

Price Discrimination in the Market for Corporate Law

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PRICE DISCRIMINATION IN THE MARKET FOR CORPORATE LAW

Marcel Kahan† & *Ehud Kamar*††

| | |
|--|------|
| INTRODUCTION | 1206 |
| I. DELAWARE'S MARKET POWER AND THE THEORY OF PRICE DISCRIMINATION | 1209 |
| A. Delaware's Market Power | 1210 |
| 1. <i>Evidence of Delaware's Market Power</i> | 1210 |
| 2. <i>Sources of Delaware's Market Power</i> | 1212 |
| B. The Theory of Price Discrimination | 1214 |
| 1. <i>Competitive and Monopoly Pricing</i> | 1215 |
| 2. <i>Price Discrimination</i> | 1215 |
| 3. <i>Applicability to the Market for Incorporations</i> | 1217 |
| II. HOW DELAWARE PRICE DISCRIMINATES | 1217 |
| A. Price Discrimination Through Franchise Taxes | 1218 |
| 1. <i>The Uniqueness of Delaware's Franchise Tax</i> | 1219 |
| 2. <i>Delaware's Franchise Tax and Price Discrimination</i> .. | 1223 |
| a. <i>The Incidence of Delaware's Annual Franchise Tax</i> | 1223 |
| b. <i>The Value Firms Place on Delaware Incorporation</i> | 1225 |

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| | | |
|------|--|------|
| c. | <i>Why Cost Differences Do Not Account for Price Differences</i> | 1230 |
| B. | Price Discrimination Through Litigation-Intensive Law | 1232 |
| 1. | <i>Delaware Law and the Level of Litigation</i> | 1233 |
| a. | <i>Use of Fact-Intensive and Standard-Based Tests</i> .. | 1236 |
| b. | <i>Ambiguity About the Applicable Legal Test</i> | 1237 |
| c. | <i>Narrow Breadth of Precedents</i> | 1239 |
| d. | <i>"The Essence of Delaware Law"</i> | 1239 |
| e. | <i>The Effect on the Level of Litigation</i> | 1240 |
| 2. | <i>Litigation-Intensive Law and Price Discrimination</i> ... | 1242 |
| a. | <i>The Incidence of Litigation-Related Costs</i> | 1242 |
| b. | <i>Delaware's Incentives to Structure Its Corporate Law</i> | 1245 |
| c. | <i>Why Cost Differences Do Not Account for Price Differences</i> | 1248 |
| III. | EFFICIENCY EFFECTS OF PRICE DISCRIMINATION | 1250 |
| A. | Franchise-Tax Price Discrimination | 1250 |
| B. | Price Discrimination Through Increased Litigation . | 1252 |
| C. | Implications for the Incorporation Debate | 1252 |
| | CONCLUSION | 1253 |
| | APPENDIX A | 1255 |
| | APPENDIX B | 1256 |

This Article analyzes how Delaware uses its market power in the market for incorporations to increase its profits through price discrimination. Price discrimination entails charging different prices to different consumers according to their willingness to pay. Two features of Delaware law constitute price discrimination. First, Delaware's uniquely structured franchise-tax schedule assesses a higher tax to public than to nonpublic firms. Second, Delaware's litigation-intensive corporate law effectively price discriminates among firms according to the level of their involvement in corporate disputes. From the perspective of social welfare, tax discrimination is likely to enhance efficiency. By contrast, price discrimination through litigation-intensive corporate law is likely to reduce efficiency.

INTRODUCTION

The competition among states in selling corporate laws to firms has long been the subject of extensive legal scholarship.¹ According

¹ See, e.g., FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1461-70 (1992); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. REV. 542 (1990); William L. Cary, *Federalism and*

to conventional wisdom, states compete in the market for incorporations by tailoring their laws to the taste of corporate decision makers. Since Delaware has for many years been more successful than any other state in attracting incorporations, its law is taken to epitomize what corporate decision makers want.²

Within this analytical framework, the views about state competition and the quality of law that it produces cover a wide spectrum. William Cary claimed that competition for incorporations is bad because corporate legal rules unduly benefit managers at the expense of shareholders.³ Ralph Winter, and more recently Roberta Romano, Frank Easterbrook, and Daniel Fischel, argue that competition is good because it induces states to devise corporate laws that maximize firm value.⁴ Lucian Bebchuk and Allen Ferrell contend that state competition is sometimes good and sometimes bad, depending on the issue involved.⁵ And Bernard Black suggests that competition does not really matter because it results in laws that are market mimicking, avoidable by advance planning, changeable by political forces when they matter, or simply unimportant.⁶

One issue that until recently has remained surprisingly unexplored, however, is the tension between Delaware's prolonged dominance of the market for incorporations and the assumption that this market is competitive and thus serves the interests of corporate decision makers. To be sure, commentators have acknowledged Dela-

Corporate Law: Reflections upon Delaware, 83 YALE L.J. 663 (1974); Robert Daines, *Does Delaware Law Improve Firm Value?*, J. FIN. ECON. (forthcoming 2002), available at <http://jfe.rochester.edu/2k488.pdf>; Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1512-12 (1989); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913 (1982); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 841-51 (1995); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225 (1985); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

² See ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 9 (1993) ("[I]f Delaware is not the pioneer for a corporate law innovation, it is among the first to imitate.").

³ See, e.g., Cary, *supra* note 1, at 663-68, 705 (arguing that competition leads to a race for the bottom, in which states adopt corporate laws that offer benefits to management at the expense of shareholder protections).

⁴ See, e.g., Fischel, *supra* note 1, at 913-20 (arguing that competition results in a race to the top); Romano, *supra* note 1, at 233-79 (presenting empirical evidence suggesting that state competition results in a race to the top); Winter, *supra* note 1, at 274-75 (arguing that capital markets induce companies to incorporate in "those states which offer the optimal yield to both shareholders and management," because otherwise the company would not attract or retain investors).

⁵ See Bebchuk, *supra* note 1, at 1458-84 (arguing that state competition leads to pro-management rules when management gains represent a high fraction of shareholder losses); Bebchuk & Ferrell, *supra* note 1, at 1172-78 (arguing that state competition for incorporations leads to pro-management takeover laws).

⁶ See Black, *supra* note 1, *passim* (arguing that corporate law is trivial).

ware's dominance and noted the competitive advantages that give rise to it.⁷ But apart from passing references to the fact that these advantages furnish Delaware with market power, they have said little about its potential uses.⁸

Recently, the simple view underlying this first generation of state competition scholarship has been giving way to a more realistic one that takes account of the complexities of the market for incorporations. The thrust of the second generation of state competition scholarship is that, if the market paradigm is to be taken seriously, it must reflect the various imperfections that characterize markets in reality. Thus, Michael Klausner, by himself and with one of us, has argued that, as a result of network and learning externalities, competition for incorporations among states may not yield optimal law either to shareholders or to managers.⁹ Building on this work, the other of us has argued that a corporate law that grants courts broad discretion excludes other states from Delaware's network externalities, and therefore it may develop even if it is not optimal.¹⁰

In this Article, we explore a different way in which the imperfections in the market for incorporations manifest themselves. We argue that Delaware exploits its market power through price discrimination. Price discrimination involves charging different prices to different consumers according to their willingness to pay in order to increase profits. We discuss two features of Delaware's corporate law that have a discriminatory effect: its franchise-tax formula and the litigation-intensive structure of its substantive law.

⁷ See, e.g., *id.* at 589-90 (discussing Delaware's expert judiciary); Klausner, *supra* note 1, at 841-47 (discussing network externalities associated with Delaware law); Romano, *supra* note 1, at 276-78 (discussing Delaware's substantive law, its judiciary, and its commitment to innovation).

⁸ A notable exception is the recognition by various commentators that Delaware charges a premium for its law. See, e.g., Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 *TEX. L. REV.* 469, 491-98 (1987) (examining Delaware's profits from the incorporation business); Romano, *supra* note 1, at 240-42 (same).

⁹ See Klausner, *supra* note 1, at 842-47; see also Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 *WASH. U. L.Q.* 347 (1996) [hereinafter Kahan & Klausner, *Path Dependence*] (relating network and learning effects to agency problems and cognitive biases); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 *VA. L. REV.* 713, 750-51, 760-61 (1997) [hereinafter Kahan & Klausner, *Economics of Boilerplate*] (expanding the analysis and empirically testing the presence of network and learning benefits).

¹⁰ See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 *COLUM. L. REV.* 1908 (1998) (arguing that legal indeterminacy prevents other states from tapping Delaware's learning and network externalities through emulation of Delaware law, accentuates the judicial expertise that has developed in Delaware, makes Delaware's commitment to corporate chartering more credible, and increases the costs for firms already incorporated in Delaware of reincorporating elsewhere).

In Part I we lay out the analytical foundation for our claim that Delaware engages in price discrimination by showing that Delaware has substantial market power in the market for incorporations and by discussing how a producer with market power can employ price discrimination to increase profits.

In Part II, we examine two features of Delaware law. First, we show that Delaware uses its uniquely structured franchise tax to charge a higher incorporation price to public corporations than it does to nonpublic corporations, and that among public corporations, it charges a higher price to larger corporations than it does to smaller ones. Second, we argue that Delaware's corporate law is litigation intensive, which has the effect of charging a higher price to corporations that have a greater involvement in corporate disputes.

Both of these practices function as price discrimination devices because they track important proxies for the value firms place on incorporating in Delaware. Yet—with the possible exception of tax differences among public firms—they do not reflect cost differences of serving different companies. With respect to the franchise tax, the ratio of taxes payable by public firms to taxes payable by nonpublic firms exceeds the cost ratio of serving these firms.¹¹ With respect to litigation intensiveness, this product design is in itself price discriminatory even if, given this design, the ratio of the rents that Delaware extracts from firms through litigation to the costs it incurs in providing litigation services is the same for all firms.¹²

In Part III, we analyze the normative implications of Delaware's price discrimination. We argue that Delaware's franchise tax probably increases social welfare by enabling more firms to benefit from using Delaware law. By contrast, Delaware's litigation-intensive substantive law probably decreases social welfare by making the advantages of using Delaware law smaller than they could be.

1

DELAWARE'S MARKET POWER AND THE THEORY OF PRICE DISCRIMINATION

In this Part, we review the economic theory of price discrimination and examine its applicability to the market for incorporations. We proceed in two steps. First, we show that Delaware possesses substantial market power in the market for incorporations. Second, we consider how producers with market power can increase their profits through price discrimination.

¹¹ See *infra* Part II.A.2(c).

¹² See *infra* Part II.B.2(c).

A. Delaware's Market Power

The choice of an incorporation state has several consequences. First, the corporation law of the state becomes the law that governs the internal affairs of the corporation.¹³ Second, the courts of the state acquire personal jurisdiction over the corporation and its directors in disputes related to its internal affairs.¹⁴ Third, the corporation becomes a user of the state's administrative services, which include obtaining corporate certificates, making corporate filings, and paying corporate franchise tax. These three consequences—applicability of the state's law, availability of the state's courts, and use of the state's administrative services—are the product that states provide in the market for incorporations.

In this market, Delaware is the most important domicile for publicly traded corporations. At present, about half of all public corporations in the United States are incorporated in Delaware. No other state accounts for more than five percent of public corporations.¹⁵ Moreover, most of the corporations not incorporated in Delaware are incorporated in the state where they are headquartered.¹⁶ These facts by themselves suggest that there is something special about Delaware in the market for incorporations. In this subpart, we argue that Delaware's preeminence is the result of competitive advantages, and that these advantages give Delaware market power—the ability to charge a premium for its law. We first present empirical evidence of Delaware's market power. We then examine the competitive advantages that are the basis for this market power.

1. *Evidence of Delaware's Market Power*

In competitive markets, producers have to sell their goods at a price equal to the marginal cost of production and earn zero economic profit.¹⁷ In markets that are not competitive, some producers

¹³ MELVIN ARON EISENBERG, *CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS* 101 (8th ed. unabridged 2000).

¹⁴ See, e.g., DEL. CODE ANN. tit. 10, §§ 3111, 3114 (1991). A plaintiff, however, can also bring a corporate dispute in another court as long as that court has subject matter and personal jurisdiction. Arguably, a corporation incorporated in another state could provide in its charter that all claims related to its internal affairs be brought in courts in a state other than its state of incorporation. We are unaware of any corporation that has included such a clause in its charter, and unsure whether a state court would accept jurisdiction over a dispute with such tangential ties to the state.

¹⁵ John C. Coates IV, *An Index for the Contestability of Corporate Control: Studying Variation in Legal Takeover Vulnerability* 29 (July 17, 1999) (unpublished manuscript, on file with authors); see also Del. Div. of Corps., *Home Page*, at <http://www.state.de.us/corp/index.htm> (last updated May 30, 2001) (reporting that 50% of the companies listed on the New York Stock Exchange are chartered in Delaware).

¹⁶ See Robert Daines, *The Demand for Corporate Law* (2000) (unpublished manuscript, on file with authors).

¹⁷ See *infra* Part I.B.1.

possess market power, which is defined as the ability to charge more for a product than its marginal cost.¹⁸ Since charging more for a product than its marginal cost is a condition for earning a profit, the ability to earn a profit over an extended period of time is evidence that a producer has market power.¹⁹

On this metric, it is evident that Delaware possesses substantial market power. Over the past thirty-five years,²⁰ Delaware appropriated less than three percent of its franchise-tax revenues to cover the costs of operating its chartering business,²¹ including the cost of running the Division of Corporations, the Delaware Court of Chancery, and the Delaware Supreme Court,²² and thus earned profit margins of several thousand percent. In dollar terms, Delaware's franchise-tax revenues averaged \$275 million per year on average outlays of \$7.33 million in the 1990s, \$113 million per year on average outlays of \$3.4 million in the 1980s, \$55 million per year on average outlays of \$1.03 million in the 1970s, and \$18 million per year on average outlays of \$0.57 million in the 1960s.²³ Clearly, Delaware's economic profits are substantial and have persisted for several decades.

¹⁸ DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 137 (2d ed. 1994).

¹⁹ Joe S. Bain, *The Profit Rate as a Measure of Monopoly Power*, 55 Q.J. ECON. 271, 274 (1941); see also A.P. Lerner, *The Concept of Monopoly and the Measurement of Monopoly Power*, 1 REV. ECON. STUD. 157 (1934) (using price markup to measure market power).

²⁰ Delaware's market power probably dates back more than thirty-five years. While we do not have data on the costs that Delaware incurred in serving chartered firms for the first half of the twentieth century from which to estimate Delaware's profits, the available data on Delaware's tax revenue strongly suggest that its market power was by then well established. Between 1915 and 1934, Delaware's corporate revenue averaged 35.8% of its total revenue, RUSSELL C. LARCOM, *THE DELAWARE CORPORATION* 167 tbl.IV (1937), and Delaware's share of incorporations among publicly traded companies increased significantly, *id.* at 175 tbl.VI, 176 tbl.VII. It seems unlikely that the cost to Delaware of serving its chartered firms kept pace with the rapidly increasing revenues from incorporations. However, Delaware's expanding market did not go unchallenged in that period. In the 1940s, over thirty states revised their corporation laws to match Delaware's, causing Delaware's percentage of franchise-tax revenues of total state revenues to decline from a high of 42.5% in 1929 to a low of 7.2% in 1955. See Joel Seligman, *A Brief History of Delaware's General Corporation Law of 1899*, 1 DEL. J. CORP. L. 249, 279 & n.153 (1976). In the 1960s, Delaware launched an ambitious program of modernizing its entire corporate law and marketing it aggressively to corporate counsel nationwide. Since then Delaware's incorporation revenues have steadily increased, totaling more than 20% of the state revenues in 1996. Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359 app. at 2429 tbl.1 (1998).

²¹ See Romano, *supra* note 20, app. at 2429 tbl.1.

²² *Id.*

²³ *Id.* app. at 2429 (reporting data from 1966 through 1996). As we explain below, most of Delaware's franchise-tax revenues reflect the price of incorporating in Delaware rather than the price of conducting business in the state. While some other states also derive substantial net revenues from their franchise tax, those revenues do not result from incorporating in those states but rather from doing business in them. See *infra* Part II.A.1.

2. Sources of Delaware's Market Power

Delaware's ability to charge a premium for incorporation is tied to the three facets of the product that Delaware is selling: substantive law, a forum for litigating disputes, and administrative services.

First, 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. The greater predictability that accompanies a highly evolved case law helps corporate actors plan transactions and reduces legal risk.²⁴ In addition, most national law firms have developed the expertise to advise their clients expediently on matters of Delaware corporate law.²⁵ The ease with which corporations can obtain legal advice on Delaware law reduces the costs of undertaking corporate transactions.²⁶ Similarly, the financial community's familiarity with Delaware law reduces the cost of analyzing and pricing its effect on corporate securities. Lowering these costs benefits corporations by reducing their cost of capital.²⁷

Second, Delaware courts are a desirable forum for litigating corporate disputes. When a corporate dispute arises, the ability to resolve the dispute quickly and sensibly is critical. This is where Delaware really shines. In Delaware, the chancery court has original jurisdiction over most corporate disputes.²⁸ Because the chancery court also has limited subject matter jurisdiction,²⁹ its docket consists mostly of corporate claims and its members decide cases without juries.³⁰ Members of the court thus have ample opportunity to develop expertise on matters of Delaware corporate law and have developed a national reputation for handling cases expeditiously. As a result, Delaware's chancery court is one of the most highly regarded courts in the country.³¹

²⁴ See Kamar, *supra* note 10, at 1923-24 (discussing network benefits generated by case law); Klausner, *supra* note 1, at 844-47 (same); Romano, *supra* note 1, at 276-77 (discussing the benefits generated by the large volume of Delaware cases).

²⁵ David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 161 (1997) (noting the experience of prominent New York law firms in Delaware corporate law).

²⁶ Klausner, *supra* note 1, at 846.

²⁷ *Id.* at 785.

²⁸ Rochelle C. Dreyfuss, *Forums of the Future: The Role of Specialized Courts in Resolving Business Disputes*, 61 BROOK. L. REV. 1, 5-8 (1995).

²⁹ *Id.*

³⁰ *Id.*

³¹ See, e.g., William H. Rehnquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 BUS. LAW. 351, 354-55 (1992).

Third, on a day-to-day basis, incorporation in Delaware gives corporations access to the state's efficient filing, registration, and other administrative services.³²

Fourth, Delaware is said to be uniquely committed to corporate needs. This commitment arguably derives from the substantial revenue historically generated by Delaware's franchise tax and the concomitant pressure to maintain this revenue stream.³³ Corporations value this commitment inasmuch as it reduces the likelihood of having to reincorporate in another state should Delaware law become less attractive in the future.³⁴

The significance of the factors underlying Delaware's substantial market power should be assessed in light of the fact that entry into the market for incorporations is restricted to states of the United States and foreign countries. Several states and many foreign countries suffer from competitive disadvantages—an inconvenient geographic location, nonautomatic recognition of their judgments in United States courts, language barriers, or a negative political reputation—that hamper their ability to attract incorporations. Of the remaining jurisdictions, none has made a determined effort to compete with Delaware.³⁵ This failure to compete may be attributed to political constraints, inattentiveness, or a perception that Delaware's competi-

³² See, e.g., CARTER S. COWLES, 5 COURT TECHNOLOGY REPORTS: DOCUMENT IMAGING, at app. A-1 (National Ctr. for State Courts, Publication No. R-173, 1995), at http://www.ncsc.dni.us/ncsc/ctr/appndx_1.htm (last visited Apr. 19, 2001) (praising the Delaware Division of Corporations imaging system). Delaware's market share may also enable the state to enjoy scale economies in rendering administrative and adjudicatory services.

³³ Romano, *supra* note 1, at 276 (stating that Delaware is "captive to demand by virtue of the revenues collected from incorporated firms"). In fiscal year 2002, Delaware's estimated revenues from its franchise tax will be \$557.6 million, constituting 22.7% of the state budget. Office of the Governor, State of Del., *Financial Overview: Fiscal Year 2002*, at 4, at <http://www.state.de.us/budget/fy2002/finover.pdf> (last revised Jan. 3, 2001). Delaware's commitment is further enhanced by the dependence of the local corporate bar on incorporations. See Romano, *supra* note 1, at 241. A lesser-known aspect of Delaware's investment in legal capital is its developed industry of corporate service companies. See Macey & Miller, *supra* note 8, at 503. Delaware law requires all chartered firms to be represented in the state by a local registered agent. See DEL. CODE ANN. tit. 8, § 102(a)(2) (1991). The Delaware Division of Corporations refers firms without Delaware offices to a list of 112 registered agents. Del. Div. of Corps., *Registered Agents*, at <http://www.state.de.us/corp/agents/agt2.htm> (last updated Feb. 15, 2001).

³⁴ See Romano, *supra* note 1, at 248-49 (arguing that reincorporation costs tie corporations to their domicile and are positively correlated with the size of the firm). *But see* Black, *supra* note 1, at 586-88 (arguing that reincorporation costs are low and a credible commitment is therefore not a significant advantage).

³⁵ For example, none of the three states frequently mentioned as competing with Delaware in the market for incorporations—Nevada, Pennsylvania, and Virginia—have instituted a specialized court modeled after the Delaware Court of Chancery. See, e.g., Douglas J. Cumming & Jeffrey G. MacIntosh, *The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law*, 20 INT'L REV. L. & ECON. 141, 147 (2000) (mentioning Nevada, Pennsylvania, and Virginia). For a discussion of the failed attempts to establish such a court in Pennsylvania, see *infra* text accompanying notes 171-75.

tive advantages are too formidable to overcome. At any rate, the lack of a serious competitor allows Delaware to raise its price for incorporations.

We should note, however, that Delaware's superiority does not necessarily mean that its law is optimal.³⁶ In fact, as we suggest below, Delaware law is likely to be suboptimal in precisely the areas where it is superior to the laws of other states.³⁷ Thus, Delaware's expert judiciary and wealth of legal precedents render its law more predictable than the laws of other states, but not as predictable as it could be if its precedents were more clear.³⁸ Similarly, the widespread use of Delaware law leads to greater familiarity among legal and financial professionals, but this level of familiarity could be further enhanced with more determinate law. In the same vein, Delaware's commitment to corporate needs guarantees that it will keep its law competitive with other states' laws, but does not guarantee that its law will be optimal.³⁹ In sum, while Delaware law is predictable and clear in comparison to the laws of other states, it does not live up to its unique potential for predictability and clarity that is generated by its vast body of precedents and its specialized trial court.

B. The Theory of Price Discrimination

Delaware can take advantage of its market power to increase profit in various ways. Most simply, it can—and in fact does—price an incorporation in Delaware at a premium above marginal cost.⁴⁰ We argue, however, that Delaware not only charges a premium for incorporation, but also engages in price discrimination by tailoring that premium to the benefits that different firms derive from incorporating in Delaware. In order to inform our discussion of Delaware's price discrimination, we briefly present the theory of price discrimination and discuss how it functions in the marketplace.

³⁶ The economic literature recognizes that producers offering a superior product may even intentionally damage their product to extract more consumer surplus through price discrimination. See, e.g., Raymond J. Deneckere & R. Preston McAfee, *Damaged Goods*, 5 J. ECON. & MGMT. STRATEGY 149, 169 (1996). In Delaware's case, we will argue, the damage is not intentional. See *infra* note 116 and accompanying text.

³⁷ See *infra* Part II.B.1.

³⁸ See Kamar, *supra* note 10, at 1913-14.

³⁹ See ROMANO, *supra* note 2, at 148. Because the profitability of Delaware's chartering business animates the state's commitment to firms, increasing profits from incorporations by offering even suboptimal litigation-intensive law may actually strengthen Delaware's commitment. Delaware's commitment to firms is no different from any other quality advantage that a producer enjoys. In either case, superiority does not translate into optimality.

⁴⁰ See, e.g., Macey & Miller, *supra* note 8, at 491-92; Romano, *supra* note 1, at 240-41.

1. *Competitive and Monopoly Pricing*

In perfectly competitive markets, producers sell products at a price equal to the marginal cost of production.⁴¹ Because any product in such a market has perfect substitutes, competition drives the price down to the lowest level at which producers are willing to manufacture and sell the product.⁴² That price equals the cost of producing the last unit sold, or the marginal cost.⁴³

In contrast, producers with market power can increase their profits by charging a price above marginal cost. Market power exists whenever a producer offers a product that has only imperfect substitutes. A producer in such a market need not fear competition by rivals offering an identical product, and can therefore set prices high enough to earn positive economic profits.⁴⁴

2. *Price Discrimination*

While monopoly pricing is more profitable than competitive pricing, a producer with market power can further increase profits by engaging in price discrimination. Price discrimination occurs when a producer charges a higher price to consumers with a higher willingness to pay and a lower price to consumers with a lower willingness to pay. Products do not have to be identical in order for their sale to different consumers at different prices to be discriminatory. What distinguishes price discrimination from regular price differences between products in competitive markets is that price discrimination is the sale of products by the same producer at prices that are in different ratios to marginal costs of production.⁴⁵ Thus, the sale of a book in hardcover for three times the price of a paperback version is presumably price discrimination because—although the books are not identical—the binding costs do not explain the price difference.⁴⁶

Economists distinguish between three types of price discrimination: first-degree, second-degree, and third-degree.⁴⁷ For ease of exposition, we start by explaining first-degree price discrimination, then

⁴¹ CARLTON & PERFLOFF, *supra* note 18, at 89.

⁴² *Id.* at 87-89.

⁴³ *Id.* at 89. Competitive pricing does not depend on the actual existence of perfect substitutes. It suffices that such substitutes could potentially be offered by new producers facing no entry barriers. *Id.* at 108-10.

⁴⁴ *Id.*

⁴⁵ See LOUIS PHILIPS, *THE ECONOMICS OF PRICE DISCRIMINATION* 6 (1983); GEORGE J. STIGLER, *THE THEORY OF PRICE* 210 (4th ed. 1987); JEAN TIROLE, *THE THEORY OF INDUSTRIAL ORGANIZATION* 133-34 (1988); Hal R. Varian, *Price Discrimination*, in 1 *HANDBOOK OF INDUSTRIAL ORGANIZATION* 597-99 (Richard Schmalensee & Robert D. Willig eds., 1989).

⁴⁶ See STIGLER, *supra* note 45, at 210.

⁴⁷ For accessible discussions of the literature on price discrimination, see CARLTON & PERFLOFF, *supra* note 18, at 431-82; TIROLE, *supra* note 45, at 133-52.

address third-degree price discrimination, and conclude with a discussion of second-degree price discrimination.

First-degree, or perfect, price discrimination is the most profitable type of price discrimination because it extracts each consumer's entire surplus.⁴⁸ To engage in perfect price discrimination, however, a producer must know the demand function of each consumer. Because producers are unlikely to possess this knowledge, perfect price discrimination is virtually never used in the real world and primarily serves as a benchmark for evaluating other pricing schemes.

Third-degree price discrimination is an imprecise version of perfect price discrimination. For a producer to engage in third-degree price discrimination, the producer must be able to distinguish among groups of consumers with different average willingness to pay. Unlike perfect price discrimination, however, the producer cannot distinguish between consumers within the same group.⁴⁹ The producer therefore charges a low price to all consumers in the low-willingness-to-pay group, and a high price to those in the high-willingness-to-pay group.⁵⁰ For example, a museum operator who knows that students are generally less willing to pay for admission than other adults may offer discounted student admission.

In the case of second-degree price discrimination, the producer also knows that a certain group of consumers has on average a higher willingness to pay than another group. The producer, however, cannot tell to which group an individual consumer belongs. To distinguish between different groups of consumers, the producer can offer different product-price packages that will induce each consumer to select the package targeted to her group. An airline, for example, may know that business travelers have a higher willingness to pay than leisure travelers, but not whether a particular passenger is a business or leisure traveler. To address this difficulty, the airline attempts to distinguish between the two groups by offering a lower round-trip fare for trips that include a weekend stay. Because leisure travelers, unlike business travelers, rarely mind staying over the weekend, this pricing

⁴⁸ TIROLE, *supra* note 45, at 135-37. In markets where consumers purchase no more than one unit of the product, like the market for corporate charters, a producer can first-degree price discriminate by charging to each consumer a price equal to the personal surplus from consumption of a single unit. When consumers choose not only whether to purchase the product but also how many units to purchase, the profit-maximizing strategy is to set the price per unit equal to marginal cost and charge to each consumer an additional lump sum equal to her surplus. This drives consumers to purchase exactly the same quantity of the product they would purchase in a competitive market but leaves them with none of the surplus. *Id.* at 136.

⁴⁹ Specifically, because differences between members of the same group are unobservable, the producer ignores them when pricing and instead treats each group as a separate market.

⁵⁰ TIROLE, *supra* note 45, at 136.

scheme enables the airline to charge a higher price to business travelers than to leisure travelers.⁵¹

3. *Applicability to the Market for Incorporations*

Since Delaware has market power in the market for incorporations, it may be able to derive higher profits if it engages in price discrimination. To engage in effective price discrimination, Delaware must be able to distinguish between consumers according to their willingness to pay and limit resale by consumers paying the lower price to those who would pay the higher price.⁵² The latter condition for price discrimination is clearly met in the incorporation market because companies cannot resell incorporations. How Delaware distinguishes among corporations according to their willingness to pay is the topic of Part II.

II

HOW DELAWARE PRICE DISCRIMINATES

In this Part, we examine two ways in which Delaware relies on its dominant position in the market for incorporations to engage in price discrimination. First, Delaware employs a franchise-tax schedule that results in higher charges to public companies than to nonpublic companies.⁵³ Second, the structure of Delaware's corporate law generates a heightened level of litigation. This increases the costs to firms that are more involved in legal disputes and the concomitant profits that Delaware derives from those firms. The status of a firm as publicly traded and the degree of its involvement in legal disputes are proxies for the value it assigns to incorporating in Delaware. By charging a higher price to firms that tend to attribute a greater value to incorpo-

⁵¹ See generally Michael Mussa & Sherwin Rosen, *Monopoly and Product Quality*, 18 J. ECON. THEORY 301 (1978) (explaining the economic principles underlying second-degree price discrimination). Second-degree price discrimination can also take the form of quantity discounts that induce consumers with a high willingness to pay to purchase more of the product. See TIROLE, *supra* note 45, at 148-49.

⁵² Economists refer to the resale of products by consumers paying the lower price to those who would pay the higher price as "personal arbitrage." See TIROLE, *supra* note 45, at 142-52.

⁵³ Price discrimination between public and nonpublic firms only requires having market power with respect to public firms. From the standpoint of nonpublic firms, incorporation in Delaware may well have close substitutes, and thus they may not be willing to pay a premium for it. Empirical evidence suggests that, if Delaware does enjoy some market with respect to nonpublic firms, that market power is rather slight. To be sure, Delaware is known to be the state of choice for nonpublic firms that incorporate outside their home state. See *supra* note 16 and accompanying text. Nevertheless, Delaware's small market share of nonpublic firms and the low rents it extracts from them suggest that its market power with respect to these firms is insubstantial. See *infra* note 79 and accompanying text.

rating in Delaware, Delaware engages in third-degree price discrimination.⁵⁴

A. Price Discrimination Through Franchise Taxes

In this subpart, we discuss Delaware's franchise tax. After showing that Delaware's franchise tax structure is unique, we argue that it results in higher charges to the firms that value incorporating in Delaware the most. Delaware is the only state that imposes substantial franchise taxes unrelated to the amount of business that firms conduct in the state. Other states either tax firms only to the extent that they conduct business in the state (regardless of where they are chartered) or impose only trivial charges on chartered firms. The design of Delaware's franchise tax, its uniqueness, and its effect strongly suggest that it is intended to effect third-degree price discrimination.⁵⁵

⁵⁴ Our account of Delaware's practice as constituting third-degree price discrimination is consistent with incorporation patterns in the United States. Because third-degree price discrimination is inherently inaccurate, it may leave those consumers who are charged more than they care to pay unserved, and may leave the served consumers who are charged less than they are willing to pay with varying amounts of surplus. The fact that about half of the public companies, but only a fraction of the nonpublic companies, incorporate in Delaware suggests that for most nonpublic firms, and for about half of public firms, the benefits of a Delaware corporate charter do not justify the associated costs. See *supra* text accompanying note 98. It also suggests that even with price discrimination, Delaware leaves public firms with a greater surplus than nonpublic firms. Similar differences, albeit on a smaller scale, seem to exist among public firms of different sizes. According to one study, Delaware's share of New York Stock Exchange firms was 49.4% in 1981 and 62.2% in 1996. Daines, *supra* note 1, tbl.3. In those years, Delaware's share of Nasdaq firms, which are typically smaller, was 34.7% and 52.0%, respectively. *Id.*

⁵⁵ Conceptually, Delaware may also be viewed as engaging in second-degree price discrimination which, in contrast to third-degree price discrimination, is premised on inducing consumers to self-select rather than imposing different prices on them. See *supra* notes 49-51 and accompanying text. After all, firms choose by themselves whether to go public. However, because the economic implications of going-public decisions seem to dwarf their franchise tax implications, Kara Scannell, *Year-End Review of Markets & Finance*, WALL ST. J., Jan. 2, 2001, at R6 (reporting a record \$80.6 billion raised through 452 initial public offerings in 2000), firms cannot realistically be expected to adjust their behavior in order to reduce franchise-tax liability. Tailoring the costs of incorporation to these firm characteristics is thus best analyzed as third-degree price discrimination. We view similarly Delaware's price discrimination through litigation intensiveness. See *infra* note 153.

At first glance, it may appear that Delaware's franchise tax is not price discriminatory because Delaware is in fact selling two distinct products: corporate law plus a little adjudication to nonpublic firms, and corporate law plus a lot more adjudication to public firms. We believe that appearance to be misleading. What Delaware is selling is a bundle of legal consequences that follow from incorporation. One such legal consequence is that Delaware courts will exercise personal jurisdiction over the corporation and, with respect to corporate matters, over corporate directors (which, in turn, increases the likelihood that a suit involving the corporation will be brought in Delaware). These legal consequences—and thus the product—are identical for all corporations. See *infra* Part II.B.2(c).

However, little turns on whether we use the term "price discrimination" or some other label. What we describe and analyze is a set of legal and economic facts and relations: the uniqueness of Delaware's franchise tax, its different incidence for public and nonpublic

1. *The Uniqueness of Delaware's Franchise Tax*

Annual franchise taxes are the most significant charges states levy on incorporated firms.⁵⁶ Most states employ one of two methodologies to determine the amount of annual franchise taxes a corporation must pay. First, twenty-four states and the District of Columbia charge domestic firms (firms chartered in the state) either no franchise tax or only a flat annual fee, ranging from \$4.50 to \$150, with a median rate of \$25.⁵⁷ The annual cost of incorporating in these states is thus insubstantial. Second, twenty states charge both domestic firms and foreign firms a tax based on the portion of some measure of the company's value, such as assets or equity, that is attributed to business activity conducted in-state.⁵⁸ Since domestic and foreign corporations

corporations, the different values placed by these corporations on incorporating in Delaware, the different costs to Delaware in servicing these corporations, the litigation-intensive structure of Delaware corporate law, the incidence of that structure, its effect on incentives to revise the law, the profits that Delaware derives from litigation, and the efficiency effects of these dynamics. The accuracy of our factual description and the persuasiveness of our analysis do not depend on whether Delaware is selling the same product to public and nonpublic firms (and firms value it differently because of their different likelihood of benefiting from one of its attributes) or whether public and nonpublic firms buy different products.

⁵⁶ STATE TAX GUIDE: ALL STATES ¶¶ 5-200 to 5-951 (CCH ed., 2001) [hereinafter TAX GUIDE]. States also charge companies initial incorporation fees and fees for specific services. *Id.* ¶¶ 1-200 to 1-951. These fees, however, tend not to result in substantial revenues. Forty-one states and the District of Columbia charge flat initial incorporation fees (ranging from \$35 to \$300 and with a median fee of \$72.50) and an initial filing fee payable by a foreign corporation that is at least as high. *Id.* Twenty states (including eleven of the states charging flat incorporation fees) and the District of Columbia charge incorporation fees based on the number of authorized shares or the authorized amount of stated capital. *Id.* In many of these states, even corporations with a large number of shares pay relatively small initial charges, although in some states the fee can be substantial. *Id.* For example, Ohio (which assesses the highest fee) would charge a company with 100 million authorized shares a one-time fee of \$252,600. *Id.* ¶ 1-726. Even this fee is small, however, compared to Delaware's \$150,000 annual franchise tax payable by large public companies. *Id.* ¶ 5-306.

In addition to these fees, which are payable by chartered firms, states also charge corporate income taxes to firms conducting business in their jurisdiction. Corporate income taxes are unrelated to our discussion because they are unaffected by where the firm is chartered. Telephone Interview with Jeffrey Gollinger, State and Local Tax Partner, Ernst & Young, New York (June 2000) [hereinafter Gollinger Interview].

⁵⁷ TAX GUIDE, *supra* note 56, ¶¶ 5-200 to 5-951. Moreover, each of these states charges its chartered companies an annual fee that is either the same as, or lower than, the fee it charges to companies that conduct business in-state but are chartered elsewhere. *Id.* Thus, for a company that conducts business in one of these states, there is no additional cost to incorporating in that state. Appendix A presents a listing of the states charging either no franchise taxes or only flat annual fees to domestic and foreign corporations.

⁵⁸ *Id.* ¶¶ 5-200 to 5-951. For a listing of the states employing this methodology, their tax base, and their apportionment method, see Appendix B. Thirteen of these states charge their chartered firms a flat annual fee in addition to an apportioned fee.

are taxed equally on the in-state portion of their tax base, corporations face no additional cost to incorporating in one of these states.⁵⁹

The six remaining states—Delaware, Georgia, Nebraska, Rhode Island, Virginia, and West Virginia—employ methodologies that could theoretically result in higher annual fees to domestic corporations.⁶⁰ However, in each of these states, with the exception of Delaware, any difference is likely to be modest. In four states, the annual franchise tax is capped: Georgia's at \$5000,⁶¹ Nebraska's at \$11,995,⁶² Virginia's at \$850,⁶³ and West Virginia's at \$2500.⁶⁴ And Rhode Island's tax, while uncapped, is very low. For example, a company with 100 million authorized shares with a par value of \$0.1 would pay an annual tax of \$2500.⁶⁵

This leaves Delaware. Delaware corporations pay as franchise tax the lower of two figures.⁶⁶ The first figure is based on the number of

⁵⁹ For example, Arkansas charges an annual franchise tax of 0.27% on a corporation's capital stock, multiplied by the ratio of the corporation's property in Arkansas to the corporation's total property. TAX GUIDE, *supra* note 56, ¶ 5-246. Because Arkansas corporations and foreign corporations conducting business in Arkansas pay this 0.27% tax on the portion of their capital stock allocated to Arkansas, their incorporation in Arkansas does not affect the tax they pay.

⁶⁰ *Id.* ¶¶ 5-305 to 5-310, 5-350 to 5-355, 5-605 to 5-606, 5-785 to 5-790, 5-890 to 5-895, 5-920 to 5-925. Georgia and Nebraska allocate the tax base only when determining the tax payable by foreign companies. *Id.* ¶¶ 5-350 to 5-355, 5-605 to 5-606. Domestic corporations pay tax based on their net worth (Georgia), *id.* ¶ 5-351, or total capital (Nebraska), although Nebraska charges a lower percentage tax rate to domestic companies than to foreign ones, *id.* ¶ 5-606. West Virginia charges two types of annual taxes: the first allocates the tax base between business activity conducted in-state and that conducted elsewhere, and the state taxes domestic and foreign firms equally on the in-state portion of the tax base, *id.* ¶ 5-921; the second, on stated capital, resembles the tax charged by Nebraska, *id.* ¶ 5-925. In the case of Nebraska and West Virginia, only companies that conduct relatively little business in the state face an additional charge for incorporating in it. Companies that conduct a lot of business in the state pay less if they are incorporated in it because the tax rate for domestic companies is lower than the rate for foreign companies. Rhode Island charges domestic and foreign companies a fee based on authorized capital. *Id.* ¶ 5-786. Virginia charges domestic and foreign corporations an annual fee based on the number of authorized shares. *Id.* ¶ 5-895. These fees represent additional costs to firms that are chartered in Rhode Island or Virginia without conducting business in those states.

⁶¹ *Id.* ¶ 5-351.

⁶² *Id.* ¶ 5-606. The cap for foreign corporations is slightly higher—\$15,000. *Id.*

⁶³ *Id.* ¶ 5-895.

⁶⁴ *Id.* ¶ 5-921. West Virginia's cap applies only to its tax on stated capital. *Id.*

⁶⁵ *Id.* ¶ 5-786.

⁶⁶ DEL. CODE ANN. tit. 8, § 503(a) (1991). The structure of Delaware's franchise tax is the product of four decades of experimentation. Initially, Delaware based its franchise tax on the par value of issued and outstanding shares. 21 Del. Laws, ch. 166, § 4 (1899). In 1901, Delaware changed the tax base from "capital stock issued and outstanding" to "capital actually paid in." 22 Del. Laws, ch. 16, § 2 (1901). In 1907, Delaware changed the tax base to the amount of the authorized capital stock. 24 Del. Laws, ch. 47, § 1 (1907). In 1927, Delaware changed the tax base to the number of authorized shares. 35 Del. Laws, ch. 5, § 4 (1927). Finally, in 1937, Delaware amended the law once again to bring it to its current structure. 41 Del. Laws, ch. 5, § 1 (1937).

authorized shares.⁶⁷ For corporations with more than 10,000 authorized shares, the fee amounts to \$90 for the first 10,000 shares plus \$50 for each additional 10,000 shares.⁶⁸ The second figure is based on the so-called "assumed par value capital" (APVC) of the firm.⁶⁹ Ordinarily, the APVC is the product of the assets of the company and the ratio of authorized to issued shares.⁷⁰ For companies with an APVC that exceeds \$1 million, the fee is \$200 for the first \$1 million plus \$200 for each additional \$1 million in APVC.⁷¹ The maximum fee is \$150,000 per year.⁷² Foreign companies pay a flat fee of \$50 per year.⁷³

Delaware's method of assessing annual franchise taxes is thus unique in two respects. First, Delaware is the only state where the additional charge for incorporating is often substantial. Second, no state but Delaware uses a system where the annual franchise tax is the lower of two figures: one based on the number of authorized shares and the other on APVC.

The fact that no state but Delaware structures its tax to gain substantial additional revenues from chartered firms casts doubt on the claim that states actively compete for incorporations. The desire to increase franchise-tax revenues is supposedly the main engine that drives state competition.⁷⁴ As presently structured, however, franchise

⁶⁷ DEL. CODE ANN. tit. 8, § 503(a)(1) (1991).

⁶⁸ *Id.* Firms with less than 3000 shares pay \$30 annually, firms with between 3000 and 5000 authorized shares pay \$50 annually, and firms with between 5000 and 10,000 authorized shares pay \$90. *Id.* Delaware companies also pay a filing fee of \$20. *Id.* § 391(a)(17).

⁶⁹ *Id.* § 503(a)(2).

⁷⁰ If the firm has shares with a par value that is higher than the firm's gross assets divided by the number of issued shares, the APVC of these shares is the number of authorized shares times their par value. *Id.* This scenario, however, is uncommon. Because the par value of the shares has no economic significance, firms typically set it at a very low level, if only to economize on franchise tax expenditures. John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law*, 89 COLUM. L. REV. 1618, 1692 n.35 (1989). Similarly, the calculation of APVC by companies with no par value shares is different from that described in the text. DEL. CODE ANN. tit. 8 § 503(a)(2) (1991). In practice, however, no-par capital is rare.

⁷¹ *Id.*

⁷² *Id.* § 503(c).

⁷³ *Id.* § 391(a)(8). While Delaware's franchise tax exceeds those of other states, its corporate income-tax system is advantageous for companies whose only assets are intangibles (such as securities, intellectual property, or debt). However, Delaware companies that pay higher franchise taxes than they would elsewhere are not motivated by the desire to reduce their corporate income taxes. First, non-Delaware companies can obtain these advantages by holding all of their income-generating intangibles through a Delaware subsidiary. Tax saving therefore cannot explain why so many publicly traded companies choose Delaware as a state of incorporation for themselves rather than only for their subsidiaries. Second, other states offer tax advantages that equal or surpass Delaware's. See Godlinger Interview, *supra* note 56. Thus, even subsidiaries do not need to be incorporated in Delaware to reduce taxes.

⁷⁴ See, e.g., Bebchuk, *supra* note 1, at 1443; Cary, *supra* note 1, at 668-69; Winter, *supra* note 1, at 255. But see Mark J. Loewenstein, *Delaware as Demon: Twenty-five Years After Profes-*

taxes provide only Delaware with a substantial incentive to attract incorporations.

To be sure, there is still validity to the claim that a market for incorporations exists. First, even in the absence of active competition, the present system offers companies a choice of where to incorporate. Second, states may still compete for incorporations in order to increase their incorporation-related business.⁷⁵ Moreover, while the franchise taxes of states other than Delaware are currently not structured in a way that motivates states to attract incorporations, nothing stops states from changing their franchise taxes so that, like Delaware, they would gain higher tax revenues from increased incorporations and, correspondingly, would have incentives to compete. Third, even if no other state competes, Delaware is to some degree motivated to make its corporate law attractive in order to charge a higher price for incorporating in Delaware.⁷⁶ While we therefore acknowledge that a market for incorporations exists, we challenge the assumption made by first-generation state-competition scholars that this market is a competitive one.⁷⁷

sor Cary's Polemic, 71 U. COLO. L. REV. 497, 501-02 (2000) (arguing that legislators devise corporate law out of regard for public policy and not to attract incorporations). Roberta Romano argues that her finding, that states that are more responsive to corporate concerns earn a higher proportion of their revenues from franchise taxes, provides empirical support for the claim that franchise-tax revenues motivate states to compete. *See* Romano, *supra* note 1, at 236-40. Romano's franchise-tax variable depends on a state's total franchise-tax revenues, not on the additional revenues that a state receives as a result of incorporations. *Id.* at 238-39. As presently structured, however, it is unlikely that total franchise-tax revenues are significantly correlated with additional revenues from incorporations.

⁷⁵ *See* Romano, *supra* note 1, at 241; *infra* Part II.B.2(b). The desire to increase incorporation-related business has generally only led to half-hearted attempts to compete with Delaware. *See supra* note 35 and accompanying text. A notable exception is Nevada, which actively competes for incorporation by certain holding companies. *See, e.g.*, John Chavez, *Mesa Airline Move to Nevada Sparks Debate on Tax Burdens*, ALBUQUERQUE J., Apr. 29, 1996, Business Outlook at 2 (discussing corporate income-tax advantages to holding companies that incorporate in Nevada). Even Nevada, however, has not made major attempts to make itself attractive to publicly traded companies by forming a court of chancery similar to Delaware's. Recently, Maine has been exploring the possibility of attracting Delaware firms by offering law that is more shareholder friendly than Delaware's. *See* OFFICE OF POLICY & LEGAL ANALYSIS, STATE OF ME., EXECUTIVE SUMMARY OF THE COMMISSION TO ENCOURAGE INCORPORATIONS IN MAINE, 119th Leg., 1st Sess., at 4-6 (1999), available at <http://www.state.me.us/legis/opla/corpor.PDF> (last visited Apr. 14, 2001); *see also* Letter from Richard H. Koppes, Co-Coordinator of the Stanford Institutional Investor Forum, to Senator Susan W. Longley and Representative Verdi L. Tripp, Co-Chairs of the Commission to Encourage Incorporations in Maine (June 12, 2000) (on file with authors) (expressing doubts of an institutional investors group about Maine's proposal in light of the inability of shareholders to initiate reincorporations and the difficulty of duplicating Delaware's sophisticated judiciary).

⁷⁶ *See* TIROLE, *supra* note 45, at 100-02 (describing a monopolist's choice of product quality).

⁷⁷ The fact that each state has adopted a corporation law is consistent with our claim that states do not actively compete for incorporations. States offer corporation laws, like

2. *Delaware's Franchise Tax and Price Discrimination*

In this section, we argue that Delaware's peculiar tax schedule is designed to price discriminate between corporations that assign a high value and corporations that assign a low value to being incorporated in Delaware. We first analyze the incidence of Delaware's franchise tax for different types of firms. We then demonstrate how this incidence corresponds to the value that firms place on incorporating in Delaware. Finally, we examine whether the differences in franchise taxes payable by different firms are related to Delaware's cost of serving these firms.

a. *The Incidence of Delaware's Annual Franchise Tax*

Delaware's franchise tax is the lower of two rates, the first derived from the number of authorized shares, and the second from the company's APVC.⁷⁸ As a result, a high tax is payable only by companies that have both a large number of authorized shares and a high APVC.

These criteria assure, for one, that nonpublic companies have to pay only minimal annual franchise taxes. Companies with 3000 or fewer authorized shares pay the minimum fee of \$30, regardless of their APVC.⁷⁹ Virtually all nonpublic companies can achieve any desired equity allocation among their owners with 3000 shares. Thus, there is no business reason why they would have to pay more than the minimum fee.⁸⁰

Companies with publicly traded shares, by contrast, have a number of authorized shares, and an APVC that yields a substantially higher franchise tax. Public companies need a large number of outstanding shares to create a wide distribution of share ownership and thus a liquid public market.⁸¹ A liquid public market, of course, is one of the main benefits of being publicly traded.⁸² The necessary number of outstanding shares is further increased by the fact that

other laws, as a service to residents (who, for example, save transaction costs by incorporating in their state of residence). The desire to provide a service for residents may also account for the pattern of diffusion of corporate law innovations, which Roberta Romano interprets as evidence of competition. See Romano, *supra* note 1, at 233-35.

⁷⁸ DEL. CODE ANN. tit. 8, § 503(a) (1991); see *supra* notes 66-73 and accompanying text.

⁷⁹ See DEL. CODE ANN. tit. 8, § 503(a) (1991).

⁸⁰ Moreover, nonpublic companies do not need to have a substantial number of unissued shares. When they need to issue additional shares, nonpublic companies can easily obtain shareholder approval for a charter amendment increasing the number of authorized shares.

⁸¹ Thomas E. Copeland, *Liquidity Changes Following Stock Splits*, 34 J. FIN. 115, 115-16 (1979) (relating stock splits, which increase the number of shares outstanding, to liquidity increases).

⁸² See Yakov Amihud & Haim Mendelson, *Liquidity, Asset Prices and Financial Policy*, FIN. ANALYSTS J., Nov.-Dec. 1991, at 56, 56.

shares are commonly traded in blocks of 100.⁸³ Finally, public companies often have a substantial number of authorized but unissued shares, which can be used to raise new capital, issue stock in stock splits, issue stock to strategic investors in defense against hostile takeovers, or fund acquisitions without having to obtain shareholder approval.⁸⁴

Public companies also have a high APVC. Recall that the APVC is generally the product of the company's assets and the ratio of its authorized to issued shares. For any company, then, the APVC is at least as high as its assets.⁸⁵ Public companies, of course, tend to have substantial assets. Moreover, as we noted above, public companies often have a large number of unissued authorized shares, further increasing their APVC.

To place the fees payable by public companies in perspective, we used publicly available data on firms' capital stock and assets to calculate the franchise tax payable by three random samples of public Delaware companies whose stock is, respectively, listed on the New York Stock Exchange (NYSE companies), traded on the Nasdaq National Market (Nasdaq-NM companies), or traded over the counter (OTC companies). This method of data selection ensured that our sample spans the spectrum of firm sizes for public companies, since NYSE companies tend to be larger than Nasdaq-NM companies, and the latter tend to be larger than OTC companies. As Table 1 shows, the annual franchise taxes payable by public companies are multiple orders of magnitude above the minimum tax of \$30. Indeed, most NYSE companies pay the maximum franchise tax of \$150,000 a year, and few NYSE or Nasdaq-NM companies pay less than \$10,000. Even OTC companies pay on average over \$20,000 in annual franchise taxes.

⁸³ N.Y. INST. OF FIN., *HOW THE STOCK MARKET WORKS* 27 (John M. Dalton ed., 2d ed. 1993).

⁸⁴ See, e.g., Coyote Network Sys., Inc., *Proxy Statement* 18 (June 29, 2000), available at <http://www.sec.gov/Archives/edgar/data/57201/000095014800001363/def14a.txt> (last visited Apr. 20, 2001) (stating that increasing the number of authorized shares will enable the company to issue equity without the delay and expense of a special shareholder meeting in connection with financings, acquisitions, other growth programs, stock splits, dividends, and benefit plans). Stock exchange listing rules limit public companies to issuing no more than 20% of their common stock or securities convertible into or exercisable to common stock without shareholder approval. See NEW YORK STOCK EXCHANGE, LISTED COMPANY MANUAL § 312.03 (1983); cf. NATIONAL ASS'N OF SECURITIES DEALERS, INC., NASD MANUAL § 4310(c)(25)(H)(i) (relating to Nasdaq SmallCap issuers); *id.* § 4460(i)(1) (relating to Nasdaq National Market issuers) (1980).

⁸⁵ See *supra* notes 69-72 and accompanying text.

TABLE 1: 1999 FRANCHISE TAX ESTIMATES BY FIRM TYPE

| Firm Type | Sample | Firms Paying \$150,000 | Average Paid by Others | Average Paid by All Firms | Firms Paying Less than \$10,000 |
|-----------|--------|---------------------------|------------------------------|---------------------------------|---------------------------------------|
| NYSE | 50 | 40 (80%) | \$71,000 | \$134,000 | 0 (0%) |
| Nasdaq-NM | 30 | 5 (17%) | \$51,000 | \$ 68,000 | 2 (7%) |
| OTC | 30 | 0 (0%) | \$21,000 | \$ 21,000 | 19 (63%) |

Most of Delaware's franchise-tax revenues, in turn, originate from publicly traded companies. As of 1997, for example, we estimate that between 10,000 and 12,000 United States companies had publicly traded stock, of which 3000 were traded on the New York Stock Exchange, 4200 on the Nasdaq National Market, 800 on the Nasdaq SmallCap market, 750 on the American Stock Exchange, and the remainder on regional exchanges or over-the-counter.⁸⁶ In fiscal year 1997, Delaware received \$314 million in annual franchise-tax revenues from 5050 firms paying \$10,000 or more.⁸⁷ To pay at least \$10,000 in annual franchise taxes, a company must have had at least 1.99 million authorized shares and at least \$50 million in APVC. Thus, virtually all firms that paid such franchise taxes should have been publicly traded corporations. By contrast, revenues from the 211,600 firms that paid less than \$10,000, most of which were nonpublic, were only \$35 million.⁸⁸

b. *The Value Firms Place on Delaware Incorporation*

The unusual incidence of Delaware's franchise tax—where public companies pay a much higher tax than nonpublic companies and, among the former, larger corporations pay a higher tax than smaller ones—corresponds to the relative value that different firms place on being incorporated in Delaware.

Consider first the distinction between public and nonpublic corporations. All of the competitive advantages that Delaware enjoys over other states are more meaningful to public companies. First, public corporations are more likely than nonpublic ones to benefit from Delaware's expert judiciary because they are more likely to be

⁸⁶ In 1997, about 13,200 companies were required to file annual reports with the Securities and Exchange Commission. See OFFICE OF POLICY RESEARCH, U.S. SEC. & EXCH. COMM'N, DIRECTORY OF COMPANIES REQUIRED TO FILE ANNUAL REPORTS WITH THE SECURITIES AND EXCHANGE COMMISSION (1997). This figure, however, includes some foreign companies and companies that have publicly traded securities other than stock. For data on companies listed on the various markets, see Nat'l Ass'n of Sec. Dealers, Inc., *Market Data*, at http://www.marketdata.nasdaq.com/mr_outline.asp (last visited Mar. 19, 2001).

⁸⁷ See *infra* Table 3.

⁸⁸ *Id.*

involved in corporate disputes.⁸⁹ Many nonpublic corporations have only a single shareholder. Such companies are rarely involved in corporate disputes, which mostly concern conflicts among shareholders or conflicts between dispersed shareholders and managers. And even compared to nonpublic companies with more than one shareholder, public companies are more likely to be involved in corporate disputes because they have thousands of shareholders and the potential to be subject to entrepreneurial class and derivative actions.⁹⁰

In fact, even though less than 2.5% of Delaware corporations are public, most of Delaware's corporate litigation concerns public companies. For example, of 78 chancery court opinions on corporate law released in 1990, 65 involved public corporations, and only 13 involved nonpublic ones.⁹¹ Put differently, the probability for a public corporation to be involved in one of these cases was about 200 times higher than the respective probability for a nonpublic corporation.

Second, public corporations are more likely than nonpublic ones to benefit from Delaware's highly developed case law and from the ease of obtaining legal advice. The legal problems facing public corporations differ from those facing nonpublic corporations. For example, the rules on hostile takeovers are significant only to public corporations.⁹² And even though both public and nonpublic corporations may face problems of self-dealing, the factual context of the self-dealing and the availability of cleansing devices, such as approval by disinterested directors, differ greatly.⁹³ The product of many years of litigation involving predominantly public corporations, Delaware case law relates mostly to these firms and thus is more valuable to them.⁹⁴

⁸⁹ To the extent that some nonpublic companies are involved in corporate disputes, they benefit from Delaware's expert judiciary even though they need to pay only minimal franchise taxes. As we argue below, however, Delaware derives profits from such nonpublic companies through its price discriminatory legal structure. See *infra* Part II.B.

⁹⁰ Public companies are also more likely than nonpublic ones to benefit from Delaware's expert judiciary because they tend to be larger. The effect of firm size is discussed *infra* text accompanying notes 99-105.

⁹¹ In the same year, all six Delaware Supreme Court opinions that related to corporate law involved public corporations. These figures were obtained from a review of all 105 opinions dated 1990 in the DE-CS Westlaw database that contain the search term "Chancery." We excluded 21 documents because they were not related to corporate law or were summary affirmances. The database includes both reported and unreported opinions.

⁹² See Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 280 (1967).

⁹³ See *id.*

⁹⁴ See, e.g., ROBERT C. CLARK, CORPORATE LAW 29, 164-66, 220-21, 234-43 (1986) (arguing that the law that suits public corporations does not suit nonpublic ones in the areas of self-dealing, executive compensation, and corporate opportunities); Tara J. Wortman, Note, *Unlocking Lock-In: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1374-79 (1995) (arguing that rules well-suited for public corporations, such as rules giving a high degree of deference to management, can

Similarly, it is more important to public than to nonpublic corporations that most national law firms have specialized in Delaware law because the law firms' expertise relates to disputes involving public corporations.⁹⁵

Third, only public corporations are likely to derive significant benefits from the familiarity of investors and analysts with Delaware corporate law. This familiarity makes it easier for companies to sell, and for investors to trade, shares governed by Delaware law.⁹⁶ For nonpublic companies, the shares of which are not traded, the financial community's familiarity with Delaware law is irrelevant.

Finally, Delaware's commitment to corporate needs is relevant only to public firms. This commitment is important inasmuch as companies incur costs in changing their state of incorporation. Commentators disagree about the extent of these costs with respect to public firms.⁹⁷ It is clear, however, that most nonpublic firms would incur only trivial costs in changing their state of incorporation and thus should place no value on Delaware's commitment.

Empirical evidence confirms that public companies value Delaware law more than nonpublic companies. Delaware is the state of incorporation for about 50% of the public companies in the United States, but only for about 6% of the nonpublic companies.⁹⁸ That Delaware's market share among public companies substantially exceeds its share among nonpublic companies, even though Delaware charges public companies a much higher franchise tax, suggests that incorporation in Delaware is more valuable to public companies.

For similar reasons, among public corporations, the value of incorporation in Delaware increases with the size of the company. Larger public companies benefit more than smaller public companies

have adverse effects on nonpublic corporations). *See generally* RICHARD A. POSNER & KENNETH E. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 111 (1980) (describing specialization among state corporate laws); Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 *J.L. & ECON.* 179 (1985) (same). Arguably, the expertise of Delaware's judiciary is also, to some extent, specific to disputes involving public corporations.

⁹⁵ *See* Skeel, *supra* note 25, at 161 (discussing the expertise of New York law firms in takeover litigation).

⁹⁶ *See* Kahan & Klausner, *Economics of Boilerplate*, *supra* note 9, at 719-29 (discussing learning and network benefits related to familiarity with corporate contract terms); Klausner, *supra* note 1, at 785-89 (discussing network benefits related to familiarity with corporate contract terms).

⁹⁷ *See supra* note 34 and accompanying text.

⁹⁸ *See* ECON. & STATISTICS ADMIN., U.S. CENSUS BUREAU, *STATISTICAL ABSTRACT OF THE UNITED STATES: 2000*, at 535 tbls. 854-55 (120th ed., 2000) (reporting United States incorporations data); Del. Div. of Corps., *Delaware Incorporating Statistics—1997*, at <http://www.state.de.us/corp/graphs97.htm> (last visited July 25, 2000) (reporting Delaware incorporation data). Indeed, many companies change their state of incorporation to Delaware shortly before they go public. *See* Romano, *supra* note 1, at 250, 252 tbl.4.

from Delaware's developed law and expert judiciary because they tend to be more frequently involved in corporate legal disputes.⁹⁹ Table 2 presents data on the frequency of corporate lawsuits from 1989 to 1998 for public companies participating in the Tillinghast-Towers Perrin Directors and Officers Liability Survey.¹⁰⁰ As Table 2 illustrates, the frequency of corporate litigation for the largest public firms is about 15 times higher than the frequency for the smallest public firms. In a chi-square test, the differences in the average number of lawsuits are significant at a 1% level. Moreover, the stakes of legal disputes—and the corresponding benefits of litigating in Delaware—are likely to be higher for larger corporations than for smaller ones.

TABLE 2: FREQUENCY OF CORPORATE LAWSUITS AMONG PUBLIC FIRMS IN 1989-1998

| Total Assets (in \$1 millions) | Number of Firms | Number of Firms Involved in Litigation | Percentage of Firms Involved in Litigation | Total Number of Lawsuits | Number of Lawsuits Per 1000 Firms |
|-----------------------------------|--------------------|---|---|--------------------------------|--|
| assets ≤ 100 | 236 | 4 | 1.7 | 4 | .017 |
| 100 < assets ≤ 400 | 156 | 4 | 2.6 | 4 | .026 |
| 400 < assets ≤ 1000 | 123 | 9 | 7.3 | 10 | .081 |
| 1000 < assets ≤ 2000 | 118 | 18 | 15.3 | 21 | .178 |
| 2000 < assets | 235 | 34 | 14.5 | 57 | .243 |

Source: Tillinghast-Towers Perrin

In addition, large public companies benefit from Delaware's rich body of case law and readily available legal advice more than small public companies because the size of transactions they undertake is typically larger.¹⁰¹ The large stakes involved in the operations of large

⁹⁹ Arguably, the larger the public company, the greater the benefits from investors' familiarity with Delaware law (because it has more investors) and from Delaware's commitment (because obtaining shareholder approval for a reincorporation is more costly).

¹⁰⁰ To focus on lawsuits arising under state corporate law, the data include only shareholder lawsuits brought in federal or state court relating to: golden parachutes or executive compensation; a repurchase or a bid to repurchase securities; a breach of duty to minority shareholders; general breach of fiduciary duty; shareholder suits, other than suits brought exclusively in federal courts, relating to a takeover defense measure; a bid or a threat by another company to take over the surveyed company; a bid or a threat by the surveyed company to take over another company; a merger or an acquisition; and a divestiture or a spinoff. See TILLINGHAST-TOWERS PERRIN, 1998 DIRECTORS AND OFFICERS LIABILITY SURVEY: U.S. AND CANADIAN RESULTS 8-9, 62-72 (1999) [hereinafter LITIGATION SURVEY]. We thank Mark Larsen of Tillinghast-Towers Perrin for providing us with the data in Table 2, which is not reported in that publication. For a summary of the 1999 *Directors and Officers Liability Survey* issued by Tillinghast-Towers Perrin in 2000, see 2 WILLIAM F. KNEPPER & DAN A. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 27-1 to 27-10 (6th ed. 1998 & Supp. 2000).

¹⁰¹ According to Roberta Romano, the initiation or expansion of an acquisitions plan is the most common reason why public companies reincorporate in Delaware. See Romano, *supra* note 1, at 256.

public companies also induce them to hire expensive national law firms more often, and the value added from using that advice tends to be higher for them.

Consistent with these arguments, empirical evidence shows that large public corporations are more likely than small public corporations to incorporate in Delaware, even though large public corporations face higher annual franchise taxes.¹⁰² Once again, this suggests that larger public companies value incorporating in Delaware more highly than smaller ones.

Given all these benefits, a maximum tax of \$150,000 for incorporating in Delaware may appear to be rather modest, especially for very large companies, suggesting the possibility that Delaware is not charging the most it could. Part of the explanation for the restrained tax policy is that, as we argue below, Delaware charges an additional price in the form of litigation intensiveness.¹⁰³ However, Delaware's franchise-tax rates have not changed over the last ten years despite substantial inflation over that period, and so rates probably could be higher. Moreover, according to a study by Robert Daines, even after considering all the costs involved, shareholders still value Delaware firms by as much as 5% higher than comparable firms incorporated in other states.¹⁰⁴ Arguably, Delaware could appropriate some of this surplus, through higher taxes.

Another part of the explanation for Delaware's restraint may therefore be that political considerations induce Delaware not to increase its franchise-tax rates. For example, when we asked former and present Delaware officials why franchise-tax rates are set at their current levels, they explained that Delaware does not need more money, that keeping taxes at modest levels increases Delaware's goodwill and enables it to raise taxes when a need arises, that increasing franchise taxes while reducing other taxes would be considered improper, and that overdependence on corporate franchise taxes is not prudent.¹⁰⁵ Perhaps the strongest pressure on Delaware not to raise taxes comes from local interest groups, notably the corporate bar and corporate service companies, which would not benefit directly from higher franchise-tax revenues. Those interest groups could only be hurt by

¹⁰² Daines, *supra* note 1; *supra* Table 1.

¹⁰³ *See infra* Part II.B.

¹⁰⁴ *See* Daines, *supra* note 1, at 13. For the argument that this premium, which can be worth millions of dollars to large public firms, may well reflect the benefits we listed, see Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001).

¹⁰⁵ Interview with Secretary of the State of Delaware Edward J. Freel, in Wilmington, Del. (Dec. 11, 2000); Interview with Vice Chancellor Leo E. Strine, Jr., Delaware Court of Chancery, in Wilmington, Del. (Dec. 11, 2000) [hereinafter Strine Interview].

any tax increase because it could drive some of their clients away from Delaware.

c. *Why Cost Differences Do Not Account for Price Differences*

Charging different franchise taxes to different companies, even if the taxes are related to the value that these companies derive from incorporating in Delaware, would nevertheless not constitute price discrimination if the tax differences were based on differences in the costs that Delaware incurs in providing services to these firms.¹⁰⁶ Evidence strongly suggests, however, that cost differences do not explain the tax differences, at least with respect to the tax differences between public and nonpublic companies.

For example, the franchise tax payable in Delaware by a large public firm can be as high as 5000 times the tax payable by a typical nonpublic firm: \$150,000 versus \$30 per year.¹⁰⁷ Although it costs Delaware more to serve large public firms than nonpublic firms, the ratio of these costs is nowhere near 5000 to 1.

Delaware's costs are mostly associated with the provision of administrative services by the Division of Corporations and the provision of judicial services by the chancery court.¹⁰⁸ The total costs budgeted by Delaware for these items were \$10.1 million in fiscal year 2000.¹⁰⁹ The relative costs of serving public and nonpublic firms depend on whether public firms use these services more frequently than nonpublic ones and whether it is more costly, per use, to serve public firms than nonpublic ones.

Consider first the provision of administrative services, such as the filing of charter amendments or merger certificates. Arguably, large public companies use these services somewhat more frequently than private ones. On a per-use basis, however, according to administrators in the Delaware Division of Corporations, the paperwork is similar for all corporations.¹¹⁰ Thus, even though it is plausible that the overall costs of providing administrative services to a large public firm are higher than the costs of providing these services to a nonpublic firm,

¹⁰⁶ Price discrimination is defined as the sale of products at prices that are in different ratios to marginal costs. See *supra* Part I.B.2.

¹⁰⁷ See *supra* notes 66-80 and accompanying text.

¹⁰⁸ See Romano, *supra* note 1, at 240. The costs of legislation are probably small and, in any case, would not constitute marginal costs.

¹⁰⁹ The amounts budgeted for the Division of Corporations and the chancery court in fiscal year 2000 were, respectively, \$8.1 million and \$2 million. Office of the Budget, State of Del., *FY2001 Governor's Recommended Budget*, at <http://www.state.de.us/budget/fy2001/vol2-2001.htm> (last visited Mar. 29, 2001).

¹¹⁰ See Interview with Laura Y. Marvel, Corporation Administrator, Delaware Division of Corporations, in Wilmington, Del. (Dec. 11, 2000); Interview with Eileen H. Simpson, Franchise Tax Administrator, Delaware Division of Corporations, in Wilmington, Del. (Dec. 11, 2000).

it is highly implausible that the ratio of these costs is anywhere near 5000 to 1.

Turning to the provision of judicial services, our survey indicates that a public firm is about 200 times more likely to be involved in a corporate lawsuit than a nonpublic firm.¹¹¹ On a per-lawsuit basis, however, two members of the Delaware judiciary report that a typical dispute involving a public firm consumes the same amount of judicial time as a dispute involving a nonpublic firm.¹¹² Thus, the overall cost difference between large public firms and nonpublic firms that is related to judicial services is several orders of magnitude below the tax difference. Even if these estimates of the differences in the cost of providing administrative services as well as in the frequency and duration of lawsuits between large public and nonpublic Delaware firms are overly conservative, they are far too low to account for the franchise-tax difference.

That Delaware's franchise-tax differences do not reflect administrative and judicial cost differences is consistent with the pricing structure employed by other states. Most states charge the same marginal incorporation tax to public and nonpublic firms.¹¹³ Moreover, while Delaware charges by far the highest franchise tax to public firms, the tax it levies on nonpublic firms is comparatively low. These pricing regimes make it implausible that Delaware's cost of serving large public firms is 5000 times as high as its cost of serving nonpublic firms, and that Delaware extracts the same percentage premium from both public and nonpublic firms.

While we can conclude that the difference in franchise taxes payable by public and nonpublic firms cannot be attributed to cost differences, we are less confident about the difference in taxes payable by larger and smaller public firms. For one, the difference in taxes payable by large and small public firms is only about fifteen to one.¹¹⁴ And while there is no reason to believe that large and small public firms make different use of administrative services, the Tillinghast-Towers Perrin survey indicates a difference in the frequency of lawsuits for the largest and smallest public companies in the same order of magni-

¹¹¹ See *supra* note 91 and accompanying text. This figure averages large and small public firms. About one out of four public firms incorporated in Delaware pays the maximum franchise tax of \$150,000. See *supra* text accompanying notes 87-88 and *infra* Table 3. Thus, even if all corporate litigation by public firms involved firms paying the maximum franchise tax, such firms would be about 800 times more likely to be involved in lawsuits than nonpublic firms—far less than the 5000 to 1 ratio in franchise taxes.

¹¹² Interview with Vice Chancellor Jack B. Jacobs, Delaware Court of Chancery, in Wilmington, Del. (Dec. 11, 2000); Strine Interview, *supra* note 105. The judges attributed this fact to inadequate corporate legal planning or acrimonious personal relations in lawsuits involving nonpublic firms. *Id.*

¹¹³ See *supra* notes 57-66 and accompanying text.

¹¹⁴ See *infra* Table 3.

tude.¹¹⁵ Given the roughness of the available data, the evidence is thus insufficient to determine whether the difference in taxes payable by large and small public firms reflects cost differences or constitutes price discrimination.

B. Price Discrimination Through Litigation-Intensive Law

In this subpart, we argue that the litigation-intensive structure of Delaware law results in third-degree price discrimination. We first examine several features of Delaware's corporate law that cause it to be litigation intensive. We then argue that the costs of such law fall primarily on firms that derive the highest net benefit from incorporating in Delaware.

In contrast to franchise-tax price discrimination—which we regard as intentional—we view price discrimination through litigation-intensive corporate law as incidental. That is, we do not claim that anyone, least of all members of Delaware's judiciary,¹¹⁶ has made Delaware corporate law litigation intensive for the purpose of raising Delaware's profits. But even if unintended, the price-discriminatory effect of this law impairs Delaware's incentives to reduce excessive litigation intensiveness. If the costs of litigation intensiveness did not fall primarily on companies that derive high net benefits from incorporating in Delaware, and therefore had a stronger adverse effect on Delaware's incorporation business, Delaware would have stronger incentives to make its law less litigation intensive, whether by a legislative override or by the appointment of judges that follow a different judicial approach.¹¹⁷

¹¹⁵ See *supra* Table 2.

¹¹⁶ For factors that may motivate judges in general and Delaware judges in particular, see RICHARD A. POSNER, *OVERCOMING LAW* 109-44 (1995); Frank H. Easterbrook, *What's So Special About Judges?*, 61 U. COLO. L. REV. 773, 775-78 (1990); Kamar, *supra* note 10, at 1940-43; Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 SUP. CT. ECON. REV. 1 (1993). Moreover, arguments by legal counsel for parties to corporate disputes, whose benefit from litigation is evident, may influence court decisions.

¹¹⁷ See WILLIAM A. KLEIN ET AL., *BUSINESS ASSOCIATIONS: CASES AND MATERIALS ON AGENCY, PARTNERSHIPS, AND CORPORATIONS* 336-37 (4th ed. 2000) (noting that the anxiety among directors and officers caused by the landmark decision in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), motivated the Delaware legislature to enact a statute that permits firms to opt out of monetary liability for breaches of the duty of care, DEL. CODE ANN. tit. 8, § 102(b)(7) (1991)). While it may be hard to predict whether a judicial candidate will turn out to write litigation-intensive opinions, once appointed to the bench it is possible not to reappoint a judge who writes such opinions at the end of his or her twelve-year term. For an example of a failure to reappoint a Delaware Supreme Court Justice due to opposition from the corporate bar, see Richard B. Schmitt, *Reappointment Seems Unlikely for Moore*, WALL ST. J., May 18, 1994, at B7. Similarly, to the extent a litigation-intensive system results in benefits to Delaware's corporate bar, the corporate bar will be inclined not to endorse proposals to make Delaware law less litigation-intensive even if doing so would benefit Delaware corporations. Cf. Demetrios G. Kaouris, Note, *Is Delaware Still a Haven for Incorpo-*

1. *Delaware Law and the Level of Litigation*

In this section, we discuss four qualities that make Delaware's corporate law litigation intensive. First, Delaware law is based on standards requiring judicial application after the fact. Second, the standards it employs are fact intensive. Third, Delaware law contains substantial ambiguities concerning which legal test applies. Finally, its judicial precedents are narrow.¹¹⁸

It is helpful to clarify at the outset several aspects of our claim. First, the discussion that follows is not meant as proof that Delaware law in its entirety, or even the aspects of it we discuss, are in fact excessively litigation intensive. We know of no way of providing such a proof.¹¹⁹ Rather, we provide examples of what appears to us and to many others as a high degree of litigation intensiveness.¹²⁰ These im-

ration?, 20 DEL. J. CORP. L. 965, 971-72 (1995) (noting that the Delaware Bar Association's Section on General Corporation Law has substantial responsibility for revising the statute).

¹¹⁸ Delaware complements these substantive qualities with a liberal approach toward directors' and officers' liability insurance and indemnification, negligible court fees, absence of a requirement for plaintiffs to post security for expenses, extraterritorial reach, and generous fee awards to plaintiffs' attorneys. All of these features further encourage litigation. See Cary, *supra* note 1, at 686-87; Macey & Miller, *supra* note 8, at 496-97.

¹¹⁹ Determination of the optimal use of standards, the optimal degree of fact specificity, the optimal extent of ambiguity, and the optimal scope of precedents would be tauntingly complex. It would involve consideration of many factors, including the cost of creating and applying different legal rules and standards, the frequency with which different types of disputes occur, the social value of certainty in legal outcomes, the cost of obtaining legal advice, the effect of imperfect legal tests on primary behavior, and the significance of learning through experience. Cf. Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 YALE L.J. 65, 67-68 (1983); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 J. LEGAL STUD. 257 (1974); Ehud Kamar, *Shareholder Litigation Under Indeterminate Corporate Law*, 66 U. CHI. L. REV. 887 (1999) (discussing the costs of indeterminacy in corporate law and the costs of reducing indeterminacy through the production of precedents); Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1687-1701 (1976); Klausner, *supra* note 1, at 777 (discussing the costs of indeterminacy in corporate law).

¹²⁰ Commentators are in wide agreement that Delaware corporate law lacks clarity. See, e.g., Bebchuk & Ferrell, *supra* note 1, at 1190 ("pro-uncertainty tilt"); Victor Brudney, *Revisiting the Import of Shareholder Consent for Corporate Fiduciary Loyalty Obligations*, 25 J. CORP. L. 209, 235 (2000); John C. Coates IV, "Fair Value" as an Avoidable Rule in Corporate Law: *Minority Discounts in Conflicts Transactions*, 107 U. PA. L. REV. 1251, 1287 (1999) (labeling Delaware law on minority discounts in appraisal proceedings as "a mess"); Ronald J. Gilson, *Unocal Fifteen Years Later (And What We Can Do About It)*, 26 DEL. J. CORP. L. 491 (2001) (arguing that Delaware's takeover jurisprudence is ambiguous); Ronald J. Gilson & Reinier Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37, 56 (1990) (arguing that the scope of the duty to sell the firm at the highest possible price is insufficiently defined); Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1015 (1997) (claiming that Delaware corporate law is made up of "fact-intensive, normatively saturated descriptions" of conduct and "of process—descriptions that are not reducible to rules"); Bernard Black & Reinier Kraakman, *Path-Dependent Competition for Corporate Charters: Manager Choice, Shareholder Veto* 7 (Apr. 1999) (unpublished manuscript, on file with authors) (describing Delaware law as "vague" and "litigation intensive"). But see Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for*

pressions are consistent with our claim that the price-discriminatory effect of litigation intensiveness provides incentives to Delaware to offer law that is excessively litigation intensive.¹²¹ But because other

Corporate Charters, 68 U. CIN. L. REV. 1061, 1063-64 (2000) (arguing that the heavy reliance of Delaware corporate law on courts is a virtue).

Practitioners, some of whom writing either before or after serving on the bench, seem to agree. See, e.g., William T. Allen, *Ambiguity in Corporation Law*, 22 DEL. J. CORP. L. 894, 903 (1997) (noting that the practice of contextualism suffuses Delaware's corporate jurisprudence); Stephen Fraidin & Jon D. Hanson, *Toward Unlocking Lockups*, 103 YALE L.J. 1739, 1749-52 (1994) (criticizing Delaware's legal standard for evaluating lockup options as lacking content); Leo Herzl et al., *Sales and Acquisitions of Divisions*, 5 J. CORP. L. 3, 25-26 (1982) (noting uncertainty regarding the meaning of "sale of substantially all assets" for purposes of shareholder vote); John F. Olson & Patricia M. Hynes, *Defensive Techniques and Avoiding Problems*, in 23RD ANNUAL INSTITUTE ON SECURITIES REGULATION 357, 360 (Harvey L. Pitt et al. eds., 1992) (suggesting that corporate counsel trust their instincts when advising clients about the legitimacy of antitakeover defenses); E. Norman Veasey, *The New Incarnation of the Business Judgment Rule in Takeover Defenses*, 11 DEL. J. CORP. L. 503, 512 (1986) (reducing Delaware law to a "smell test"); Pat Vlahakis, *Fiduciary Duties and Fiduciary Outs: Is There a New Delaware Standard?*, 2 M&A J. 13 (2000) (arguing that recent Delaware takeover cases create uncertainty); *Back to the Future: A Reunion with Tulane's Class of '94*, 2 M&A J. 1, 3 (2001). The following exchange was reported between former Delaware Supreme Court Justice Andrew Moore and renowned corporate law practitioner Martin Lipton at the Seventh Annual Corporate Institute sponsored by Tulane Law School in 1994:

Mr. Lipton: Obviously, the single most significant question with respect to mergers and acquisitions today is, "What did they mean in Paramount?"

Justice Moore: When you say much is to be learned from Paramount, it's as if no one ever had a hint of what the rules of the game were before Paramount. After [the Delaware Supreme Court decisions in] Unocal, Revlon, MacMillan, and certainly Smith versus Van Gorkom, one would have thought that the rules were well known.

Mr. Lipton: Obviously not.

Id. at 3.

Indeed, even Delaware judges speaking from the bench acknowledge the uncertainty in Delaware corporate law. See, e.g., *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 901-02 (Del. Ch. 1999) (noting that the waste doctrine engenders excessive and wasteful litigation and urging its reexamination); *In re Gaylord Container Corp. Shareholder Litig.*, 747 A.2d 71, 77 (Del. Ch. 1999) (noting "doctrinal inconsistencies" in, and lack of rationale for, distinction between derivative and direct claims alleging breach of fiduciary duties in corporate control cases); *Solomon v. Armstrong*, 747 A.2d 1098, 1113-15 (Del. Ch. 1999), *aff'd*, 746 A.2d 277 (Del. 2000) (noting that Delaware law concerning the effect of shareholder ratification in the face of an alleged breach "is not a model of clarity," that it contains "confusing distinctions," and that "the legal effect of shareholder ratification, as it relates to alleged breaches of the duty of loyalty, may be one of the most tortured areas of Delaware law"); *Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1287-88 (Del. 1989) (noting that the proportionality test for antitakeover defensive measures may have caused confusion).

Admittedly, the Delaware General Corporation Law regulates some aspects of corporate law with a fair amount of clarity. For example, it contains precise rules on how to perfect appraisal rights. See DEL. CODE ANN. tit. 8, § 262 (1991). However, even where the code contains relatively precise language, Delaware courts do not necessarily follow the code when they find the results objectionable. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) (adopting a non-literal interpretation of § 262(h)); *Speiser v. Baker*, 525 A.2d 1001 (Del. Ch. 1987) (adopting a non-literal interpretation of § 160(c)).

¹²¹ See *infra* Part II.B.2.

forces also shape Delaware law, one cannot be certain that the degree of litigation intensiveness is determined by these incentives.

Similarly, we do not argue that Delaware law is litigation intensive to a degree that it provides no guidance at all. If that were the case, Delaware law would have no special appeal to corporations: its wealth of precedents would be as good as none and the widespread use of its law would not lead to familiarity. But that is not the case. Although individual Delaware decisions are often not a model of clarity, taken as a whole they do clarify the law. And since Delaware offers by far the largest body of corporate law precedents, its law is more predictable than those of other states.¹²²

The relevant comparison, however, is not between Delaware law and the laws of other states.¹²³ We can infer very little from the choices made by other states because they do not appear to compete vigorously for incorporations.¹²⁴ Instead, they seem to try to economize on lawmaking costs by following the Model Business Corporation Act and, occasionally, Delaware legal precedents.¹²⁵ Even for a state intent on competing with Delaware, losing the benefits associated with offering law bearing some resemblance to Delaware law may well prove counter-productive.¹²⁶ Such a state may also be reluctant to invest in formulating clearer alternatives to Delaware law because by doing so it would lose the advantages of at least partial compatibility with

¹²² See, e.g., Romano, *supra* note 1, at 277; Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 709, 725 (1987); see also Klausner, *supra* note 1, at 842-47 (arguing that interpretative network externalities increase the value of Delaware law).

¹²³ The uniqueness of Delaware's franchise tax is different. We mentioned it not only as an indication of Delaware's intention to price discriminate (indeed, Delaware's franchise tax would be discriminatory regardless of other states' actions), but mainly to refute the widespread belief that states compete to increase their franchise-tax revenues. See *supra* note 74 and accompanying text.

¹²⁴ See, e.g., *supra* note 35 and accompanying text. Similarly, we can infer little from Congress's decision to exempt disclosure claims arising under traditional corporate law (the so-called Delaware carve-out, though the exemption applies to the law of any state) from the scope of the Securities Litigation Uniform Standards Act, Pub. L. No. 105-353, 112 Stat. 3227 (1998) (codified in scattered sections of 15 U.S.C.). For one, Congress designed the Uniform Standards Act to preempt suits under state securities laws (principally California's) that resemble typical 10b-5 suits where secondary-market purchasers claim that they have been misled by false statements into buying shares at an inflated price. David M. Levine & Adam C. Pritchard, *The Securities Litigation Uniform Standards Act of 1998: The Sun Sets on California's Blue Sky Laws*, 54 BUS. LAW. 1 (1998). Such claims cannot even be asserted under Delaware law. *Malone v. Brincat*, 722 A.2d 5, 13 (Del. 1998). Moreover, our argument that Delaware law may well be excessively litigation intensive does not imply that federal law should preempt it.

¹²⁵ See William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 725, 734 (1998). The most important area where state corporate laws do significantly differ is antitakeover protection. See *id.* at 735-36. Legislation in that area, however, has historically responded to requests by "broad coalitions of interest groups," rather than to the desire to attract incorporations. See Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 120-22 (1987).

¹²⁶ See Kamar, *supra* note 10, at 1937-39.

Delaware law and because a successful formulation could readily be emulated by others.¹²⁷ The only relevant comparison is thus between actual Delaware law and Delaware's potential, given its substantial body of precedents. On this front, predictability is wanting.¹²⁸

a. *Use of Fact-Intensive and Standard-Based Tests*

Delaware's corporate law tends to rely on fact-intensive, standard-based tests. By fact-intensive, we mean that a wide array of factual circumstances is relevant to the resolution of a legal dispute. By standard-based, we mean that the relation between a certain set of facts and the outcome of a legal dispute is determined *ex post* rather than *ex ante*.¹²⁹

To illustrate these aspects of Delaware law, consider the entire fairness test.¹³⁰ The entire fairness test is one of the most important elements of fiduciary duty law, and applies, at least initially, to all self-dealing transactions.¹³¹ Here is the classic statement of the test:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.¹³²

The entire fairness test thus involves a multi-factor, multi-dimensional balancing test. What constitutes fair price depends on multiple fac-

¹²⁷ See *id.*; see also Ian Ayres, *Supply-Side Inefficiencies in Corporate Charter Competition: Lessons from Patents, Yachting and Bluebooks*, 43 U. KAN. L. REV. 541, 545-50 (1995) (observing that the absence of patent protection deters corporate law innovations); Ronald J. Daniels, *Should Provinces Compete? The Case for a Competitive Corporate Law Market*, 36 MCGILL L.J. 130, 182 (1991) (suggesting that governments have an incentive to agree not to innovate in the area of corporate law). Rational herding may also explain other states' adoption of Delaware's indeterminate law. Kamar, *supra* note 10, at 1938. For general discussion of herd behavior in corporate law, see Kahan & Klausner, *Path Dependence*, *supra* note 9, at 353-58.

¹²⁸ Kamar, *supra* note 10, at 1914.

¹²⁹ Ehrlich & Posner, *supra* note 119, at 258; Kaplow, *supra* note 119, at 559-60; Kennedy, *supra* note 119, at 1687-88.

¹³⁰ For additional examples of fact-intensive standards in Delaware law, see Kamar, *supra* note 10, at 1915-17.

¹³¹ See Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1136 (1999). The entire fairness test also applies where the plaintiff proves that the directors breached their duty of care. See *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1164 (Del. 1995).

¹³² *Weinberger v. UOP, Inc.*, 457 A.2d 701, 711 (Del. 1983) (citations omitted).

tors. What constitutes fair dealing depends on multiple factors. And the relationship between fair price and fair dealing—"not a bifurcated one," but rather "examined as a whole"—approaches the transcendental.¹³³

To be sure, corporate fiduciaries can avoid an entire fairness review by having disinterested directors or shareholders approve the transaction. Alas, the law pertaining to such approvals is no less fact intensive and standard based than the entire fairness test itself.¹³⁴

b. *Ambiguity About the Applicable Legal Test*

A related feature of Delaware corporate law is its tendency to be ambiguous about which legal test applies to a certain set of facts. A well-known instance of such ambiguity involved an important issue in hostile takeovers: does a change of control alter the test according to which defensive tactics are judged from the less exacting *Unocal* test¹³⁵ to the more exacting *Revlon* test?¹³⁶ In 1989, when Paramount Communications tried to acquire Time, the Delaware Supreme Court rejected Paramount's argument that *Revlon* applied:

¹³³ For an alternative approach based on requiring disinterested shareholder vote, see for example Ont. Sec. Comm'n, Rule 61-501: Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions, 23 O.S.G.B. 965 (2000), available at http://www.osc.gov.on.ca/en/Regulation/Rulemaking/Rules/61-501fr_20000414.html (last visited Mar. 20, 2001); United Kingdom Listing Authority Listing Rules § 11.4 (May 2000).

¹³⁴ Shareholder approval is effective only when shareholders are uncoerced and fully informed. See *Smith v. Van Gorkom*, 488 A.2d 858, 889 (Del. 1985); *Weinberger*, 457 A.2d at 707. Similarly, director approval is effective only when the directors are truly independent and disinterested, and effectively negotiate the transaction. *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997); *Kahn v. Lynch Communication Sys.*, 638 A.2d 1110, 1120-21 (Del. 1994); *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1106 (Del. 1985). In all three cases, the application of this test led the trial court and the appellate court to opposite conclusions. Moreover, in controlling shareholder transactions, even effective approval by disinterested directors or shareholders only shifts the burden of proof to the plaintiff to prove that the transaction was not entirely fair. *Lynch Communication Sys.*, 638 A.2d at 1117.

¹³⁵ See *Unocal Corp. v. Mesa Petroleum Corp.*, 493 A.2d 946, 958 (Del. 1985).

¹³⁶ See *MacAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239, 1250 (Del. Ch. 1985). For other examples of ambiguity, compare *Loudon v. Archer-Daniels-Midland Co.*, 700 A.2d 135, 142 (Del. 1997) (holding that there is no per se rule of damages for breach of the duty of disclosure), with *In re Tri-Star Pictures, Inc., Litig.*, 634 A.2d 319, 333 (Del. 1993) (holding that there is a per se rule of damages for breach of the duty of disclosure); and compare *Weinberger*, 457 A.2d at 715 (holding that appraisal remedy shall govern the financial remedy available to minority shareholders in a cash-out merger), with *Rabkin*, 498 A.2d at 1107-08 (holding that appraisal is not an exclusive remedy when the defendant engaged in faithless acts that were reasonably related to and have a substantial impact upon the price offered in freeze-out merger). For discussion by commentators of ambiguity in Delaware law, see Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1934-48 (1991); Mark J. Roe, *Takeover Politics, in THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE* 321, 340-42 (Margaret M. Blair ed., 1993); Skeel, *supra* note 25, at 152 & n.75.

[T]he Chancellor found the original Time-Warner merger agreement not to constitute a "change of control" and concluded that the transaction did not trigger *Revlon* duties. The Chancellor's conclusion is premised on a finding that "[b]efore the merger agreement was signed, control of the corporation existed in a fluid aggregation of unaffiliated shareholders representing a voting majority—in other words, in the market." The Chancellor's findings of fact are supported by the record and his conclusion is correct as a matter of law. However, we premise our rejection of plaintiffs' *Revlon* claim on different grounds, namely, the absence of any substantial evidence to conclude that Time's board, in negotiating with Warner, made the dissolution or break-up of the corporate entity inevitable, as was the case in *Revlon*.

Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction involving the breakup of the company.¹³⁷

As irony has it, five years later Paramount was the target of a hostile bid by QVC Network.¹³⁸ Even though Paramount had clearly embarked on a change of control before QVC made its bid, Paramount argued, citing *Time*, that it was not subject to *Revlon* duties. The Delaware Supreme Court disagreed. After quoting the above passage from *Time*, the court explained:

The Paramount defendants have misread the holding of *Time-Warner*. Contrary to their argument, our decision in *Time-Warner* expressly states that the two general scenarios discussed in the above-quoted paragraph are not the only instances where "*Revlon* duties" may be implicated. The Paramount defendants' argument totally ignores the phrase "without excluding other possibilities."¹³⁹

A change of control, the court held, does trigger *Revlon*.¹⁴⁰

¹³⁷ *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1150 (Del. 1990) (second alteration in original) (citation omitted).

¹³⁸ See *Paramount Communications Inc. v. QVC Network Inc.*, 637 A.2d 34, 38-40 (Del. 1994).

¹³⁹ *Id.* at 47 (typeface altered).

¹⁴⁰ *Id.* at 45. More recent decisions of the Court of Chancery appear to further muddy the water by stating that even absent a change of control the board must retain the freedom to negotiate with third parties. See *ACE Ltd. v. Capital Re Corp.*, 747 A.2d 95, 105 (Del. Ch. 1999) (asserting that the board must retain this freedom); *Phelps Dodge Corp. v. Cyprus Amax Minerals Co.*, Civil Action No. 17398, 1999 Del. Ch. LEXIS 202, at *4 (Del. Ch. Sept. 27, 1999) (similarly holding that the board must retain the freedom to negotiate with third parties). But see *IXC Communications, Inc. S'holders Litig.*, C.A. No. 17324, 1999 Del. Ch. LEXIS 210, at *16-*17 (Del. Ch. Oct. 27, 1999) (holding that the board need

c. *Narrow Breadth of Precedents*

The fact-intensive, standard-based approach of Delaware corporate law necessarily limits the breadth of Delaware precedents. Delaware precedents, however, are narrow for another reason as well. Delaware judges intend their decisions to be interpreted narrowly. Delaware opinions thus frequently include admonitions that they are dependent on a particular set of facts and regularly shy away from announcing general rules that do not leave any escape hatch. Consider the following quotations, all taken from textbook cases:

[W]e do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate.¹⁴¹

It is the nature of the judicial process that we decide only the case before us—a case which, on its facts, is clearly controlled by established Delaware law. . . . In other cases [the result] may be less clear.¹⁴²

In my view, our inability to foresee now all of the future settings . . . counsels against the adoption of a *per se* rule.¹⁴³

Judges presumably make occasional statements of this sort not only in Delaware, and not only in corporate cases. In Delaware corporate cases, however, these statements seem to be very common indeed, and appear to reflect an exceptionally particularized approach to judicial lawmaking.

The limited predictive value of Delaware corporate law precedents is striking in light of the fact that these precedents—unlike, say, federal court precedents on issues of securities regulation—are produced in a state that takes pride in offering predictability. Indeed, one would expect a law that has been shaped by competition not only to be at least as predictable as laws that are not the product of competition, but to be markedly better on that front.¹⁴⁴ Delaware law, in our assessment, is not.

d. *“The Essence of Delaware Law”*

Maybe the best evidence that the examples we presented are not isolated anomalies, but rather characteristic of Delaware law, is the

not retain this freedom). For criticism leveled at these cases by practitioners for breaking with precedents, see Vlahakis, *supra* note 120.

¹⁴¹ *Weinberger*, 457 A.2d at 714.

¹⁴² *QVC*, 637 A.2d at 51.

¹⁴³ *Blasius Indus. v. Atlas Corp.*, 564 A.2d 651, 662 (Del. Ch. 1988).

¹⁴⁴ It is therefore inapposite to our thesis that some also view as indeterminate legal areas such as tort and products liability law, antitrust law, constitutional law, or health law. See Leo E. Strine, Jr., *Delaware’s Corporate Law System: Is Corporate America Buying an Exquisite Jewel or a Diamond in the Rough?: A Response to Kahan & Kamar’s Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1257, 1274-75 (2001) (noting these views).

following anecdote, told to us by William Allen, the former Chancellor of Delaware and now a professor in the law and business schools at New York University:

After I had been serving as Chancellor for about three years, I had lunch with Samuel Arsht. Arsht, who by that time was retired from active practice of law, was regarded in his time as the leading Delaware expert on corporation law. We discussed corporation law (which was always the subject of our chats) and particularly the need to find the most elemental aspects of the law. Arsht, who had served as revisor of the Delaware Code in 1953, suggested seriously (as he reported, at any rate) that the Delaware corporation law be rewritten to have a single provision: "A corporation may do any act that a natural person is privileged to do and corporate directors are free from liability to the corporation whenever they authorize the corporation to do any lawful act, so long as they exercise a good faith business judgment that the act is in the best interests of the corporation." It was Sam's view that such a provision would not constitute a change in the Delaware law and would give the essence of the law. Everything else was gloss. While I would not have disagreed (I didn't) with Sam at the time, it was only after several more years on the bench that I came to appreciate fully the force in Sam's exaggerated brevity.¹⁴⁵

e. *The Effect on the Level of Litigation*

Each of the qualities of Delaware corporate law that we discussed has the effect of increasing the level of Delaware litigation. Because the law is fact intensive, there are many potential factual disputes that need to be resolved through litigation. Because the law is standard based and there is uncertainty about which test applies, litigation may ensue even absent factual disputes.¹⁴⁶ And because the precedents are narrow, uncertainties are slowly resolved.

We are aware of the challenge in suggesting that Delaware's renowned legal system is not as clear as it could be—although we note that even Vice Chancellor Leo Strine, who otherwise takes issue with our thesis, agrees that "in many ways Delaware law is less than optimally clear."¹⁴⁷ While it is not our intention to endorse any specific change in Delaware law, we wish to point out some ingredients that would render Delaware law more predictable. For one, Delaware law

¹⁴⁵ Interview with William T. Allen, in New York, N.Y. (Mar. 2000).

¹⁴⁶ Legal uncertainty leads to disagreement between litigants and to more disputes proceeding to trial without settling. See Robert D. Cooter & Daniel L. Rubinfeld, *Economic Analysis of Legal Disputes and Their Resolution*, 27 J. ECON. LIT. 1067, 1092 (1989); Richard A. Posner, *An Economic Approach to Legal Procedure and Judicial Administration*, 2 J. LEGAL STUD. 399 (1973); Steven Shavell, *Suit, Settlement, and Trial: A Theoretical Analysis Under Alternative Methods for the Allocation of Legal Costs*, 11 J. LEGAL STUD. 55, 63 & n.36 (1982).

¹⁴⁷ Strine, *supra* note 144, at 1265.

could accord a greater role to shareholders. For example, Delaware law could require a shareholder vote when a company receives an unsolicited tender offer,¹⁴⁸ or require shareholder approval for certain self-dealing transactions.¹⁴⁹ Even where Delaware law retained flexible standards, the standards could be rendered more determinate by employing presumptions or safe harbors or by limiting or prioritizing the criteria to their application.¹⁵⁰ Any of these devices could be adopted either in case law or in statutes and could provide more predictability than in the present system without increasing its complexity.¹⁵¹ We present them here not as our proposed alternatives to Delaware law—to do so is unwarranted for purposes of our analysis—but simply to illustrate that alternatives do exist, both in commentary and in actual use.¹⁵²

¹⁴⁸ A similar rule governs takeovers in the United Kingdom. See THE CITY CODE ON TAKEOVERS AND MERGERS § B(7), reprinted in P.F.C. BEGG, CORPORATE ACQUISITIONS AND MERGERS app. 7 at A7.4 (3d ed. 1998); see also Bebchuk & Ferrell, *supra* note 1, at 1190-93 (praising the clarity of the United Kingdom rule and contrasting it with the uncertainty resulting from Delaware's takeover jurisprudence). Indeed, thanks to that legal environment, takeovers occur in the United Kingdom regularly with much less litigation than in the United States. See Jeffrey Sheban, *Takeover Game Is Played in Britain With Rules That Would Halt U.S. Deals*, WALL ST. J., Nov. 3, 1989, at B5E.

¹⁴⁹ A similar rule governs self-dealing transactions of public corporations in Canada and the United Kingdom. See *supra* note 133.

¹⁵⁰ See Kaplow, *supra* note 119, at 600. For an example of the potential use of presumptions, compare *Aronson v. Lewis*, 473 A.2d 805, 815 (Del. 1984) (holding that even a 47% shareholder may be deemed a noncontrolling shareholder), with AMERICAN LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 1.10(b) (1994) (providing that holding 25% of the voting power creates a presumption of control). For an example of the potential use of safe harbors, compare DEL. CODE ANN. tit. 8, § 271(a) (1991) (providing that shareholder approval is required for sale of "all or substantially all" assets of the firm), with the Revised Model Business Corporation Act, REVISED MODEL BUS. CORP. ACT § 12.02(a) (1999) (providing that shareholder approval is not required when the corporation retains at least 25% of total assets and 25% of either income before taxes or revenues from continuing operations for that fiscal year). According to the Official Comment to the Revised Model Business Corporation Act, the safe harbor "represents a policy judgment that a greater measure of certainty than is provided by interpretations of the current case law is highly desirable," and "[t]he application of this bright-line safe-harbor test should, in most cases, produce a reasonably clear result substantially in conformity with the approaches taken in the better case developing the 'quantitative' and the 'qualitative' analyses." *Id.* § 12.02(a), cmt. 1 (1999).

¹⁵¹ For discussion of why standards are not synonymous with simplicity and rules are not synonymous with complexity, see Kaplow, *supra* note 119, at 586-90.

¹⁵² To be sure, none of these alternatives would, in Vice Chancellor Strine's words, "generate a consensus among American corporate law practitioners and commentators." Strine, *supra* note 144, at 1267, 1270 (mentioning lack of consensus in some areas of Delaware corporate law as driving litigation intensiveness). Neither, however, does Delaware's current approach. Judicial and legislative lawmaking is an easy task when a consensus exists. We thus agree with Vice Chancellor Strine that Delaware law is litigation intensive primarily "in areas where there is no consensus among its constituency." *Id.* at 1268. The absence of a consensus, however, neither requires the law to be litigation intensive nor implies that litigation intensiveness is optimal.

2. *Litigation-Intensive Law and Price Discrimination*

We shall now explain why Delaware's litigation-intensive law results in price discrimination. First, we argue that the cost of the increased level of litigation falls primarily on companies that derive the highest value from incorporating in Delaware. We then examine how this price-discriminatory incidence affects Delaware's profits and its incentives to modify its legal system. Finally, we argue that cost differences do not account for the different charges that Delaware's litigation-intensive law imposes on firms.

a. *The Incidence of Litigation-Related Costs*

The costs of a litigation-intensive system fall primarily on Delaware corporations that participate in the kind of activities that tend to give rise to legal disputes.¹⁵³ To the extent that these companies are involved in litigation, they directly bear the costs of a more litigation-intensive corporate law. But even if they are not involved in litigation, these companies may suffer costs associated with planning transactions to avoid lawsuits, forgoing business opportunities, or making flawed business decisions due to uncertainty.¹⁵⁴

Companies that are involved in litigation or undertake transactions that may result in litigation are the ones assigning the highest value to incorporating in Delaware. These companies gain most from the fact that Delaware law, though litigation intensive, offers a higher quality judiciary, a better developed case law, and more readily available legal advice than any other states' laws.¹⁵⁵

¹⁵³ We view the incidence of litigation-related costs as third-degree, rather than second-degree, price discrimination because, as in the case of the franchise tax, it would be much too costly for firms to forgo the transactions that expose them to litigation. For a similar analysis of Delaware's franchise tax discrimination, see *supra* note 55. The choice of the level of litigation intensiveness is analogous to quality choice. Indeed, the economic literature views quality choice as a price discrimination tool, particularly with respect to second-degree price discrimination. See, e.g., Mussa & Rosen, *supra* note 51. This logic, however, applies to third-degree price discrimination as well. Producers with market power choose the quality of their product to maximize profits, where higher quality means a higher price (or higher prices, in the case of a price discriminating producer), but also higher costs. See TIROLE, *supra* note 45, at 149-50 (discussing quality discrimination). The litigation gains that Delaware would lose if it made its law less litigation intensive are similar to the higher costs that a producer would incur in improving the quality of its product. Delaware's lost gains from firms that use the law a lot would be higher than its lost gains from firms that use the law only a little because the lower rate of litigation would affect the former firms more than the latter. Similarly, a producer's cost of improving the quality of the product it sells to high-demand consumers would be higher than its cost of improving the quality of the product it sells to low-demand consumers because the former consumers consume more.

¹⁵⁴ See Kamar, *supra* note 119, at 892-96; Klausner, *supra* note 1, at 777; Romano, *supra* note 1, at 277-78.

¹⁵⁵ In a litigation-oriented system (as opposed to a system based on regulation or private ordering), involvement in litigation reflects firms' use of the law. The level of litigation

The discriminatory incidence of the costs of litigation-intensive law is not affected by the presence of liability insurance, by a company's inability to predict whether it will be involved in corporate disputes, by Delaware's price-discriminatory franchise tax, or by the availability of alternative, possibly more effective, devices to price discriminate on the basis of involvement in disputes.

Directors' and officers' liability insurance would neutralize the discriminatory effect of Delaware's litigation-intensive legal system only if all companies paid the same premiums and insurance covered all expenses generated by the system. If that were the case, all companies would bear the same cost of involvement in legal disputes—the uniform insurance rate—regardless of their actual involvement in disputes. In reality, however, premiums are higher for companies that are frequently involved in litigation.¹⁵⁶ Moreover, liability insurance covers only a portion of the legal fees and covers none of the increased planning costs, the costs of a constrained ability to achieve business goals, the costs of special litigation committees, or the costs of managerial time spent in defending against lawsuits.¹⁵⁷

Similarly, our argument does not hinge on the ability of companies to predict the extent to which they will be involved in corporate disputes. If a company is involved in fewer disputes than it anticipates, it will realize lower benefits from incorporating in Delaware. Such a company, however, will not bear the cost of Delaware's litigation-intensive law. Correspondingly, if a company is involved in more disputes than anticipated, it will bear higher costs, but also derive greater benefits.

The price-discriminatory effect of a litigation-intensive legal structure remains even after taking account of Delaware's franchise tax which, as we have argued, imposes higher charges on companies that are more likely to be involved in litigation.¹⁵⁸ The proxies that Dela-

tion is determined by the extent to which the law generally fosters litigation and by the propensity of individual firms to be involved in lawsuits. If Delaware law was less litigation intensive, but still litigation oriented, the same firms would demonstrate a higher incidence of involvement in lawsuits than others as today, but the general level of litigation would be lower.

¹⁵⁶ See *Litigation Survey*, *supra* note 100.

¹⁵⁷ Insurance policies contain deductibles, limits, and exclusions for dishonesty, acts that personally benefitted the defendant, and occasionally for takeover litigation. See KNEPPER & BAILEY, *supra* note 100, §§ 24-10, 25-3, 25-12, 25-23. Insurers rely on these deductibles, limits, and exclusions to pay only part of the costs of lawsuits. See *id.* § 21-1. Moreover, insurance policies only cover directors and officers, and persons related to them. See *id.* § 24-3. Thus, in cases where a controlling shareholder is sued, such as freeze-out cases, insurers allocate the costs between covered directors and officers and uncovered controlling shareholders. See *id.* § 24-5, at 401.

¹⁵⁸ See *supra* Part II.A. It is fairly evident that the reverse is also true, namely that Delaware's franchise tax enhances overall price discrimination even though Delaware already unintentionally discriminates among companies through its litigation-intensive law.

ware uses for assessing its franchise tax—the number of authorized shares and APVC—track the involvement in corporate disputes only imperfectly. By contrast, the costs resulting from litigation-intensive law directly track involvement in corporate disputes. The costs of such law thus fall mainly on firms that derive the greatest benefits, net of their franchise taxes, from incorporating in Delaware.¹⁵⁹

Finally, we make no claim that litigation-intensive law is the most effective way to use involvement in disputes as a basis for price discrimination. It is possible that court filing fees,¹⁶⁰ taxes on legal services, charges for use of judicial time, or similar devices would be more effective.¹⁶¹ Delaware officials have probably never analyzed the

Franchise taxes are an efficient way for Delaware to profit from incorporations: all of the franchise-tax revenues benefit Delaware, and Delaware's costs in collecting the tax and providing incorporation-related services are small. By contrast, a significant portion of the costs that companies incur in conducting corporate litigation benefits out-of-state parties (such as New York lawyers who often represent companies in corporate litigation, investment banks, liability insurance carriers, and expert witnesses), or no one at all (as in the case of missed business opportunities or other costly business decisions made under legal uncertainty, or in the case of risk-bearing costs that corporate fiduciaries bear under legal uncertainty and pass on to shareholders). Moreover, of the revenues from corporate litigation that do stay in Delaware, only a fraction represents profits.

¹⁵⁹ Franchise-tax discrimination, however, by at least imperfectly tracking the likelihood of being involved in corporate disputes, reduces the correlation between the incidence of litigation-intensive law and net benefits from a Delaware incorporation, and thus reduces the incentives to engage in price discrimination through litigation-intensive law.

¹⁶⁰ Delaware does not charge significant court fees to corporate litigants. The fee for a new civil action with three or more defendants, which is the category under which most corporate lawsuits fall, is \$200; the fee for filing and recording any pleading is \$1 per page, up to a maximum of \$50. DEL. CH. R. § 3 (2001).

¹⁶¹ Some of these devices suffer from shortcomings that may undermine their utility. Court fees, for example, are at least initially borne by plaintiffs, not by Delaware's corporate consumers. Moreover, these fees could induce plaintiffs to sue in other courts (or not to sue at all) and eliminate any profits for Delaware from these suits. Additionally, political opposition by the corporate bar would make it difficult for Delaware to raise fees while lowering the level of litigation. Finally, litigation intensiveness enhances Delaware's lead. The dependence of Delaware law on litigation prevents other states from successfully emulating the law, while ensuring that the state's courts maintain their expertise and update the state's stock of corporate legal precedents. All of these are the basis for Delaware's continued ability to price discriminate and, indeed, to charge any premium for its law. See Kamar, *supra* note 10.

Litigation intensiveness is different. Litigation intensiveness means that plaintiffs more frequently have viable claims to bring to the court, which, in the absence of significant court fees, are relatively inexpensive to file. Indeed, Delaware law does not require a security for expenses, thus ensuring that the cost of filing the claim is low. Cary, *supra* note 1, at 686; Macey & Miller, *supra* note 8, at 511. Although litigation intensiveness can increase the cost to plaintiffs of pursuing their claims in court, the higher cost does not reduce litigation because it imposes higher costs on defendants (whose work is disrupted by time-consuming and personally unpleasant depositions and compliance with discovery requests) and is therefore likely to increase the settlement value of legal claims. See Lucian Arye Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL. STUD. 437 (1988); David Rosenberg & Stephen Shavell, *A Model in Which Suits Are Brought for Their Nuisance Value*, 5 INT'L REV. L. & ECON. 3 (1985). In addition to entrepreneurial corporate litigation, hostile bidders bring some corporate lawsuits in the course of battles for corporate control. The

best method to price discriminate on the basis of involvement in disputes, and they may not even be conscious of the price-discriminatory impact of Delaware law. Those officials would, however, respond to public companies leaving Delaware because of dissatisfaction with its law. Since the cost of litigation-intensive law falls predominantly on companies that derive high net benefits from incorporating in Delaware, excessive litigation intensiveness does not result in such migration. This is true regardless of whether litigation-intensive law is the best way to price discriminate.

b. *Delaware's Incentives to Structure Its Corporate Law*

The fact that the costs of a litigation-intensive legal system fall primarily on companies deriving high net benefits from incorporating in Delaware results in insufficient incentives for Delaware to make its law less litigation intensive when doing so would improve the quality of the law.¹⁶² From a social perspective, the value of any such improvement depends on its value to the average Delaware company. But Delaware's economic incentive to offer improvements depends on its ability to charge a higher price for the improved law. This ability in

stakes for the plaintiffs in this type of lawsuit are significantly higher than their costs of going to trial, especially given that courts conduct these trials in an expedited manner. See *In re Dunkin' Donuts S'holders Litig.*, 16 DEL. J. CORP. L. 1443, 1458-61 (1991) (Del. Ch. Nov. 27, 1990) (relying on that reasoning to deny a losing hostile bidder's motion for trial counsel fees and expenses).

¹⁶² Although we argue that the price-discriminatory effect reduces Delaware's incentive to make its law less litigation intensive, other factors explain why aspects of Delaware law start off being excessively litigation intensive. In addition to random imperfections in the law, these factors may include the fact that corporate adjudication in Delaware takes place in a court of equity, whose inclination not to limit judicial discretion is part of its legacy. See, e.g., *In re Holly Farms Corp. S'holders Litig.*, 564 A.2d 342, 348 (Del. Ch. 1989) ("The Court of Chancery has historically been vested with considerable discretion in delicately balancing all the equities and, although some might desire a more definite standard, no hard and fast rule is likely or desirable which will apply to all factual circumstances."); William T. Allen, *A Bicentennial Toast to the Delaware Court of Chancery 1792-1992*, 48 BUS. LAW. 363, 365 (1992) ("The strong identification of the judges of the Court of Chancery with the historic role of chancery, had, I think, subtle but real effects on the jurisprudence of the court over its long life."); Maurice A. Hartnett, III, *The History of the Delaware Court of Chancery*, 48 BUS. LAW. 367, 369 (1992) ("Some of us believe that the[] maxims of equity, although not so often quoted now, are as important today as ever."); William T. Quillen & Michael Hanrahan, *A Short History of the Delaware Court of Chancery—1792-1992*, 18 DEL. J. CORP. L. 819, 821-22 (1993) ("Equity is the flexible application of broad moral principles (maxims) to fact specific situations for the sake of justice. Delaware has preserved the essence."). For a well-known example of a Delaware decision reversing previous case law to expand judicial discretion, see *Paramount Communications, Inc. v. Time Inc.*, 571 A.2d 1140, 1153 (Del. 1990) (rejecting previous case law on the proportionality test as unduly restrictive of judicial discretion). Vice Chancellor Strine mentions additional reasons why Delaware law may be excessively litigation intensive, such as constituent pressures and institutional rivalries. Strine, *supra* note 144, at 1270-72. Our argument is consistent with any of these explanations. We would add to them, however, that the price-discriminatory incidence of litigation-intensive law makes it less costly for Delaware to offer such law even if Delaware corporations would prefer the law to be less litigation intensive.

turn depends on the value of the improvement to the marginal Delaware company, which is the company whose net benefits from incorporating in Delaware approach zero.¹⁶³ Because Delaware law has a price-discriminatory incidence, however, the marginal company would benefit from such an improvement less than the average company.¹⁶⁴ Delaware would thus not be able to raise its price by an amount commensurate with the social benefits of improved law.

Aggravating these insufficient incentives to reduce the level of litigation are a number of benefits that Delaware derives from litigation. Though costly for firms, lawsuits benefit Delaware. Increased corporate litigation stimulates Delaware's economy. Because Delaware is the incorporation state of choice for public companies, Wilmington—Delaware's largest city—has become home to some of the nation's most respected law firms. These law firms derive substantial revenues from representing and advising clients in corporate disputes and in transactions that are susceptible to becoming the subject of corporate disputes. These revenues in turn fund salaries of associates and support staff, pay for office space and supplies, and remunerate partners. All of this economic activity directly generates revenues for Delaware's personal income tax, corporate income tax, and business and occupational gross receipts tax.¹⁶⁵ It also generates revenues indirectly as lawyers, employees, and suppliers spend their income in Delaware.

The corporate litigation business, of course, also generates income for lawyers and other providers of litigation-related services. Indeed, probably because of the prevalence of corporate lawyers, the average annual income of Delaware lawyers (\$117,276 in 1990) is higher, even before adjusting for differences in the cost of living, than that of lawyers in such metropolitan hubs as New York (\$111,572), Washington, D.C. (\$92,259), or Chicago (\$90,722).¹⁶⁶

¹⁶³ See TIROLE, *supra* note 45, at 101 (noting the difference between the social value of quality, which relates to the average consumer's valuation of quality changes, and the monopolist's value of quality, which relates to the marginal consumer's valuation of quality changes). Because Delaware charges different franchise taxes to different firms, a marginal Delaware company exists in each franchise-tax bracket. However, within each bracket, a marginal company would benefit less from an improvement that makes the law less litigation intensive than the average company in that bracket.

¹⁶⁴ Correspondingly, the marginal company benefits more than the average company from an improvement that makes the law more litigation intensive. Delaware thus has socially excessive incentives to institute such improvements.

¹⁶⁵ As of 2000, Delaware's personal income-tax rate ranged from 0 to 6.4%. Delaware's corporate income-tax rate was 8.7% (assessed on net income derived from business activities or property in Delaware). Delaware's business and occupational gross receipts tax rate ranged from 0.096% to 1.92%. Office of the Governor, State of Del., *Financial Overview Fiscal Year 2001* (Jan. 31, 2000), at <http://www.state.de.us/budget/fy2001/fy2001-media-package.pdf> (last visited Apr. 14, 2001).

¹⁶⁶ Gov't Info. Sharing Project, Or. State Univ., *Earnings by Occupation and Education: 1990* (compiling data provided by the United States Bureau of the Census et al.), at <http://govinfo.library.orst.edu/earn-stateis.html> (last visited Apr. 14, 2001).

To be sure, unless Delaware's corporate lawyers have market power, the people who are now Delaware lawyers could obtain an equivalent income in a different employ or at a different location.¹⁶⁷ But even in the absence of market power, a drop in the level of litigation could impose substantial losses. Some providers of litigation-related services have made over the years specific investments in their work that they would lose if they had to change their occupation or location.¹⁶⁸ In addition, many Delaware residents would face substantial transaction and relocation costs—such as the costs of selling one's home, moving one's family, and enduring temporary unemployment—if they had to change jobs.¹⁶⁹ Similarly, until additional corporate litigators enter practice in Delaware, an increase in the level of litigation would raise income for Delaware lawyers.¹⁷⁰

The benefits that Delaware residents derive from a thriving litigation industry are difficult to quantify. Pennsylvania's recent efforts to establish a chancery court with expert judges and jurisdiction confined to corporate and business disputes gives some indication, however, that these benefits are material.¹⁷¹ An avowed aim of this endeavor was to compete with Delaware for incorporations.¹⁷² But Pennsylvania would not have derived significant franchise taxes from

¹⁶⁷ Several factors suggest that Delaware corporate law firms may have market power. A small number of Delaware firms dominate the local bar. Until recently, only these firms had extensive files containing unpublished letter rulings by the Delaware Chancery Court. These firms have also developed a reputation for quality and knowledge of the local judiciary that new entrants may find difficult to match.

¹⁶⁸ Romano, *supra* note 1, at 276.

¹⁶⁹ The presence of these benefits also strengthens Delaware's commitment to responding to corporate needs because the groups of citizens that benefit from Delaware incorporations will favor such responsiveness. See Kamar, *supra* note 10, at 1936. In addition, these benefits induce Delaware corporate lawyers to provide free services to the state to keep Delaware's corporate law current. See S. Samuel Arshat, *A History of Delaware Corporation Law*, 1 DEL. J. CORP. L. 1, 17-21 (1976) (describing the work of the Delaware Bar Association Standing Committee on the General Corporation Law).

¹⁷⁰ In addition to benefits accruing to Delaware residents, and from them to the entire state through taxation, fact-intensive and standard-based law also bolsters Delaware's market power. It is hard for other states to replicate such law and to tap Delaware's network and learning benefits. See Kamar, *supra* note 10, at 1928-32. Furthermore, the incompatibility of Delaware law with other laws raises migration costs for the many corporations that are already incorporated in Delaware. *Id.* at 1937. Other states cannot respond by offering clearer laws because that would cost them in losing the appeal of at least partial compatibility with a leading standard and, if they nevertheless succeed in attracting incorporations, would expose them to emulation by other states. *Id.* at 1938.

¹⁷¹ John L. Kennedy, *Chancery Court Proposal Sent to Full Senate*, PA. L. WKLY., May 17, 1993, at 6; Thomas A. Slowey, *Pa. Chancery Court Is a Sound Proposal*, PA. L. WKLY., May 2, 1994, at 6. The legislation was never enacted, at least in part due to political opposition to merit-based selection of judges. *Id.* A revised proposal to create a specialized commercial (as opposed to corporate) court is still pending, but is not seen as an effort to attract incorporations. Telephone Interview with William H. Clark, head of the Pennsylvania chancery court coalition (June 1999) [hereinafter Clark Interview].

¹⁷² Clark Interview, *supra* note 171.

such incorporations.¹⁷³ And while Pennsylvania law firms actively supported the chancery court proposal, the Pennsylvania Treasury remained indifferent.¹⁷⁴ This suggests that the benefits from additional litigation-related business, not those from additional franchise-tax revenues, motivated the chancery court proposal.¹⁷⁵

Our argument regarding Delaware's incentives does not depend on whether litigation-intensive law in fact benefits Delaware as a whole or whether—as Jonathan Macey and Geoffrey Miller have argued—Delaware's influential corporate bar induces the adoption and retention of laws that increase its rents while being detrimental to the state as a whole.¹⁷⁶ Even under the latter conception, the Delaware corporate bar has to expend political capital to pass laws that stimulate litigation but reduce Delaware's franchise-tax revenues. The price-discriminatory incidence of litigation-intensive law implies that the franchise-tax impact of this law is less than it would be if its incidence were neutral. Consequently, less influence is needed to induce Delaware to offer litigation-intensive law.¹⁷⁷ Our analysis thus explains why the Delaware bar may have been successful in maintaining a litigation-intensive corporate law.

c. *Why Cost Differences Do Not Account for Price Differences*

The differences in rents that Delaware extracts from firms through litigation do not merely reflect differences in costs. To be sure, it is possible that the gain that Delaware derives from each hour its judges spend on corporate litigation is the same regardless of the corporation involved. Although Delaware extracts higher gains from firms that are more involved in litigation than from firms that are less so involved, it would seem that these gains merely reflect higher costs of serving these firms, not different premiums.

¹⁷³ Pennsylvania's annual franchise tax depends on where a company's property is located, where its sales are made, and where its employees are based, rather than where it is incorporated. TAX GUIDE, *supra* note 56, ¶ 5-771. There is no indication that Pennsylvania was planning to change its franchise-tax system.

¹⁷⁴ Clark Interview, *supra* note 170; Clifford E. Haines, *A Chancery Court Could Assist Pa.*, PHILA. BUS. J., Mar. 28, 1997, available at <http://www.amcity.com/philadelphia/stories/1997/03/31/editorial3.html> (last visited Mar. 29, 2001); Board of Governors of the Philadelphia Bar Association Resolution of April 24, 1997, *Support for Legislation Creating a Commerce Court in Pennsylvania*, at <http://www.philadelphiabar.org/member/governance/resolutions/resolution.asp?pubid=1741502222000> (last visited Mar. 20, 2001).

¹⁷⁵ *Cf.* Romano, *supra* note 1, at 241 (arguing that the income to Delaware residents from servicing Delaware corporations considerably exceeds franchise-tax collections). Of course, the lack of direct fiscal benefits to Pennsylvania from the chancery court proposal may have accounted for its failure.

¹⁷⁶ See Macey & Miller, *supra* note 8, at 491-98.

¹⁷⁷ *Cf.* Kamar, *supra* note 10, at 1939-40 (arguing that the bar's influence in promoting Delaware's litigation intensiveness is consistent with the argument that litigation intensiveness is essential for Delaware's competitive advantages).

This reasoning, however, fails to take into account that the level of litigation itself is the result of Delaware's product design. Assume, for example, that Delaware offered a law that generated very little litigation. This type of a legal system would impose on all firms virtually the same cost of being incorporated in Delaware, even though different firms would obtain different net benefits from being incorporated in Delaware. Compared to such a system, a litigation-intensive law imposes higher costs on firms that benefit more from incorporating in Delaware. Litigation intensiveness thus functions as a metering device—metering not the consumption of litigation services (the need for which would be lower in a less litigation-intensive regime), but rather the need to resort to law to resolve disputes (which, in a less litigation-intensive regime, would be resolved without litigation).¹⁷⁸ By analogy, if publishers were able to charge a double price to readers who read their books twice, no one would argue that they price their product by the unit. After all, they would sell only one book to each reader. Delaware is doing just that, the only difference being that the method it uses to gauge firms' benefit from its legal system—litigation intensiveness—is costly to Delaware.¹⁷⁹

Moreover, litigation services are not a separate product that Delaware sells. Delaware does not allow firms to choose how much of its substantive law to buy and, separately, how much of its litigation services to buy. Rather, firms buy a package that includes substantive law, litigation services, and administrative services. There are many ways of structuring such a package. The package that Delaware offers comes with litigation-intensive substantive law, which affects some firms more than others. An optimal corporate-law package would probably contain some litigation, and firms would probably prefer to have Delaware courts handle that litigation. But Delaware's package seems to contain more litigation than is optimal, and thus to compel firms that

¹⁷⁸ The use of litigation intensiveness as a metering device is consistent with our analysis of litigation intensiveness as third-degree price discrimination. Third-degree price discrimination differs from second-degree price discrimination in that the producer offers products at different prices to different consumer groups, rather than letting consumers choose from a menu of different products at different prices. See *supra* notes 47-51 and accompanying text. Delaware firms do not choose their level of involvement in litigation in any meaningful way. To be sure, they can forgo public equity offerings or mergers and acquisitions to reduce their exposure to litigation, but these options are too costly for them (just as it would be too costly for anyone to become a student only to enjoy student discounts in museums). For a similar example of using metering for third-degree price discrimination, see CARLTON & PERLOFF, *supra* note 18, at 476-79.

¹⁷⁹ The costliness to producers of price-discrimination devices is not only common, but perhaps unavoidable given the need to treat different consumers differently and forgo scale economies in consumer handling. Even printing special discount tickets for students and inspecting student identification documents at a museum entrance is costly. Museums continue to engage in this costly practice because their additional revenues exceed their costs.

prefer the services of Delaware's expert judiciary to use them more than they would ideally like. The fact that it is Delaware courts that handle the excess litigation mitigates the firms' loss from that excess, but does not turn it into a gain. Firms nevertheless incorporate in Delaware because they are still better off than they would be by incorporating in other states with courts of lesser quality.

III

EFFICIENCY EFFECTS OF PRICE DISCRIMINATION

Our analysis so far has focused on how Delaware gains from price discrimination. It has not addressed the social desirability of price discrimination, which depends on the aggregate benefits of price discrimination to Delaware and to corporations. Below we shall analyze separately the efficiency effects of franchise-tax price discrimination and of price discrimination through litigation-intensive law.

A. Franchise-Tax Price Discrimination

From an economic standpoint, the taxes that firms pay to Delaware represent pure wealth transfers and so do not affect social welfare. Tax discrimination, however, implicates social welfare insofar as it affects which firms incorporate in Delaware. Compared to a uniform monopoly tax rate, tax discrimination enhances social welfare to the extent that it causes firms to incorporate in Delaware, whose law, even if suboptimal, is still superior to the laws of other states. Conversely, tax discrimination reduces social welfare to the extent that it causes firms that would benefit from incorporating in Delaware to incorporate elsewhere.¹⁸⁰ In theory, either effect can dominate.¹⁸¹

To determine the net welfare effect of tax discrimination, one has to assess what uniform tax Delaware would charge if it did not discriminate. Any intermediate uniform tax between the current maximum of \$150,000 per year and the current minimum of \$30 per year would both lead some non-Delaware firms that would be assessed a lower tax under a uniform structure than under a discriminatory one to enter Delaware, and some Delaware firms that would be assessed a higher tax to exit Delaware. The higher the uniform tax, the stronger is the latter effect relative to the former and the more likely it is that tax discrimination enhances social welfare.¹⁸²

¹⁸⁰ Current Delaware firms that would remain in the state under the hypothetical uniform tax have no effect on social welfare. These firms would merely share with Delaware a different portion of their consumer surplus than they do today.

¹⁸¹ The two effects would cancel out only if all firms had a linear demand for Delaware law. See TIROLE, *supra* note 45, at 139. There is, of course, no reason to expect this particular shape of demand to represent reality.

¹⁸² Increasing the number of Delaware firms by reducing franchise taxes is likely to be desirable regardless of whether Delaware law favors managers or shareholders. Firms

Table 3 presents a stratified report of Delaware's franchise-tax revenues. As Table 3 shows, approximately 1600 Delaware firms pay annual franchise taxes of \$100,000 or more. Even assuming that all firms presently paying less than \$100,000 would exit Delaware if it charged a uniform tax rate of \$100,000, Delaware's franchise-tax revenues at that rate would still be \$160 million.

TABLE 3: DELAWARE FRANCHISE TAX RECEIPTS IN FISCAL YEARS 1997-1999

| Tax Rate in Dollars | Tax Paid in Fiscal Year 1999 | | Tax Paid in Fiscal Year 1998 | | Tax Paid in Fiscal Year 1997 | |
|---------------------|------------------------------|--------------------|------------------------------|--------------------|------------------------------|--------------------|
| | Number of Firms | Revenue in Dollars | Number of Firms | Revenue in Dollars | Number of Firms | Revenue in Dollars |
| 0-29 | 3,564 | 64,710 | 3,738 | 67,444 | 3,177 | 56,567 |
| 30-49 | 147,805 | 4,453,728 | 147,825 | 4,478,737 | 140,586 | 4,237,122 |
| 50-99 | 38,382 | 2,996,688 | 36,481 | 2,837,385 | 36,025 | 2,804,886 |
| 100-499 | 22,088 | 4,057,405 | 22,055 | 4,048,526 | 21,472 | 3,898,617 |
| 500-999 | 4,565 | 2,910,072 | 4,257 | 2,722,380 | 4,122 | 2,616,643 |
| 1,000-4,999 | 5,218 | 11,848,680 | 5,018 | 11,232,215 | 4,713 | 10,619,127 |
| 5,000-9,999 | 1,765 | 12,312,147 | 1,745 | 12,233,360 | 1,537 | 10,707,414 |
| 10,000-19,999 | 1,518 | 21,243,842 | 1,418 | 19,866,212 | 1,347 | 18,777,100 |
| 20,000-49,999 | 1,513 | 48,190,673 | 1,510 | 48,485,448 | 1,391 | 44,293,327 |
| 50,000-99,999 | 916 | 64,382,041 | 906 | 63,631,498 | 777 | 54,330,119 |
| 100,000-109,999 | 107 | 11,180,387 | 108 | 11,261,048 | 101 | 10,573,309 |
| 110,000-119,999 | 98 | 11,243,290 | 75 | 8,599,461 | 77 | 8,810,424 |
| 120,000-129,999 | 83 | 10,383,007 | 61 | 7,600,478 | 57 | 7,139,400 |
| 130,000-139,999 | 67 | 9,036,466 | 62 | 8,359,901 | 60 | 8,079,925 |
| 140,000-149,999 | 97 | 14,096,328 | 63 | 9,208,731 | 66 | 9,678,761 |
| 150,000 or more | 1,229 | 196,269,956 | 1,315 | 173,840,354 | 1,172 | 152,030,939 |
| Others | 254 | -306,375 | 0 | 0 | 0 | 0 |
| Total | 229,249 | 424,363,045 | 226,637 | 388,473,178 | 216,680 | 348,653,680 |

Figures include interest payments and penalties.

Source: Delaware Division of Corporations

To earn similar revenues from a uniform low rate, for instance, in the \$30 to \$500 range, Delaware would have to induce a large net inflow of incorporations. Table 3 confirms, however, our assessment that nonpublic corporations can presently incorporate in Delaware by paying the minimum rate of \$30 (the rate most Delaware firms pay).¹⁸³ Nonpublic firms are thus not a major source of entry into Delaware—indeed, some would presumably exit if Delaware charged more than \$30. While some public firms might enter Delaware if it lowered its fees, their number would be rather limited. It is therefore unlikely that Delaware could charge a uniform rate that would attract

choosing Delaware over states less protective of shareholders gain both from better shareholder protection and from the improved services that Delaware offers. Firms choosing Delaware over states more protective of shareholders do so because their decision makers, whose choice of a pro-shareholder jurisdiction when Delaware franchise taxes were higher indicates their alignment with shareholders, believe that the superior services offered by Delaware outweigh its inferior protection of shareholders.

¹⁸³ See *supra* note 68 and accompanying text.

additional incorporations sufficient to yield \$160 million in revenues.¹⁸⁴ Thus, if Delaware had to choose between setting a low rate (and keeping many nonpublic firms), and setting a high rate (and losing them), the profit-maximizing choice would likely be the latter. Tax discrimination between public and nonpublic firms therefore probably enhances social welfare.¹⁸⁵

B. Price Discrimination Through Increased Litigation

Assessing the social-welfare implications of Delaware's litigation-intensive law warrants consideration of additional effects. Unlike franchise-tax discrimination, price discrimination through litigation-intensive law also affects the very quality of the product that Delaware is selling. As we have explained above, to the extent that price discrimination shapes Delaware law, it likely reduces social welfare.¹⁸⁶ Among other things, the ensuing litigation intensiveness may increase the cost of business planning and litigation, the cost of risk-bearing by corporate managers, and the cost of suboptimal decisions by corporate decision makers.¹⁸⁷

C. Implications for the Incorporation Debate

It is difficult to write about the market for corporate law today without addressing the much debated question of whether the ability of firms to choose their corporate law by choosing where to incorporate is desirable. The thesis we have presented is compatible both with the view that it is desirable and the view that it is not.¹⁸⁸ A freedom to choose a corporate law through incorporation is desirable if incorporators favor substantive laws that afford optimal protection to shareholder interests; it is undesirable if they favor substantive laws that grant managers excessive freedom to pursue their own interests.

Either way, Delaware has competitive advantages in the market for incorporations because it not only tailors its law to incorporators' preferences, but also offers excellent adjudication and administrative services, extensive precedents, familiarity to the legal and financial

¹⁸⁴ This analysis ignores the fact that the number of Delaware corporations may in itself, through network and learning effects, affect the value of incorporating in Delaware. Other things being equal, this effect will reduce the profit-maximizing uniform tax that Delaware would charge for an incorporation.

¹⁸⁵ Whether the different franchise taxes payable by different public firms, assuming that the taxes are price discriminatory, enhance social welfare is more difficult to assess. Even though we can confidently conclude that Delaware would maximize its profits by setting the uniform rate so high that nonpublic corporations would exit, the data are insufficient to predict how a uniform rate would affect incorporations by public companies. The net social-welfare effect of price discrimination among public firms is thus ambiguous.

¹⁸⁶ See *supra* Part II.B.2(b).

¹⁸⁷ See *supra* notes 153-54 and accompanying text.

¹⁸⁸ Cf. Kamar, *supra* note 10, at 1948.

community, and commitment to continued responsiveness. The value of these advantages to firms is separate from the value of its substantive law.¹⁸⁹ These advantages, in turn, confer market power on Delaware—market power that Delaware uses to price discriminate and to increase its profits. It is hard to determine the overall social-welfare effect resulting from the likely positive effect of discrimination through franchise tax and the likely negative effect of discrimination through litigation intensiveness. The social-welfare implications of price discrimination are clear, however, insofar as one focuses on the criterion traditionally used to evaluate the market for incorporations—the quality of corporate law. Here price discrimination probably only makes the market for incorporations less desirable than it seems to its proponents and more undesirable than it seems to its opponents.¹⁹⁰

CONCLUSION

This Article has challenged the received wisdom that the outcome of a market for incorporations depends entirely on the degree to which corporate decision makers are motivated to incorporate in the jurisdiction that maximizes the value of the corporation. Against this overly simplified description, we have argued that Delaware relies on competitive advantages in the market for incorporations to increase its profits through price discrimination.

Two features of Delaware law involve price discrimination. First, Delaware's uniquely structured franchise tax results in higher charges to public firms than to nonpublic firms. Public firms value incorporating in Delaware more highly than nonpublic firms. The different franchise taxes payable by these firms, which are not based on cost differences, constitute third-degree price discrimination.

Second, Delaware's substantive corporate law tends to be standard based and fact intensive, there is often ambiguity as to what legal test is applicable, and precedents tends to be narrow in scope. Each of these factors makes Delaware law litigation intensive. This quality of the law also constitutes third-degree price discrimination because, on one hand, the costs of incorporating in Delaware are higher for companies that tend to be involved in legal disputes more than

¹⁸⁹ See Bebchuk & Ferrell, *supra* note 1, at 1174 (arguing that the value that shareholders reportedly assign to Delaware firms in comparison to firms incorporated in other states may reflect the value of these advantages, rather than the adequacy of shareholder protection under Delaware law); Klausner, *supra* note 1, at 850-51.

¹⁹⁰ Cf. Kamar, *supra* note 10, at 1948 (making a similar argument regarding the effect of legal indeterminacy that results from other uncompetitive practices that Delaware employs).

others, and on the other hand, these companies assign a higher value to incorporating in Delaware.

Finally, we have examined the efficiency implications of Delaware's price discrimination. We have argued that franchise-tax discrimination between public and nonpublic firms is likely to enhance social welfare. By contrast, the price discriminatory effect of litigation-intensive law weakens Delaware's incentives to improve its law and is therefore likely to reduce social welfare.

APPENDIX A

STATES WITH NO FRANCHISE TAXES OR ONLY FLAT
ANNUAL FEES

| State | Tax to Domestic Firms in Dollars | Tax to Foreign Firms in Dollars |
|-----------------------|----------------------------------|---------------------------------|
| Alaska ¹⁹¹ | 50 | 100 |
| Arizona | 45 | 45 |
| California | 20 | 20 |
| Colorado | 12.50 | 50 |
| Connecticut | 75 | 300 ¹⁹² |
| District of Columbia | 100 | 100 |
| Florida | 150 | 150 |
| Hawaii | 25 | 125 ¹⁹³ |
| Idaho | 0 | 0 |
| Indiana | 15 | 15 |
| Iowa | 30 | 30 |
| Maine | 60 | 60 |
| Maryland | 100 | 100 |
| Michigan | 15 | 15 |
| Minnesota | 0 | 20 |
| Montana | 10 | 10 |
| New Mexico | 62.50 | 62.50 |
| New York | 4.50 | 4.50 |
| North Dakota | 25 | 25 |
| Oregon | 30 | 220 |
| South Dakota | 10 | 10 ¹⁹⁴ |
| Utah | 10 | 10 |
| Vermont | 15 | 100 |
| Washington | 50 | 50 |
| Wisconsin | 25 | 50 |

Source: State Tax Guide: All States ¶¶ 5-200 to 5-951 (CCH ed., 2001)

¹⁹¹ The actual tax is double the tax reported in the table and is shared biannually.

¹⁹² Includes \$225 license fee in addition to the \$75 filing fee. TAX GUIDE, *supra* note 56, ¶ 1-300.

¹⁹³ Includes \$100 license fee in addition to the \$25 filing fee. *Id.* ¶¶ 5-366, 5-370.

¹⁹⁴ Foreign companies pay an additional fee based on the number of authorized or issued shares. *Id.* ¶ 5-820.

APPENDIX B

STATES WITH NON-INCOME APPORTIONED ANNUAL
CORPORATE TAXES

| State | Tax Base | Apportionment Method |
|----------------|---|---|
| Alabama | net worth | property/payroll/sales |
| Arkansas | outstanding capital stock | real and tangible personal property |
| Illinois | paid-in capital | "represented in" Illinois |
| Kansas | shareholders' equity | "attributable to" Kansas |
| Kentucky | capital | property/payroll/sales |
| Louisiana | capital stock, surplus, undivided profits, borrowed capital | sales/property |
| Massachusetts | tangible property or net worth | manufacturing (and defense): sales others: property/payroll/sales |
| Mississippi | capital | property/gross receipts |
| Missouri | outstanding shares and surplus | property/assets |
| Nevada | number of employees | full-time employees |
| New Hampshire | enterprise value | compensation/interest (property)/sales |
| New Jersey | net worth | property/payroll/sales |
| North Carolina | capital stock, surplus, undivided profits | property/payroll/sales |
| Ohio | issued and outstanding shares of stock | property/payroll/sales |
| Oklahoma | outstanding capital stock, surplus, undivided profits, bonds, and other indebtedness (maturing at least 3 years after issuance) | property/business |
| Pennsylvania | capital stock | property/payroll/sales |
| South Carolina | capital stock and paid in capital surplus | manufacturers/dealers in tangible personal property: property/payroll/sales others: gross receipts |
| Tennessee | property/net worth | property/payroll/receipts |
| Texas | capital and earned surplus | gross receipts |
| Wyoming | property/assets | located and employed in Wyoming |

Source: State Tax Guide: All States ¶¶ 5-200 to 5-951, 10-522, 10-657, 10-730, 10-807 (CCH ed., 2001)