delaware law. Focusing on one national standard allows them to economize on the need to keep up to date with developments in multiple jurisdictions."<sup>47</sup>

Our third foundational assumption is that investors and their lawyers are less likely to be familiar with the corporate law of a third state; in other words, one that is neither the investor's home state nor Delaware. Unless the lawyers went to law school in the third state, they likely did not learn the third state's law in school.<sup>48</sup> Additionally, unless they passed the bar in the third state, which is unlikely if not routinely practicing there, they did not learn the state's corporate law for a bar exam. And if they do not regularly practice or invest in that state, they did not gain comfort with that state's law through experience. This unfamiliarity with third state law suggests that the value of Delaware incorporation, as a *lingua franca*, increases when a firm receives financing from out-of-state investors.<sup>49</sup>

Returning to our numeric example, we can now model unfamiliarity cost. Because all parties are expected to be familiar with Delaware corporate law, if *Startup* incorporates in Delaware unfamiliarity cost equals zero.

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44. Carney, Shepherd & Bailey, *supra* note 11, at 143 (reporting that 92% of underwriters' lawyers, and 83% of issuers' lawyers, agreed with the statement: "Delaware is a better place than my state to incorporate for public companies because investors are more familiar with Delaware law").

45. Delaware corporate law is the cornerstone of public corporation legal study. See Daines, *supra* note 17, at 1581 ("Some lawyers also know Delaware law, as it is something of a national standard, frequently taught in law schools. In particular, lawyers specializing in large, complicated transactions, . . . or who have a multistate practice, are likely to know Delaware law.").

46. McDonnell, *supra* note 1, at 704 ("Corporate lawyers across the country tend to be familiar with Delaware because of the state's prominence. They can thus provide advice on Delaware law more cheaply, having to do less research.").

47. Daines, *supra* note 17, at 1581.

48. Although if the corporate law course contrasted Delaware with the Model Business Corporation Act (MBCA), and the state is an MBCA-adopting state, then the lawyers have at least some education in MBCA, and thus the third state's, law.

49. See Carney, Shepherd & Bailey, *supra* note 11, at 125 ("Delaware is chosen because of the ignorance of investors. Because so many corporations are incorporated in Delaware—especially most large ones—many investors are familiar only with Delaware corporate law and with businesses that are incorporated there. Even if other states' laws are superior, investors prefer incorporation in familiar Delaware.").

By contrast if *Startup* incorporates in its home state, this will introduce transaction costs for each out-of-state investor financing the firm. Consequently, if *Startup* is incorporated in Virginia, out-of-state investors may have trouble evaluating the financing contract and will likely demand a lower price per share to compensate for the cost of learning Virginia law. That is, their lawyers are likely to charge higher legal fees to negotiate a deal in an unfamiliar body of law. To reflect this concern, we assume that if *Startup* incorporates in Virginia it will face additional transaction, or unfamiliarity, costs equal to two for each out-of-state investor.<sup>50</sup>

Now we can complete the net benefit equation by providing values for *law quality*, *franchise tax*, and *network externalities*. The values suggested below are merely for illustrative purposes. Importantly, our analysis does not depend on the magnitude of these costs and benefits, these of course could be debated. All that matters for purposes of our lingua franca hypothesis is that unfamiliarity cost increases with the number of out-of-state investors, and that this cost is sufficiently large that it may cause some firms which otherwise may have domiciled in their home state to instead select Delaware.

To illustrate this point assume that law quality equals eighteen for Delaware and equals twenty for Virginia. In other words, assume for argument's sake that Virginia offers higher quality corporate law than Delaware. Even with this assumption, the analysis below suggests that some firms may rationally choose to incorporate in Delaware for familiarity reasons.

Delaware has the highest franchise tax fees among U.S. states.<sup>51</sup> This cost differential is even greater for a firm headquartered outside Delaware choosing between Delaware and home-state domicile. In such case, if the firm incorporates in Delaware, in addition to paying Delaware franchise tax, the firm will also have to pay a foreign qualification fee to its home state and it will have to appoint an agent for service of process in Delaware. To capture this effect we assume that Delaware's franchise tax lowers net benefit by five, while Virginia's franchise tax only lowers net benefit by one.

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50. Our analysis does not depend on the magnitude of this cost. What matters is that the presence of an unfamiliarity cost decreases net benefit.

51. Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1218–25 (2001) (noting that especially for large publicly held firms, Delaware corporations pay higher franchise taxes).

Finally, we consider network externalities, both the network effects and learning effects previously discussed.<sup>52</sup> In our example, Delaware has a clear advantage. More than half of all publicly held businesses domicile in Delaware. This large network of Delaware firms reduces uncertainty in the interpretation of Delaware law and provides *Startup* with more case law—a large network means that more cases are litigated—and better availability of legal services in the future, particularly when compared to Virginia, where the incorporation network is considerably smaller. We assume *Startup* would receive a network externality benefit equal to four by incorporating in Delaware, and a benefit equal to one if it were to incorporate in Virginia.

TABLE 1: *STARTUP* SCENARIOS

# of out of state invstrs	state of inc.	quality of law	franchise tax	unfamiliarity cost	network extrnlty	net benefit
0	DE	18	-5	0	4	17
	Home	20	-1	0	1	20
1	DE	18	-5	0	4	17
	Home	20	-1	-2	1	18
2	DE	18	-5	0	4	17
	Home	20	-1	-4	1	16
3	DE	18	-5	0	4	17
	Home	20	-1	-6	1	14
4	DE	18	-5	0	4	17
	Home	20	-1	-8	1	12

Table 1 summarizes the above costs and benefit considerations for *Startup*. The first column lists the number of out-of-state investors financing *Startup*. The last column compares the net benefit of Delaware domicile to home-state domicile depending on the number of out-of-state investors. Each additional out-of-state investor decreases the net benefit of home-state domicile, but has no effect on the benefit provided by Delaware law. To illustrate, if *Startup* is financed entirely by in-state parties, it will likely incorporate in its home state (because  $20 > 17$ ). But if *Startup* receives financing from two or more out-of-state investors, it will likely switch to Delaware (because  $16 < 17$ ). Note that the number of in-state investors has no effect on the decision, since they are assumed to be equally familiar with both their home-state and Delaware law. By

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52. *Id.* at 1210.

contrast, the number of out-of-state investors matters greatly, because each lowers the net benefit of home-state domicile by two.

To be sure, we do not mean to imply that *all firms* with two or more out-of-state investors will domicile in Delaware, nor do we mean to suggest that *no firms* with less out-of-state investors will choose Delaware. There are certainly idiosyncratic reasons, captured by our error term  $\varepsilon$ , that may cause a specific firm to favor its home state over Delaware or vice versa. Rather, our point is simply that the relative benefit of Delaware as compared to home-state domicile increases with the number of out-of-state investors, and thus we would expect greater likelihood of Delaware domicile as the number of out-of-state parties financing a firm increases.

### C. Hypotheses

The above example illustrates several points. First, even though Delaware charges higher franchise tax fees and Delaware law is assumed to be of lower quality than Virginia,<sup>53</sup> Delaware may nonetheless provide a greater net benefit because these costs are counterbalanced by (i) out-of-state investors' unfamiliarity with Virginia law, and (ii) large positive network externalities associated with Delaware domicile.

Second, network benefits and widespread familiarity with Delaware law may help explain why the state can charge high franchise tax fees. In contrast to some authors who implicitly assume that Delaware's high franchise tax fees are evidence of its high-quality law,<sup>54</sup> our analysis suggests that network externalities and widespread legal familiarity give Delaware a type of monopoly power, allowing it to charge higher franchise tax fees than the inherent quality of its law might suggest.<sup>55</sup>

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53. Note if we instead assume that Delaware provides the same quality (or better) law than Virginia, the only change is that it takes less out-of-state investors to cause a firm to switch to Delaware. The unfamiliarity cost associated with home-state domicile remains a factor pushing firms toward Delaware and away from home-state domicile. Idiosyncratic reasons ( $\varepsilon$ ) may still cause some firms to domicile in their home state, even if Delaware's quality of law were set sufficiently high that the numeric example would suggest that Delaware has a higher expected net benefit than Virginia even absent out-of-state investors. The likelihood of Delaware domicile still increases relative to Virginia with the number of out of state investors.

54. Romano, *supra* note 8, at 231 (finding a correlation between the percentage of state franchise tax revenue to a state's total revenue and the state's legal innovativeness).

55. See Kahan & Kamar, *supra* note 41, at 1207 ("We argue that Delaware exploits its market power through price discrimination. Price discrimination involves charging



Third, the numeric example also helps explain the bimodal choice in selecting state of incorporation. If a business were to select anything other than (i) Delaware or (ii) home state domicile, the parties would likely encounter even larger unfamiliarity costs. Domiciling in a third state would mean that all parties, both in state and out, would likely be unfamiliar with the relevant law.

Fourth, the above example illustrates that familiarity is conceptually distinct from network benefits. The unfamiliarity cost term is based on the number of out-of-state investors financing *Startup*, while the network externality term is based on the total number of firms incorporated in the relevant state. Even if there are no out-of-state investors, and all parties are perfectly familiar with home-state law (in other words, *unfamiliarity cost* equals zero), Delaware corporate law still provides greater network benefits than the home state. By incorporating in Delaware, *Startup* would have access to more case law, better legal services, and could take advantage of drafting efficiencies from past use of Delaware law. These network benefits arise regardless of the familiarity of the specific investors providing financing.

Putting this altogether, our analysis yields testable predictions regarding investor familiarity and network externalities. Our investor familiarity hypothesis is as follows: the likelihood that a firm will incorporate in Delaware increases with the number of out-of-state investors financing the firm. The more out-of-state investors, the more likely such investors share in common only a familiarity with Delaware corporate law, as opposed to home-state law or third-state law. In short, Delaware law is needed as a lingua franca that investors from various states all “speak,” since they do not all speak home-state, or third-state, law.

Our hypothesis should be especially true if the out-of-state investors have not previously financed a firm incorporated in *Startup*'s home state. Investors who have previously financed a business incorporated in a third state, one that is neither the business party's home state nor Delaware, may gain some familiarity with that third state's law through their past experience. To illustrate, an investor from Texas may have previously financed a firm incorporated in California. In doing so, the investor may have learned a bit about California corporate law causing him to be more familiar with California than a typical out-of-state party. To be sure, the Texas investor may not be as familiar with California law as a party actually located in California, but he may have become sufficiently comfortable with California law that he is somewhat more willing to finance another

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different prices to different consumers according to their willingness to pay in order to increase profits.”).

firm domiciled in California in the future. To use our language metaphor, the investor may have working knowledge of California corporate law but not native-level fluency. This form of partial fluency suggests that some out-of-state investors—those with past exposure to the home-state law—may have less need for Delaware to serve as a lingua franca. Thus we can restate our lingua-franca hypothesis: All else being equal, the likelihood that a firm will incorporate in—or reincorporate in—Delaware as opposed to its home state increases with the number of out-of-state investors financing the firm, especially if such out-of-state investors have no past experience working with the firm's home-state corporate law.

Although our Article is focused on investor familiarity as a new explanation for Delaware's continued success in attracting corporate charters, our analysis also suggests a straightforward network effects hypothesis: All else being equal, the likelihood that a firm will incorporate in Delaware as opposed to its home state decreases with the total number of other firms incorporated in the firm's home-state. If the home-state also has a large network of incorporations, then the network benefit associated with Delaware will be somewhat less critical, because the home state also provides a meaningful network benefit.<sup>56</sup>

Importantly, our familiarity and network externality hypotheses run orthogonal to the leading explanation for Delaware's dominance to date—its substantive quality. Broadly this includes the merits and predictability of the Delaware General Corporation Law (DGCL) and its substantial case law,<sup>57</sup> the flexibility of that law,<sup>58</sup> and the expertise of the Delaware

56. The Model Business Corporation Act (MBCA) also provides a type of network benefit to the states that adopt it. By incorporating in a state that has adopted the MBCA, a firm can take advantage of a larger body of case law interpreting the MBCA code. See McDonnell, *supra* note 1, at 731 (“The MBCA makes it easier for states with limited resources and few corporations to update their corporate laws, a hard technical task. It thereby puts some more pressure on Delaware to improve its laws, as other states look more attractive than they would without the MBCA.”).

57. Kahan & Kamar, *supra* note 41, at 1212 (“Delaware boasts a well-developed corporate case law. Because many corporate disputes arise under Delaware law, Delaware's case law is more developed than the case law of other states.”).

58. EASTERBROOK & FISCHER, *supra* note 8, at 15 (most DGCL statutory provisions are only default provisions that can be overridden in corporate charters and bylaws); William T. Allen, *The Pride and the Hope of Delaware Corporate Law*, 25 DEL. J. CORP. L. 70, 71 (2000) (the DGCL is “kept evergreen by careful annual amendments,” continuously reflecting “its original commitment to private ordering, flexibility, predictability and fairness”); Omari Scott Simons, *Branding the Small Wonder: Delaware's Dominance and the Market*

Chancery Court and Delaware Supreme Court to hand down new decisions.<sup>59</sup> We attempt to test both Delaware's familiarity and, separately, its substantive virtues, to determine their relative importance in explaining Delaware's continued success in attracting incorporations.

### III. EMPIRICAL SUPPORT FOR FAMILIARITY

We now use data from our prior empirical study to test the familiarity and network externality hypotheses.<sup>60</sup> Data are from 1850 U.S. start-up firms financed by venture capital (VC).<sup>61</sup>

VC-backed start-ups provide a desirable empirical setting, as they exhibit heterogeneity regarding investor location.<sup>62</sup> Some VC-backed start-ups receive out-of-state financing, while others are funded primarily by in-state investors. Furthermore, because VC-backed start-ups are financed in stages,<sup>63</sup> there is also heterogeneity over time in the mix of in-state and out-of-state investors. For example, an early VC round may include only in-state investors, but in a subsequent round the same firm may receive funding from out-of-state VC investors. This variation allows us to test the importance of investor familiarity as a determinant of incorporation choice in our regression analysis.

It is difficult to think of another type of firm that exhibits the sufficient in-state versus out-of-state investor heterogeneity necessary to test a

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for *Corporate Law*, 42 U. RICH. L. REV. 1129, 1159 n.140 (2008) (crediting the "flexibility of the Delaware Model" as "leav[ing] room for economically useful innovation and creativity").

59. Kahan & Kamar, *supra* note 41, at 1212 (noting that the quality of its courts is "where Delaware really shines" and observing that "[m]embers of the [Chancery] court . . . have ample opportunity to develop expertise on matters of Delaware corporate law and have developed a national reputation for handling cases expeditiously"); McDonnell, *supra* note 1, at 703 ("[Delaware courts ''] are able to decide cases quickly and in a well-considered way.").

60. See generally Broughman, Fried & Ibrahim, *supra* note 13.

61. See *id.* at 871. Data were collected primarily from the VentureXpert database maintained by Thomson Financial to collect our data. For our parameters, we chose start-ups that received their first VC financing round during the three-year period from January 1, 2000, to December 31, 2002. Due to staged financing, choosing this early timeframe for the initial VC round gives the start-up time to obtain follow-on rounds in subsequent years before we collected our data. Importantly, while a start-up may begin by incorporating in one state, its domicile may be changed mid-stream by reincorporating into another state, often in connection with a new VC round. There may be selection bias in our timeframe given the dot.com bust of the late 1990s, but we hoped to capture start-ups initially funded after the bust and with sufficient time to reincorporate before we collected data. For more details on how the dataset was put together see our earlier paper. *Id.* at 871-72.

62. *Id.* at 868.

63. See Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 304 (2003) (discussing staged financing of VC-backed start-ups).

familiarity hypothesis. Public corporations, almost by definition, are largely owned by out-of-state investors. Conversely, closely-held lifestyle firms are mostly owned by in-state investors.<sup>64</sup> In fact, the difficulty of testing the familiarity hypothesis among non-VC-backed start-ups may explain its absence in the otherwise voluminous incorporations literature.

#### A. Summary of Dataset

Our sample, collected from VentureXpert, consists of U.S.-based start-ups that received their first VC financing round during the three-year period from January 1, 2000, to December 31, 2002, and received at least \$5 million in total VC financing.<sup>65</sup> We then used Lexis-Nexis public records data and the Delaware Secretary of State's webpage to match each start-up in our sample with incorporation records from the relevant secretary of state.<sup>66</sup> This gave us a sample of 1850 start-up firms.<sup>67</sup>

These 1850 start-ups each received, on average, \$36.8 million in VC financing—over 3.6 rounds of financing. Emphasizing the risk inherent in start-up firms, approximately one third of the firms in our sample had achieved a successful exit by 2008, either via an IPO or a merger & acquisition (M&A) sale. The remaining sample firms have either gone out of business or are active. Readers interested in more background on the firms in our database should see the original empirical paper.<sup>68</sup>

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64. Jens Dammann & Matthias Schündeln, *Where Are Limited Liability Companies Formed? An Empirical Analysis*, 55 J. L. & ECON. 741, 743 (2012); Dammann & Schündeln, *supra* note 28, at 84–85.

65. See Broughman, Fried & Ibrahim, *supra* note 13, at 871–72.

66. Broughman, Fried & Ibrahim, *supra* note 13, at 872 n.8 (“Lexis-Nexis public records data includes domicile data (via secretary-of-state filings) for locally domiciled firms of all states except Delaware. Information about Delaware domicile was obtained from (a) doing-business forms filed by Delaware-domiciled firms in their home states and (b) the Delaware’s Secretary of State webpage (<https://delecorp.delaware.gov/tin/GINameSearch.jsp>).”). Corporate law is more important to us than other business associations law such as limited liability company law, because VC-backed start-ups are generally organized as corporations. See Joseph Bankman, *The Structure of Silicon Valley Start-ups*, 41 UCLA L. REV. 1737, 1739–40 (1994); Victor Fleischer, *The Rational Exuberance of Structuring Venture Capital Start-ups*, 57 TAX L. REV. 137, 137 (2003).

67. Broughman, Fried & Ibrahim, *supra* note 13, at 871–72.

68. See generally *id.*

### B. Results: State of Incorporation

First, we found that the race for VC-backed start-up charters is a “bimodal” race between Delaware and the start-up’s home state.<sup>69</sup> Only a small percentage of start-ups in our sample chose to incorporate or reincorporate in a state that was not either Delaware or the start-up’s home state.<sup>70</sup> This result supports the prior literature claiming that national competition among states for incorporations is largely a myth.<sup>71</sup>

Second, in this bimodal race, Delaware beats the home state handily. Almost sixty-eight percent (67.8%) of start-ups chose Delaware as their initial state of incorporation, versus twenty-nine percent (28.7%) who chose their home state. Reincorporation figures are even more striking. A total of 212 firms in our sample changed legal domicile by reincorporating in connection with a new round of financing. When reincorporation occurs it is almost always into Delaware and away from the firm’s home state or another third state. Indeed, ninety-five percent of reincorporations—205 out of 212—in our sample were in Delaware.<sup>72</sup> When incorporations and reincorporations are combined to tally final state of domicile, 1457 start-ups—79% of the sample—chose Delaware. The particulars of these results are detailed in Table 2 below.

TABLE 2: STATE OF INCORPORATION (N=1850)

	Original Inc.		Final Inc.		Percent Change
	Count	(%)	Count	(%)	
Delaware	1254	(67.8)	1457	(78.8)	+11.0%
Home State	531	(28.7)	359	(19.4)	-9.3%
Other State	65	(3.5)	34	(1.8)	-1.7%

Third, out-of-state investors have more impact on choice of domicile than in-state investors. As seen in Tables 3 and 4 below, the likelihood of Delaware incorporation increases with the number of out-of-state VC investors. For example, in the first round [Table 3], firms receiving exclusively in-state financing incorporate in Delaware with 64% to 71% likelihood, compared to 72% to 82% for firms that received first round financing from two out-of-state investors. The effect is even more pronounced

69. This confirms Rob Daines’ findings in his study of IPO firms. Daines, *supra* note 17, at 1562.

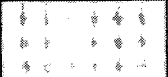
70. The third-state total domicile percentage was 1.8%. See *infra* Table 2.

71. See Kahan & Kamar, *supra* note 3, at 748.

72. See Romano, *Law as a Product*, *supra* note 8, at 226 (explaining that a large percentage of reincorporations go to Delaware).

in later round financing where “[m]oving from one out-of-state investor to four or more out-of-state investors is associated with an approximate 17% increase in the probability of Delaware incorporation.”<sup>73</sup> Adding out-of-state VCs suggests greater need for a lingua franca, and thus for Delaware corporate law. This result is consistent with our familiarity hypothesis.

TABLE 3: DELAWARE INCORPORATION IN FIRST-ROUND FINANCING

		Number of Out-of-State Investors			
		0	1	2	3+
Number of In-State Investors	0		73.4%	78.7%	93.1%
	1	63.6%	73.3%	82.0%	84.2%
	2	68.9%	81.2%	72.2%	87.5%
	3+	70.8%	79.5%	72.8%	100%

Percent Delaware Incorporation

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73. Broughman, Fried & Ibrahim, *supra* note 13, at 874.

TABLE 4: DELAWARE INCORPORATION IN FOLLOW-ON ROUND FINANCING

		Number of Out-of-State Investors				
		0	1	2	3	4+
Number of In-State Investors	0		77.6%	81.9%	79.8%	92.2%
	1	67.2%	72.1%	73.8%	82.6%	92.0%
	2	65.8%	71.1%	86.2%	83.8%	92.3%
	3	69.8%	79.2%	80.8%	81.5%	93.1%
	4+	66.0%	77.8%	77.6%	81.5%	94.4%
			Percent Delaware Incorporation			

By contrast, the number of in-state investors has little effect on choice of domicile. For example, in later round financing going from one to four or more in-state investors only increases the likelihood of Delaware incorporation by approximately 2%. Out-of-state VCs need Delaware because they are unfamiliar with home state law, whereas in-state investors have no similar need to incorporate in Delaware. In-state VCs are already familiar with both home-state law and with Delaware. Absent other considerations, in-state investors appear to be largely indifferent between Delaware and home-state law.<sup>74</sup>

*C. Results: Investor Familiarity and Network Externalities*

To test the familiarity and network externality hypotheses we estimate the likelihood of Delaware incorporation at the first round of VC financing:

$$Delaware = \alpha + \beta_i * [Familiarity\ Variables] + \beta_j * [Network\ Ext.\ Variables] + \beta * X + \epsilon$$

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74. See Tables 3 and 4.

In this equation  $\beta_i$  and  $\beta_j$  are coefficient estimates for variables used to measure investor familiarity and network externalities;  $X$  is a vector of other included control variables; and  $\varepsilon$  is the error term. *Delaware* equals one if the firm is incorporated in Delaware and zero otherwise.

For investor familiarity, our primary explanatory variable is *Out-of-State Investors*. We predict that the likelihood of Delaware incorporation will increase with the number of out-of-state investors. Next we define *Local Exposure* as the number of out-of-state investors who have previously financed a firm incorporated in the start-up's home state. Such investors have at least some familiarity with the local dialect—home-state law—and thus we predict that the likelihood of Delaware incorporation will decrease with local exposure.

As stated, network externalities do not depend on the specific investors providing financing, but rather on the total number of other firms incorporated in the state. To operationalize this, we define *State Inc. Count* as the total number of publicly held firms incorporated in the start-up's home state, and we predict that the likelihood of Delaware incorporation will decrease with *State Inc. Count*. Finally, we also record whether the start-up is located in a state that has adopted, at least in part, the Model Business Corporation Act (MBCA state). The MBCA provides a type of network benefit. By incorporating in a state that has adopted the MBCA, a firm can take advantage of a larger body of case law interpreting the MBCA code,<sup>75</sup> and thus we would expect less demand for Delaware if the start-up's home state has adopted the MBCA.

We also control for various firm-level and state-level variables that may affect a start-up's state of incorporation. The Appendix at the end of this Article defines all variables used in the regression analysis. Table 5 presents regression results, reporting logit marginal effects estimated with all variables at their mean values.

TABLE 5: STATE OF INCORPORATION AT THE FIRST  
ROUND OF VC FINANCING

This table reports marginal effects based on logit estimates evaluated at the mean of each variable. All variables are defined as of the first round of VC financing. The dependent variable is *Delaware*, which equals one if the firm was incorporated in Delaware, and zero otherwise. All

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75. See McDonnell, *supra* note 1, at 731.



explanatory variables are defined in the Appendix. Standard errors, clustered at the state level and calculated via the delta-method, are reported in parentheses to the right of each coefficient estimate. We use a two-sided test for statistical significance (\* = 10% and \*\* = 1% significance).

	Logit Marginal Effects (Dependent Variable = <i>Delaware</i> )			
	Model 1		Model 2	
<b>Familiarity Variables</b>				
<i>Out-of-State Investors</i>	.0872**	(.010)	.0812**	(.011)
<i>Local Exposure</i>	-.0594*	(.033)	-.0433	(.029)
<b>Network Ext. Variables</b>				
<i>State Inc. Count</i>	.0003	(.001)	-.0004	(.001)
<i>MBCA state</i>	.0382	(.098)	.0169	(.084)
<b>Other Control Variables</b>				
<i>In-State Investors</i>	.0127	(.011)	.0166*	(.009)
<i>Investment (\$M)</i>	.0018	(.001)	.0016	(.001)
<i>VC Reputation</i>	-.0026**	(.001)	-.0028**	(.001)
<i>Judicial Quality</i>			-.1263	(.134)
<i>Flexibility</i>			-.0646	(.056)
<i>Franchise Tax</i>			.0000	(.000)
<i>West of Mississippi</i>			-.1715**	(.061)
<i>Sector Dummies</i>	Yes		Yes	
<i>Year Dummies</i>	Yes		Yes	
Observations	1789		1789	
Pseudo R-squared	.063		.083	

### 1. Findings Related to Investor Familiarity

As shown in this new regression, Table 5, which was not included in our prior study, we find strong support for the familiarity hypothesis. In both Model 1 and Model 2 we find that each additional out-of-state investor increases the likelihood of Delaware incorporation by approximately eight to nine percentage points. This result is significant at the one percent level. We also find that when an out-of-state VC has previously invested in a home-state start-up, specifically, where Local Exposure equals one, the VC is more likely to accept future incorporations in that home state

over Delaware. These results show that once an out-of-state VC becomes familiar with a home state's law, it is more likely to use that law again in the future—this is exactly what our familiarity hypothesis predicts.

Beyond statistical significance, note that the magnitude of the familiarity effect is large. Most start-up firms incorporate in Delaware regardless if they receive out-of-state financing. For example, holding all other variables at their mean value, we find that firms with zero out-of-state investors still choose Delaware at their first round of financing with approximately 68% probability. However, if we increase the number of out-of-state investors from zero to two, the likelihood of Delaware incorporation rises to approximately 82% and the likelihood of home-state domicile nearly falls in half—from 32% to 18%.

Our finding regarding the importance of investor familiarity is robust to alternative econometric specifications and does not appear to be driven by unobserved heterogeneity, specifically, endogenous selection of firms that receive in-state versus out-of-state financing. In our prior study, we considered two identification strategies to address potential endogeneity concerns. First, we took advantage of the longitudinal variation in our data to see if the arrival of out-of-state investors in a follow-on round of financing caused firms originally incorporated in their home states to reincorporate in Delaware.<sup>76</sup> Using a first differences regression approach—designed to eliminate bias due to unobserved traits of each firm—we found that each additional out-of-state investor had a statistically significant impact on reincorporation, increasing the likelihood of reincorporation into Delaware by approximately four to five percentage points. Second, we used a VC fixed-effect regression model to isolate variation within each VC's portfolio of investments.<sup>77</sup> We found, consistent with familiarity, that a given VC is more likely to choose Delaware domicile when investing out-of-state than when the same VC invests in its home state.<sup>78</sup> Collectively, these findings from our prior study provide further support for the familiarity hypothesis. We refer interested readers to that article for further details.

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76. Broughman, Fried & Ibrahim, *supra* note 13, at 884–86.

77. *Id.*

78. *Id.* at 869.

## 2. Findings Related to Network Externalities and Substantive Law Quality

By contrast, we do not find a statistically significant result for network externalities. The coefficient estimates reported in Table 5 for both *State Inc. Count* and *MBCA State* are small in magnitude and insignificant. The fact that we control for network externalities in these regressions reaffirms our view that investor familiarity is an independent consideration causing firms to migrate to Delaware.

This does not, however, mean network externalities are irrelevant. There are at least two reasons that network externalities may still have an important impact on choice of domicile and do not show up in our regression results. First, as we have discussed,<sup>79</sup> familiarity is likely derivative of network effects at least in an historic sense. So, it may be that network effects originally caused investors and lawyers to become familiar with Delaware, but today familiarity appears to have an independent effect on choice of domicile.

Second, the regression analysis above only compares the relative network effect associated with states other than Delaware. Technically, the variable *State Inc. Count* looks at the number of publicly held firms incorporated in the start-up's home state. In our sample, however, there are no firms headquartered in Delaware, and consequently we are left comparing the network value of non-Delaware states. Put another way, our results suggest that the fact that more publicly held firms are incorporated in New York than, Virginia for example, does not give New York a significant network advantage relative to Virginia. It may be that no network other than Delaware is great enough to make any real difference. However, as with network externalities, although it was not a statistically significant result, we find that states with a high-quality judiciary and more flexible corporate law are somewhat more likely to retain their in-state start-ups.<sup>80</sup> These results are consistent with Marcel Kahan's study of public firms.<sup>81</sup>

The only other variables with statistically significant effects on incorporation choice are VC reputation and West of the Mississippi.<sup>82</sup> We find that start-

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79. See *supra* notes 27–28 and accompanying text.

80. The lack of statistical significance here may be due to the fact that we cluster our standard errors at the state level, making it more difficult to find significant results for such state-level variables.

81. Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 340, 341 (2006).

82. Although not reflected in this Table, in our other paper we found that VCs represented by national law firms are more likely to have the start-ups they fund incorporated in Delaware. This is consistent with Daines's prior work. Daines, *supra* note 17, at 1604. This result does not necessarily go against a familiarity explanation, however. For national law firms, Delaware may be the only corporate law familiar to all the firm's

ups financed by older, more reputable VC firms are less likely to incorporate in Delaware, and start-ups headquartered west of the Mississippi River are also less likely to incorporate in Delaware. This does not mean that other explanations for incorporation choice are not meaningful or accurate. This issue is addressed further in Part III, Section 3 below.

### 3. *Lingua Franca or Signaling?*

Finally, it could be that business parties are choosing Delaware law not because it serves as a lingua franca, but to signal something about the start-up. While familiarity gets at a party's *internal* reasons for choosing Delaware because *they* know it, signaling would look at the party's *external* reasons for choosing Delaware because *others* know it. A party might favor Delaware incorporation because it brands the start-up as high-quality. In this sense, signaling is akin to network externalities. Signaling and network externalities both focus on other users. But while network externalities are concerned with other firms in the network, signaling is concerned with the investors in those firms.

While we could not determine a suitable way to test a signaling hypothesis using our data, it is certainly possible that parties chose Delaware in an attempt to signal their corporate quality. However, as a theoretical matter, several factors cut against a signaling explanation for Delaware's dominance. First, if signaling was the primary story, start-ups funded by mostly in-state VCs would mostly need that signal to combat their regionalness. Yet these start-ups are more likely to choose home-state domicile than Delaware domicile. Second, Michal Barzuza suggests that Delaware law, which is neither the laxest or strictest corporate law, provides at best a "noisy" signal to investors, not a strong, positive one.<sup>83</sup> Third, a signal must be costly to be effective, and Delaware incorporation is not significantly costly for private firms due to the way franchise taxes are calculated

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attorneys, who hail from multiple offices in different states. Conversely, regional firms have less heterogeneity in lawyer location, and thus all of their lawyers are more likely to know local law. Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 976 (2012) ("Local lawyers tend to advise the firms they represent to incorporate in their home states. National firms, on the other hand, tend to recommend incorporation in Delaware."); McDonnell, *supra* note 1, at 712 (it may be "that lawyers in smaller firms servicing smaller businesses are less familiar with Delaware and more familiar with local law")

83. Barzuza, *supra* note 67, at 968–70 (noting that in contrast to Delaware, Nevada's corporate law provides a stronger signal of laxity).

there.<sup>84</sup> Although Delaware franchise taxes are costly for public corporations, they are smaller for private start-ups.<sup>85</sup> Finally, the entrepreneurship literature suggests that there are better signals for start-up quality than legal domicile, including patent portfolios and willingness to give the VCs preferred stock as opposed to the entrepreneur's common stock.<sup>86</sup>

#### IV. IMPLICATIONS

We find that business parties choose Delaware corporate law for its familiarity as much as for its quality. We do not suggest that the two—familiarity and substantive virtues—are mutually exclusive. Delaware law likely became familiar to parties due to its high quality, and thus more frequent use. The same is true of network externalities. But familiarity as an alternative, independent explanation of Delaware's dominance, leads to interesting potential ramifications. In this Part we examine the normative implications of our familiarity explanation, a topic left largely unaddressed in our prior empirical paper.

##### *A. Normative Implications of Delaware's Familiarity: Positives*

###### *1. Lowering Transaction Costs of Financing*

The most important advantage of Delaware's familiarity is its ability to lower transaction costs when investors fund start-ups. Delaware's advantage in lowering transaction costs for public corporations has been observed by Marcel Kahan and Ehud Kamar, who note that “[t]he extensiveness and familiarity of Delaware case law reduces the cost of planning transactions for Delaware corporations, obtaining legal advice for them, and assessing their value.”<sup>87</sup> More in tune with our focus on firm financing, Klausner observes that Delaware's superior ability to provide judicial interpretation of legal terms may reduce a corporation's cost of capital.<sup>88</sup>

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84. See Kahan & Kamar, *supra* note 41, at 1223, 1227 (finding that Delaware assesses minimal franchise taxes on non-public corporations, as low as \$30 per year).

85. See *id.* Of course, incorporating in Delaware is more costly than incorporating in home state, as previously discussed. See *supra* note 41 and accompanying text.

86. See Darian M. Ibrahim, *Financing the Next Silicon Valley*, 87 WASH. U. L. REV. 717, 750 (2010) (“[P]rivate VCs look to a start-up's patent portfolio as a proxy for its quality.”); *id.* at 751–52 (“By selling preferred stock to private VCs while holding common stock themselves, entrepreneurs signal their belief that the value of the start-up will exceed the amount of the VC's preference.”).

87. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 725 (2002).

88. Klausner, *supra* note 20, at 777 (Delaware's superior ability to judicially interpret terms “may be reflected in a firm's cost of capital”). In scholarly work on contracting more generally, Kahan and Klausner note that the benefits of using standard terms in contracts

### a. Reducing Legal Costs

While most start-up firms are unable to attract VC financing,<sup>89</sup> those that do are under considerable pressure to keep the cost of legal representation low.<sup>90</sup> If a start-up firm has to spend thirty thousand in legal fees to raise only three million, the lawyers just took one percent of the investors' expected returns.<sup>91</sup> For cash-strapped start-ups, spending precious cash on legal fees—as opposed to research and development (R&D), is an unwelcome development.<sup>92</sup>

Of course, the lawyers feel a competing pressure to design a sophisticated private financing contract using preferred stock with complicated cash flow contingencies. Doing sophisticated legal work, at a very low cost, can be one of those difficult requests that clients make of lawyers. There will be plenty of contingencies in the financing that will require the lawyer's time and expertise. The body of law to govern the start-up should generally not be one of them. Therefore, by choosing to incorporate in Delaware, the lawyer has removed one source of uncertainty that could require her time and has a better chance of accomplishing her dual objectives—a high-quality legal product, yet at a low cost to the client.

### b. Menu-Based Contracting

Another way to see how Delaware's familiarity reduces transaction costs is to consider Delaware law under the “menu” approach to contracting.<sup>93</sup>

include efficiency, reduced uncertainty, and general understanding among “lawyers, other professionals, and the investment community.” Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting*, 83 VA. L. REV. 713, 719–20 (1997). The authors liken a commonly understood term to “the use of standard weights and measures for physical products—they reduce the cost of comparison.” *Id.* at 723 n.25.

89. Ibrahim, *supra* note 12, at 1428 (noting that VCs fund only 1–3% of the proposals they receive).

90. Fred Wilson, *A Challenge to Startup Lawyers*, AVC BLOG (Mar. 23, 2011), <http://avc.com/2011/03/a-challenge-to-startup-lawyers/> [<http://perma.cc/T54T-SP3C>] (urging start-up lawyers to do early round financing deals for \$5,000 or less).

91. See Bengtsston & Bernhardt, *supra* note 19, at 397. The investor's lawyer will charge more to do legal work using an unfamiliar body of corporate law.

92. See John S. Dzienkowski & Robert J. Peroni, *The Decline in Lawyer Independence: Lawyer Equity Investments in Clients*, 81 TEX. L. REV. 405, 430 n.19 (2002) (asserting that start-ups would prefer to dedicate their cash to R&D over legal fees).

93. Ian Ayres, *Menus Matter*, 73 U. CHI L. REV. 3, 3 (2006); Yair Listokin, *What Do Corporate Default Rules and Menus Do? An Empirical Examination*, 6 J. EMPIRICAL LEGAL STUD. 279, 288 (2009).

Menus of contract choices lower transaction costs by providing parties with bundled alternatives that work together without the parties having to explicitly contract for them. For example, Delaware offers a traditional corporation statute and a close corporations statute.<sup>94</sup> Due to its widespread familiarity, Delaware's menu of choices resembles a McDonald's menu. No matter where you are in the United States, you know the menu at McDonald's. This makes ordering quicker, and perhaps, is what attracted you to visit there to begin with.<sup>95</sup> By contrast, a third state's law offers the equivalent of a local restaurant's menu, which is unfamiliar to anyone from out-of-town.

Menus also reduce choices once you choose to eat at a restaurant.<sup>96</sup> The menus offer bounded rationality to the parties' choices of options.<sup>97</sup> Pivoting back to corporate law, Delaware's section 102(b)(7) essentially allows companies to choose between two standards of directors' monetary liability for breach of fiduciary duty—gross negligence or bad faith.<sup>98</sup> Finally, menus lower transaction costs by offering a delegated third party—in our case, the Delaware legislature—that can change outdated rules in an efficient manner, rather than the parties having to revisit their contracts and do this themselves.<sup>99</sup> Delaware's well-known menu reduces transaction costs, including legal fees, and thereby lowers a start-up's cost of capital.

## 2. *Reducing Asymmetric Information*

Delaware's familiarity can also reduce contracting problems caused by one party operating at an informational advantage. While investors may be generally reluctant to negotiate an investment if they are unfamiliar with the relevant body of corporate law, they may be especially concerned if entrepreneurs incorporate in a state that the entrepreneurs, or their legal

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94. See Listokin, *supra* note 78, at 288 (conceptualizing Delaware's anti-takeover provisions as a menu option).

95. Listokin has previously noted the tie between the menu idea and network externalities. *Id.* at 285 ("Menus also create a focal point that engenders the formation of a network effect, which also reduces transaction costs.")

96. Listokin distinguishes these transaction costs—lowering benefits with the traditional mandatory versus enabling statute discussion. *Id.* at 284 ("The difference in initial transaction costs between opting in and opting out of a statute is minimal. Therefore, the large difference in outcomes between companies incorporated in opt-in versus opt-out states is inconsistent with the transaction-cost minimization theory of corporate enabling law.")

97. Daniel M. Hausermann, *The Case Against Statutory Menus in Corporate Law*, 9 HASTINGS BUS. L.J. 45, 67 (2012).

98. Del. Code. Ann. Tit. 8, § 102(b)(7), *see also supra* note 83 (describing 102(b)(7) as the "most famous of all corporate law menus").

99. Listokin, *supra* note 78, at 284–85.

advisors, are familiar with, but the investors are not. In this case, the entrepreneurs could use their informational edge to take advantage of the investors.

For example, an investor from the East Coast may acquiesce to a Silicon Valley entrepreneur's request for California law. The investor may later be surprised to learn of California law's separate class vote for common stock—as opposed to voting with the preferred—which gives entrepreneurs holdup value in sale of the start-up. One of us has empirically found that this holdup power facilitated by California law allows entrepreneurs to extract more sale proceeds than they are contractually entitled to, reducing the investor's share.<sup>100</sup> This example illustrates why, if asked to fund a start-up domiciled in an unfamiliar state, the investors are likely to demand a lower price for the firm's shares.

## *B. Normative Implications of Delaware's Familiarity: Negatives*

### *1. Suboptimal Tipping*

The primary downside of Delaware's familiarity advantage is that Delaware law will still be chosen even if it is not objectively the best law for the transaction at hand. Klausner suggests that even if there is a race to the top for corporate charters, "Delaware may have already won without getting to the top—and it may never have to get there."<sup>101</sup> As a simple example, if five out of ten corporations would choose to incorporate in Delaware because of its superiority, but another four choose it not because it is better but because they are familiar with it, Delaware has increased its lead in the incorporations race without improving its law. In a world without a familiarity advantage, Delaware would have to improve its corporate law to attract the additional corporations. But in the real world with familiarity at play, Delaware law can remain stagnant and the state

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100. Brian J. Broughman & Jesse M. Fried, *Renegotiation of Cash Flow Rights in the Sale of VC-Backed Firms*, 95 J. FIN. ECON. 384, 392–93 (2010).

101. Klausner, *supra* note 20, at 842.



will still nab the extra charters.<sup>102</sup> Brett McDonnell describes this possibility as locking in a suboptimal corporate law regime.<sup>103</sup>

While familiarity can reduce transaction and agency costs and thus the firm's cost of capital, it may also lock in inefficient laws.<sup>104</sup> To put it differently, "[c]lassical economic theory presumes that economies of scale at some point become diseconomies of scale."<sup>105</sup> This is the "suboptimal tipping" concern.<sup>106</sup> Even worse than causing stagnation in Delaware law, suboptimal tipping may allow Delaware to take harmful steps and not suffer the consequences. Delaware may "benefit from offering law that protects and exploits its market power."<sup>107</sup> Delaware could begin extracting rents in the form of franchise taxes when chosen for familiarity over substance.<sup>108</sup>

Delaware may also offer law that is overly indeterminate. A lack of clarity requires more litigation—benefiting Delaware lawyers and courts—and makes Delaware's body of law more difficult to copy.<sup>109</sup> There may also be suboptimality in other states' corporate laws, as Delaware's familiarity advantage gives them little incentive to innovate.<sup>110</sup>

## 2. Path Dependence and Increased Switching Costs

We previously theorized about familiarity's close relationship to network effects and learning effects, both of which are positive reasons for firms

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102. But see the case of Delaware's disastrous decision in *Smith v. Van Gorkom* and other states' first move to eliminate director liability for breach of the duty of care. James J. Hanks, Jr., *Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification*, 43 BUS. LAW. 1207, 1209 (1988) (reporting that the first state to pass a law allowing director relief from duty of care breaches was Indiana in April 1986, followed by Delaware two months later in June 1986); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 754 (1987) (studying corporate adoption of 102(b)(7) provisions after passage of the statute and finding, on the basis of event studies, no significant stock price reaction).

103. McDonnell, *supra* note 1, at 709.

104. Kahan & Klausner, *supra* note 73, at 721 (observing that sometimes a term might be selected for familiarity with that term even if the term is suboptimal).

105. Lemley & McGowan, *supra* note 24, at 596.

106. We borrow this terminology from Klausner. See Klausner, *supra* note 20, at 789.

107. Kahan & Klausner, *supra* note 73, at 739.

108. Barzuza, *supra* note 67, at 968; Kahan & Kamar, *supra* note 41, at 1227. See also McDonnell, *supra* note 1, at 709 ("Corporations will be reluctant to switch to other states because of the network and learning effect advantages of being in Delaware, and so Delaware will be able to impose significant costs on those companies.")

109. Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1071 (2000); McDonnell, *supra* note 1, at 696–97.

110. Klausner, *supra* note 20, at 850 ("Network externalities . . . may lead states to copy Delaware law rather than attempting to serve [corporations that would benefit from a different corporate law].").

to incorporate in Delaware. However, familiarity could also be seen as having elements of path dependence, or the “tendency of history to influence present decision making.”<sup>111</sup> Path dependence includes consideration of the sunk costs of the original path, making a new path more costly to undertake.<sup>112</sup> It follows that even if Delaware law becomes suboptimal, path dependence will be a reason for parties to continue to choose it. Because of path dependence, the switching costs of choosing to incorporate in another state are high.

Switching costs lock a party into a choice that everything else equal, they would not prefer, but given the costs of switching, they accept.<sup>113</sup> Switching costs can be inherent or strategic. Inherent strategic costs “arise from the nature of the product(s) or market.”<sup>114</sup> Strategic switching costs are choices that parties make to increase switching costs beyond their inherent nature.<sup>115</sup> Incorporating in an unfamiliar state presents both inherent and strategic switching costs. Inherently, firms that incorporate in an unfamiliar state are faced with unknown corporate law provisions; strategically, Delaware has been said to make its laws more difficult for other states to copy through its case law,<sup>116</sup> which increases switching costs beyond their inherent nature.

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111. Lemley & McGowan, *supra* note 24, at 597. See also Oona A. Hathaway, *Path Dependence in the Law: The Course and Pattern of Legal Change in a Common Law System*, 86 IOWA L. REV. 601, 604 (2001) (arguing history matters to where we are at present).

112. See Mark J. Roe, *Chaos and Evolution in Law and Economics*, 109 HARV. L. REV. 641, 643–44 (1996) (discussing a winding road created for period-specific and inefficient reasons that persists despite the possibility of a more efficient straighter road now).

113. Aaron S. Edlin & Robert G. Harris, *The Role of Switching Costs in Antitrust Analysis: A Comparison of Microsoft and Google*, 15 YALE J.L. & TECH. 169, 176 (2012) (“‘Lock-in’ is defined as switching costs that are sufficiently high so that buyers stay with a current supplier rather than switch to a supplier whose product they consider to be preferable (or, alternatively, that the costs of switching suppliers exceed the benefits of switching.”).

114. *Id.*

115. *Id.*

116. See *supra* note 94 and accompanying text; William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1, 11–18 (2009) (observing the indeterminacy of Delaware law).

As Kahan and Klausner observe, switching costs are higher when network externalities are present.<sup>117</sup> When network externalities and familiarity are present, switching costs are even higher. Thus, incorporating outside of Delaware involves substantial switching costs, which could exacerbate suboptimal tipping.<sup>118</sup> Domiciling outside of Delaware is more like moving away from the Microsoft operating system embedded in most computers than moving away from the Google search engine—which involves only the click of a button.<sup>119</sup>

### C. How Other States Might Still Compete With Delaware

Kahan and Kamar, as well as Bebchuk and Hamdani, have argued that there is in fact very little competition with Delaware for incorporations.<sup>120</sup> Kahan and Kamar attribute this lack of competition to a combination of weak economic incentives and political constraints. On the economic side, they observe that “[o]ther than Delaware, no state structures its taxes to gain from incorporations or stands to reap substantial benefits from legal business by attracting incorporations.”<sup>121</sup> On the political side, they note that no state has sought to replicate Delaware’s Chancery Court with a dedicated corporate law court with appointed judges and no juries. They persuasively argue that this lack of imitation is politically driven by pointing to Pennsylvania, where labor unions and public interest lawyers opposed a bill to mimic Delaware courts because they prefer local juries to hear their cases.<sup>122</sup> Likewise, Bill Carney observes that politics may cut against competition with Delaware: “The political benefits to individual legislators of sponsoring arcane legislation such as corporate law changes must be small, if they exist at all.”<sup>123</sup>

Some states claim to compete for national incorporations, including North Dakota, Nevada, and Maryland. However, these claims are probably tepid or misnomers at best. North Dakota has tried to offer a shareholder-

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117. Kahan & Klausner, *supra* note 73, at 727 (“When internal learning or network benefits are present, they result in ‘switching costs’ which may induce a firm to adopt the same term repeatedly in different documents.”).

118. *Id.* at 729 (“[T]he presence of switching costs affects the degree to which network externalities may result in suboptimal contracting.”).

119. Edlin & Harris, *supra* note 98, at 172–73.

120. Kahan & Kamar, *supra* note 3, at 684–85; *see also* Bebchuk & Hamdani, *supra* note 4, at 578.

121. Kahan & Kamar, *supra* note 3, at 687; *see also* William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 719 (1998) (“Revenues from chartering corporations do not represent a significant income source for most large welfare states to motivate them to write laws to attract chartering business.”).

122. Kahan & Kamar, *supra* note 3, at 733–34.

123. Carney, *supra* note 106, at 719–20.

friendly alternative to Delaware's perceived management-friendly corporate law.<sup>124</sup> So far, this has not been successful.<sup>125</sup> Also, while Nevada and Maryland have been somewhat more successful in the national race, a closer look reveals that they are each competing for specialized corporations that Delaware does not serve. Nevada is pursuing close corporations seeking a lax corporate law,<sup>126</sup> while Maryland is catering to investment trusts, which may not even be organized as corporations, and specifically real estate investment trusts (REITs).<sup>127</sup>

Therefore, states probably provide little effective national competition to prevent Delaware from the point of suboptimal tipping. A more effective means of state competition may come from states trying to keep their own incorporations at "home." Roberta Romano has most prominently suggested that states engage in this "defensive competition."<sup>128</sup> Romano finds a correlation between a state's franchise tax revenues and responsiveness on four corporate law innovations.<sup>129</sup>

Kahan and Kamar debate whether this defensive competition occurs, and the incentives for it to occur.<sup>130</sup> Carney, on the other hand, observes that defensive competition may occur because local lawyers benefit from it.<sup>131</sup> Because local lawyers specialize in the corporate law of their home state, they face little competition from out-of-state lawyers, who are unfamiliar with home-state law.<sup>132</sup> There may be spillover advantages to

124. Martha Graybow, *Delaware Beware: North Dakota Wants Your Business*, REUTERS, Apr. 25, 2007, <http://www.reuters.com/article/domesticNews/idUSN2543618020070425> [<http://perma.cc/V5NE-BW9K>].

125. See generally Stephen M. Bainbridge, *Why the North Dakota Publicly Traded Corporations Act Will Fail*, 84 N.D. L. REV. 1043, 1045–47 (2008) (enumerating the reasons why North Dakota's gambit will not succeed).

126. Kahan and Kamar, *supra* note 3, at 717; Barzuzu, *supra* note 67, at 940–41.

127. Kahan and Kamar, *supra* note 3, at 721–22 (discussing Maryland's investment trust business).

128. Romano, *supra* note 43, at 226.

129. *Id.* at 233, 239.

130. Kahan and Kamar, *supra* note 3, at 699–700.

131. Carney, *supra* note 106, at 722–23. Macey and Miller also observed a similar local-bar influence on Delaware corporate law. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 472, 522–32 (1987).

132. Carney, *supra* note 106, at 723 ("By specializing in the law of their own state, local lawyers can generally limit competition for services for their locally incorporated clients to members of the local bar.").

local communities from keeping entrepreneurial firms home.<sup>133</sup> However, it is unclear to what extent home-state competition actually keeps Delaware from suboptimally tipping. As noted in our dataset, Delaware wins the bimodal race with home states by a wide margin.<sup>134</sup> On the other hand, states with better corporate laws tend to keep more of their own chartering business.<sup>135</sup>

*D. Even Without Effective State Competition, Will Delaware Law Become Suboptimal?*

The previous Section argued that states may have some incentives to compete with Delaware, either for specialized national firms as Maryland has with REITs, or more likely, to retain in-state incorporations. This Section argues that the federal government may be more effective in pressuring Delaware to offer high-quality corporate law than Delaware's state competitors.

In important work, Mark Roe has argued that Delaware still faces pressure from federal authorities including Congress, the Securities and Exchange Commission, federal courts, and the securities exchanges.<sup>136</sup> Congress's 1934 Securities and Exchange Act, and the Securities and Exchange Commission rules since, give the federal government control over a key issue in corporate governance—shareholder voting.<sup>137</sup> Congress likewise took a major step to governing corporate officer conduct in the Sarbanes-Oxley Act of 2002.<sup>138</sup> In a similar vein, Robert Thompson and Hillary Sale have observed that securities law, a federal statutory regime, has come to consume some traditional items in corporate governance—

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133. One of us has discussed these spillover advantages in retaining home-state startups. See Darian M. Ibrahim, *Should Angel-Backed Start-ups Reject Venture Capital?*, 2 MICH. J. PRIVATE EQUITY & VENTURE CAP. L. 251, 264–65 (2013). However, spillover effects such as job creation, tax revenues, etc., are related to a firm's *physical* presence in a state, not its legal domicile. The spillover effects from legal domicile primarily benefit local lawyers.

134. See *supra* notes 58–60 and accompanying text.

135. Roberta Romano, *Law as a Product*, *supra* note 8, at 225, 258–60. Daines made a similar finding in his Article on IPO firms. Daines, *supra* note 17, at 1600.

136. Roe, *Delaware's Competition*, *supra* note 7 at 598–600.

137. *Id.* at 611 (“The wide SEC regulation of shareholder proxies determines” most aspects of shareholder voting, including proxy fights).

138. 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, 790 (2004) (“The enactment of Sarbanes-Oxley and related rules propelled federal law to its current position as the dominant regulator of officer conduct.”).

the states' traditional territory.<sup>139</sup> Periodically calls for federal incorporation also spring up, most recently after the financial crisis of 2008–2009.<sup>140</sup> Therefore, Delaware may be prevented from suboptimal tipping by federal pressure, if not pressure from other states. These are all speculations, and more work needs to be done to determine if and when Delaware law might suboptimally tip.

## V. CONCLUSION

As one Silicon Valley VC lawyer told us: “VCs don’t want to learn the corporate-law rules of a new state. Everyone knows [the] Delaware rules, whereas states like Washington and Minnesota might have weird dissenter rights, so why bother?”<sup>141</sup>

This lawyer’s statement nicely captures the main contribution of this Article. That is, while Delaware may have taken the lead in the corporate chartering race by being superior to its rival states, it has remained on top more for its familiarity investors than for its superiority. Our Article first outlines the familiarity theory as a theoretical matter, distinguishing familiarity from the economic concept of network externalities. Next we empirically document that familiarity trumps both substantive quality and network externalities in explaining why firms domicile in Delaware.

The normative implications of our familiarity findings are both positive and negative. Familiarity is a positive because it reduces the transaction and agency costs of financing a firm and thus the firm’s cost of capital. However, at some point Delaware law may suboptimally tip and continue to be chosen even if it offers worse law than other states. This would enable Delaware to extract rents through increased franchise taxes.

When the tipping point to suboptimal law is reached is an open question. Empirical work finds that Delaware firms are worth more than firms incorporated elsewhere,<sup>142</sup> suggesting that Delaware is still producing

139. Robert B. Thompson & Hillary A. Sale, *Securities Fraud as Corporate Governance: Reflections on Federalism*, 56 VAND. L. REV. 859, 860–61 (2003); Thompson, *supra* note 123, at 784–85.

140. See, e.g., George W. Dent, Jr., *For Optional Federal Incorporation*, 35 J. CORP. L. 499, 501 (2010) (stating that the “current economic downturn” has revealed more problems with state incorporation).

141. Interview by Brian Broughman & Jeffery Ibrahim with Anonymous, notes on file with Authors.

142. Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 527 (2001); see also Romano, *Law as a Product*, *supra* note 8.

superior corporate law despite its familiarity advantage. Other work disputes this conclusion.<sup>143</sup> We have suggested possible reasons why Delaware remains in check despite its familiarity advantage, including the fact that states still have some incentive to compete for either specialized national firms or to retain their home-state corporations, and that the federal government is keeping Delaware in check.

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143. Carney, Shepherd & Bailey, *supra* note 11, at 127–28.

## VI. APPENDIX: VARIABLE DEFINITIONS FOR TABLE 5

Variable Name	Definition
<i>Delaware</i>	equals one if the firm is incorporated in Delaware, and zero otherwise;
<i>Out-of-State Investors</i>	the number of out-of-state investors participating in the round;
<i>Local Exposure</i>	the number of out-of-state investors participating in a financing round that have previously financed a firm within the sample of 1850 start-ups that is incorporated in the start-up's home state;
<i>State Inc. Count</i>	the number of publicly held firms incorporated in the start-up's home state.
<i>MBCA state</i>	equals one if the firm is located in an MBCA state, and zero otherwise;
<i>In-State Investors</i>	is the number of in-state investors participating in the round;
<i>Investment (\$M)</i>	equals the amount of financing received in the new round (in millions of dollars);
<i>VC Reputation</i>	equals the average age, as of 2010, of the VC firms participating in a round of financing
<i>Judicial Quality</i>	the Chamber of Commerce 2001 score for each state's judicial quality
<i>Flexibility</i>	an index variable (0 to 4) measuring how much flexibility a state's corporate law provides for firms to design their governance arrangements <sup>144</sup>
<i>Franchise Tax</i>	equals the sum of the home state's initial incorporation fee and its annual franchise tax and/or annual report fee, minus the sum of the home state's foreign qualification fee and its annual foreign report fee, based on tax rates as of 1/1/2000 and an assumption of 100,000 shares outstanding (par value = \$.001/share)
<i>West of Mississippi</i>	equals one if the firm is located in a state located west of the Mississippi River, and zero otherwise.

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144. The index scale for *Flexibility* is defined in Kahan, *supra* note 81, at 343–44.



