# Nevada and the Market for Corporate Law

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## I. INTRODUCTION

Berle and Means altered the direction of debate on corporate governance by presenting evidence to suggest the owners of corporations did not in fact control their corporations.[1] In Berle and Means's view, the shareholders were too dispersed and uncoordinated to effectively exercise control so that power devolved to the non-owner agents charged with managing the firm.

An important implication of Berle and Means's book is that the states could not be trusted to continue to regulate corporate governance. If managers control their corporations, then they also effectively choose the law that regulates corporate governance because the law of the state where the firm chooses to incorporate governs the relationship between the managers, the shareholders, and the corporation.[2] It is not surprising that Berle and Means's work influenced the development of New Deal legislation,[3] including the Federal Securities Act of 1933[4] and the Securities Exchange Act of 1934,[5] the first federal laws regulating corporate governance. Stigler and Friedland note that "Samuel Rayburn, chairman of the House Commerce Committee, presented the 1933 bill in language

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1. *See* ADOLF A. BERLE, JR. & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

2. *See* RESTATEMENT (SECOND) OF CONFLICT OF LAWS, §§ 304, 307 (1971).

3. *See generally* William W. Bratton & Michael L. Wachter, *Shareholder Primacy's Corporatist Origins: Adolf Berle and the 'Modern Corporation,'* 34 J. CORP. L. 99 (2008) (discussing the influence of Adolf Berle, as well as Berle and Means's book, on New Deal legislation generally).

4. Federal Securities Act of 1933, 15 U.S.C. §§ 77a–77z, 77aa.

5. Securities Exchange Act of 1934, 15 U.S.C. §§ 78a–78z, 78aa–78pp.

that could have been, and in a sense was, provided by Berle and Means."[6]

> Where the stock is widely distributed, as in the case of so many American corporations, the officials of the company, through the use of proxies and the advantage they have in obtaining proxies, are able to continue in office without much regard to their efficiency . . . . Two hundred companies own 75 percent of the total wealth of the United States.
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> The management of these big corporations, as a rule, own an insignificant percentage of the outstanding voting stocks.[7]

The link between Berle and Means and the distrust of state law is also evident in Justice Louis Brandeis's famous 1933 dissent in *Louis K. Liggett Co. v. Lee*:

> The typical business corporation of the last century, owned by a small group of individuals, managed by their owners, and limited in size by their personal wealth, is being supplanted by huge concerns in which the lives of tens or hundreds of thousands of employees and the property of tens or hundreds of thousands of investors are subjected, through the corporate mechanism, to the control of a few men. Ownership has been separated from control; and this separation has removed many of the checks which formerly operated to curb the misuse of wealth and power . . . . Such is the Frankenstein monster which states have created by their corporation laws.[8]

These ideas have retained a powerful hold on the popular and scholarly imagination. More than forty years after Berle and Means, William Cary denounced U.S. corporate law as a race to the bottom, with Delaware as the "bottom," where managers could use their power over the demand side of the market to determine the nature of the law supplied by the leading incorporation jurisdiction.[9] Cary's assertion that Delaware could win incorporation business by attracting selfish managers and ignoring shareholders has provided a powerful basis for federalization of corporate law.

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6. *See* George J. Stigler & Claire Friedland, *The Literature of Economics: The Case of Berle & Means*, 26 J.L. & ECON. 237, 243 (1983). They also note, however, "the presumption is that the book was at most a most minor influence on the formulation and passage of the security acts." *Id.*

7. *Id.* (citing 4 THE ECONOMIC REGULATION OF BUSINESS AND INDUSTRY 2615–16 (Bernard Schwartz ed., 1973)). They also note that the "two hundred corporations language," contained in Berle and Means's book, reappeared in President Roosevelt's letter to Rayburn asking for the Securities Exchange Act of 1934. *Id.*

8. Louis K. Liggett Co. v. Lee, 288 U.S. 517, 564–67 (1933) (footnotes omitted).

9. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

In the eighty years since the publication of Berle and Means's book, other ideas have risen to challenge its assumptions. Although the logic that the dispersed many are weaker than the concentrated few may seem compelling, the logic breaks down when one considers the market forces that discipline corporate governance.[10] Corporate executives have nothing to manage unless their firms can attract investments in highly competitive capital markets. Investors who are at the mercy of corporate managers will demand a discount to reflect potential cheating. It follows that the firms that can best protect their owners from cheating can raise money at the lowest cost.[11] In other words, managers must pay investors for permission to cheat them. Investors can determine the likelihood of cheating from firms' disclosures about their managers and business. If investors cannot trust firms' disclosures, they will charge an additional discount to reflect the risks imposed by poor information.[12] In short, efficient securities markets discipline managers.

This logic extends to state law. Even if managers can choose the governing state, they will pay a price for choosing a law that ignores shareholders' interests.[13] Contrary to the assumption that Delaware is the "bottom" in the competition for corporate law, evidence developed in connection with the competing corporate finance thesis shows that investors actually pay more for firms that are incorporated in Delaware.[14]

Many scholars continue to share Cary's skepticism that Delaware's dominance of the national market for corporate law[15] indicates the exist-

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10. *See, e.g.*, ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 45–46 (2002); Henry G. Manne, *Current Views on the "Modern Corporation*,*"* 38 U. DET. L.J. 559, 583 (1961).

11. *See* ROMANO, *supra* note 10, at 46.

12. *Id.*

13. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

14. There is evidence that the stock market rewards firms that reincorporate in Delaware from another jurisdiction. *See* ROMANO, *supra* note 10, at 64–75 (summarizing the results of empirical studies examining stock price reaction to firms' decision to reincorporate as "compelling evidence that competition for corporate charters benefits investors"); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 525 (2001) (noting Delaware firms had higher "Tobin's Q's" than non-Delaware firms between 1981 and 1996); Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" Versus Federal Regulation*, 53 J. BUS. 259 (1980) (noting firms earned positive stock market returns from reincorporating in Delaware).

15. The market for corporate law is now generally understood to consist of a "local" market in which about half of publicly held firms choose their home state over Delaware and a "national" market for out-of-state corporations that Delaware dominates. *See* Lucian Arye Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775 (2002) (noting Delaware has a 58% overall share of publicly traded nonfinancial firms); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1566 (2002) (noting about half of Fortune 500 firms choose Delaware).

ence of a healthy competition for corporate law.[16] A leading explanation that Delaware's dominance is not evidence of a race to the top is based on the hypothesis that the market for incorporations is least effective in disciplining law that protects managers from threats to their control.[17] This theory suggests that Delaware wins the state competition by providing takeover protection. Another leading theory suggests Delaware caters to lawyers who constitute a powerful Delaware interest group responsible for crafting corporate law.[18] There is also concern that Delaware's competitive edge, derived from its sophisticated legal infrastructure of courts and lawyers,[19] precludes effective competition. Even if the state competition for corporate law does not produce optimal corporate law, however, a question remains as to whether a monolithic and cumbersome federal system could provide a sufficient improvement to justify displacing the current system.

This brief overview of the corporate federalism debate provides the backdrop for analyzing recent papers on Nevada corporation law as the first viable alternative to Delaware in the national market for out-of-state incorporations.[20] These papers argue that Nevada's recent moves to impose lax director fiduciary duties and become a low-liability haven for managers present a competitive threat to Delaware to which the latter state may not be able to respond effectively. Evidence that Nevada-incorporated firms have a higher rate of issuing accounting restatements seems to support the conclusion that Nevada is attracting managers of firms with lax governance.[21] This theory and evidence could renew concern about a potential race to the bottom.

We suggest an alternative version of what is happening in Nevada. Instead of managers racing their firms to Nevada to take advantage of lax fiduciary duties that make it easier for them to cheat, firms may be going

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16. *See* Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 786–89 (2006) (reviewing the literature).

17. Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 405–06 (2003).

18. Jonathan R. Macey & Geoffrey Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 503–04 (1987).

19. *See* Roberta Romano, *Law as Product: Some Pieces of the Incorporation Puzzle,* 1 J.L. ECON. & ORG. 225 (1985). This explanation appears to be robust as to business form in light of evidence of Delaware's ability to dominate the competition for large limited liability companies. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies*, 2011 U. ILL. L. REV. 91, 101.

20. *See* Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, VA. L. REV. (forthcoming 2012), *available at* http://ssrn.com/abstract=1920538; Michal Barzuza & David Smith, *What Happens in Nevada? Self-Selecting into Lax Law* (Va. Law & Econ. Research Paper No. 2011-08, 2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1644974.

21. Barzuza & Smith, *supra* note 20.

to Nevada to reduce their costs of controlling cheating. Part of this strategy is based on Nevada's use of lower cost, bright-line rules for imposing liability. Taking the costs of controlling cheating into account, Nevada law therefore actually may reduce rather than increase firms' overall costs of delegating power to agents. Evidence concerning a higher rate of restatements by firms that incorporate in Nevada does not refute this alternative story. Furthermore, the availability of relatively lax fiduciary duties in other jurisdictions, including Delaware, cast doubt on the race for suboptimal laxity as the primary explanation for Nevada's success.

In sum, the debate over Nevada essentially reduces to two accounts of Nevada's role in the market for corporate law. One view is that Nevada law is racing to the bottom by enabling corporate managers to escape the discipline of fiduciary duties. Nevada thus can earn incorporation fees for its taxpayers by disregarding the interests of out-of-state shareholders. Our alternative view is that Nevada provides a differentiated and lower cost alternative corporate law that better fits the needs of some firms and their shareholders.

This theory and evidence highlight the need to exercise caution before concluding that evidence from Nevada implies legal intervention is warranted in the market for corporate law.[22] This Article also suggests a broader response to continued assertions that the Berle–Means hypothesis implies that strong federal law is necessary to deal with the separation of ownership and control. The general lesson is that before concluding that a significant federal regulatory expansion is necessary, it is important to consider carefully the reasons underlying firms' choices and the effectiveness of market mechanisms for disciplining bad choices.

Apart from Nevada's implications for the federalization of corporate law, the appearance of a significant competitor to Delaware triggers reevaluation of state competition for corporate law and consideration of whether some legal reform might promote a broader and more efficient set of corporate laws. In particular, given the appearance of Nevada, it is worth asking why *only* Nevada, and why other states have not entered the marketplace for corporate law with their own differentiated statutes. The answer to this question may lie outside the box of state corporation law in alternative business forms[23] and private lawmaking.[24]

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22. Note that our analysis is focused on corporate fiduciary duties. News stories also have alleged that Nevada is a haven for corporate shells promoted by purveyors of tax avoidance and asset protection devices. *See, e.g.*, Brian Grow & Kelly Carr, *Special Report: Nevada's Big Bet on Secrecy*, REUTERS, Sept. 26, 2011, *available at* http://www.reuters.com/article/2011/09/26/us-shell-games-nevada-idUSTRE78P1Y020110926. While these devices are indirectly relevant to this Article insofar as they relate to Nevada's general reputation and market niche, they are legally distinct from fiduciary duty provisions of corporate law.

23. LARRY E. RIBSTEIN, THE RISE OF THE UNCORPORATION (2010).

The remainder of this Article is organized as follows. Part II presents the race-to-the-bottom view of Nevada law that is used to support federalizing corporate law. Part III discusses the alternative view of Nevada's role that raises doubts about whether Nevada is providing suboptimally lax law and the use of Nevada law as a basis for federalization. Part IV examines the evidence on Nevada firms in light of the alternative hypotheses set out in Parts II and III. Part V discusses some limited evidence on the effect of Nevada reincorporation on shareholder value. Part VI concludes.

## II. RACE TO LAXITY

Under the hypothesis that Nevada represents a race to the bottom, Nevada corporate law was revised to attract tax revenues by exploiting manager and shareholder agency costs created by the separation of ownership and control. Nevada's significant participation in the national market for corporate law began in 2001 when Nevada changed its statutory rules defining the fiduciary liability of Nevada corporation directors as part of a plan to significantly raise franchise taxes for Nevada corporations and to encourage corporations to pay the higher taxes.[25] Under the 2001 law, Nevada directors and officers have mandatory liability only for intentional misconduct and no other default or mandatory liability.[26] Nevada corporation law provides, in relevant part, "Directors and officers shall exercise their powers in good faith and with a view to the interests of the corporation."[27] Except as otherwise provided in the articles of incorporation or certain provisions of the corporation law, however,

> a director or officer is not individually liable to the corporation or its stockholders or creditors for any damages as a result of any act or failure to act in his capacity as a director or officer unless it is proven that: (a) His act or failure to act constituted a breach of his fiduciary duties as a director or officer; and (b) His breach of those duties involved intentional misconduct, fraud or a knowing violation of law.[28]

In 2003, Nevada followed through on its plan to bolster revenue by raising its maximum annual franchise tax from $85 to $11,100. These changes combine with Nevada's 1999 clarification of the business judg-

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24. Bruce H. Kobayashi & Larry E. Ribstein, *Law as a ByProduct: Theories of Private Law Production* (Ill. Program in Law, Behavior & Soc. Science Paper No. LBSS11-27, 2011), *available at* http://ssrn.com/abstract=1884985.

25. *See* Barzuza, *supra* note 20.

26. *See* NEV. REV. STAT. § 78.138(7) (2011).

27. *Id.* § 78.138(1).

28. *Id.* § 78.138(7).

ment rule's application to takeover defenses that do not restrict shareholders' voting rights.[29]

In order to assess Nevada's role in the national market for corporate law, it is necessary to compare Nevada with the leading competitor in that market. Delaware default rules provide for the standard director fiduciary duties of care and loyalty.[30] Most publicly held Delaware corporations, however, have taken advantage of a provision that allows a corporation to include in its articles of incorporation:

> A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.[31]

On the revenue side, Delaware provides for taxes of $75 to $180,000.[32]

It is important to emphasize that the difference between Nevada law and Delaware law is not as stark as it might appear.[33] As noted above, the Nevada statute does impose a default fiduciary duty to act in good faith. The Nevada Supreme Court explicitly recognized this duty in 2006 in a case involving demand excuse in a shareholder derivative suit.[34] The court cited Delaware law throughout the opinion.[35]

The key difference between Delaware law and Nevada law lies in the standard for imposing liability for breach of the standard fiduciary duty. Under Nevada law, directors are liable only for a breach of fiduciary duty that involves "intentional misconduct, fraud or a knowing violation of law."[36] A conflict of interest transaction would breach Nevada's

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29. *Id.* § 78.139. The business judgment rule operates to give wide discretion to directors by insulating their decisions from liability as long as the director rationally believed that the decision was in the corporation's best interests. *See generally* PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS & RECOMMENDATIONS § 4.01(c)(3) (1994); Larry E. Ribstein & Kelli A. Alces, *Directors' Duties in Failing Firms*, 1 J. BUS. & TECH. L. 529, 532–33 (2006).

30. *See* DEL. CODE ANN. tit. 8, § 144 (West 2011).

31. *Id.* § 102(b)(7).

32. *How to Calculate Franchise Taxes*, STATE OF DEL., http://corp.delaware.gov/frtaxcalc.shtml (last visited Apr. 14, 2012).

33. Indeed, other states also feature fiduciary duties that are more "lax" than Delaware. *See, e.g.*, Laurence V. Parker, Jr., *Virginia is for Lovers and Directors: Important Differences Between Fiduciary Duties in Virginia and Delaware*, 2 WM. & MARY BUS. L. REV. 51, 58 (2011).

34. Shoen v. SAC Holding Corp., 137 P.3d 1171 (Nev. 2006).

35. *Id.*

36. NEV. REV. STAT. § 78.138(7) (2011).

default fiduciary standard. It arguably follows that a deliberate breach of this duty would constitute intentional misconduct or an act not in good faith; therefore, the breach would fall outside Nevada's exculpatory provision. Under Delaware law, corporations that opt out under section 102(b)(7) are liable not only for intentional misconduct, knowing violation of law, or improper personal benefit—all of which are arguably actionable in Nevada—but also for breach of the duty of loyalty or acts or omissions that are not in good faith.[37] These categories may involve conduct that is neither selfish nor intentionally wrongful, bordering on conduct protected by the business judgment rule.

The difference between Nevada law and Delaware law is highlighted by the Delaware Supreme Court's opinion in *Stone v. Ritter*,[38] which held that a board's conscious failure to adopt a compliance program in the face of a known duty to act may constitute a breach of good faith that survives a charter limitation on the board's duty of care.[39] It is unlikely that such a claim would survive dismissal in Nevada because, assuming Nevada law does not mandate a compliance program, managers' failure to adopt such a program may not amount to intentional misconduct. Moreover, Nevada does not have an open-ended bad faith exception that could catch this conduct like in Delaware. In other words, the key difference between Nevada and Delaware is not that Nevada managers have no liability for wrongdoing, but that they are liable only when they know they are engaging in wrongdoing.

Apart from the precise standard of liability in Nevada, the relevant empirical question to ask in order to determine whether Nevada is facilitating a race to the bottom is whether firms' opportunity to incorporate under Nevada law injures shareholders. This question is deceivingly complex. It is not enough that Nevada offers its managers a greater opportunity to cheat than other states' laws. As discussed below in Part III, shareholders might reasonably trade higher cheating costs for lower costs of controlling cheating. Nor is Nevada law necessarily a problem if it raises the cost of capital for Nevada firms compared to that of comparable firms incorporated under other states' laws. If this were the case, post-incorporation shareholders would not be harmed because they would pay a lower price for their shares to reflect the possibility of managerial cheating.

The main concern here is for existing shareholders who have been harmed by their managers' decision to reincorporate in Nevada, perhaps because they were misled by faulty proxy disclosures. At that point the

37. DEL. CODE ANN. tit. 8, § 102(b)(7) (West 2011).

38. Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).

39. *Id.* at 367.

shareholders may be stuck with the choice of living with higher agency costs, selling out for the lower price caused by the reincorporation, or incurring the substantial expense of removing the managers or otherwise forcing a move out of Nevada. Nevada's corporate law can contribute to the risk of poor governance by offering managers an opportunity to escape monitoring that would not exist in other states.[40]

It is difficult to definitively determine whether a particular state's corporate law provision reduces shareholder welfare in the context of a generally competitive market for corporate law. If shareholders generally are getting what they pay for, offering investors an additional governance choice may be worth the risk to shareholders who are injured by transition to the new law. But there may be a point at which a state's corporate law offers so little potential benefit to the overall market that it is not worth the risk of injury to some shareholders. Part III addresses this concern by considering Nevada's potential contribution to the overall market for corporate law. This analysis is important in determining whether the Nevada statute supports imposing federal minimum standards or other regulation.

## III. EFFICIENT MARKET SEGMENTATION

Part II presents the worst case for Nevada—it provides a refuge for inefficiently lax governance. This Part discusses an alternative or additional perspective on Nevada law—it provides a mechanism for reducing agency costs. Nevada law reduces agency costs by tailoring managers' fiduciary duties to fit both the type of firm that chooses Nevada law and the Nevada courts' institutional capacity to judge whether corporate agents have met these duties. Policymakers must evaluate both the perspective set out in Part II and the alternative perspective set out in this Part before deciding the implications of Nevada corporate law for federalizing corporate law.

### *A. Agency Costs and State Corporate Law*

An important objective of corporate law is to promote contractual provisions that minimize agency costs. This principle is not the same as minimizing the amount of cheating by agents. Rather, agency costs are better understood as the total costs of owners delegating control over the management of property to agents, thereby separating control from ownership of the property. These costs include not only losses from agent cheating, but also principals and agents' monitoring and bonding costs of

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40. *See infra* Part V for an attempt to empirically test the effect of reincorporation on stock prices.

reducing the risk of loss.[41] For example, a principal could reduce agent cheating by watching everything the agent does or by reducing the agent's discretion. Nevertheless, this approach could *increase total* agency costs because the costs of watching the agent or reducing the value of the agent's exercise of discretion exceed the benefits of reduced cheating. Agency costs, defined as the costs of hiring an agent, are never zero because the incentive problem inherent in separating ownership and control requires either incurring the costs of controlling cheating or leaving the agent free to cheat. At the same time, there may be significant benefits associated with delegating to agents, particularly in situations where agency costs are highest—that is, where numerous and dispersed principals must delegate control to a central authority because of the impossibility of effectively coordinating decision-making.

In evaluating the efficiency of state corporate law, it is important to keep in mind that law is just one of many potential ways principals have to reduce agent cheating. State-imposed fiduciary duties involve ex post judicial review of fiduciary conduct and judicially enforced damages and equitable relief for misconduct. Principals could supplement or substitute for these duties, among other things, shareholder approval of agents' acts, incentive compensation to align agents' incentives with the firm's interests, shareholder transfer or exit rights, and review of agent conduct by independent directors, auditors, or lawyers. Principals could also rely on market mechanisms such as price signals in product and securities markets, markets for corporate control and managerial services, and reputational incentives. Judicially enforced contract provisions, rather than default or mandatory rules in state corporate law, could provide some of these terms. The federal securities laws provide additional mandatory penalties for fraud, nondisclosure, and other misconduct. This helps ensure that shareholders have the facts about how well their firms are governed. Federal law also provides some minimum governance standards for publicly held firms.[42] In short, the efficiency of state corporate law depends on its marginal costs and benefits in controlling agent cheating given other constraints on agency costs.

An additional consideration in assessing state corporate law is that firms have differing governance needs. Firms with concentrated shareholdings or majority or controlling shareholders may have very different agency cost control problems from firms with widely dispersed share-

41. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

42. *See, e.g.*, Sarbanes-Oxley Act, 15 U.S.C.A. § 7262 (West 2002); HENRY N. BUTLER & LARRY E. RIBSTEIN, THE SARBANES OXLEY DEBACLE: WHAT WE'VE LEARNED; HOW TO FIX IT (2006).

holders. Firms may select the rules that fit their needs not only by entering into customized contracts but also by choosing a suitable organizational form or state law.[43] It follows that state competition may be efficient even if it does not produce a single superior "winner," but rather a mix of laws that is suitable for different types of firms.[44]

Nevada law can be further analyzed in terms of error costs. Even if fiduciary duties might seem to add a necessary constraint on cheating, these duties still may not be efficient in the real world in which human judges decide fiduciary duty cases. Lax fiduciary standards could lead to "Type II" errors, meaning the standards allow more cheating than the shareholders would prefer.[45] On the other hand, Nevada law could also reduce "Type I" errors by reducing liability that might motivate managers to engage in acts that do not benefit shareholders such as non-cost-justified monitoring or avoiding risky but positive net present value business decisions.[46]

The risk of Type I error is compounded by agency costs in litigating fiduciary breaches. Courts must determine, in hindsight, whether business judgments that turn out poorly were reasonably made under the circumstances. The risk of error may be compounded by another set of agents, plaintiffs' lawyers, who can earn fees for bringing marginal cases that survive dismissal even if these cases cause net harm to shareholders.[47] Thus, restricting fiduciary duties in order to reduce error costs could improve efficiency even when fiduciary duties provide efficient discipline in an ideal world.

### *B. Nevada's Strategy*

This section examines Nevada law's approach to agency costs in light of the analysis discussed above. As emphasized in Part II, the key difference between Nevada law and Delaware law is that Nevada law imposes liability for a breach of fiduciary duty only when the defendant

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43. *See* RIBSTEIN, *supra* note 23.

44. *Id.*; *see also* RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION (1980); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 179 (1985).

45. Type II errors are also known as "false negatives." In the context of enforcement of a legal rule, a Type II error occurs when there is an erroneous finding of no liability, or in the criminal context, when the guilty are allowed to go free. *See* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 218 (6th ed. 2003).

46. Type I errors are also known as "false positives." In the context of enforcement of a legal rule, a Type I error occurs when there is an erroneous finding of liability, or in the criminal context, when the innocent are falsely convicted. *Id.*

47. *See, e.g.*, Marilyn F. Johnson, Karen K. Nelson & A. C. Pritchard, *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J.L. ECON. & ORG. 627 (2007).

knows she is breaching a legal duty. Nevada law thus ensures that Nevada courts have a limited ability to second-guess business decisions. Nevada's intentional misconduct standard alleviates the indeterminacy problem that plagues Delaware judges' attempts to draw fine lines between business decisions that do and do not warrant special judicial attention.[48] This reflects a tradeoff between the benefits of strict discipline of fiduciary misconduct and the potential costs of excessive error from judicial monitoring.[49]

Analysis of Nevada's competitive strategy must explain not only how Nevada's supposed laxity attracts out-of-state incorporations but also how it can maintain its competitive advantage, despite charging more for incorporation than any state in the country other than Delaware while lacking Delaware's substantial infrastructure and long-standing reputation. The problem for Nevada is that it cannot copyright its law, so any state could pass the same law and charge a lower price.[50] And unlike Delaware, Nevada has no obvious institutional or reputational mechanism to protect it from such price-cutting competition.[51] It would seem that another state could take over Nevada's leadership as a Delaware alternative just as swiftly as Delaware took over New Jersey's spot in the early days of the corporate competition in the United States.[52]

One explanation for the unique success of Nevada's strategy is that it not only attracts firms by enacting beneficial corporate law, but Nevada is also able to credibly bond its promise to refrain from materially changing the law after corporations have incurred the costs of incorporating in the state. Nevada's dependence on the substantial future revenues

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48. *See* William J. Carney & George B. Shepherd, *The Mystery of Delaware's Continuing Success*, 2009 U. ILL. L. REV. 1, 12–17 (arguing that Delaware law suffers from excessive indeterminacy); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1908 (1998) (arguing that indeterminacy enhances Delaware's competitive position); Macey & Miller, *supra* note 18, at 503–04 (arguing that the complexity of Delaware law serves lawyers' interests by increasing litigation).

49. The point here is not that Nevada law reduces the risk of "frivolous" lawsuits that have a low likelihood of liability. *See* Barzuza, *supra* note 20, at 37. Rather, it guards against Type I error by narrowing the situations in which liability can be imposed to those that can be avoided at a relatively low cost. For a similar explanation of the mens rea requirement in criminal law, see Jeffrey S. Parker, *The Economics of Mens Rea*, 79 VA. L. REV. 741 (1993).

50. *See* Bruce H. Kobayashi & Larry E. Ribstein, *Law's Information Revolution*, 53 ARIZ. L. REV. 1169 (2011) (discussing lack of property rights in law); Kobayashi & Ribstein, *supra* note 24 (same).

51. *See* Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 MO. L. REV. 299 (2004).

52. *See* Christopher Grandy, *New Jersey Corporate Charter-Mongering, 1875–1929*, 49 J. ECON. HIST. 677 (1989).

generated by its unique law acts as a reputational bond that makes it politically difficult for the legislature to change the standard ex post.[53]

There is an additional question of why Nevada chooses to compete with Delaware on the low end of monitoring rather than by offering a stricter law. One explanation is that Nevada's bright-line approach to liability meshes well with Nevada's legal infrastructure of judges and lawyers. Delaware corporate judges are adept at writing extensive opinions, sometimes on a tight schedule that analyze corporate transactions with care and expertise. These decisions must distinguish between acceptable business judgment at the time of the decision and a violation of the applicable legal standards in the particular case. Judges also must prescribe governance practices that are both realistic and effective and fit the case into the complex network of existing Delaware law. In order to do their job, even the most expert judges rely on comparably expert advocates to navigate this process. Indeed, Delaware judges are drawn from the ranks of the Delaware bar. By contrast, Nevada, like other states aside from Delaware, lacks a comparable corporate law infrastructure and is unlikely to acquire such an infrastructure without either first attracting the high-end incorporation business or making a substantial investment in infrastructure on the gamble that the business will come.

Delaware faces the converse problem from Nevada. Because Delaware has invested in a high-level infrastructure, it can maintain its competitive advantage only by applying legal rules that use this infrastructure. If Delaware were to imitate Nevada's bright-line approach, it would effectively devalue its costly infrastructure and sacrifice its main competitive advantage. In other words, Nevada and Delaware are essentially in two distinct businesses—low infrastructure coupled with bright-line rules versus high infrastructure coupled with flexible standards of corporate law.

There are many other states that lack Delaware's infrastructure that could enact corporate law provisions similar to Nevada and generate similar assurances against change; Nevada, however, has two unique characteristics that complement its low-monitoring strategy and thereby enable it to out-compete other states. First, Nevada's ability to provide assurance that it will not change its laws is supported by its relatively sparse population. This makes it more dependent on incorporation fees than more populous states. Second, Nevada can successfully compete against other small states because its general reputation, based on a large and successful gambling industry, reduces the likelihood of political backlash

53. *See* Benjamin Klein & Keith B. Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 J. POL. ECON. 615 (1981).

based on public concern that lax corporate law will cast the state in a bad light.

Nevada's strategy also has implications for the types of firms for which Nevada could be expected to compete. In general, firms could be expected to choose Delaware law if they want to offer investors strong assurances that they are making substantial investments in monitoring. Consistent with our agency cost analysis above, firms would select Delaware when the marginal benefits exceed the marginal costs of such additional monitoring. Two characteristics of Nevada firms are consistent with a demand for lower levels of monitoring. First, Nevada public firms are smaller than those in Delaware. This characteristic alone increases the per capitalization cost of establishing controls to catch accounting errors. Indeed, small size is one of the factors generally associated with weaker controls.[54] Second, Nevada has a relatively high percentage of family firms.[55] Such firms are generally directly controlled by their shareholders and therefore need not rely on auditors and disclosure to discipline managers. John Coffee attributes the presence of fewer accounting scandals in Europe than in the United States following the 2001 stock market crash to basic differences between European and U.S. firms with respect to shareholder concentration.[56] U.S.-style dispersed shareholder firms are more likely to rely on option compensation, which increases the risk of revenue-recognition problems.[57] The relatively high percentage of family firms in Nevada suggests that Nevada firms are more like those in Europe than those incorporated in Delaware.

### *C. Choice of Form*

Section B discusses reasons why Nevada is able to secure a position as a key competitor to Delaware in the market for corporate law. But an alternative scenario is competition in the market for noncorporate business forms. Indeed, Delaware is already competing successfully by offering uncorporate (limited partnership and LLC) law that is laxer than Nevada corporate law, in addition to access to Delaware's superior infrastructure,[58] all at a significantly lower price than both Nevada and Dela-

54. *See* Jeffrey T. Doyle, Weili Ge & Sarah E. McVay, *Determinants of Weaknesses in Internal Control over Financial Reporting*, 44 J. ACCT. & ECON. 193, 193–94 (2007).

55. *See* Barzuza, *supra* note 20, at 41.

56. John C. Coffee, Jr., *A Theory of Corporate Scandals: Why the U.S. and Europe Differ*, 21 OXFORD REV. ECON. POL'Y 198 (2005).

57. *See id.*

58. *See* Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, 2009 U. ILL. L. REV. 131, 133.

ware corporate law.[59] The uncorporate alternative provides further support for the proposition that the Nevada phenomenon is not simply a competition over laxity, but rather a more nuanced competition over the nature of agency cost control and the role of legal infrastructure.

Delaware's limited partnership and LLC statutes provide for near complete opt-out from all fiduciary duties, comparable to the freedom under the Nevada corporate statute. For example, Delaware's limited partnership statute provides:

> (d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement, the partner's or other person's duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.
>
> (e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner's or other person's good faith reliance on the provisions of the partnership agreement.
>
> (f) A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to another person that is a party to or is otherwise bound by a partnership agreement; provided that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.[60]

Notably, the Delaware uncorporate statutes, unlike both Nevada and Delaware corporate law, provide for *complete* waiver of fiduciary duties, leaving only the implied contractual covenant of good faith and fair dealing. Delaware's courts have confirmed that these statutes do indeed allow complete waiver of default fiduciary duties, leaving only a contractual duty that is defined with reference to the parties' contracts.[61] These

59. Mohsen Manesh, *Delaware and the Market for LLC Law: A Theory of Contractibility and Legal Indeterminacy*, 52 B.C. L. REV. 189, 191, 198–209 (2011) (discussing the implications of the different pricing of Delaware corporations and uncorporations).

60. *See* DEL. CODE ANN. tit. 6, § 17-1101 (West 2010) (applying to LPs). A similar provision applies to LLCs. *See id.* § 18-1101.

61. *See* Ribstein, *supra* note 58, at 143.

features of Delaware uncorporations come at a much lower price than either Nevada or Delaware incorporation.[62]

Delaware uncorporate law provides additional insights into state competition for business association law in general and Nevada corporation law in particular. As noted above, a key difference between Delaware and other states with regard to both corporate and uncorporate law is legal infrastructure. Delaware uncorporate law demands a substantial infrastructure for interpreting agreements that dispense with the rich background of fiduciary duties.[63] The Delaware uncorporate alternative also raises the question of why firms need to go to Nevada to opt out of liability for unintentional breach of fiduciary duty when they can completely avoid fiduciary duties through Delaware uncorporate law.[64] The wide availability of lax corporation and uncorporation law in jurisdictions other than Nevada supports the above explanation of Nevada law based on error costs rather than laxity.[65]

## IV. DID NEVADA ATTRACT MISCREANTS? EVIDENCE FROM RESTATEMENTS

Part III shows that the Nevada statute can be explained as a way to reasonably economize on agency costs rather than more simplistically as a platform for managers to cheat shareholders. But this benign explanation for Nevada law does not eliminate the possibility that—whatever its strategy—Nevada is in fact a haven for cheaters and therefore contributes to a race to the bottom in the market for corporate law. Part IV addresses this argument by analyzing the evidence regarding the types of firms that are incorporating in Nevada.

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62. *See* Manesh, *supra* note 59.

63. For an analysis of these cases, see Ribstein, *supra* note 58, at 143–61. Indeed, this indeterminacy could be as much a problem for uncorporations as for corporations. *See id.* at 165–66. This has prompted Delaware's Chief Justice Steele to suggest that Delaware should dispense with *default* fiduciary duties, a change that would move Delaware uncorporate law even beyond Nevada corporate law in laxity. Myron Steele, *Freedom of Contract and Default Contractual Duties in the Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 238–41 (2009); *see also* Larry E. Ribstein, *Should There Be Default Fiduciary Duties in Delaware LLCs and LPs?*, TRUTH ON THE MARKET (Dec. 9, 2011), http://truthonthemarket.com/2011/12/09/should-there-be-default-fiduciary-duties-in-delaware-llcs-and-lps/.

64. In fact, shedding fiduciary duties makes more sense for uncorporations, which trade these duties for other agency cost control mechanisms, particularly including exit and high-powered managerial incentives. *See generally* RIBSTEIN, *supra* note 23.

65. Delaware's embrace of open-ended contracting for fiduciary duties raises doubts about Barzuza's argument that Delaware would hesitate to compete with Nevada for laxity in corporate law for fear of diluting its brand or increasing the possibility of federal regulation. *See* Barzuza, *supra* note 20, at 25–28.

Barzuza and Smith approach this determination by using firms' accounting restatements as a proxy for bad governance.[66] They find that firms incorporated in Nevada between 2000 and 2008, mostly after Nevada changed its law, have a 40% higher likelihood of issuing a restatement than those incorporated in Delaware and other states during this period after controlling for various firm-level characteristics. They note that accounting restatements involve an admission by the firm that its previous accounting was materially inaccurate, as shown by data indicating a strong negative market reaction to restatement issuance.[67] Barzuza and Barzuza and Smith also cite data that they argue support the link between restatements and lax governance.[68]

Note that Barzuza does not claim that Nevada law causes or even permits more accounting restatements.[69] Indeed, Barzuza and Smith found no evidence of increased restatements following reincorporation under Nevada's lax provisions.[70] But Nevada corporations' higher likelihood of restatements may indicate that Nevada's lax law attracts poorly governed firms. On the other hand, as emphasized throughout this Article, a higher probability of an accounting restatement may simply reflect a rational corporate decision to reduce overall agency costs by investing fewer resources in monitoring.[71] The question then is whether Nevada firms' high level of restatements indicates that they are poorly governed not simply because they optimally invest less in monitoring than other firms, but because they choose a level of monitoring that decreases firm value. This depends on the type of restatements prevalent among Nevada

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66. *See* Barzuza & Smith, *supra* note 20. Firms file restated financial statements to correct errors in the statements previously submitted to the Securities and Exchange Commission (SEC). *See* Kristen L. Anderson & Teri Lombardi Yohn, The Effect of 10K Restatements on Firm Value, Information Asymmetries, and Investors' Reliance on Earnings (Sept. 2002) (unpublished manuscript), *available at* http://ssrn.com/abstract=332380.

67. Anderson & Yohn, *supra* note 66; Coffee, *supra* note 56.

68. William R. Baber et al., Shareholder Rights, Corporate Governance and Accounting Restatement, (Feb. 1, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=760324 (noting restating firms have less exposure to the market for control and shareholder discipline); Jap Efendi, Anup Srivastava & Edward P. Swanson, *Why Do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors*, 85 J. FIN. ECON. 667 (2007) (link between restatements and CEO in-the-money stock options); Michael Ettredge et al., *How Do Restatements Begin? Evidence of Earnings Management Preceding Restated Financial Reports*, 37 J. BUS. FIN. & ACCT. 332 (2010) (restatements tend to reflect balance sheet bloating); *see* Simi Kedia & Thomas Philippon, *The Economics of Fraudulent Accounting,* 22 REV. FIN. STUD. 2169 (2009) (linking restatements and worse governance as reflected by governance indices).

69. *See* Barzuza & Smith, *supra* note 20, at 21–22 (discussing regressions in Table 8 that include firm-level fixed effects).

70. *Id.*

71. Indeed, they find that Nevada firms are much less likely to use Big 4 audit firms at the time of the restatement and generally rely on smaller, regional accounting firms. *Id.* at tbl.4.

firms and the connection between these restatements and firm governance.

For several reasons, the Nevada restatements noted by Barzuza and Smith do not necessarily indicate a high prevalence of fraud, as distinguished from mistakes that could result from a decision not to invest in stringent monitoring. First, the raw data indicate that while Nevada firms are about 60% more likely than other states to require restatements, they are only marginally more likely than Delaware firms to involve fraud allegations or an investigation by regulators (1.3% versus 1.2%).[72] This is not surprising given that *federal* law primarily disciplines accounting fraud.

Second, even the restatements accompanied by fraud allegations may not indicate *excessively* low monitoring that would result in reductions in firm value. Alleging accounting restatements has become a significant way to escape dismissal in the wake of the higher pleading standards under the Private Securities Litigation Reform Act (PSLRA).[73] Because such cases are much more likely to be filed, some of the filed cases alleging fraud will be Type I errors. The PSLRA's heightened pleading requirement therefore may tend to exaggerate restatements' association with fraud allegations in the post-PSLRA data used by Barzuza and Smith.

Third, the data do not indicate that Nevada restatements are the types of restatements particularly associated with fraud. Nevada firms lost less income as a result of restatements than firms in other states, including Delaware,[74] suggesting that Nevada firms with bad accounting are less prone to inflating income than firms with bad accounting in other states. Revenue recognition in particular has been most directly associated with poor controls.[75] Barzuza and Smith's random sample of restatements[76] indicates a variety of problems that do not point to a particular propensity for fraud. Indeed, Barzuza notes, "We found that no one type of restatements dominates Nevada companies in a way that could explain the frequencies of such restatements."[77] The summary reveals accounting errors that, for example, "do not reflect a net gain or benefit from certain

72. *Id.* at tbl.3, panel A. Note, however, that there is a positive and significant Nevada effect on fraud allegations in the regressions. *See id.* at tbl.6, panel C.

73. *See* Stephen J. Choi, Karen K. Nelson & A. C. Pritchard, *The Screening Effect of the Private Securities Litigation Reform Act*, 1 J. EMPIRICAL LEGAL STUD. 35 (2009); Johnson, Nelson & Pritchard, *supra* note 47.

74. *See* Michal Barzuza & David C. Smith, What Happens in Nevada? Self-Selecting into Lax Law, at tbl.3, panel B (October 2010) (unpublished manuscript) (on file with author).

75. *See* Anderson & Yohn, *supra* note 66; Coffee, *supra* note 56.

76. *See* Barzuza & Smith, *supra* note 20, at app. tbl.A3.

77. Barzuza, *supra* note 20, at n.156.

embedded derivative securities"; "did not affect the Company's earnings or net worth"; "[reflect] an adjustment of $79,750 which had been erroneously included in paid-up capital rather than shareholder loans"; and "inadvertently failed to record the appropriate expense for such Options in accordance with FAS 123(R)."[78]

Fourth, the association between Nevada incorporation and restatements may be consistent with firms selecting Nevada because they incur high costs or derive lower benefits from monitoring. For example, Nevada firms may be more volatile than other types of firms. Volatility has been found to be a stronger predictor than size of internal controls weakness.[79] Volatile firms are inherently subject to more influences on earnings variation and therefore may have to invest more in monitoring and accounting controls to avoid restatements. A high propensity for restatements in these firms therefore may reflect economizing on monitoring rather than a likelihood of fraud.

Fifth, Barzuza's emphasis on accounting restatements assumes a link between restatements and weak governance. This assumption arguably supports the inference that managers of weakly governed firms use their power to incorporate in Nevada in order to take advantage of weak ex post judicial scrutiny of their conduct. Indeed, stronger external governance, such as takeover discipline, has been associated with fewer accounting restatements.[80] Barzuza and Smith, however, find that Nevada firms actually do not have worse governance than firms incorporated in other states as shown by the "G" and "E" governance indices.[81] In Nevada, the lack of a correlation between governance indices and restatements is consistent with other data showing that governance is no more than weakly related to accounting restatements.[82] This lack of correlation, in turn, counters the suggestion that the prevalence of restatements in Nevada indicates that poorly governed firms are flocking to the state.

## V. EFFECT OF NEVADA INCORPORATION ON FIRM VALUE

The price investors are willing to pay for Nevada corporations is the ultimate test of whether there is a problem with Nevada law. The val-

78. *Id.*

79. *See* Cindy R. Alexander & Kathleen Weiss Hanley, Regulatory Monitoring Under the Sarbanes-Oxley Act (Oct. 2, 2007) (unpublished manuscript), *available at* http://ssrn.com/abstract=1022161.

80. *See* Baber et al., *supra* note 68.

81. *See* Barzuza & Smith, *supra* note 20, at tbl.5. The E index, which includes antitakeover defenses, is lower in Nevada than in Delaware or the average of states other than Nevada or Delaware. The Nevada G index is higher.

82. *See* David F. Larcker, Scott A. Richardson & Irem Tuna, *Corporate Governance, Accounting Outcomes, and Organizational Performance*, 83 ACCT. REV. 963 (2007).

ue of Nevada firms compared to comparable firms incorporated elsewhere could indicate the market's evaluation of Nevada law's tradeoff between costs and benefits of monitoring.

Barzuza and Smith show that Nevada corporations do not have a lower Tobin's Q than those incorporated in states other than Delaware or Nevada, although Nevada incorporation has a less favorable effect on Tobin's Q than Delaware incorporation, which is associated with increased value.[83] Barzuza recognizes, however, that Tobin's Q may be an unreliable reflection of shareholder value, particularly in small firms.[84] Moreover, Nevada firms' Tobin's Q may reflect characteristics not controlled for in the regressions rather than the effect of Nevada incorporation.

The most direct evidence of what Nevada law adds or subtracts from the value of firms incorporated there would be an event study showing shareholders' reactions to a publicly held firm's decision to reincorporate to Nevada from some other state.[85] But data that would allow one to examine the stock price effects of Nevada reincorporations are sparse. Our research disclosed few publicly held corporations that reincorporated from another state to Nevada after 2001 for which there was sufficient event and stock price data to enable such an event study.[86] While the lack of data limits the general inferences that can be made,[87] we present data from one firm, Dynacq Healthcare (Dynacq), to illustrate the potential costs and benefits of alternative approaches to the reduction of total agency costs discussed in Part III above and to highlight the need for better and more complete data on small firms.

Indeed, apart from its potentially limited use as the basis for a statistical study, Dynacq's corporate history usefully illustrates some of the costs facing a small firm incorporated in Delaware, as well as the problems of inferring that Nevada law is suboptimally lax. Dynacq initially

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83. *See* Barzuza & Smith, *supra* note 20, at tbl.11. Tobin's Q equals the ratio of the market value of a firm's assets to the book value of a firm's assets and is used as a measure of financial performance. *Id.* at 14.

84. *See* Barzuza, *supra* note 20, at 46.

85. *See* Romano, *supra* note 14.

86. We began with a list of 319 firms that had reincorporated to Nevada after its 2001 corporate law revisions. Dynacq Healthcare was the only firm in which stock price data and specific event data, including the board meeting date on which the decision to reincorporate was made, was simultaneously available.

87. The lack of a substantial number of firms with usable data would raise questions regarding the external validity of any results obtained from a statistical study of the abnormal returns around the announcement of the firm's decision to reincorporate to Nevada (i.e., the ability to generalize any results obtained). *See* Jonathan Klick & Robert H. Sitkoff, *Agency Costs, Charitable Trusts, and Corporate Control: Evidence from Hershey's Kiss-Off*, 108 COLUM. L. REV. 749, 786 (2008) (discussing these issues in the context of a single firm event study). There are also issues with respect to the internal validity of any results that are discussed *infra* in note 91.

incorporated under the laws of Nevada. Thus, the firm began with the low-cost and low-infrastructure Nevada strategy. In 2003, the firm reincorporated under Delaware law and hired a "big four" accounting firm (Ernst & Young). The firm's transition to the higher-cost and high-infrastructure Delaware strategy did not go smoothly. The move exposed Dynacq's low levels of internal controls. Soon after reincorporating in Delaware, the company was forced to delay the filing of its quarterly and annual reports. Ernst & Young resigned as its auditor, and Dynacq was forced to restate its earnings for the years 1999 through 2002.[88] Delisting from NASDAQ and a round of class action lawsuits followed.[89]

While the move to Delaware and the hiring of a big four accounting firm exposed Dynacq's low level of internal controls and forced it to restate its earnings, this does not necessarily imply that its initial choice of Nevada law or its low level of internal controls was suboptimal. Indeed, the firm subsequently reversed its 2003 decision to reincorporate under Delaware law by reincorporating under Nevada law in 2006.[90]

This 2006 decision offers a potential opportunity to test between the two accounts of Nevada law presented in Parts II and III. It allows us to

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88. The Dynacq restatements are similar to those discussed *supra* in the text accompanying notes 75 and 76. Specifically, none of the restatements resulted in reductions in reported net revenue, cash flows from operating activities, or stockholders' equity. *See* Press Release, Dynacq Healthcare, Inc., Dynacq Healthcare, Inc. Announces Changes in Previously Reported Financial Results and Provides Litigation Update (July 14, 2004), *available at* http://www.dynacq.com/NewsItem.cfm?ItemID=23.

89. These suits were the second set of class action lawsuits filed against Dynacq and resulted in a settlement in 2007 for 1.5 million dollars, an amount that included the payment to the class, as well as all administrative costs and attorneys' fees. These suits are summarized at *Stanford Law School Securities Class Action Clearinghouse*, DYNACQ HEALTHCARE, INC., http://securities.stanford.edu/1029/DYIIE03-01/ (last visited Apr. 14, 2012). The prior set of class action lawsuits occurred in 2002 during the firm's first incorporation in Nevada. The lawsuit was dismissed in 2003 prior to Dynacq's reincorporation to Delaware. These suits are summarized at *id*., http://securities.stanford.edu/1023/DYII02-01/ (last visited Apr. 14, 2012).

90. In its proxy statement, Dynacq states the "principal reason for reincorporation from Delaware to Nevada is to eliminate our obligation to pay the annual Delaware franchise tax which will result in significant savings to us in the future." The proxy statement also notes that a

> potential disadvantage of reincorporating from Delaware to Nevada is that Delaware for many years has followed a policy of encouraging incorporation in that state and, in furtherance of that policy, has adopted comprehensive, modern and flexible corporate laws that Delaware periodically updates and revises to meet changing business needs. Because of Delaware's prominence as a state of incorporation for many large corporations, the Delaware courts have developed considerable expertise in dealing with corporate issues and a substantial body of case law has developed construing Delaware law and establishing public policies with respect to Delaware corporations. By reincorporating in Nevada, we may experience less predictability with respect to management of our corporate affairs.

*Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934*, DYNACQ HEALTHCARE, INC., *available at* http://www.sec.gov/Archives/edgar/data/890908/000119312506261075/ddef14a.htm.

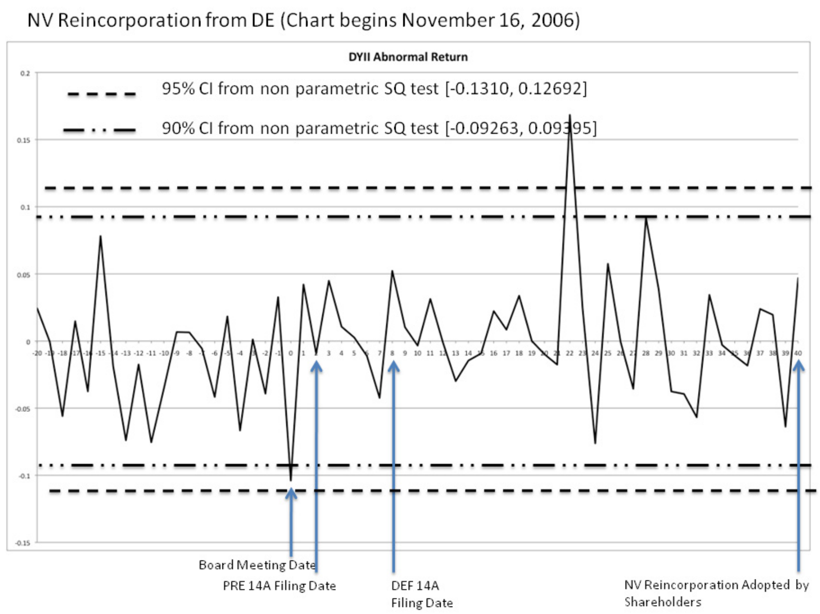
perform a single firm event study based on the firm's stock price reaction to its decision to reincorporate under Nevada law. With a null hypothesis that shareholders were unaffected by the decision to reincorporate to Nevada, the two accounts of Nevada law yield two alternative hypotheses. The first is that the Nevada reincorporation is the result of the firm managers' self-serving decision to move to a jurisdiction with lax controls. Under this race-to-the-bottom hypothesis, the announcement of the decision to reincorporate from Delaware to Nevada should result in negative abnormal returns to shareholders. The second alternative hypothesis is that the decision to reincorporate reflects the managers' choice to move to a lower cost jurisdiction in order to minimize overall monitoring costs. Under this hypothesis, the reincorporation announcement should result in positive abnormal returns to shareholders.

Figure 1 shows the abnormal returns surrounding the board's 2006 decision to reincorporate in Nevada. We could not reject the null hypothesis that shareholders were unaffected by the decision to reincorporate, as there is no evidence of statistically significant negative or positive abnormal returns generated by the announcement of the firm's decision to reincorporate under Nevada law.[91] Specifically, using a two-tailed nonparametric SQ test with a standard .05 significance level, there are no statistically significant abnormal returns on or around the proxy mailing date or the date the shareholders approved the move back to Nevada.[92]

91. Event studies based on small numbers of firms pose special problems resulting from the greater volatility experienced by a portfolio of a small number of firms and the fact that the assumption of normally distributed abnormal returns assumed in conventional hypothesis testing may not approximate the actual distribution of returns. *See* Klick & Sitkoff, *supra* note 87, at 810. These problems are exacerbated when looking at a portfolio made up of a single *small* firm. Indeed, a plot of the abnormal return from the estimation period of the Dynacq market model indicates these returns were not normally distributed. In the statistical tests reported in this Article, we used a nonparametric SQ test to adjust for the possibility of abnormally distributed abnormal returns. For a discussion of this test and its use in single firm event studies, see Jonah B. Gelbach, Eric Helland & Jonathan Klick, *Valid Inference in Single-Firm, Single-Event Studies* (Jan. 6, 2011) (unpublished manuscript), *available at* http://ssrn.com/abstract=1442222.

92. Given the two alternative hypotheses, using a two-tailed test is appropriate. Our nonfinding with respect to the existence of statistically significant abnormal returns and the high volatility associated with our portfolio of a single small firm do generate concerns regarding the potentially limited power of our test (the inability of our statistical test to correctly reject the null hypothesis of no effect when the alternative hypothesis that Nevada reincorporation harms shareholders is true). For a general discussion of these issues, see STEVEN T. ZILIAK & DEIRDRE N. MCCLOSKEY, THE CULT OF STATISTICAL SIGNIFICANCE: HOW THE STANDARD ERROR COSTS JOBS, JUSTICE, AND LIVES (2007); Deirdre N. McCloskey & Stephen T. Ziliak, *The Standard Error of Regressions*, 34 J. ECON. LITERATURE 97 (1996). For example, our test would not detect a 13% negative abnormal return that was caused by Dynacq's decision to reincorporate under Nevada law. Increasing the significance level can increase the power of our test. Indeed, there is a single 10.34% negative abnormal return on the date of board meeting where the decision to reincorporate back to Nevada was made that is statistically significant if a .10 significance level is used. But there is reason to question whether this large magnitude negative abnormal return signals the market's reaction to the decision to reincorpo-

Figure 1 – Dynacq Healthcare (DYII) Abnormal Returns




Thus, while the single firm event study gives us a limited opportunity to test shareholder reaction to Nevada versus Delaware incorporation, the results obtained fail to provide evidence that would clarify this issue.[93] The most that we can say at this time is that there is a general absence of direct stock price evidence regarding the validity of a Nevada race-to-the-bottom theory.

## VI. Conclusion and Implications

The 2001 Nevada corporate law amendments reignited the specter of a race to the bottom in corporate law raised by Cary and suggested a need for federal corporation law advocated by Cary and Berle and Means. But we have provided a benign explanation for Nevada law that emphasizes a firm's decision to reduce agency costs by choosing cost-effective mechanisms for monitoring agents. Rather than supporting federalization, Nevada corporation law indicates the depth and complexity

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rate to Nevada. Specifically, this date precedes the public disclosure date, and there is no evidence of any insider selling on or around the date of the board meeting.

93. In addition, we performed an event study examining Dynacq Healthcare's earlier 2003 decision to reincorporate from Nevada to Delaware. We find no evidence of significant positive abnormal returns generated by announcement of the firm's decision to reincorporate from Nevada to Delaware.

of the state law market for monitoring and therefore an important cost of one-size-fits-all devices for controlling agency costs.

Data on the causes and effects of Nevada incorporation could change this conclusion; the data so far, however, are sparse and inconclusive. This raises the question of the appropriate burden of proof in problems related to state law that could warrant federal control. Even if some evidence were to indicate that Nevada was providing a refuge for inefficiently governed firms, it is not clear that this would justify outlawing experimentation in the market for state law. Problems with a first-mover state like Nevada are likely to be sufficiently salient that shareholders in Nevada corporations know what they are getting. As long as the market applies an appropriate discount, there is room for Nevada-type experimentation.

All of this is not to say that the market for corporate law functions perfectly. In particular, it is still not clear why there are only two competitors in this market, why one of these competitors is dominant, and why there is not more diversity in state corporate law. We have elsewhere suggested that the problem may lie in government legislators' weak incentives to innovate and the limited and skewed incentives for private parties' participation in the market for business association standard forms.[94] If private actors had stronger property rights in law, they might have an incentive to create a variety of different standard forms that states could adopt. There might then be more alternative standard forms and more variations on each standard form.

In general, the market is still learning about what does and does not work in corporate governance. Just as Berle and Means's warning of the dangers of separating ownership and control have given rise to a large literature that demonstrates the offsetting benefits of this separation and how the dangers that result can be addressed, so too has Cary's warning about Delaware's race to the bottom spawned theories and evidence concerning the benefits of the market for corporate law. We should now be skeptical about substituting Nevada for Delaware as the new "bottom," and we should wait for more evidence that Nevada represents a systematic problem before attempting to regulate it.

94. *See* Kobayashi & Ribstein, *supra* note 24.