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ARTICLES

MARKET SEGMENTATION: THE RISE OF NEVADA AS A LIABILITY-FREE JURISDICTION

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THIS Article exposes and analyzes the rise of Nevada as an almost liability-free jurisdiction. Without much public attention, Nevada has embarked on a strategy of market segmentation with a differentiated product—a shockingly lax corporate law.

Nevada law generally protects directors and officers from liability for breaches of the duties of loyalty, good faith, and care that are widely believed to be staples of U.S. corporate law. Nevada highlights these broad protections as a reason to incorporate there rather than in Delaware, the dominant state in the interstate market for incorporations.

Market segmentation with lax law has allowed Nevada to overcome significant barriers to entry. By tailoring its product to a particular subset of the market, Nevada gained market power in a segment that is not served by Delaware. Nevada's clear, no-liability law makes Delaware's competitive advantages less significant and leaves

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it unable to respond effectively. In offering lax corporate law, Nevada capitalizes on its reputation as a lax regulator.

Firms may incorporate in Nevada for a variety of reasons that include extracting private benefits, saving on incorporation taxes, and minimizing litigation costs. The data, however, is consistent with some firms choosing Nevada for the first, less benign reason.

Normatively, policymakers should find it worrisome if high agency cost firms, which would benefit the most from legal oversight, disproportionally choose Nevada's lax law. Another reason for concern is that Nevada may create competitive pressures towards the bottom.

INTRODUCTION

This Article exposes and analyzes the shocking rise of the State of Nevada as a no-liability corporate safe heaven. Without much public attention, Nevada has reformed its laws to free officers and directors from virtually any liability arising from the operation and supervision of their companies. This strategy has allowed Nevada to attract a particular segment of the interstate market for incorporations—firms with a preference for strong management protection that is not satisfied by Delaware law.

Scholars have long debated the desirability of allowing firms to incorporate in (and hence choose the law of) any state, regardless of where they actually do business. In a voluminous literature, they have argued whether our current system drives states to race to the top or to the bottom.[1] Over the past decade, however, an important fact has been established: the race is over, Delaware has won.[2]

Home to more than half of all publicly-traded companies, Delaware has attained significant competitive advantages: network externalities, an elaborate body of case law, and an expert judiciary.[3] These advantages, combined with political impediments, made it unlikely that a state would successfully compete with Delaware.[4] Moreover, if a state were to make the initial investments necessary to compete, Delaware could respond by promptly reducing its tax

[1] See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of Corporate Law 212–27 (1991); Roberta Romano, The Genius of American Corporate Law 14–31 (1993) [hereinafter Romano, The Genius]; Oren Bar-Gill, Michal Barzuza & Lucian A. Bebchuk, The Market for Corporate Law, 162 J. Institutional & Theoretical Econ. 134, 134–38 (2006); Lucian A. Bebchuk & Allen Ferrell, Federalism and Corporate Law: The Race to Protect Managers from Takeovers, 99 Colum. L. Rev. 1168, 1193–99 (1999); Lucian A. Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 Harv. L. Rev. 1435, 1444–46 (1992) [hereinafter Bebchuk, Desirable Limits]; William L. Cary, Federalism and Corporate Law: Reflections upon Delaware, 83 Yale L.J. 663, 663–68 (1974); Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225, 225–32 (1985) [hereinafter Romano, Law as a Product]; Ralph K. Winter, Jr., State Law, Shareholder Protection, and the Theory of the Corporation, 6 J. Legal Stud. 251, 254–58 (1977).

[2] See Lucian A. Bebchuk & Assaf Hamdani, Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters, 112 Yale L.J. 553, 563–64 (2002) (arguing that Delaware's dominant position imposes insurmountable barriers to entry); Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679, 684–85 (2002) (arguing that no state competes with Delaware); see also Stephen M. Bainbridge, Dodd-Frank: Quack Federal Corporate Governance Round II, 95 Minn. L. Rev. 1779, 1790 (2011) ("Some recent evidence, however, suggests that the basic premise of both stories (i.e., that states compete actively for corporate charters) is wrong."); Mark J. Roe, Delaware's Shrinking Half-Life, 62 Stan. L. Rev. 125, 125 (2009) ("A revisionist consensus among corporate law academics has begun to coalesce that, after a century of academic thinking to the contrary, states do not compete head-to-head on an ongoing basis for chartering revenues, leaving Delaware alone in the ongoing interstate charter market."); id. at 127 (quoting Ronald Gilson as saying that "'Kahan and Kamar ha[ve] demonstrated [that] there is no[] competition for corporate charters in the U.S. [and] no competition among states for the revenue from incorporation'").

[3] Bebchuk & Hamdani, supra note 2, at 586–89.

[4] Id. at 595 (arguing that due to insurmountable barriers to entry no state should invest in competing with Delaware); cf. Kahan & Kamar, supra note 2, at 724–25 (arguing that barriers to entry alone could not explain the lack of competition, but rather it is the combination of these barriers with political impediments that accounts for the lack of competition).

rate, changing its law, or both, effectively quelling the intrepid state's entry.[5] Indeed, other than Delaware, no state stood to make significant profits from incorporations. And, except Nevada, no state attempted to compete with Delaware—either by reforming its laws or judicial systems.[6] Nevada itself was unsuccessful in its attempts. At the time, Nevada was not deriving meaningful profits from publicly-traded corporations and its efforts were focused on entities other than publicly-traded corporations.[7]

Recently, however, Nevada has identified an opportunity. Additional profits could be realized by targeting a poorly served market segment.[8] Nevada has capitalized on this opportunity by offering, and aggressively marketing, a unique product—a no-liability corporate law—that has proven attractive to a subset of American companies.

This Article proceeds as follows. Part I discusses the existing literature on interstate competition for incorporations. Part II describes Nevada's strategy and the success it has achieved. While it was widely believed that Nevada follows Delaware law,[9] over time

[5] See Bebchuk & Hamdani, supra note 2, at 593–95; see also Bar-Gill, Barzuza & Bebchuk, supra note 1 (constructing a formal model of the market for corporate law in which Delaware can cut prices in response to entry).

[6] See generally Kahan & Kamar, supra note 2 (showing persuasively that no state has made serious attempts to compete with Delaware).

[7] See id. at 716–20 (showing that Nevada marketing efforts were focused on attracting close corporations).

[8] Several other scholars have suggested some form of segmentation by states. Professors Marcel Kahan and Ehud Kamar were the first to suggest that Nevada is catering to a particular segment, showing that Nevada used to focus on close corporations. See id. at 717. In a short note, Richard Posner and Kenneth Scott suggested that Delaware specializes in providing corporate law for large publicly-traded firms. See Richard A. Posner & Kenneth E. Scott, Economics of Corporation Law and Securities Regulation 111 (1980). Professors Barry Baysinger and Henry Butler have argued that firms with weak controls self-select into strict legal regimes. Barry D. Baysinger & Henry N. Butler, Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law, 10 J. Corp. L. 431, 460 (1985) [hereinafter Baysinger & Butler, Uniformity in Corporate Law]; Barry D. Baysinger & Henry N. Butler, The Role of Corporate Law in the Theory of the Firm, 28 J.L. & Econ. 179, 183 (1985) [hereinafter Baysinger & Butler, The Role of Corporate Law].

[9] See, e.g., Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1346 (D. Nev. 1997); Jill E. Fisch, The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters, 68 U. Cin. L. Rev. 1061, 1067 (2000); Ehud Kamar, A Regulatory Competition Theory of Indeterminacy in Corporate Law, 98 Colum. L. Rev. 1908, 1911 (1998); Jonathan R. Macey, Federal Deference to Local Regulators and the Economic Theory of Regulation: Toward a Public-Choice Explanation of Federalism,

Nevada has shielded corporate actors from liability for various acts and omissions, allowing officers and directors to avoid liabilities that are considered almost axiomatic, such as those for breaches of the duty of loyalty, acts or omissions not in good faith, and transactions from which an officer or a director derived an improper personal benefit.[10]

This strategy is far from disguised—Nevada has all but hung up a "no law for sale" sign.[11] Whynevada.com, for example, a website owned and run by the state, offers as the number one reason to incorporate in Nevada rather than in Delaware the fact that Nevada "[p]rovides stronger personal liability protection to officers and directors."[12] The website's message is amplified by a multiplicity of other websites that encourage Nevada incorporation by identifying "acts for which officers and directors would be *protected* under Nevada law, but <u>exposed</u> under Delaware Statutes."[13]

The Nevada legislators who amended the state's corporate law were fully aware of possible adverse consequences. In legislative debates over the bill broadening directors' and officers' liability protections, some lawmakers voiced their concern that the bill would cause "scoundrels" and "sleazeballs" to incorporate in Nevada. Proponents of the bill successfully convinced their peers that offering a highly permissive law was necessary to differentiate Nevada from Delaware and to make it an attractive jurisdiction in

76 Va. L. Rev. 265, 277 n.41 (1990); Kresimir Pirsl, Trends, Developments, and Mutual Influences between United States Corporate Law(s) and European Community Company Law(s), 14 Colum. J. Eur. L. 277, 317 (2008). A notable exception is Kahan & Kamar, supra note 2, at 726 n.168 ("Despite occasional claims to the contrary, Nevada does not imitate Delaware.").

[10] See discussion infra Subsection II.B.1. The most commonly used textbooks in corporate law describe extensively how directors and officers face liability for such acts. See William T. Allen, Reinier Kraakman & Guhan Subramanian, Commentaries and Cases on the Law of Business Organization 239, 295 (3d ed. 2009); William A. Klein, J. Mark Ramseyer & Stephen M. Bainbridge, Business Associations: Agency, Partnerships, and Corporations, 310–62 (7th ed. 2009).

[11] See Harry First, Comment, Law for Sale: A Study of the Delaware Corporation Law of 1967, 117 U. Pa. L. Rev. 861, 861 (1969) (paraphrasing from the article that opened the literature on regulatory competition in corporate law).

[12] Secretary of State Ross Miller, Lionel Sawyer and Collins Law Firm, Legal Advantages: A Comparison with Delaware, Why Nevada?, http://whynevada.com/commercialrecordings/Why.Nevada.Legal.Comparison.pdf (last visited Apr. 7, 2012).

[13] See, e.g., Nev. Corporate Planners Inc., Why Form an LLC in Nevada (or Corporation)?, http://www.nvinc.com/nservice12.htm (last visited Apr. 7, 2012).

which to incorporate. Transitioning to a liability-free regime, proponents argued, was the only strategy that would allow the state to profit from the incorporations business.[14]

The bill's proponents had a point. Following its legal changes, Nevada's share of the market of publicly-traded firms has risen by 20%, despite a significant increase to its incorporation tax, and its corporate tax revenues from these firms have jumped more than 10,000%. Offering a no-liability law has been an effective strategy for several reasons, which are explored in depth in Part III. For example, Nevada has been able to engage in market segmentation because the incorporations market is heterogeneous with respect to firms' preferences.[15] The literature has assumed that all firms are interested in the same law (bad or good) and, consequently, that all states race in the same direction, either to the bottom or to the top. In fact, some firms appear to have a stronger preference than others to free their officers and directors from liability. Section III.A argues that by offering a highly permissive law, Nevada has been able to capture such companies. Absent meaningful competition in this segment, Nevada has been able to charge supra-competitive prices and turn a profit.

This Section also presents evidence that Nevada firms have a high preference for liability protections, that they voluntarily adopt protection clauses and contracts in higher proportions than firms in other states, and that, more than Delaware firms, they are sensitive to how protective their home state is. States that are notorious for empowering their managers lose significantly fewer corporations to Nevada than other states. Thus, Nevada law is perfectly tailored to the preferences of the target segment.

[14] Opponents eventually agreed after it was promised that some of the newly obtained incorporation revenue would go to raising school teachers' salaries. See discussion infra Subsection II.B.1.

[15] Market segmentation refers to the process of dividing the market to serve distinct consumer groups with similar demand preferences. Segmentation is a lucrative strategy since it allows a producer who does not have market power vis-à-vis the entire market to gain market power in a particular segment. See Michael E. Porter, Competitive Strategy: Techniques for Analyzing Industries and Competitors 196–200 (1980). For a broader discussion of market segmentation in general and for the argument that Nevada's strategy has all components of market segmentation, see infra Section III.A.

Section III.B explains why Delaware's competitive advantages are relatively ineffectual against Nevada's entry. Nevada's no-liability law is clear and predictable; its application requires little to no discretion or expertise. Delaware's well-developed body of case law, specialized judiciary and network externalities—features which protect it from direct competition—are of limited utility when deployed against the certitude of Nevada law. In addition, Nevada leverages its own competitive advantage by offering lax law. Because of its long history of offering lax laws and the favorable political climate for it, Nevada can credibly commit to maintaining its lax corporate law going forward.

Finally, Section III.C argues that Nevada's strategy is also effective because Delaware is constrained in responding to Nevada's entry. If Delaware were to respond by adopting its own no-liability law, it would likely risk unwelcome federal intervention. It would also have to lower its fees in order to continue to appeal to shareholders. In the alternative, Delaware could offer corporations a menu of corporate laws from which to choose, but doing so could create confusion and weaken Delaware's brand. Further, while choosing Nevada law sends a mixed signal, the choice between different corporate law forms would produce less ambiguity. A firm that selects an inferior option under Delaware law would be making a clearer statement of its preferences to the market.

Part IV embarks on a normative analysis of Nevada's entry. If it is true that Nevada law attracts questionable firms, as some of the bill's opponents predicted, then the current interstate corporate law system has a serious flaw. But firms can go to Nevada for other, more benign reasons, such as to avoid frivolous shareholder lawsuits or to save on taxes. This Part analyzes these diverging stories and explains why in some firms shareholders may not object to a Nevada incorporation even when their corporate insiders seek to extract private benefits under Nevada law.

This Part also discusses data from a joint work with Professor David Smith on Nevada firms to assess the foregoing stories. Overall, the data is consistent with firms going to Nevada for mixed reasons. Unlike an incorporation in Delaware, which is associated with a higher firm value, a Nevada incorporation is not associated with a statistically significant premium. But it is also not associated with a discount relative to the other states. The evidence, however, is also consistent with Nevada's ability to attract some high-private-benefits firms, as firms in Nevada are significantly more prone to file accounting restatements than firms in other jurisdictions.

Nevada's story has important implications for the race to the top/race to the bottom debate. Part V discusses these implications. Nevada and Delaware appear to be racing in different directions, Delaware to the top and Nevada to the bottom. Section V.A argues that Nevada's success in segmenting the incorporations market means that the "race" metaphor, as presently construed, is inapt. Instead, market segmentation is a more accurate description. As a result, it is not sufficient to ask whether there is an interstate race for incorporations, and if so in which direction it is headed. Rather, it is necessary to ask, which are the firms that choose lax law, and which are the firms that choose strict law? In other words, an important question that market segmentation raises is whether what we see is an efficient sorting of firms into lax and restrictive jurisdictions or whether our system results in insiders opting into lax legal environments in order to take advantage of their laxity.

Furthermore, the analysis exposes overlooked benefits and costs in the current system relative to a system of federal corporate law, which are discussed in Section V.B. Sorting by firms into states' laws is beneficial to some extent since shareholders can derive information from firms' choices. Sorting also allows firms with strong internal controls to save on litigation costs. There are several reasons to believe, however, that Nevada's strategy should be of concern to policymakers. The current system permits the firms that need regulation the most to opt into a no-liability regime. Moreover, because incorporating in Nevada sends a mixed signal, it is unclear whether investors will adequately deter companies that would incorporate there for invidious reasons. A final cause for concern is that Nevada's strikingly lax law may pressure Delaware into compromising the quality of its law.

Finally, this Part also discusses broader implications. First, as Section V.C shows, the analysis can easily extend beyond Nevada's immediate context since many firms choose to stay in their home states, where their headquarters are located. Since, in their home state, managers can wield political influence to obtain protections, some firms' choices to remain in their home state may be motivated by agency costs. As a result, states other than Delaware and

Nevada also contribute, even if not intentionally, to market segmentation.

Section V.D argues that the implications of the analysis extend beyond the market for corporate law. The choice of state for incorporation is not the only choice that corporations make. Firms choose whether to adopt defensive tactics, majority voting, proxy access, and other potential commitments. A common argument in favor of this freedom is that one size does not fit all: each firm is in the best position to determine which individual package would maximize its value.[16] This Article, however, suggests that firms' sorting is not necessarily efficient. Firms that suffer from weak internal controls—those which need regulation the most—may choose to amass takeover defenses and avoid majority voting, proxy access, and other commitments, whereas firms that already have strong shareholders and low private benefits may opt for strict commitments. This Article then concludes by suggesting that further exploration of which firms self-select into lax and strict legal arrangements is likely to prove fruitful in additional settings.

I. EXISTING THEORIES

Scholars have long debated whether market forces drive states to enact laws favoring either managers or shareholders. This debate began with one of the most cited papers by William Cary. Cary argued that Delaware leads a race to the bottom, catering to managers at the expense of shareholders.[17]

Race to the top scholars disagree with Cary. They laud the prevailing system as providing states with economic incentives to invest in efficient corporate law.[18] Leading scholars have participated

[16] See, e.g., Comment letter from Cravath, Swaine & Moore LLP et al. to SEC concerning File No. S7-10-09; Release Nos. 33-9086; 34-61161; IC-29069, at 6–8 (Jan. 19, 2010), available at http://www.sec.gov/comments/s7-10-09/s71009-619.pdf (employing a "one size does not fit all" argument to oppose a mandatory federal proxy access rule).

[17] Cary, supra note 1, at 665–66.

[18] See, e.g., Easterbrook & Fischel, supra note 1, at 214–15; Romano, The Genius, supra note 1; Romano, Law as a Product, supra note 1; Winter, supra note 1; Ralph K. Winter, Jr., The "Race for the Top" Revisited: A Comment on Eisenberg, 89 Colum. L. Rev. 1526, 1526–29 (1989).

in this debate, and both sides have amassed significant evidence.[19] No consensus has yet been reached.

Despite both sides' disagreements regarding the desirability of the prevailing system, all agree that, whichever direction the race is headed, it has already been won.[20] Competition among states is only illusory. Delaware now controls an overwhelming share of the market; its market power is amply demonstrated by the monopolistic prices that it can and does charge.[21]

Delaware's dominant position in the interstate incorporations market poses significant barriers to entry. Since Delaware is home to more than half of all publicly-traded corporations, its law is associated with significant network externalities, namely the advantage of having so many firms already incorporated in the state,[22] and it is able to offer a well-developed body of case law and specialized, experienced judges.

Delaware's network externalities make it a potentially more favorable jurisdiction in which to incorporate, even than others offering a superior package of law and price.[23] Thus, a state could dethrone Delaware only if it were to attract a critical mass of corporations and gain network externalities, an almost impossible task. Put differently, network externalities make competition with Delaware an all-or-nothing game.[24]

Another significant barrier to entry, as Professors Bebchuk and Hamdani argue, is Delaware's ability to respond promptly to mar-

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[19] See, e.g., Lucian A. Bebchuk & Alma Cohen, Firms' Decisions Where to Incorporate, 46 J.L. & Econ. 383, 383 (2003); Robert Daines, Does Delaware Law Improve Firm Value?, 62 J. Fin. Econ. 525, 525 (2001) [hereinafter Daines, Firm Value]; Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. Rev. 1559, 1559–60 (2002); Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching, 150 U. Pa. L. Rev. 1795, 1795, 1797 (2002) [hereinafter Subramanian, Incorporation Choice].

[20] See, e.g., Bebchuk & Hamdani, supra note 2, at 555–57; Kahan & Kamar, supra note 2, at 684.

[21] See Bebchuk & Hamdani, supra note 2, at 582–84.

[22] The association of network externalities with Delaware law is attributed to Michael Klausner. See Michael Klausner, Corporations, Corporate Law, and Networks of Contracts, 81 Va. L. Rev. 757, 849–51 (1995).

[23] See Bebchuk & Hamdani, supra note 2, at 557; Klausner, supra note 22.

[24] See, e.g., Bebchuk & Hamdani, supra note 2, at 587 (stating that due to network externalities in the market for corporate law, "competition is 'for the field' rather than 'within the field'").

ket entry on the part of other states.[25] Upon detecting new entry, Delaware can, in a fairly prompt manner, reduce its price, change its law, or broaden its menu of corporate law forms. Moreover, other states would find it initially costly to replicate Delaware's judicial infrastructure. Ex ante, recognizing the potential for a price war, a state might not find such an investment to be warranted.[26]

Though significant, Professors Marcel Kahan and Ehud Kamar argue barriers to entry are not sufficient to explain the absence of any competitive attempts. The explanation, they argue, lies in the combination of these barriers and a third impediment to entry, state politics.[27] States, even if they could theoretically challenge Delaware, are not focused exclusively on revenues; they must deal with political constraints when designing their strategy.[28] But if a state can overcome political impediments, it may be able to enter the market.[29] Accordingly, Kahan and Kamar recognize that more serious competition to Delaware may develop in the future.[30]

Until recently, however, as Kahan and Kamar showed, no state has come close to attaining meaningful incorporation revenues.[31] Apart from Nevada, no state has even clearly attempted to compete with Delaware. Nevada itself, as recently as a decade ago, had not been deriving meaningful profits from publicly-traded corporations and accordingly focused its efforts on a different segment of close corporations.[32]

II. NEVADA'S RISE AS A LIABILITY-FREE JURISDICTION

In the last decade, Nevada has expanded its strategy to target a segment of the market of public corporations. Section II.A shows that during this decade Nevada has raised its taxes and increased its revenues from incorporations. Section II.B shows that Nevada

[25] See id. at 593–95.
[26] See id. at 595.
[27] See Kahan & Kamar, supra note 2, at 730–35 (raising this argument and bringing examples of states facing political constraints).
[28] See id.
[29] See id. at 726 (suggesting that another state could either copy Delaware law or adopt a clear detailed code that does not suffer from the lack of case law).
[30] See id. at 685.
[31] Id. at 688–93.
[32] Id. at 716–20 (showing that Nevada marketing efforts were focused on closely held corporations).

achieved that result by offering and aggressively marketing a strikingly lax body of corporate law.

A. Market Share and Revenues

In 2003, Nevada raised the maximum annual tax for domestic incorporations from a practically negligible $85 to a much more substantial $11,100, a more than 10,000% increase. To accommodate this increase, as shown below, Nevada amended its law in 2001 to provide broader protection to directors and officers. As Table 1 shows,[33] in the three years following the legislative change, Nevada's market share increased more than 25% (from 5.56% to 7.01%). It later decreased slightly due to the increase in Nevada's tax rate. Overall, as a result of these changes, Nevada's share of the out-of-state-incorporations market has risen from 5.56% in 2000 to 6.66% in 2008, an increase of 20%. As a result, in the eight years of this new tax regime, Nevada has collected at least several million dollars in incorporation fees from publicly-traded firms,[34] compared to the mere tens of thousands of dollars earned annually from these firms in previous decades.[35]

During these eight years of overall increase, Nevada's share of the incorporation market has decreased on two separate occasions. First, as mentioned above, several companies exited the state in response to the 2003 tax increase. Nevada's market share declined in 2003 and slightly in 2004 before resuming its ascension.

[33] Table 1 reports the proportion of firms that Nevada attracts out of the firms that choose to leave their home state, namely the firms that shop for law. The sample reports all publicly-traded U.S. firms reporting state-of-incorporation information in Compustat as of 2008. Standard and Poor's, Compustat Database, http://www.compustat.com/Compustat_Database/ (last visited Aug. 3, 2009) (data on file with the author). The historical data was taken from Mergent. Mergent, www.mergent.com (last visited Aug. 3, 2009) (data on file with the author).

[34] Warren Lowman & Dr. Paul Chalekian, Introduction, Should the Secretary of State Propose Nevada Establish a Business Portal? 1–2 (Sept. 23, 2008), http://nvsos.gov/Modules/ShowDocument.aspx?documentid=1282. This document discussed changes to Nevada incorporation taxes and reported that, as a result, Nevada revenue from incorporations increased to $83 million. This sum, however, includes fees from other entities such as limited liability companies. Nevada does not keep a separate record for fees collected from publicly-traded companies. See e-mail from Jeffery Landerfelt, Management, Analyst, Sec'y of State Ross Miller's Office, to author (Aug. 12, 2011, 14:54 EST) (on file with author).

[35] See Kahan & Kamar, supra note 2, at 693.

Second, Nevada's market share declined in 2008, the beginning of the financial crisis. This fact, however, does not necessarily indicate that corporations were fleeing the state. 2008 saw many firms ceasing to exist, shutting down, or going private. One possible explanation for Nevada's decrease in market share is that Nevada corporations dissolved at a greater rate than Delaware corporations.

Table 1: Nevada's Market Share of Out-of-State Incorporations

Year	Proportion of out-of-state incorporations in Nevada (%)	Nevada key changes
2000	5.56	
2001	5.98	No liability is set as a default
2002	6.54	
2003	7.01	The maximum annual tax is raised from $85 to $11,100
2004	6.72	
2005	6.71	
2006	6.73	
2007	6.87	
2008	6.66	

B. Nevada Law

Nevada's strategy is no less remarkable than the success it has achieved. It has been widely thought that Nevada was following the Delaware legal regime closely.[36] Yet, this Section will show that over time Nevada has differentiated itself from Delaware by applying a strikingly lax corporate law to its corporations and aggressively advertising its lax policies as a reason to incorporate there.

1. Directors and Officers Face Almost No Liability

In every introductory corporate law class, students learn that directors are subject to certain liabilities out of which they cannot

[36] See references in supra note 9.

contract.[37] In particular, under Delaware law, directors and officers are liable for:

(1) Breach of the duty of loyalty;
(2) Breach of the duty of care;
(3) Behavior that is not in good faith;
(4) Improper personal benefits; and
(5) Intentional misconduct, fraud, or a knowing violation of law.

Section 102(b)(7) famously allowed Delaware companies to opt out of subjecting directors to liability for breaches of the duty of care. However, Delaware corporations are disallowed from opting out of liability for the remaining categories.[38]

The situation in Nevada is radically different. Nevada law imposes only one of the above-listed duties. Directors and officers may be held liable only if their behavior was so egregious that it involved *both* a breach of the duty of loyalty *and* intentional misconduct, fraud or a knowing violation of law.[39] As a result, in stark con-

[37] See, e.g., Allen, Kraakman & Subramanian, supra note 10, at 239–240; Klein, Ramseyer & Bainbridge, supra note 10, at 310–74.

[38] Section 102(b)(7) was passed to avoid directors' excessive risk aversion and accordingly provides protection only for duty-of-care violations. It was passed following the decision of the Delaware Supreme Court in *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), which found directors liable for breaching the duty of care for selling their company without sufficient information and deliberations despite the fact that the directors did not have a self-interest and the company was sold for more than a 50% premium. Id. at 893. Section 102(b)(7) explicitly prohibits opting out of any of the other categories. Del. Code Ann. tit. 8, § 102(b)(7) (2011) ("[T]he certificate of incorporation may also contain any or all of the following matters: . . . (7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, *provided that such provision shall not eliminate or limit the liability of a director*: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit.") (emphasis added).

[39] Nev. Rev. Stat. Ann. § 78.138(7) (LexisNexis 2010) ("Except as otherwise provided in NRS 35.230, 90.660, 91.250, 452.200, 452.270, 668.045 and 694A.030, or unless the articles of incorporation or an amendment thereto, in each case filed on or after October 1, 2003, provide for greater individual liability, a director or officer is not individually liable to the corporation or its stockholders or creditors for any damages as a result of any act or failure to act in his or her capacity as a director or officer unless it is proven that: (a) The director's or officer's act or failure to act constituted a breach of his or her fiduciary duties as a director or officer; *and* (b) The breach of those duties involved intentional misconduct, fraud or a knowing violation of law.") (emphasis added); see also Keith Paul Bishop, Silver Standard, L.A. Lawyer, Nov.

trast to those in Delaware, directors and officers in Nevada are liable only for intentional misconduct, fraud, or a knowing violation of law. This may result in no liability for a number of important categories, including conflicts of interest, self-dealing with the company, personal benefits, and conscious disregard of duties.[40]

Another important difference between Delaware and Nevada is the scope of the no-liability provision. Whereas 102(b)(7) only exculpates directors, Nevada's Section 78.138 exculpates *officers* as well. This distinction is particularly significant given that officers have better access to information and more influence on corporate decision making than non-executive directors.

Furthermore, Nevada's liability protection extends to the right of directors to be indemnified by their company for legal expenses. Nevada law permits firms to indemnify directors for all acts, provided that no intentional misconduct or knowing violation of law is involved. Conversely, bad-faith acts are not indemnifiable in Delaware,[41] and Institutional Shareholder Services ("ISS") advises shareholders to vote against any indemnification that is not limited to good-faith acts.[42]

Finally and importantly, while in Delaware protection from liability for even duty-of-care violations is conditioned on shareholder approval, in Nevada the *default* is sweeping protection from

2008, at 34 (noting that Nevada automatically relieves directors and officers from liability unless both conditions are met).

[40] Conscious disregard of duties constitutes a breach of the duty of good faith under Delaware law. See In re The Walt Disney Co. Derivative Litig., 907 A.2d 693, 755 (Del. Ch. 2005).

[41] Del. Code Ann. tit. 8, § 145(a) (2011); Waltuch v. Conticommodity Servs., 88 F.3d 87, 95 (2d Cir. 1996) (holding that a corporation cannot indemnify a director who acted in bad faith despite a charter term that attempts to provide directors with unconditional indemnification rights).

[42] ISS, ISS' 2011 U.S. Proxy Voting Guidelines Summary 1, 18 (Dec. 16, 2010), http://www.issgovernance.com/files/ISS2011USPolicySummaryGuidelines20101216.pdf ("Vote AGAINST proposals to eliminate entirely directors' and officers' liability for monetary damages for violating the duty of care."). Corporations in Nevada also have broad authority to purchase insurance and make other financial arrangements to reduce directors' and officers' potential exposure to liability such as creation of a trust fund or granting of a security interest or other lien on any assets of the corporation. See Nev. Rev. Stat. Ann. § 78.752 (LexisNexis 2010).

breaches of both the duties of care and loyalty. Companies can only opt out of the default with management approval.[43]

To summarize, Table 2a indicates the duties out of which Delaware companies are not permitted to opt: the duty of loyalty, the duty to act in good faith, and the duty not to act for personal benefits. By contrast, under Nevada law, these duties are neither mandatory nor even the default setting. Nevada retains mandatory liability only for intentional misconduct and knowing violations of law. Additional liability is permitted, but, once again, conditioned on management approval.[44]

Table 2a: Exposure for Liability for Breach of Fiduciary Duties

Standard	Delaware	Nevada
Intentional misconduct or knowing violation of law	Mandatory liability	Mandatory liability
Duty of loyalty	Mandatory liability	No liability by default
Duty of good faith	Mandatory liability	No liability by default
Acting for improper personal benefit	Mandatory liability	No liability by default
Duty of care	Liability by default for directors, mandatory liability for officers	No liability by default

2. The 2001 Legislative Change

Nevada's exculpation statute, adopted in 1987, was originally broader than Delaware's, allowing firms to waive liability for all categories but one—intentional misconduct, fraud, or knowing violation of law.[45] Yet, opting into these liability protections was conditioned on shareholder approval.

[43] At first glance this may not seem to be an important difference since in Delaware 90% of the companies have opted into 102(b)(7) protection, but since Nevada offered a stronger protection than 102(b)(7), it is possible that shareholders of existing companies in Nevada would not have opted in.

[44] See Nev. Rev. Stat. Ann. § 78.752(4)(a) (LexisNexis 2010).

[45] Nev. Rev. Stat. Ann. § 78.037 (LexisNexis 2010).

In 2001, Nevada broadened the differences between the two states by flipping its default from liability to no liability. In one day, all of Nevada's directors and officers were granted protection from most sources of liability. Shareholders could continue to avoid protection and subject directors and officers to liability for breach of the duty of loyalty, but only if they were able to secure the approval of management.

This change was not specifically approved by the shareholders of Nevada companies. The legislation applied to all of Nevada's existing companies. Thus, shareholders who chose Nevada incorporation prior to the change in the law were forced to accept significant liability protections for directors and officers.

As Table 1 shows, in the three years following the legislative change, Nevada's market share increased more than 25% (from 5.56% to 7.01%). It later slightly decreased 20% due to the increase in Nevada's tax rate. Indeed, as the following Subsection shows, the legislative changes were adopted in order to accommodate the tax increase that followed.

3. Legislative History of the 2001 Amendment: Intentional Differentiation from Delaware

Presenting the proposed legislative amendment to the Senate Committee on Judiciary, the Nevada Chairman of the House, Senator Mark A. James, argued that in order to accommodate incorporation-fee increases and to derive significant incorporation revenues "Nevada ought to offer some liability protection to directors of corporations."[46]

In support, Michael J. Bonner, a Nevada attorney, argued that given Delaware's dominant market position, robust liability protection would be needed to attract firms to Nevada:

> When we look at our Nevada corporate business statutes we have to recognize that . . . if it is Delaware versus home state versus Nevada, if it is a tie, . . . if the corporate laws of these jurisdic-

[46] Hearing on S.B. 277 Before the S. Comm. on Judiciary, 2001 Leg., 71st Sess. (Nev. 2001) (statement of Sen. Mark James, Chairman, S. Comm. on Judiciary), available at http://www.leg.state.nv.us/Session/71st2001/Minutes/Senate/JUD/Final/1464.html. Senator James further explained that since "[d]irectors are the ones who decide where to incorporate, . . . this will be a major incentive." Id.

> tions are equally favorable, . . . typically, they are going to select Delaware. That is just the way it is . . . . [I]f Nevada can enhance the liability protection for [directors and officers] and strike the proper balance to not protect those who have participated in a criminal activity or fraud, the State will go a long way to making Nevada an attractive place in which to incorporate.[47]

Opponents were concerned that the proposed liability protections were excessive. As Senator Terry Care remarked, "It is unfortunate because what we are being asked here . . . [is to] protect . . . corporate crooks. . . . I would like to say [that the proposal] comes with a terrible price."[48]

Opponents of the bills perceived that further limiting director and officer liability might cause the wrong kinds of companies to incorporate in Nevada. Senator Dina Titus warned that the state might just as well hang up a sign reading, "Sleaze balls and rip off artists welcome here."[49]

Senator Bob Coffin echoed Titus's sentiments. Coffin predicted that, as a result of the bill, "reputable companies" would "not . . . want to come here to save a few dollars."[50] Nevada would become "the place where Butch Cassidy and the Sundance Kid would go, the Hole in the Wall." He warned his peers: "Make no mistake, these subtle changes are significant. Scoundrels can move here[,] and there are scoundrels in the mutual fund business and in the pension business and in many corporations. If I was [sic] one of them I might consider moving here now."[51]

The bill's opponents ultimately relented, but only because the incremental $30 million in projected revenues would go to fund salary increases for public school teachers. Senator Titus's remarks are revealing:

> I have been threatened, and I do not use this term lightly, that if Senate Bill No. 577 does not pass in this exact form, the so-called

[47] See id. (statement of Michael J. Bonner, a Nevada attorney).

[48] Senate Debate, S.B. No. 577, One Hundred and Eleventh Day (May 6, 2011) (statement of Sen. Terry Care), available at http://www.leg.state.nv.us/Session/71st2001/Journal/Senate/Final/SJ111.html.

[49] Id. (statement of Sen. Dina Titus).

[50] Id. (statement of Sen. Bob Coffin).

[51] Id.

> education funding package deal falls apart . . . . For that reason, I will vote for this bill, but I do so with a heavy heart. Nevada has sold its soul, tarnished its already shaken reputation, today, in exchange for a $30 million band-aid.[52]

Although the promise of additional revenues finally induced the bill's opponents to acquiesce in its enactment, the contemplated tax increases did not immediately follow. They were passed two years later, and then only in a reduced form.[53]

This legislative history suggests that increasing protection for directors and officers was a conscious move calculated to differentiate Nevada from Delaware. The move was intended to appeal to directors and officers and was adopted at the risk of attracting some questionable firms.

4. Latitude to Use Defensive Tactics

Nevada has further differentiated itself from Delaware through its anti-takeover law. Most significantly, and contrary to conventional wisdom, Nevada deliberately applies more lenient standards to managers' use of defensive tactics.[54] Managers have developed tools to defend against hostile takeovers where the bidder intends to buy control over the company and replace management. Delaware courts have approved most of these tools but have applied enhanced fiduciary duties for their use in three iconic cases.[55] These

[52] Id. (statement of Sen. Dina Titus). The opponents managed to block a clear and convincing evidence standard that would have created a significant burden to prove directors' guilt; the rest of the bill, however, passed intact.

[53] Taxes were raised in 2003, but not by as much as originally anticipated.

[54] Another difference between Nevada and Delaware is that, unlike Delaware, Nevada has adopted five antitakeover statutes including pill endorsement, other constituency, control share acquisition, fair price, and freeze-out statutes. See Bebchuk & Cohen, supra note 19, at 407 tbl.9. These authors, however, argue elsewhere that these statutes are not significantly different from Delaware case law. See Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, Does the Evidence Favor State Competition in Corporate Law?, 90 Calif. L. Rev. 1775, 1803–04 (2002).

[55] See Revlon, Inc., v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986) (holding when a sale or a break-up of the company is inevitable, the director's role shifts to one of an auctioneer, and he has a duty to act to maximize the sale value to shareholders); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946, 955 (Del. 1985) (holding when directors use defensive tactics they are not awarded with the high deference of the business judgment rule, but rather have to show that their use constituted a proportional response to a cognizable threat); Blasius Indus., Inc. v. At-

famous, enhanced standards from *Unocal v. Mesa Petroleum*, *Revlon v. MacAndrews & Forbes Holdings*, and *Blasius Industries v. Atlas* do not apply to Nevada corporations.

The notable federal district court case that applies Nevada law, *Hilton Hotels v. ITT*, is widely cited for its proposition, in dicta, that Nevada follows Delaware's enhanced standards for the use of defensive tactics.[56] Less well known is the fact that, in 1999, two years after *Hilton Hotels* was decided, the Nevada legislature rejected this interpretation of Nevada law. Instead, the legislature endorsed the more deferential business judgment rule for most change-of-control situations.[57] As a result, when presented with more than one offer for their companies, managers of Nevada companies are not legally obligated to sell to the highest bidder. Table 2b summarizes the differences between the standards that apply in Delaware and Nevada for use of defensive tactics.

This change also signals Nevada's commitment to differentiating itself from Delaware. Rather than coalesce to a federal court decision that would have brought Nevada law into closer alignment with Delaware's, the Nevada legislature stepped in to clarify the management-friendly nature of the state's corporate law.[58]

las Corp., 564 A.2d 651, 661 (Del. Ch. 1988) (holding that when directors act with the primary purpose of impairing shareholders' power to vote they have the burden to show that there was a compelling justification for their acts).

[56] Hilton Hotels Corp. v. ITT Corp., 978 F. Supp. 1342, 1346 (D. Nev. 1997).

[57] See Nev. Rev. Stat. Ann. § 78.139 (LexisNexis 2010) (replacing the *Unocal* and *Revlon* standards with the business judgment rule and replacing the *Blasius* standard with the standard in *Unocal*).

[58] The legislative history of this action suggests it was a direct response to *Hilton Hotels*: "[T]he Executive Committee believes the decision [*Hilton Hotels*] contained language which *could be interpreted* too broadly and wish[es] to clarify Nevada law by changing NRS 78.138. If actions taken in response to takeover threats do not involve the disenfranchisement of stockholders, the directors should obtain the benefits of the business judgment rule <u>without</u> first having to establish (i) that management had reasonable grounds to believe a danger existed to the corporation, and (ii) that the response to the takeover danger was reasonable." Memorandum from John P. Fowler, Chair, Exec. Comm., Bus. Law Section, State Bar of Nev. to S. Judiciary Comm., State of Nev. 5 (Feb. 3, 1999), available at http://www.leg.state.nv.us/Division/Research/Library/LegHistory/LHs/1999/SB061,1999pt1.pdf (first emphasis added).

Table 2b: Standards that Apply to Management's use of Defensive Tactics

	Delaware	Nevada
Use of defensive tactics	*Unocal*	Business Judgment Rule
Use of defensive tactics when sale is inevitable	*Revlon*	Business Judgment Rule
Use of defensive tactic that amounts to intervention in shareholder franchise	*Blasius*	*Unocal*

5. Proxy Materials

The forgoing legal differences have also been noted in proxy materials of firms that move from Delaware to Nevada. Reincorporations from one state to another are revealing since reincorporations require shareholder approval. In soliciting shareholder votes, firms must disclose to shareholders the legal differences between the two states.

Indeed, proxy statements of firms that have moved to Nevada support the foregoing analysis: the statements are explicit about the differences between Nevada and Delaware law. For instance, one representative proxy statement explains that "reincorporation will result in the elimination of any liability of a director for a breach of the duty of loyalty unless arising from intentional misconduct, fraud, or a knowing violation of law."[59]

[59] ITIS Inc., Definitive Information Statement (Form DEF 14C) 11 (Sept. 18, 2002), available at http://www.sec.gov/Archives/edgar/data/3959/000091205702035583/a2089350zdef14c.htm; see also ATSI Commc'ns, Inc., Definitive Proxy Statement (Form DEF 14A), at 18 (Mar. 26, 2004), available at http://www.sec.gov/Archives/edgar/data/1014052/000101540204001156/0001015402-04-001156.txt (noting the lack of liability for breach of duty of loyalty under Nevada law); Daleco Resources Corp., Definitive Proxy Statement (Form DEF 14A) E-3 (Feb. 6, 2002), available at http://www.sec.gov/Archives/edgar/data/746967/000095011602000159/def14a.txt.

6. Marketing Strategies

In addition to changing its law, Nevada also embarked on a strategy to market its no-liability regime. Nevada's marketing pitch highlights the greater protections afforded to managers under Nevada law.[60]

For example, the Nevada Secretary of State website lists as the first difference between Delaware and Nevada, "Nevada['s] . . . stronger personal liability protection to directors and officers."[61] It also states that Nevada managers have greater freedoms to defend against hostile takeovers because they do not have to satisfy *Revlon* duties, meaning that in *Revlon*-type situations they are not required to sell their companies to the highest bidders.[62]

Similarly, marketing materials of Nevada promoters explain that while Delaware "has adopted a statute that allows the corporation to limit the liability of a director for monetary damages," it "has far to go to be compared to similar statutes adopted by Nevada."[63] These materials go on to describe the "acts for which officers and directors would be *protected* under Nevada law, but <u>exposed</u> under Delaware Statutes."[64] Among these are acts or omissions not in good faith, breach of a director's duty of loyalty, and transactions involving undisclosed personal benefit to the officer or director.[65] Thus, Nevada promoters are blunt in marketing Nevada as a liability-free regime.

III. WHY NEVADA'S STRATEGY HAS BEEN SUCCESSFUL: MARKET SEGMENTATION WITH LAX LAW

Why has Nevada's strategy been successful despite significant barriers to entry? This Part argues that the explanation can be found in the combination of market segmentation and lax law.

[60] Prior to the legislative change in 2001, Nevada marketing efforts were focused primarily on attracting close corporations, stressing confidentiality and tax benefits for close corporations that incorporate in Nevada. See Kahan & Kamar, supra note 2, at 717–20.

[61] Miller, supra note 12.

[62] Id.

[63] See Nev. Corporate Planners Inc., supra note 13.

[64] Id.

[65] Id.

Three explanations for Nevada's success will be taken up in turn. First, Section III.A argues that offering lax law segments the market and generates supra-competitive revenues. Second, Section III.B argues that offering lax law renders Delaware's advantages less salient. Finally, Section III.C argues that Delaware is constrained from responding to Nevada's strategy.

This Part also argues that alternative strategies—such as offering law that is more shareholder-friendly than Delaware's—are less likely to be successful.

A. Market Segmentation

This Section will describe the components of market segmentation, explain why Nevada's strategy meets all of them, and explain why market segmentation has proven so successful for Nevada.

1. The Process and Advantages of Market Segmentation

Market segmentation is a multi-step process involving: (1) identification of heterogeneity among consumers; (2) division of the market into subgroups with similar preferences; and (3) creation of a product to meet a particular segment's demand.[66]

Advantages of Market Segmentation. By offering a target segment a tailored product, a producer can generate market power. For the target segment, the tailored product has no perfect substitute. Thus, the producer faces no real competition. Due to this advantage, marketing guru Michael Porter argues that market segmentation explains how companies with low market shares are nonetheless able to achieve significant profits.[67]

[66] See, e.g., Porter, supra note 15, at 169; Alice M. Tybout & Kent Grayson, Kellogg on Marketing 27 (Alice M. Tybout & Bobby J. Calder eds., 2d ed. 2010); Michel Wedel & Wagner A. Kamakura, Market Segmentation, Conceptual and Methodological Foundations 3–4 (2d ed. 2000).

[67] This phenomenon is known as the hole-in-the-middle problem—firms with small market share are almost as profitable as firms with large market share and more profitable than firms with medium market share. See Porter, supra note 15, at 41–43. Take for example Southwest Airlines's choice to focus on short-haul point-to-point flights rather than on the hub-and-spoke model. Instead of adopting a mass marketing strategy to compete with larger airlines, Southwest targeted a segment of the market that it could best serve. By pursuing this strategy, Southwest achieved relatively high returns. See id.

Positioning. Market segmentation is most successful if the producer can develop compelling positioning of product and brand.[68] This involves marketing the specific, favorable features of the producer (such as specific competitive advantages) and the product that are valuable to the target segment.[69]

2. Nevada's Strategy Meets All Components of Effective Market Segmentation

(a) Differentiated Product: Nevada Offers a Law that Cannot Be Achieved in Delaware

In order to pursue a market segmentation strategy, it is necessary that the producer offer a differentiated product. To be sure, Delaware law is known for its flexibility. It allows companies to opt out of many arrangements. Thus, on its face, finding a product that Delaware clearly does not offer is something of a challenge. Nevertheless, as discussed above, some of Delaware law's most important terms are mandatory, including the duty of loyalty, the duty to act in good faith, and the prohibition on making undisclosed personal profits. Firms are not allowed to opt out of these duties even with shareholder approval.

Nevada designed its law with Delaware in mind, tailoring it to provide exactly the package that firms are not permitted to have in Delaware. In fact, Nevada has almost applied the mirror of Delaware corporate law, including in its default corporate law almost every protection from liability that is prohibited in Delaware.[70]

(b) Heterogeneity Among Consumers

Market segmentation involves catering to the preference of a particular market segment. As shown below, Nevada's lax law attracts corporations that have an especially strong preference for a no-liability regime. There are two significant indications that firms in Nevada prefer lax law more strongly than do Delaware firms.

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[68] See Tybout & Grayson, supra note 66, at 29.

[69] Positioning is a term of art from marketing literature that describes the process of creating an image of a product or a brand in consumers' minds. See, e.g., Al Ries & Jack Trout, Positioning: The Battle for Your Mind 2–3 (1981).

[70] See supra Section II.B.

(i) Nevada Firms Do Not Come From States that Provide Significant Takeover Protections

The first indication that Nevada firms have a strong preference for lax law can be found in the states from which they come (or, more accurately, in the states from which they do *not* come). Nevada firms come from all over the country, not just from neighboring or west coast states. Thus, we can utilize variation in state laws to investigate which states lose companies to Nevada—ones with protective laws or ones with strict laws. If Nevada companies are predominantly from states with strict laws, that would support the theory that they are interested in the protective aspect of Nevada law.

Variations in state law have been identified in the field of takeover law—the law that allows managers to defend against hostile takeovers that threaten their jobs. In particular, five states—Maryland, Massachusetts, Ohio, Pennsylvania, and Virginia—have adopted extreme takeover statutes that provide managers with power to effectively block hostile takeovers.[71]

Table 3 summarizes the proportion of firms in Nevada and in Delaware that have come from these states.[72] As the Table shows, the proportion of out-of-state firms in Nevada from the five states that offer the greatest protection to managers is low—only 5%. Conversely, the proportion of firms in Delaware from these states is 15%, relatively high and three times greater than in Nevada.[73]

Thus, unlike Delaware's firms, the firms that Nevada attracts are highly sensitive to whether or not the local law is protective. If their home state offers protective law, then they are less likely to move to Nevada. The firms that go to Delaware, on the other hand, are not tempted to stay with the strong protection that their home

[71] See Bebchuk & Cohen, supra note 19, at 409–10; Subramanian, Incorporation Choice, supra note 19, at 1828–29, 1857, 1864.

[72] Data collected from Compustat. Standard and Poor's, Compustat Database, http://www.compustat.com/Compustat_Database/ (last visited Aug. 3, 2009).

[73] Indeed, previous studies have shown that extreme takeover statutes either harm or do not help states keep their companies from moving to Delaware. See Bebchuk & Cohen, supra note 19, at 414–15 (finding that extreme antitakeover statutes do not help states to retain their corporations); Subramanian, Incorporation Choice, supra note 19, at 1838 (finding that extreme antitakeover statutes harm states' success in retaining their corporations).

states offer. Thus, the firms that go to Delaware are probably motivated by other reasons such as Delaware's network externalities.

Table 3: Headquarter States with Strong Antitakeover Law

Panel A: Nevada			Panel B: Delaware		
Headquarter State	Number of firms the state loses to Nevada	Proportion of out-of-state incorporations in Nevada (%)	Headquarter State	Number of firms the state loses to Delaware	Proportion of out-of-state incorporations in Delaware (%)
MA	2	0.90	MA	116	5.19
PA	4	1.80	PA	81	3.62
VA	4	1.80	VA	55	2.46
MD	0	0.00	MD	40	1.79
OH	1	0.45	OH	37	1.66
Total	11	4.95	Total	329	14.72

(ii) Nevada Firms Adopt More Protective Contracts

Another indication that Nevada focuses on firms with a strong preference for no-liability corporate law is the frequency with which these companies voluntarily adopt protection clauses and contracts.

Table 4 summarizes Investor Responsibility Research Center ("IRRC") data on protective clauses and contracts. As the table shows, firms in Nevada are more likely to have protective clauses in their charters or bylaws. Directors in Nevada are also more likely to have indemnification contracts with their companies. Indemnification contracts require the firm to indemnify directors for legal costs incurred in relation to their duties even if the firm's charters or bylaws are changed (possibly by a new board) to eliminate indemnification rights.[74] Thus, these contracts provide direc-

[74] See Schoon v. Troy Corp., 948 A.2d 1157, 1165–66 (Del. Ch. 2008).

tors with an additional layer of protection. The proportion of firms with indemnification contracts in Nevada is more than four times greater than the proportion among Delaware firms, suggesting that Nevada firms have an affirmative interest in strong liability protection, more so than firms that choose Delaware.[75]

Table 4: Director Liability Protection (2001–2006)

The Table reports the proportions of firms with liability-protection clauses and indemnification clauses and contracts as reported in RiskMetrics. Separate unreported regressions were run for each category. Stars represent significance of the coefficients after controlling for market cap. The symbols *, **, and *** represent significance of 10%, 5%, and 1% respectively for those regressions.

Director Liability Protection[76]	Delaware	Nevada	Other States
Director indemnification***	14.67%	30.16%	24.90%
Indemnification contracts***	7.28%	32.54%	7.43%
Director liability*	27.75%	45.24%	39.67%

[75] The overall proportions of firms with protection and indemnification clauses, which are surprisingly low, are consistent with previous findings. See Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, What Matters in Corporate Governance?, 22 Rev. Fin. Stud. 783, 797 (2009) (reporting the following average proportions across states for 2002: Director Indemnification 19.1%; Director Indemnification Contracts 8.1%; Director Liability 33.9%). These proportions used to be higher in the 1990s, but they decreased significantly over time. See Paul Gompers, Joy Ishii & Andrew Metrick, Corporate Governance and Equity Prices, 118 Q.J. Econ. 107, 112 (2003) (reporting the following proportions: indemnification clauses and contracts (they bundle together two IRRC variables) 40.9% in 1990 and 24.4% in 1998; liability protection clauses: 72.3% in 1990 and 46.8% in 1998); see also Bebchuk et al., supra (reporting higher proportions prior to 2002).

[76] IRRC definitions: *Director Indemnification*: A charter or bylaw provision indemnifying the firm's officers and directors against certain legal expenses and judgments as a result of their conduct; *Director Indemnification Contract*: A contract with individual officers and directors promising indemnification against certain legal expenses and judgments as a result of their conduct; *Limited Director Liability*: A provision that limits the personal liability of its directors.

(c) Supra-competitive Pricing

Market segmentation allows firms to accrete market power. This in turn allows firms to charge prices that are higher than marginal cost of production and higher than the prices charged by competitors who do not specialize in the target segment. Supra-competitive pricing is central to market segmentation. In fact, a common measure for the degree of market segmentation—the Celli Index of Market Segmentation—uses the price charged from the segment as a proxy for the degree of market segmentation.[77]

The price that Nevada charges for incorporation is consistent with market segmentation. Nevada corporate taxes are significantly higher than those of other states. While Nevada charges a maximum annual tax of $11,100 and a maximum initial tax of $35,000, other states tax incorporations at a rate close to zero.[78] Moreover, Nevada extracts significant profits from these taxes, as they are far higher than the marginal cost of production. Presumably, Nevada would be unable to charge these prices unless its package was significantly unique and catered to firms that are not well served by Delaware law.[79]

(d) Brand and Product Positioning

As discussed above, Nevada's strategy involves aggressive positioning. Myriad actors in Nevada position the state and market it as a provider of lax law.[80] Nevada's marketing materials stress the exceptionally low risk that directors and officers could be held liable under Nevada law. By emphasizing its no-liability regime, Nevada

[77] Celli G. GianLuca, Model of Export Specialization: Market Segmentation, The Case of Italy, Ministero dell'Economia e delle Finanze, Dipartimento del Tesoro, Note Tematiche No. 1, at 10 (2008), available at http://www.fondazionemasi.it.isiportal.com/UploadDocs/234_Celli.pdf.

[78] See Kahan & Kamar, supra note 2, at 687–92 (showing that other states charge negligible incorporation taxes).

[79] See id. It is helpful to think of Nevada and Delaware as possessing separate, local monopolies. Nevada's monopoly may be smaller, but through it Nevada is still able to charge supra-competitive prices. For a model of several local monopolies, see, e.g., Steven C. Salop, Monopolistic Competition with Outside Goods, 10 Bell J. Econ. 141, 141–45 (1979).

[80] Positioning is a term of art from marketing literature to describe the process of creating an image in consumers' mind of a product or a brand. See, e.g., Ries & Trout, supra note 69, at 2–4.

stresses its competitive advantage relative to Delaware, its brand as a long-time provider of lax laws.[81]

B. Offering Lax Law Undermines Delaware's Advantages

1. The Clarity of Lax Law Undermines the Advantages of Specialized Judiciary and Network Externalities

One of Delaware's primary advantages is the fact that many public companies are already incorporated within the state—that is, the size of Delaware's network.[82]

The expansive liability protections that Nevada provides, however, offer significant clarity. This clarity compensates for Nevada's lack of the amenities Delaware provides and contributes to the state's ability to segment the market.[83] A rich body of case law, a specialized judiciary, and network effects associated with a large number of companies are especially important when the law is indeterminate; they are less important when the law is clear.[84] If the law is clear, as Nevada's law is, these other advantages matter less.

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[81] See infra Subsection III.B.2.

[82] For the advantages of network externalities see discussion supra Part I.

[83] Kahan and Kamar predicted that a state could compete with Delaware by offering a code that reduces the need for legal precedents. See Kahan & Kamar, supra note 2, at 726 (suggesting that another state could compete by either copying Delaware law or adopting a clear code).

[84] See Kahan & Kamar, supra note 2, at 741. Even if firms in Nevada could benefit from a rich body of case law, they would value Delaware's advantages less. For example, a body of case law that interprets strict laws and a body of case law that interprets lax laws are associated with externalities that are not equally attractive to all firms. Thus, although Delaware offers more extensive network externalities than Nevada does, a stable equilibrium could result from each state offering its own differentiated product, each with its concomitant network externalities. See A. Banerji & Bhaskar Dutta, Local Network Externalities and Market Segmentation, 27 Int'l J. Indus. Org. 605, 606–07 (2009) (constructing a model of and finding the conditions for market segmentation with local network externalities when firms compete on price). One shortcoming, however, is that only the Nevada Supreme Court officially publishes its cases. See Kahan & Kamar, supra note 2, at 718–19, 719 n.137. Yet, some business court cases are accessible (though not easily), and corporate actors in Nevada are promoting wider access to these cases. See Rachel J. Anderson, Researching Nevada Business Cases, Rachel Anderson's Law Blog (Nov. 3, 2009), http://rachelandersonsblog.blogspot.com/2009/11/researching-nevada-business-cases.html.

2. Nevada Has Competitive Advantages in Offering Lax Law

While Delaware has many advantages, lax law is perhaps the one field in which Nevada has a clear edge. In other fields, Nevada has branded itself as consistently providing lax law. The state's political climate is generally hospitable to lax law, so offering lax corporate law is merely symptomatic of the state's broader approach.

Nevada's brand is important because it fosters a credible commitment that the state will *continue* to produce lax law. Apart from desirable law, firms value the consistency of a state's approach.[85] The prospect of becoming locked into a state that suddenly changes direction could deter managers from the prospect of incorporating there. The incorporation decision, once made, is not easily reversed. To leave a state, managers would need to obtain shareholder approval, a potentially daunting task in the case of a state that has unexpectedly become more shareholder-friendly.

C. Delaware is Constrained from Responding Effectively

Another reason that offering lax law is particularly effective is Delaware's incapacity to respond to Nevada's entry. As discussed above, Delaware's ability to respond to entry would deter most states from attempting to enter the market. In response to market entry, Delaware could change its law and/or reduce the price it charges, making its overall package more desirable than that of any prospective entrant.[86]

That Nevada's strategy leaves Delaware significantly unable to respond is an important reason for its success. Rather than attempting to compete with Delaware on, for example, price, Nevada has chosen a strategy which Delaware cannot readily counter.

[85] See Romano, Law as a Product, supra note 1, at 276.

[86] See Bar-Gill, Barzuza & Bebchuk, supra note 1, at 156; Bebchuk & Hamdani, supra note 2, at 593–95.

1. Delaware is Constrained from Responding to Nevada's Entry by Degrading Its Law

(a) The Risk of Federal Intervention in Corporate Law

First, in degrading its law, Delaware would increase the risk of federal intervention in corporate law. Federal intervention could cause Delaware to lose much of its incorporations business. As Professor Mark Roe has convincingly demonstrated, Congress has entered in the past and may enter again into areas that are currently regulated by state corporate law. As a result, Roe argues, Delaware acts in the shadow of a threat of federal intervention which restrains its choices.[87]

If Delaware were to follow Nevada by degrading its corporate law, Congress might intervene.[88] Since federal intervention could take many forms, even, in the most extreme scenario, the sweeping federalization of corporate law, Delaware cannot afford to degrade its law as much as Nevada does.

To be sure, Nevada also stands to lose from federal intervention. But Nevada is less likely to trigger federalization than Delaware is. Nevada is still a relatively small player in the market. Because of the smaller number of companies that Nevada attracts, the state is much less likely to draw the attention of Congress. Because of its size, Nevada is able to externalize some of the risk of federal intervention onto Delaware.

Nevada is also insulated from the risk of federal intervention in another way. Federal intervention is frequently triggered by and is responsive to public pressure. And the public's attention is more sharply attuned to Delaware law than it is to Nevada's. Provided that Nevada can continue to, by and large, avoid public scrutiny, the risk of federal intervention is small.[89]

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[87] See Mark J. Roe, Delaware's Competition, 117 Harv. L. Rev. 588, 636 (2003).

[88] Federal intervention typically kicks in during times of crisis and historically has been primarily designed to protect shareholders. See Lucian A. Bebchuk & Assaf Hamdani, Federal Corporate Law: Lessons From History, 106 Colum. L. Rev. 1793, 1798–99 (2006).

[89] Ironically, Delaware may even want to marginalize Nevada as much as possible. If Nevada were to become known as a bastion for lax law, federal intervention might follow irrespective of what Delaware does. To marginalize Nevada, Delaware might simply be inclined to ignore it.

(b) Delaware's High Franchise Tax

Delaware's franchise tax—the price that it charges for incorporations—further constrains its ability to respond to Nevada. In previous work I have argued that Delaware is able to command a premium for incorporations due to the advantages that it offers shareholders.[90] If the state were to degrade its law to favor managers, the value of its entire incorporation package, and concomitantly the premium it can charge for that package, would likely decline. In competing with Nevada, Delaware has to be careful not to risk diluting the surplus it offers to firms that incorporate there. Nevada's tax rate, while higher than the rates of many states, is still far lower than Delaware's.[91]

(c) Delaware's Brand

Delaware has branded itself as providing an efficient package that does not rely on managers' favoritism. Rather than focusing on protection for managers, Delaware's promoters stress its specialized judicial system, the system's efficiency, the state's experienced judiciary, and the state's developed body of case law.[92]

When Delaware has been criticized for being too protective of managers, in contrast to Nevada players, its players have vigorously maintained that Delaware does not exhibit favoritism towards management. Rather, they have insisted that Delaware achieves a balance between shareholders' and managers' interests.[93] If Delaware were to follow Nevada and degrade its own corporate law, its brand would suffer.

(d) The Type of Firms that Delaware Attracts

Delaware may also have preferences regarding the types of firms it attracts; in particular, it may prefer to attract firms with lower agency costs. Indeed, Delaware players have pronounced their

[90] See Michal Barzuza, Price Considerations in the Market for Corporate Law, 26 Cardozo L. Rev. 127, 163 (2004).

[91] Moreover, Nevada's segmentation strategy caters to firms for which the main constraint on Delaware's strategy—shareholder approval—may not be a binding one.

[92] See, e.g., Del. Intercorp., Inc., Why Incorporate in Delaware?, http://www.delawareintercorp.com/t-WhyIncorporateinDelaware.aspx (last visited Mar. 7, 2012).

[93] See Barzuza, supra note 90, at 176–77.

preference to attract the good firms in the market.[94] To the extent that strict law attracts firms with lower agency costs and better corporate governance, Delaware may be reluctant to risk losing those firms.

2. Can Delaware Respond with an Additional Menu?

An alternative to degrading its corporate law would be for Delaware to offer firms a menu of corporate law forms with multiple options from which firms could choose. Delaware could even charge different prices for different options. If for any or all of the preceding reasons Delaware would be unwilling to degrade its law, what accounts for Delaware's decision to stick to only a single law for public companies? For instance, Delaware could allow firms to adopt Nevada law on a voluntary basis conditioned on shareholder approval. For the following reasons, offering an additional menu would also impose costs on Delaware.

(a) Information to Investors

If Delaware were to provide a variegated menu, the signal that investors would receive when a firm incorporated in Delaware would become distorted. A firm's decision to incorporate in Delaware signals that its management believes in the superiority of the state's law, but it does not ipso facto explain why management arrived at that conclusion. For investors to ascertain why a firm chose to incorporate in Delaware would potentially require that they undertake costly investigations. This would diminish the benefit that managers presently realize from Delaware incorporation.

(b) Signal Effect

Companies might choose to incorporate in Nevada for a variety of reasons. For instance, companies might choose Nevada because it charges a lower franchise tax, because they use a Nevada lawyer, or due to other reasons of which investors are not aware. Thus, while a firm's choice to incorporate in Nevada may suggest that it is seeking lax law, the signal is a noisy one.

[94] See id. at 176.

A numerical example may serve to illustrate the point. Assume that Nevada's lax legal regime imposes a cost of 10% on a firm whose managers extract high private benefits, but only a cost of 2% on a firm whose managers extract low private benefits. Assume that firm value is 100. If investors knew that a particular company had high agency costs, they would discount its value by 10. If they knew that the same company had low agency costs and chose Nevada only because of its low taxes, they would discount its value by only 2 for choosing Nevada. If investors are unsure about agency costs, as they would be for Nevada incorporation, they will discount the firm's value at some intermediate rate.

If, however, Delaware were to offer two distinct menus—a lax one and a strict one—firms choosing the lax option would broadcast a stronger signal that they are interested in lax law. As a result, these firms would suffer more significant discounts in their valuations. Because firms choose Nevada for different reasons, a firm's decision to incorporate within the state can camouflage its interest in lax law.

(c) Delaware's Brand

As discussed above, Delaware's brand may constrain it from responding to Nevada's strategy. Offering a more management-friendly menu could also damage Delaware's brand as a provider of balanced corporate law, even if that menu would only be optional.

D. Comparison to Other Strategies

Having argued that market segmentation can be an effective strategy to overcoming significant barriers to entry, the question becomes, could segmentation be successful if attempted with strict rather than lax law? Although Nevada has chosen to segment the market with lax law, it is possible that another state could choose to enter the market from the top, catering specifically to firms that are interested in greater shareholder protections.

While Delaware law is more pro-shareholder than the law in many other states, it is not considered optimal. Even if Delaware is racing toward the top, it has not reached the top yet.[95] Thus, a different state has room to segment the market from the top. Likewise, maybe another state can enter on a different place on this spectrum between top and bottom. For instance, a state could create law that is more pro-shareholder than Nevada and less pro-shareholder than Delaware.

The following discusses a notable but thoroughly unsuccessful attempt to challenge Delaware by offering shareholder-friendly law. This example explains the challenges that these strategies face.

1. North Dakota: Why Segmentation with Strict Law Would Not Work

A recent example has demonstrated the difficulties of attempting to enter the market from the top. North Dakota recently adopted a law that is more shareholder-friendly than Delaware's.[96] However, North Dakota succeeded only in attracting a single out-of-state firm, American Railcar Inc. American Railcar was majority-owned by Carl Icahn, who had lobbied strenuously for the North Dakota bill's adoption. In firms other than American Railcar, managers and shareholders alike have overwhelmingly opposed proposals to reincorporate in North Dakota.[97]

Why has segmenting the market with strict law been so unsuccessful? There are two main challenges that impede segmentation from the top. For one, firms in Delaware have the option to voluntarily opt out of Delaware law to adopt terms that are more shareholder-friendly. For example, Delaware firms can choose to have

[95] See, e.g., Bebchuk & Hamdani, supra note 2, at 599–601.

[96] For example, it has adopted a proxy access rule allowing shareholders access to the proxy ballot. Each shareholder that has held more than 5% for at least two years can add his director nominees to the firm proxy materials. N.D. Cent. Code § 10-35-08 (Supp. 2011). It also imposes majority vote, N.D. Cent. Code § 10-35-09 (Supp. 2011), staggered boards prohibition, N.D. Cent. Code § 10-35-06(2) (Supp. 2011), and limitations on antitakeover arrangements, N.D. Cent. Code § 10-35-26 (Supp. 2011).

[97] John Chevedden, a shareholder activist, has submitted precatory proposals to move at least fifteen companies, among them Oshkosh, Whole Foods, PG&E, and Hains Celestial, to North Dakota. See Carol Icahn, More Rights for Shareholders in North Dakota, The Icahn Report (Dec. 7, 2008, 1:11 PM), http://www.icahnreport.com/report/2008/12/more-rights-for.html; see also Cari Tuna, Shareholders Ponder North Dakota Law, Wall St. J., Dec. 8, 2008, at B6. The proposals were not successful. For instance, only 5% of Home Depot's participating shareholders supported the move, while 95% objected to it. See Tuna, supra.

proxy access, not to have staggered boards or a poison pill, or to hold their directors liable for breaches of their duties of care. Thus, a state that offers strict law does not add much compared to Delaware. Yet, opting out from existing law is not cost-free and is often a complicated affair. Thus, one could argue, a state that offers a comprehensive strict menu could have some advantages for firms interested in such a menu, even though it could theoretically be achieved under Delaware law.

There is another reason, however, why Delaware provides a better alternative than North Dakota. This reason is related to Delaware's other advantages, apart from the law on its books. The added value of Delaware's other advantages makes the state attractive to firms that are interested in maximizing shareholder value, even as compared to a state that offers a somewhat better law.

As a result of Delaware's advantages, its overall package may be worth more to shareholders than the package that North Dakota or any other state is capable of offering.

2. Why Are There No Other States Along the Agency-Costs Spectrum?

If not from the top, could another state emerge with a law that targets firms with agency costs greater than those of firms in Delaware but less than those of firms in Nevada?

If Delaware law were at the top, then another state could probably enter between Delaware and Nevada. Yet, since Delaware is not at the top, its law allows managers to extract some private benefits. Because Delaware's package is multi-faceted in ways that appeal to managers and shareholders alike, it will be difficult for another state to come forward with law that, as compared to Nevada and Delaware, is intermediate with respect to agency costs and the laxity that it offers. Though there is a gap between Nevada and Delaware, it is probably quite a narrow one.

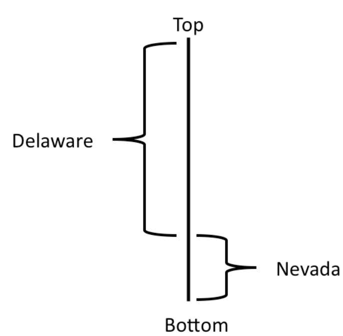
It is still possible, however, that another state will attempt to bridge that gap. Such a state, for example, could offer Delaware law as a default with an option to opt into Nevada law. This would mean permitting companies to opt out of liability for duty of loyalty and duty of good faith violations, as in Nevada, but conditioning this opting out on shareholder approval. The question is whether this strategy caters to a sufficiently large segment to make it profitable.

3. Delaware Covers a Range of Preferences

Figure 1 illustrates the forgoing discussions in mapping the range of preferences that Nevada and Delaware cover. Delaware law is well suited for most firms, including some firms whose managers are interested in extracting private benefits. Firms with the best corporate governance—who are most interested in maximizing shareholder value—will also select Delaware law thanks to Delaware's other advantages.

Nevada caters to lower-range firms that are interested in more protection than Delaware presently allows.[98] It is possible that there is some room on the spectrum between Delaware and Nevada, but given the flexibility of their packages it is not likely to be a wide one.

Figure 1: Ranges of Firms' Preferences



E. Objections

1. Nevada Succeeds Because of Its Lower Tax

One could argue that Nevada's primary attraction is not its law, but rather the lower tax that it charges. Under this argument,

[98] Nevada also covers a range because of its other advantages such as the business court. See discussion infra Subsection IV.A.2.c.

rather than segmenting the market with different law, Nevada competes primarily on price and attracts companies who are sensitive to the price. The maximum tax in Nevada is $11,100; in Delaware it is $180,000. Indeed, the difference in tax rates is one of the reasons firms that reincorporate from Delaware to Nevada give for choosing Nevada (in addition to the flexibility of Nevada law).[99]

Yet, while the difference in tax rates is significant, it is generally not sufficient to comprehensively explain Nevada's success. To begin with, Delaware is careful about pricing its overall package. Delaware appears to charge less than it could, meaning that it gives away some of its advantages for less than their market value or even for free.[100] Furthermore, incorporating in Delaware results in a significant premium above market price that more than compensates firms for the tax rate.[101] Competing on price alone cannot be a viable strategy for Nevada for still another reason. Delaware could lower its price in response to Nevada without compromising its other advantages.

Second, although Nevada's tax rate is significantly lower than Delaware's, it is significantly higher than the rates of other states. Nevada charges a maximum annual fee of $11,100 and an initial fee of $30,000. Other states charge close to zero tax to out-of-state incorporations.[102] Thus, if a company wants to save on taxes, it can simply choose to incorporate in its home state, where it will ordinarily pay next to nothing. As shown above, however, what keeps firms from going to Nevada is not a lower tax but rather legal protections that are given to executives in home states.

Third, during the last decade Nevada has increased its tax significantly and has still managed to increase its market share. Thus, companies that incorporated in Nevada during this decade did not come because of its lower tax but rather because of its lax law.

That does not mean that no firm is attracted to Nevada because its tax rates are lower than Delaware's. While taxes may not be the primary reason that firms incorporate in Nevada, for some firms taxes may still be an important factor. Still, the overall body of evidence also suggests that firms are drawn to Nevada corporate law.

[99] See infra Subsection IV.C.1.
[100] See Barzuza, supra note 90, at 175.
[101] See Daines, Firm Value, supra note 19, at 527.
[102] See Kahan & Kamar, supra note 2, at 691.

2. Is the Nevada Case Important?

One could downplay the importance of this analysis. Nevada has attracted around four hundred companies, approximately one-tenth the number incorporated in Delaware. Delaware's market power continues to increase; it attracts 70% of new IPOs. Nevertheless, Nevada's dynamism is an important and telling development in the market for corporate law for several reasons.

First, as shown above in Section II.A., Nevada's market share is growing, as is the interest in the state as a potential place of incorporation.[103] Second, as explained below, some of the companies that self-select into Nevada's law appear to be suffering from relatively high agency costs. Even if most companies choose Delaware, it should be a cause for concern that questionable companies now have a haven that allows them to operate without legal impediments. Third, Nevada may drag Delaware down. Delaware has already shown that it reacts to market forces, having changed its law several times in response to developments in other states.[104]

Fourth, the self-selection described here is not necessarily limited to Nevada. Rather, as discussed later in Part V, a similar phenomenon may be occurring in home states, in which almost half of public companies are incorporated.

Lastly, as discussed in Part V, the implications of this analysis are broader than the market for corporate law. Firms have significant freedom in designing their corporate contract. While a choice of legal terms may allow efficient sorting, it may also result in inefficient sorting.[105]

3. Can Plaintiffs Litigate out of Nevada?

If plaintiffs are not satisfied with Nevada's management-friendly law, it might be thought that they could simply choose to litigate cases in courts outside of the state. Indeed, recent studies on Delaware firms show that many cases are being litigated in courts in

[103] *Corporate Board Membe*r, a widely read magazine among directors and practitioners, has featured a long article on the pluses and minuses of incorporating in Nevada. See Craig Mellow, Taking a Chance on Nevada, Corporate Board Member, Second Quarter 2011, available at https://www.boardmember.com/Print.aspx?id=6237.

[104] See, e.g., Romano, Law as a Product, supra note 1, at 240.

[105] See discussion infra Section V.E.

other states which may apply Delaware law differently.[106] If Nevada law was less clear, courts could theoretically apply it in more shareholder-friendly ways, effectively eroding the design originally contemplated by the state legislature. That Nevada law is as clear as it is, however, inhibits out-of-state judges from distorting Nevada law in that fashion. Moreover, if they did, as the *Hilton Hotels* experience shows, Nevada legislature may move to overturn these court decisions.[107]

4. It's All About the Lawyers

Lawyers play an important role in advising companies where to incorporate. Local lawyers tend to advise the firms they represent to incorporate in their home states. National firms, on the other hand, tend to recommend incorporation in Delaware. Could the shift to Nevada be driven by just a few Nevada local law firms? During the last decade, the 156 IPOs in Nevada were advised by 100 distinct law firms.[108] Out of these 100 law firms, only six had local offices in Nevada. None of these six is even among the top ten firms in terms of the number of companies they send to Nevada. Thirty-seven are national firms; the rest are spread across the country.[109]

Thus, while it is possible that the Nevada story is slightly affected by choice of representation, it does not seem to rely heavily on it.

[106] See John Armour, Bernard Black & Brian Cheffins, Is Delaware Losing its Cases? 1 (Nw. Univ. Law Sch. Law & Econ. Research Paper No. 10-03, 2010), available at http://ssrn.com/abstract=1578404 (showing that Delaware is losing its cases to other states' courts and hypothesizing that shareholders' interests are driving this trend); see also Theodore Eisenberg & Geoffrey P. Miller, Ex Ante Choices of Law and Forum: An Empirical Analysis of Corporate Merger Agreements, 59 Vand. L. Rev. 1975, 1975 (2006); Theodore Eisenberg & Geoffrey P. Miller, The Flight to New York: An Empirical Study of Choice of Law and Choice of Forum Clauses in Publicly-Held Companies' Contracts, 30 Cardozo L. Rev. 1475, 1475–76 (2009).

[107] See supra Subsection II.B.2.

[108] Data collected from Thomson Reuters. Thomson Reuters, SDC Platinum, http://thomsonreuters.com/products_services/financial/financial_products/a-z/sdc/ (last visited Oct. 11, 2010) (Data on file with the author).

[109] Id. Most of the law firms in the sample advised only one to two Nevada firms. The two top law firms in the sample, Thomas Puzzo, a Seattle firm, and Wilson Sonsini, each advised five companies, less than 4% of the sample.

IV. NORMATIVE IMPLICATIONS

This Part discusses two potential accounts of the types and motivations of firms that choose Nevada law: a pessimistic one and an optimistic one.[110]

Opponents of the Nevada bill in legislative session expressed their concern that Nevada law would attract the wrong sort of companies—ones that would like to take advantage of the protection from liability and expropriate from their shareholders.

Another possibility, however, is that Nevada attracts companies for which it is efficient that they not face litigation. This possibility would suggest an efficient sorting of companies; Nevada allows companies to economize on litigation costs.

A. Pessimistic Story: Insiders Choose Nevada to Extract Private Benefits

This Section explains why firms with high agency costs—whose insiders are interested in and capable of extracting high private benefits from shareholders—may incorporate in Nevada. It first explains why insiders of these firms should be attracted to Nevada. It then explains why shareholders in these firms approve Nevada incorporation and why firms may choose to incorporate in Nevada at the IPO stage.

1. Why Managers that Extract High Private Benefits Prefer Lax Law

Managers of firms with high agency costs may prefer a lax legal regime for two main reasons. For one, managers who have capabilities and opportunities to extract high private benefits have to give up more than managers who extract few private benefits when they move to Delaware's stricter corporate law regime.[111] In a similar vein, firms with high agency costs and high private benefits are

[110] To be sure, Nevada has another attraction—its lower taxes—yet, as explained above, tax differences themselves do not seem to explain choosing Nevada. Nevada firms are responsive to changes in law, they explicitly look for protection, and, if all they wanted was lower taxes, they could incorporate in their home state.

[111] See Michal Barzuza, Lemon Signaling in Cross-Listing 1 (Mar. 14, 2012) (unpublished manuscript, available at http://ssrn.com/abstract=1022282) (developing a model that shows that only insiders that extract relatively low private benefits will cross-list on U.S. exchanges).

typically firms that are less disciplined by external markets. They face less competition, fewer threats from the market for corporate control, or less discipline from capital markets, which is the reason why they have higher agency costs. Accordingly, these firms will be penalized less by the markets for a wrong choice of state. In his famous reply to Cary, Professor Ralph Winter, a race to the top proponent, argued that the market penalizes managers for making self-serving choices, including choice of law.[112] Thus, he argued, managers do not seek and states have no reason to provide rules that benefit managers at the expense of shareholders. While that may be true for many firms, for some firms the disciplinary effect of the markets may be negligible. So may be the penalty for choosing bad law.

2. Why Shareholders Approve Nevada Incorporation

Firms choose Nevada in two different stages in their life: at the time of their IPO and midstream (after the IPO—when the firm is publicly traded). Midstream, managers must obtain the approval of shareholders in order to reincorporate in Nevada.[113] At the IPO stage, the founders choose the state of incorporation. This Subsection analyzes each of these situations.

a. Midstream Incorporations—In Some Firms Shareholder Approval is Not a Real Constraint

When firms reincorporate after going public, managers propose reincorporation, but shareholders must approve it. One could argue that shareholders are protected by the requirement that managers obtain their approval since shareholders will not allow managers to move to Nevada if managers are interested in extracting high private benefits.

While shareholder approval is a significant constraint for many firms, this does not necessarily hold true across the board. Firms differ in the extent to which shareholders are able to discipline managers. One facet of this is how strong and active shareholders are. Indeed, it is precisely in those firms with high agency costs that

[112] See Winter, supra note 1, at 256.

[113] Reincorporation requires managers' initiation and shareholder approval since it is done by merging into a shell corporation. See Del. Code Ann. tit. 8, § 253 (2011).

we would expect to find weak shareholders. The fact that managers can extract high private benefits is an indication that shareholders are not too strong. Managers in firms with, for example, fragmented, atomistic ownership—that are likely to extract high private benefits—may also encounter little difficulty in securing shareholder approval. Consistent with this explanation, Nevada companies have significantly fewer institutional shareholders and more powerful insiders.[114]

b. IPOs—Incentives Are Not Always Perfectly Aligned

Most firms select their state of incorporation at or before their IPO. At first glance, it would seem that at the IPO stage agency costs should be less pronounced, if present at all. Founders presumably internalize the benefits and costs of the legal regime they choose. If they choose poor law, investors will pay less for the IPO shares. Since they want to maximize the IPO price, they should choose the optimal law for their company.

Nevertheless, agency costs may be present even at the IPO stage for some firms. Circumstances can arise that cause the incentives of some groups of founders to depart from those of others. For instance, if one of the IPO shareholders will continue as an officer or as a controlling shareholder and others will not, then he or she may favor terms that allow officers or controlling shareholders to extract greater private benefits.[115] In this way, some shareholders can externalize the cost of pro-management terms onto other shareholders, who may be too passive or insufficiently informed to resist terms with potentially adverse effects on the IPO price.[116]

[114] See discussion infra Subsection IV.C.3.

[115] See Lucian A. Bebchuk, Why Firms Adopt Antitakeover Arrangements, 152 U. Pa. L. Rev. 713, 729, 735–36 (2003) (suggesting agency costs as one possible explanation for variations in antitakeover defenses at the IPO stage).

[116] Id. at 735–36. Professors Laura Field and Jonathan Karpoff have specifically investigated whether the companies that adopt antitakeover protections have higher agency costs. They found that managers that adopt takeover defenses at the IPO stage have fewer pre-IPO shares, higher compensation, and are relatively free from shareholders' monitoring. They also found that the size of the board and the presence of the CEO on the board are associated with antitakeover defenses, suggesting defenses arise when there is less monitoring by the board. See Laura C. Field & Jonathan M. Karpoff, Takeover Defenses of IPO Firms, 57 J. Fin. 1857, 1867–73 (2002). Michael Klausner provides an explanation as to why even in firms that are backed by venture capitalists ("VCs"), agency costs may affect IPO legal arrangements. Since

c. Nevada's Court and Other Advantages Compensate Shareholders for Its Suboptimal Law

Like Delaware, Nevada has advantages to offer to shareholders that could compensate at least partially for its non-optimal law.[117] Thus, managers in firms with high as well as low agency costs can point to Nevada's value-increasing characteristics as reasons for reincorporating there.

Aspiring to follow Delaware's example, Nevada established a business court in 2000. While Nevada's business court is not as good as Delaware's,[118] it is more business-oriented than the courts of many other states.[119]

The business court, network externalities, and a lower tax rate supply an efficiency-based reason for managers seeking to persuade shareholders of the desirability of incorporating in Nevada. If managers make a "take it or leave it" offer to incorporate in Nevada, shareholders, in the absence of a management offer to incorporate in Delaware, may agree to it because of Nevada's other value-increasing advantages.[120]

d. Inaccurate Pricing

Firms would be deterred from choosing Nevada as their IPO jurisdiction and shareholders would be reluctant to move to Nevada if incorporating in Nevada would result in a discount to the share

VCs need to compete with respect to investments and management, they may accommodate managers' preferences to avoid a reputation of being tough on managers. See Michael Klausner, Institutional Shareholders, Private Equity, and Antitakeover Provisions at the IPO Stage, 152 U. Pa. L. Rev. 755, 770–71 (2003).

[117] That Nevada chooses not to compete with Delaware across all possible dimensions of its product offering is consistent with successful differentiation strategies. See generally Edward Hastings Chamberlin, The Theory of Monopolistic Competition: A Re-orientation of the Theory of Value 71–72 (8th ed. 1962).

[118] See Kahan & Kamar, supra note 2, at 712–13 (listing inter alia shorter judge rotations, unpublished opinions, and juries as disadvantages of Nevada business court relative to Delaware chancery court).

[119] See id. at 708–12 (noting that only a small number of states have established specialized judicial tribunals for business disputes, and, in those that have, the courts were not designed to attract incorporations).

[120] Because managers' initiation is required for reincorporation, shareholders do not necessarily have the choice between Nevada and Delaware. Managers could choose not to reincorporate in Delaware, leaving Nevada as the shareholders' best alternative. See Bar-Gill, Barzuza & Bebchuk, supra note 1, at 136–37.

price. It is possible, however, that the market does not fully discount firms' market values to reflect the choice of a lax legal regime. The extent to which investors correctly price legal terms at the IPO stage has been questioned.[121] This phenomenon has been thought to be especially acute for small firm IPOs.[122] Because Nevada tends to attract, on average, smaller companies, the market may disproportionately fail to discount for incorporation there.

e. Mixed Signal

There is another reason why incorporating in Nevada may not trigger an appropriate discount. Nevada's advantages such as lower tax rates and a specialized business court make the Nevada incorporation signal a mixed one. While some firms incorporate in Nevada for its lax law, others may choose Nevada because of its tax rate. Since it is difficult for investors to ascertain the reason for Nevada incorporation, they will not appropriately discount for the problematic fact of Nevada incorporation.

B. Optimistic Story: Firms Choose Nevada to Save on Litigation Costs

It is possible that the choice of Nevada incorporation is an efficient one.[123] For example, incorporating in Nevada might be efficient for some firms since it saves on unnecessary litigation costs arising from frivolous lawsuits.

Legal regimes are not perfect. Invariably, firms in even the best legal regimes will be exposed to costly and unnecessary litigation. Moreover, strict laws encourage the filing of frivolous suits that companies often settle.[124] Litigation is beneficial to the extent that it

[121] See Bebchuk, Why Firms Adopt Antitakeover Arrangements, supra note 115, at 741–42; Robert Daines & Michael Klausner, Do IPO Charters Maximize Firm Value? Antitakeover Protection in IPOs, 17 J.L. Econ. & Org. 83, 113 (2001); see also Field & Karpoff, supra note 116, at 1885.

[122] See Marcel Kahan & Edward Rock, The Insignificance of Proxy Access, 97 Va. L. Rev. 1347, 1369–70 (2011) (stating that for companies below $300 million market cap it is uncommon to attract analyst coverage).

[123] See Larry Ribstein, Nevada and the Market for Corporate Law, Truth on the Market (May 27, 2011, 7:15 AM), http://truthonthemarket.com/2011/05/27/nevada-and-the-market-for-corporate-law/ (replying to an earlier version of this Article).

[124] See, e.g., Roberta Romano, The Shareholder Suit: Litigation without Foundation?, 7 J.L. Econ. & Org. 55, 57 (1991); see also James Bohn & Stephen Choi, Fraud

disciplines firms, but firms that already have strong internal controls, or are disciplined by the markets, stand to gain less from the discipline a strict legal regime provides. These firms may be better off in an environment in which they will encounter less litigation.

A second possibility is that firms choose Nevada because their exposure to litigation in Delaware is especially high.[125] For instance, Delaware law that stresses independent directors may be especially costly for family firms. Similarly, small firms may have fewer independent directors and as a result may be systematically disfavored by Delaware courts.[126] Firms with riskier operations may suffer greater costs in legal environments that make litigation, or the threat thereof, easier for plaintiffs.[127] In either case, it is reasonable to suppose that these firms would prefer a legal regime that avoids some litigation.

It is also possible that for some firms litigation costs are especially burdensome. In particular, for small firms, litigation costs may represent a relatively high expense compared to large firms with significantly higher budgets and established legal departments.

However, legal differences between Nevada and Delaware are not the ones that typically raise the specter of frivolous lawsuits. While literature on securities regulation has brought to the forefront significant concerns regarding the merit of securities class ac-

in the New-Issues Market: Empirical Evidence on Securities Class Actions, 144 U. Pa. L. Rev. 903, 979–81 (1996) (presenting evidence of frivolous suits in securities class actions).

[125] See Barry D. Baysinger & Henry N. Butler, Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law, 10 J. Corp. L. 431, 459 (1985).

[126] Delaware courts award significant deference to independent directors in different contexts. See, e.g., Cooke v. Oolie, 2000 Del. Ch. Lexis 89, at *44 (Del. Ch. May 24, 2000) (majority approval of disinterested directors provides business judgment rule protection for a self-dealing transaction).

[127] It is also possible that both are happening, that some Nevada firms have higher agency costs and seek lax law to extract private benefits, while for others having lax law is optimal. Lastly, it could even be true that the lax law is optimal for firms with high agency costs if restricting those firms would lead to adoption of more harmful devices by managers. Professors Jennifer Arlen and Eric Talley have persuasively shown that this has happened with respect to antitakeover devices. See Jennifer Arlen & Eric Talley, Unregulable Defenses and the Perils of Shareholder Choice, 152 U. Pa. L. Rev. 577, 582 (2003).

tions,[128] evidence on shareholder suits that are based on Delaware state law is less conclusive. Fiduciary duty lawsuits share some characteristics with securities class action suits.[129] Yet, significant differences exist. Researching fiduciary duty cases, Professors Randal Thomas and Bob Thompson found indications that these lawsuits were not frivolous.[130] The pattern of small shareholder suits and large attorneys' fees is not present in state law cases. Instead, plaintiffs are dispersed and, unlike the professional plaintiffs in securities class actions, almost always individuals.[131] In addition, settlements often include large monetary payments to shareholders; attorneys get proportionately less.[132] Based on these differences, the authors conclude that in these cases "more so than in . . . securities fraud suits, the merits appear to matter."[133]

Frivolous suits, thus, do not seem to be a complete explanation for the recent Nevada incorporation trend. Also, they do not explain the failure by Delaware to offer Nevada's package if it is truly an efficient one. Lastly, even if frivolous suits were a concern for some firms, the lack of liability is also likely to attract firms that are looking to take advantage of the law. For the Nevada phenomenon to be efficient the benefits of avoiding frivolous lawsuits would have to be higher than the costs of opportunism the lax law may encourage.

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[128] See, e.g., Bohn & Choi, supra note 124.

[129] Like securities class actions, most of the shareholder litigation actions settle out of court. See Romano, supra note 124, at 60 (finding that 64.8% of shareholder suits settled out of court).

[130] See Robert B. Thompson & Randall S. Thomas, The New Look of Shareholder Litigation: Acquisition-Orientated Class Actions, 57 Vand. L. Rev. 133, 207–08 (2004).

[131] Id. at 187.

[132] Id. at 208. Professors Thompson and Thomas also found that more than 70% of the cases were class actions challenging acquisitions. Id. at 169. Settlements leading to relief were concentrated in freeze-out transactions, and specifically in freeze-out transactions in which the price paid to minority shareholders was substantially lower than the average price paid in similar transactions. Id. at 199–202. Furthermore, in a recent paper these authors show that this litigation is associated with fewer completed transactions but with higher premiums that compensate shareholders for the higher offers. See C.N.V. Krishhan et al., Litigation in Mergers and Acquisitions 44 (Vanderbilt Law and Economics, Research Paper No. 10-37, 2011), (unpublished manuscript, available at http://ssrn.com/abstract =1722227).

[133] See Thompson & Thomas, supra note 130, at 139.

C. Evidence: Why Firms go to Nevada

This Section will present and discuss evidence on Nevada firms. It brings anecdotal and systematic evidence on ownership structure, accounting restatements, and valuation. It assesses the implication of this evidence to the Nevada account.

1. Proxy Materials and a Practitioner's Perspective

One way to approach the question why firms choose to go to Nevada is to look at what managers and legal advisers say about this choice. When firms reincorporate in Nevada, they are obliged to fully disclose to shareholders the reasons for the move. Looking at firms' proxy materials, firms that moved to Nevada cite the lower tax rate and the increased flexibility and predictability of Nevada law as reasons for making the shift.[134]

Similarly, a Nevada lawyer cites, among other reasons, (1) Nevada's low franchise tax; (2) its more predictable law; and (3) lesser liability; as well as (4) specific requests on the part of the represented company.[135]

Thus, proxy materials and law firms' responses support the conclusion that the law matters, at least for some of the companies that choose Nevada. They do not, however, lend clear support to either the pessimistic or optimistic explanations.

2. Anecdotal Evidence

Consider, for example, the case of ATSI Communications. Headquartered in Texas, ATSI reincorporated from Delaware to Nevada in 2004. The company has no compensation or nomination committees. When it reincorporated to Nevada, its proxy materials stated legal flexibility as a main reason for the shift.[136] On August

[134] See, e.g., Medical Solutions Management Inc., Definitive Proxy Information Statement (Form DEF 14C) 4–5 (Nov. 16, 2004), available at http://www.secinfo.com/d17Wxn.13e.htm ("In recent years, Nevada has adopted a policy of encouraging incorporation in that state and has been a leader in adopting, construing and implementing comprehensive, flexible corporate laws responsive to the legal and business needs of corporations organized under its laws.").

[135] Confidential phone interview with a Nevada attorney. Other law firms that were contacted with questions about Nevada corporations have not replied.

[136] ATSI Commc'ns, Inc., Definitive Proxy Solicitation Material (Form DEF 14A), at 14 (Mar. 26, 2004), available at http://www.secinfo.com/duvJ5.114b.htm ("We be-

25, 2004, ATSI stock traded at $1.00 per share; on March 30, 2012 it was trading at around $0.07 per share.[137] Its meager market capitalization of less than $1.5 million does not stop the CEO, who is also the company's founder, from extracting compensation in the six figures.[138]

In addition, in 2004 the company's two directors had related-party transactions with the company. The company had a month-to-month agreement with Technology Impact, a consulting firm of which one director is principal and owner, under which the director provides strategic planning, business development and financial advisory services. The company also entered into a loan with another director.[139]

The company's accountant is not one of the big four accounting firms. In fact, the company has replaced its accountants three times in three years, twice because their opinions "contained a qualification as to the uncertainty of the [c]ompany's ability to continue as a going concern."[140] With its current accountant, the firm has restated its earnings twice.

In March 2011, the company changed its name to Digerati Tech Inc. On the company message board, individual shareholders express frustration regarding the lack of institutional shareholders, the salary of executives, and the company's performance.[141] This example, which seems to support the pessimistic view of what Ne-

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lieve that the reincorporation in Nevada will provide a greater measure of flexibility and simplicity in corporate governance than is available under Delaware law . . . .").

[137] See Digerati Technologies, Inc., Yahoo! Finance, http://finance.yahoo.com/q?s=DTGI.OB (last visited Apr. 15, 2012).

[138] See Digerati Techs., Inc., Annual Report (Form 10-K) 38 (Oct. 31, 2011), available at http://www.sec.gov/Archives/edgar/data/1014052/000114420411060308/v238581_10k.htm (reporting total compensation in 2011 of $305,276 for the CEO).

[139] See ATSI Commc'ns, Inc., supra note 136, at 11.

[140] See id. at 13.

[141] Digerati Technologies, Inc., Yahoo! Message Bd. (Jan. 27, 2011, 6:21 PM), available at http://messages.finance.yahoo.com/Stocks_%28A_to_Z%29/Stocks_D/threadview?m=tm&bn=38645&tid=701&mid=701&tof=34&frt=1 ("Ceo. I don't know how to run a company, what should I do. Have a reverse split? No. Let's change the name of the company. No one will notice hell [sic] this company will never move up anyway. We'll keep our jobs and get paid every week." (spacing adjusted)); Digerati Technologies, Inc., Yahoo! Message Bd., (Jan. 16, 2011, 11:12 AM), available at http://messages.finance.yahoo.com/Stocks_%28A_to_Z%29/Stocks_D/threadview?m=tm&bn=38645&tid=699&mid=699&tof=36&frt=1 ("Another payday goes by, ceo [sic] gets his paycheck. Stock still at 4 pennies.").

vada incorporation signifies, is not necessarily representative of Nevada firms. The following Subsections accordingly examine aggregate data on Nevada firms.[142]

3. Ownership Structure and Board Composition

Nevada firms differ in their ownership structure, insider ownership, and board composition. Nevada firms are significantly smaller than firms in other states,[143] but important differences remain significant controlling for firms' market cap. Compared to Delaware, a smaller proportion of Nevada companies have significant institutional holders.[144] Institutions who hold larger fractions than dispersed shareholders tend to be more informed and less passive than the individual shareholders and thus may object to a move to Nevada, vote against a director if not satisfied with his or her performance, and in general limit managers more than individual shareholders do.

As Table 5 shows, Nevada companies also differ in the level of ownership by insiders (top management and directors). In nearly half of Nevada companies, insiders hold at least 15% of the company, one and a half times the proportion in Delaware. Nevada also has a high proportion of family firms, in which family ties play a key role in board membership and firm ownership.[145]

Table 5 further shows that Nevada companies also differ in board composition. Nevada companies have a significantly higher

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[142] Seeking aggregate data has advantages of getting a systematic view, yet aggregate data is available only for some aspects, and only for some of Nevada companies. For instance, there is no data source that provides summary information on related parties' transactions.

[143] The median-sized firm in Nevada is about \$18 million (= $e^{2.88}$), compared with median assets values of \$311 million for Delaware firms and \$189 million for firms in other states. See Michal Barzuza & David C. Smith, What Happens in Nevada? Self-Selecting into Lax Law 15–16 (Va. Law and Econ., Research Paper No. 2011-08, Dec. 26, 2011), available at http://ssrn.com/abstract =1644974.

[144] See id. at tbl.4.

[145] A family firm in the corporate library dataset is defined as: "A company where family ties, most often going back a generation or two to a founder, play a key role in both ownership and board membership. Family members may not have full control of the shareholder vote (greater than 50%), but will generally hold at least 20%." Annalisa Barrett et al., The Corporate Library's 2006 Governance Practices Report—Executive Summary 2 (Dec. 2006), available at http://www.complianceweek.com/s/documents/Compliance%20Week%202007/Resource%20Materials/Minow,%20Nell%20%20The%20Corporate%20Library/GovPrac2006_ExecSumm.pdf.

proportion of insiders and a significantly lower proportion of outside and female directors on the board.

The fact that Nevada firms have a higher presence of insiders can cut in both directions. On the one hand, insiders can benefit from self-dealing with their companies. The presence of many firms with a high proportion of insiders is therefore consistent with the pessimistic account. But the presence of insiders could also be consistent with the optimistic story. Insiders may have better control of their companies, lessening the need for external sources of discipline.

The lack of institutional ownership provides some further support for the pessimistic account. Fewer institutional owners suggest that Nevada shareholders monitor managers less; this could mean that they actually have a greater need for external discipline.

Table 5: Ownership and Board Composition

The Table reports the proportions of firms with different ownership and board composition categories as reported in Corporate Library, which covers the Russell 3000. Separate unreported regressions were run for each category. Stars represent significance of the coefficients after controlling for market cap. The symbols *, **, and *** represent a significance of 10%, 5%, and 1%, respectively, for those regressions.

Dependent Variable	Delaware	Nevada	Other states
Number of Inside Directors	1.43	1.59	1.50
Percentage of Inside Directors***	0.17	0.23	0.17
Number of Outside Directors***	5.97	4.95	6.82
Total Number of Directors***	8.38	7.21	9.29
Percentage of Women Directors***	0.08	0.05	0.10
Percentage of Shares Held by Insiders***	0.16	0.22	0.14

4. Frequency of Accounting Restatements

In a co-authored paper, David Smith and I investigate variations in corporate disclosure quality, specifically accounting restatements, as a function of state of incorporation.[146] Accounting restatements do not involve a correction of an erroneous estimate of future performance. Rather, they involve an admission by a company that its previously released statements of past financial performance were inaccurate. Not surprisingly, accounting restatements typically trigger a strong and negative market reaction.[147] On average, firm value drops approximately 10% over the three days surrounding the announcement.[148] Restatements also harm reporting credibility as investors tend to doubt subsequent financial reports.[149]

If Nevada's lax legal regime targets and attracts firms with higher agency costs, for the following reasons this could be reflected in the high frequency of restatements. First, restatements can be a way through which managers extract private value.[150] De-

[146] See Barzuza & Smith, supra note 143.

[147] For a summary of the evidence on restatements, their effects, and motivations, see John C. Coffee, Jr., A Theory of Corporate Scandals: Why the USA and Europe Differ, 21 Oxford Rev. Econ. Pol'y 198 (2005).

[148] Kirsten L. Anderson & Teri Lombardi Yohn, The Effect of 10K Restatements on Firm Value, Information Asymmetries, and Investors' Reliance on Earnings 25 (Sep. 2002) (unpublished manuscript, available at http://ssrn.com/abstract=332380) (showing that restatements result in an average negative effect of 10% of firm value); U.S. Gen. Accounting Office, GAO-03-138, Report to the Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Sen., Financial Statement Restatements: Trends, Market Impacts, Regulatory Responses and Remaining Challenges 24 (2002).

[149] See Anderson & Yohn, supra note 148, at 8–9, 19.

[150] See Jennifer H. Arlen & William J. Carney, Vicarious Liability for Fraud on Securities Market: Theory and Evidence, 1992 U. Ill. L. Rev. 691, 701 (1992); Coffee, supra note 147, at 201–04 (arguing that restatements are motivated by management desire to increase the value of their option packages); Jeffrey N. Gordon, Governance Failures of the Enron Board and the New Information Order of Sarbanes-Oxley, 35 Conn. L. Rev. 1125, 1130–31 (2003); see also Oren Bar-Gill & Lucian A. Bebchuk, Misreporting Corporate Performance 2–3 (Harvard Law and Econ. Discussion Paper No. 400, 2002, revised 2003), available at http://ssrn.com/abstract=354141. A second reason for using restatements is that, unlike other measures, restatements are regulated primarily by federal law and thus can serve as a basis for comparison across states. Since they are regulated by federal law, restatements could be symptomatic of firms' specific characteristics rather than state law. If restatements were regulated by state law, we could not determine whether a high restatement ratio in Nevada was the result of individual firm characteristics or Nevada's lax law. To be sure, liability for reporting is not completely neutral to state law. For instance, corporations have some

spite the harm to their companies, managers may privately benefit from misstatements. By the time of the restatement, managers may have already extracted high compensation.[151] Indeed, there is evidence to support a relationship between restatements and managerial agency costs:[152] restatements are preceded by balance-sheet bloating, suggesting intentional earnings manipulation;[153] the likelihood of restatements increases significantly with CEO holdings of in-the-money stock options;[154] restating firms have less exposure to the market for corporate control and shareholder participation;[155] and restating firms are ranked poorly on corporate governance indices.[156]

Using accounting restatements as a dependent variable, Nevada firms fare poorly in comparison to firms from other states. Figure 2 graphs the annual number of restating firms as a percentage of total public company incorporations for Nevada, Delaware, and all other states between the years 2000 and 2008. Compared with Delaware and other states, the restatement likelihood for Nevada-incorporated firms is nearly double on an unconditional basis and is up to 40% higher after controlling for firm-level characteristics (industry, size, age, headquarters in Nevada, and growth).[157]

limited power to indemnify for class actions. Yet, liability is mostly established by federal law. Corporations are not allowed to indemnify executives for losses that result from a Sarbanes-Oxley 304 clawback provision. See Cohen v. Viray, 622 F.3d 188, 194–96 (2d Cir. 2010).

[151] See Gordon, supra note 150, at 1131.

[152] See Coffee, supra note 147, at 201–04.

[153] See Michael Ettredge et al., How Do Restatements Begin? Evidence of Earnings Management Preceding Restated Financial Reports, 37 J. Bus. Fin. & Acct. 332, 334, 351 (2010) (showing that restatements are preceded by balance-sheet bloating especially, but not only, when fraud is involved).

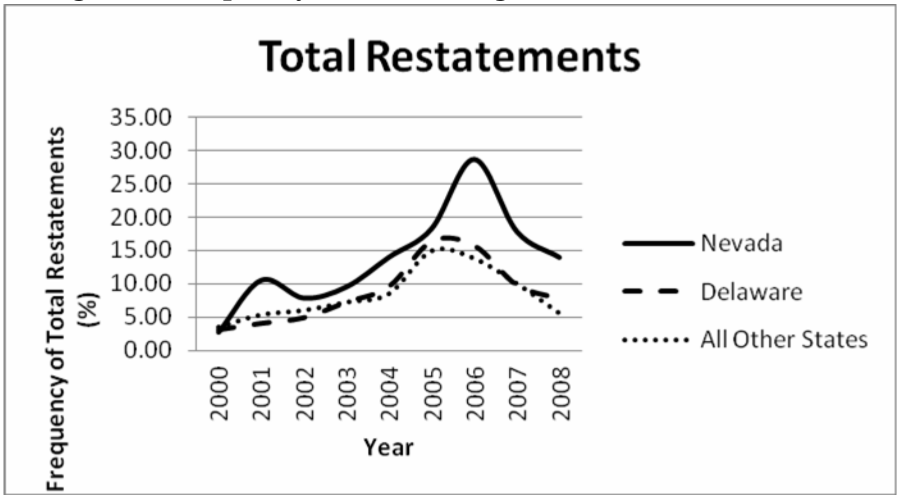
[154] See Jap Efendi et al., Why do Corporate Managers Misstate Financial Statements? The Role of Option Compensation and Other Factors, 85 J. Fin. Econ. 667, 670, 700, 703 (2007); see also Bar-Gill & Bebchuk, supra note 150, at 1–5, 33 (developing a formal model of misreporting and showing how incentive-based compensation may incentivize managers to misreport).

[155] See William R. Baber et al., Shareholder Rights, Corporate Governance and Accounting Restatement 4, 33–34, (Feb. 1, 2009) (unpublished manuscript, available at http://ssrn.com/abstract=760324).

[156] See Simi Kedia & Thomas Philippon, The Economics of Fraudulent Accounting, 22 Rev. Fin. Stud. 2169, 2187–90 (2009); see also Baber et al., supra note 155, at 33–34.

[157] See Barzuza & Smith, supra note 143, at 2, 25.

Figure 2: Frequency of Accounting Restatements[158]



As the graph shows, restatements increased significantly during the last decade and then declined significantly in recent years. One explanation for this is that both of these trends were caused primarily by Sarbanes-Oxley ("SOX").[159] SOX first triggered a cleanup of pre-SOX misstatements, and thus the initial increase in restatements.[160] But after the cleanup, better controls have kept restatements down.[161] Importantly, the difference between Nevada

[158] See id. at 2, fig.1.

[159] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 15 U.S.C. and other titles).

[160] See Ya Fang Wang & Hung-Chao Yu, Do Restatements Really Increase Substantially after the SOX? How Does the Stock Market React to Them? 31–32 (Jan. 23, 2008) (unpublished manuscript, available at http://ssrn.com/abstract=1087083) (researching a sample of voluntary restatements and finding that the increase in restatements after SOX results from misstatements that occurred prior to SOX).

[161] An Audit Analytics report attributes the decline in restatements to improvements in internal controls following SOX Section 404 and a 2008 recommendation by an SEC committee that the SEC relax its requirements for the type of errors that trigger restatements. See Audit Analytics, Restatements Disclosed by the Two Types of SOX 404 Issuers: (1) Auditor Attestation Filers and (2) Management-Only Report Filers 1, 4 (Nov. 2009), available at http://www.alacrastore.com/storecontent/Audit_Analytics_Trend_Reports-Restatements_By_SOX_404_Issuers-2033-14. SOX may have also decreased the profitability of restatements for managers. For instance, SOX clawback provisions require managers to pay back compensation that they received as a result of misstated information. See 15 U.S.C. § 7243. Though SOX clawback provi-

and other states has been significant post-SOX, both when restatements were increasing and when they subsequently declined.

Restatements can result from a range of causes. Some restatements indicate fraud. As Professors Arlen and Carney have argued, fraud in reporting could be a form of agency cost.[162] Fraud, even if proved, seldom results in personal damages, since damages fall mostly on the corporation.[163] While the SEC pursues individual executives, they rarely contribute to class action settlements.[164]

Some restatements are not a result of fraud or aggressive accounting but rather of mere error. However, these restatements too do not paint a glowing picture of the firm's internal controls. The financial reports' accuracy should be assured by a series of compliance mechanisms; that the firm did not manage to achieve compliance, even if the failure was purely accidental, is not a great sign. These restatements could also suggest a particular form of agency costs: slack that allows management to be incompetent or lazy.

Nevertheless, we attempt to isolate more problematic restatements. The results remain significant when we focus only on bad restatements—ones that reduce firm value—and also when we focus on the subset of restatements that involve fraud or trigger regulatory investigation. In fact, the last category provides our strongest results.[165]

sions may have contributed to the decrease in restatements and related agency costs, they are highly unlikely to have eliminated them entirely. These provisions have considerable limitations. Section 304, for example, does not provide a private right of action. See Neer v. Pelino, 389 F. Supp. 2d 648, 657 (E.D. Pa. 2005). It applies only to misstatements that occurred following the passage of the Act, and it is limited to CEOs and CFOs, to misconduct, and to compensation received within twelve months of the misstatement. 15 U.S.C. § 7243.

[162] See Arlen & Carney, supra note 150, at 693–95.

[163] Id. at 699–700; John C. Coffee Jr., Reforming the Securities Class Action: An Essay on Deterrence and Its Implementations, 106 Colum. L. Rev. 1534, 1536–37 (2006).

[164] See, e.g., Michael Klausner, Are Securities Class Actions "Supplemental" to SEC Enforcement? An Empirical Analysis 2–4, 9, 35 (Feb. 23, 2010) (unpublished manuscript, on file with the Virginia Law Review Association).

[165] While we controlled for differences between Nevada and Delaware firms, to decrease the likelihood that an omitted variable was driving the results, we also constructed a matched sample of similar Nevada and Delaware companies. In particular, to every company in Nevada we matched a company in Delaware from the same industry (using a four-digit SIC industry code) and with the closest market capitalization. The difference in restatement frequencies between Nevada and Delaware firms

The high ratio of restatements, and especially restatements that involve fraud or trigger federal intervention, suggests that Nevada attracts companies that are, at the very least, aggressive in their accounting and possibly prone to financial misreporting or fraud. This again does not suggest that all companies that choose Nevada, or even that all companies that restate in Nevada, belong to this category. It is consistent with the view, however, that Nevada disproportionally attracts corporations with high private benefits.

5. What is the Value of Nevada Firms?

How do investors value Nevada companies? Tobin's Q—the ratio of a firm's market value to its assets—has been a common measure to test investors' estimate of state law. On this measure, for most of the last three decades Delaware firms have shown a significant premium.[166]

Nevada firms do not exhibit a statistically significant premium. After controlling for firms' characteristics, one finds that the value of Nevada firms is statistically indistinguishable from the average state, while Delaware firms have a higher value. Thus, while investors do not award Nevada firms with a premium, they do not discount them relative to the firms that remain in their home states.

In interpreting these results several effects should be taken into account. First is the frequency with which Nevada firms restate. Overall, during the sample period, more than 50% of Nevada

remains significant and of similar magnitude in the matched sample. To further investigate whether restatements in Nevada are driven by an omitted factor, we inquired into the nature of these restatements by creating a random sample of companies' reports to the SEC. We found that no one type of restatement dominates Nevada companies in a way that could explain the frequencies of such restatements. See Barzuza & Smith, supra note 143, at 14 (noting that the random sample of eight companies shows "that the reasons for restatements vary considerably, from incorrect applications of derivative costing formulas, to mixing up operating and financial cash flows, to wrongly attributing expenditures on work-in-progress and inventory to revenues").

[166] See Daines, Firm Value, supra note 19, at 527 (finding a higher Tobin's Q for firms in Delaware for the years 1981 to 1996). But see Guhan Subramanian, The Disappearing Delaware Effect, 20 J.L. Econ. & Org. 32, 33 (2004) (finding that between 1997 and 2002, Delaware's premium disappeared and that in the Daines sample the premium existed only among small firms). We find that between the years 2000 and 2008, Delaware firms had higher Tobin's Qs than firms in other states. Our results suggest that Delaware's Tobin's Q has bounced back after the decrease that Subramanian has identified. See Barzuza & Smith, supra note 143, at 24–25.

companies restated their earnings at least once. These restatements were preceded by misstatements that could create the appearance of exceptional growth and could result in an artificially high Tobin's Q.

Second, small companies in general are less closely followed by analysts; as a result, their market price may less accurately reflect their fundamentals.[167] Since Nevada firms are significantly smaller, it is possible that their market prices are less accurate.

Third, it is also possible that investors have not learned yet the effects of incorporating in Nevada. A recent study shows that the value of corporate governance terms was not incorporated into market prices until the early 2000s when corporate governance received significant exposure.[168] Nevada strategy until recently had almost zero exposure and thus may not be reflected yet in market prices.

Lastly and most importantly, it is possible that what the results are suggesting is that incorporating in Nevada is a mixed signal. If firms incorporate in Nevada for different reasons, investors observing particular firms would not know whether they incorporated to gain access to private benefits, to save on taxes, or to minimize litigation costs. Because of this ambiguity, the discount is only partial.

This explanation is consistent with additional results showing that investors find the combination of incorporation in Nevada and financial restatements to be particularly concerning. While restating firms generally suffer a significant discount to their Tobin's Qs, this effect is more severe in Nevada than in other states.[169] Viewed collectively, the Tobin's Q results are consistent with incorporating in Nevada at first broadcasting a mixed signal. That signal, however, reduces to the presence of high agency costs as firms restate.

D. Summary: A Cause for Concern

Although hundreds of papers have been written on Delaware, none has yet been written exclusively on Nevada. The paucity of

[167] See Kahan & Rock, supra note 122.

[168] See Lucian A. Bebchuk et al., Learning and the Disappearing Association Between Governance and Return 10, 35 (forthcoming J. Fin. Econ.), available at http://ssrn.com/abstract=1589731.

[169] See Barzuza & Smith, supra note 143, at 25.

research on Nevada means that additional research is necessary in order to understand Nevada and the companies that incorporate there.

Nevertheless, the data on Nevada firms is consistent with the account that at least some firms are choosing Nevada in order to extract higher private benefits. The high ratio of accounting restatements is an apparent manifestation of this phenomenon. Nevada firms have less institutional investors that monitor them, and they adopt greater protections from liability, also on an individual basis.

Thus, while Nevada may be a favorable jurisdiction for some firms seeking to save on litigation costs, it seems to attract some questionable firms; colloquially, as Senator James argued, Nevada may in fact have become a heaven for opportunistic insiders. To the extent that the firms that need regulation the most find a protective locale in Nevada, the Nevada story may be a cause for concern.

V. IMPLICATIONS FOR THE DEBATE

A. Revisiting the Race to the Top/Race to the Bottom Debate

For the past thirty years, scholars have fiercely debated whether states race to the top or to the bottom. At some point in the debate it seemed that the race had ended, with Delaware being the clear winner. But Nevada's actions over the past decade suggest that none of the classic metaphors accurately describe what is now happening in the market.

At least two states—Delaware and Nevada—are vigorously attempting to attract out-of-state incorporations. However, they are doing so in a way that the traditional metaphors cannot explain, namely by offering different laws and targeting different types of corporations. Mapping classic terminology to current market conditions, it would seem as though Delaware is racing toward the top and Nevada is racing toward the bottom.

This account may help to explain why we have not yet reached a conclusion about the nature of the market for corporate law despite thirty years of debate. Reality is simply complicated in ways that the "race" metaphor cannot explain. States differ in the law they offer and firms differ in their preferences for it.

The paradigm of "race" should be replaced with a paradigm of market segmentation. Nevada and Delaware are targeting different firms. As a result, new questions are coming to the front. First, it is not enough anymore to focus only on Delaware since it is not the only player in the market. Second, we should start asking which are the corporations that choose strict law and which are the corporations that choose lax law.

B. Implications for the Rest of the Market: Self-Selection in Home States

The self-selection story discussed here may be broadened beyond Nevada to the rest of the market. Many firms incorporate neither in Delaware nor in Nevada but in their home states. It is possible that self-selection explains firms' choices to remain in their home states in the same way that it explains the choice between Delaware and Nevada.[170] Firms that find Delaware law insufficiently protective may find it worthwhile to stay at home, where they can attempt to influence their state legislatures, a strategy that has some intuitive appeal.

Unlike Nevada, most other states do not actively try to lure companies to incorporate and thus are not expected to embark on a market-segmentation strategy. However, other states are vulnerable to lobbying by local managers. Indeed, as Professor Roberta Romano has shown, in many states antitakeover statutes were adopted as a result of lobbying by local interest groups.[171]

For managers who are interested in protection, staying at home is an easy option. Firms often incorporate initially in their home state, and reincorporate to Delaware only if and after they grow. Since reincorporation requires managers' initiation, managers can opt for strong protection merely by not initiating a reincorporation from their home state to Delaware.

[170] See Michal Barzuza, Self-Selection in the Market for Corporate Law (Oct. 20, 2011) (unpublished manuscript, on file with the Virginia Law Review Association).

[171] Some statutes were enacted in response to pending threats of a hostile takeover of a local company. See, e.g., Roberta Romano, The Political Economy of Takeover Statutes, 73 Va. L. Rev. 111, 122–32 (1987) (describing two such occasions in the state of Connecticut). Delaware, on the other hand, adopted only one, relatively mild antitakeover statute. See Del. Code Ann. tit. 8, § 203 (2011).

Furthermore, investors may not fully discount for protective law in home states or for the agency costs the choice implies. Similar to the choice to incorporate in Nevada, the choice to remain at home sends a mixed message. Firms may choose to incorporate in their home state for reasons that have nothing to do with legal protections. First, they may do so because of the extra cost associated with incorporation in Delaware.[172] Second, local law firms typically advise firms to remain in their home states. Third, firms may stay in their home state out of simple inertia. Thus, like in Nevada, firms that choose to stay home to extract high benefits will be only partially penalized by the market.

C. Implications for the No-Competition Account of the Market

This Article has shown that Nevada has recently shifted gears and entered the market for public incorporations.

Nevada, however, does not compete head-to-head with Delaware. It does not threaten to take Delaware's business and indeed has no chance of attracting all Delaware companies. Rather, it attracts a segment of the market. It is still the case that Delaware has a significant market power, that very few states attempt to compete with Delaware, and that Delaware thus faces only weak competitive pressures.

So, the findings here are consistent with the no-competition account with a slight refinement. Given Nevada's recent entry, Delaware is not completely free from competitive pressures. Nevada's strategy may limit Delaware's choices. In particular, given Nevada's management-friendly package, Delaware might have to be careful not to become or to acquire the appearance of being too pro-shareholder. Otherwise, at the margin, it might lose more firms to Nevada. In other words, Nevada does not pose an existential threat to Delaware, but it may become a sufficient nuisance to Delaware and thus constrain it from becoming pro-shareholder.[173]

[172] See, e.g., Bebchuk & Hamdani, supra note 2, at 573.

[173] As discussed above, Delaware would not degrade its law to match Nevada law, as that would trigger federal intervention, harm Delaware brand, and reduce the price that it can charge for incorporations. But, it might slightly degrade it or even avoid making it more protective of shareholders in order to mitigate the gap between its own package and Nevada's package.

D. Revisiting the Desirability of a State-Based Corporate Law System

The debate over the market for corporate law has one direct normative implication for the desirability of federal intervention. While race to the bottom proponents argued for some form of federal intervention to reduce pro-managerial bias,[174] race to the top scholars have objected, arguing that federal officials do not have the incentives and information that Delaware has to invest in and constantly improve, its corporate law, and are likely to produce a worse corporate law.[175] That firms can self-select into lax law in Nevada and in their home states suggests some previously unrecognized costs and benefits to our state corporate law system relative to a system of federal regulation.

On the cost side, Nevada is offering an especially lax legal regime. This creates a sphere within our corporate law system within which managers can benefit themselves to a significant extent. Even more concerning, Nevada may be the shelter for shady firms, which could impose costs on shareholders and society. Finally, the fact that Nevada may be dragging Delaware down is a cost that should be taken into account in considering the desirability of federal intervention.

Despite these potential costs, it is possible that self-selection will produce some benefits. First, it is possible, though as yet not supported by significant evidence, that for some firms a no-litigation environment is efficient. Second, when firms self-select into a legal regime, investors could potentially learn something about them.[176] Yet, in the case of Nevada, it seems as though the signal is noisy

[174] See Bebchuk, Desirable Limits, supra note 1, at 1437, 1441, 1510 (arguing for federal rules, or at least federal minimum standards, with respect to self-dealing transactions, taking of corporate opportunities, freeze-out mergers, all aspects of takeover bids and proxy contests, and limitations on dividends); Cary, supra note 1, at 701 (proposing that Congress adopt federal standards for corporate responsibility); cf. Lucian Arye Bebchuk & Allen Ferrell, A New Approach to Takeover Law and Regulatory Competition, 87 Va. L. Rev. 111, 162–64 (2001) (suggesting federal intervention in the switching rules among states).

[175] See Roberta Romano, Empowering Investors: A Market Approach to Securities Regulation, 107 Yale L.J. 2359, 2383–87 (1998) (arguing for replacing federal securities regulation with state competition); Roberta Romano, The Sarbanes-Oxley Act and the Making of Quack Corporate Governance, 114 Yale L.J. 1521, 1526–29 (2005) (criticizing SOX as an unsuccessful intervention in corporate law).

[176] See Barzuza, supra note 111, at 1–2, 31.

and therefore not particularly informative, unless it is combined with an additional act such as restating.[177]

The desirability of a federal corporate law system remains an open question.[178] To the debate on this score, however, this Article raises some cause for concern regarding Nevada's strategy, and at the very least it suggests the need to monitor the Nevada phenomenon.

E. Implications for Corporate Law Policy

Corporate law provides firms with significant flexibility. After choosing a state, under most states' law, firms can make many individual decisions regarding the legal constraints that apply to them. They are permitted to choose whether to adopt a staggered board,[179] a poison pill,[180] cumulative voting,[181] proxy access,[182] majority voting,[183] and shareholder power to call special meetings.[184] With respect to all of these decisions, firms typically vary in their choices: some firms opt for stricter terms and others for laxer terms.

That flexibility is thought from one perspective to be desirable. That is because "one size does not fit all." Firms are different, and it is efficient to permit them to choose governance terms that are

[177] It is also possible that investors have not yet learned the effects of incorporating in Nevada. For evidence of learning of corporate governance terms that occurs over time, see Bebchuk et al., supra note 168, at 1–4.

[178] Another consideration to take into account is that even if, theoretically, federal law could have done better, it is possible that practically it would not. Federal law can be influenced by lobbying in the same way some states' law is, and it is possible that currently this lobbying is less vigorous because firms now have lax law options. See Ronald J. Gilson et al., Regulatory Dualism as a Development Strategy: Corporate Reform in Brazil, the U.S., and the EU 4–5, 54 (Stanford Law and Econ, Olin Working Paper No. 390), available at http://ssrn.com/abstract=1541226 (arguing that regulatory dualism can be a solution to the "Olson problem" since it allows strong groups to have protective law without imposing it on all other firms).

[179] See, e.g., Del. Code Ann. tit. 8, § 141(d) (2011).

[180] See, e.g., Moran v. Household Int'l, 500 A.2d 1346, 1348, 1357 (Del. 1985) (upholding under Delaware law the Shareholder Rights Plan).

[181] See, e.g., id. § 214.

[182] See, e.g., id. § 112.

[183] See, e.g., id. § 216.

[184] See, e.g., id. § 211(d).

best for them.[185] According to this view, the facts that some firms adopt pills and some do not and that some adopt staggered boards and some do not are evidence that market forces work and firms sort in efficient ways. If corporate law allowed less flexibility by applying mandatory terms—for instance, prohibiting staggered boards or poison pills—it would impose inefficiency costs since these rules would not equally benefit all firms.

Though it is possible that firms sort in efficient ways, it is also possible that firms with high agency costs—those that need regulation the most—will make the choices that are not socially desirable for them, amassing takeover protection and avoiding majority voting and proxy access. Conversely, firms with low agency costs that already have strong shareholders and low private benefits will opt into stricter terms such as prohibiting pills and allowing proxy access and majority voting.

Thus, this Article suggests, we should start investigating the self-selection among firms in other contexts to see whether it conforms to efficient sorting or whether the sorting is distorted.

CONCLUSION

This Article has highlighted an overlooked dynamism in the market for corporate law, one that is associated with market segmentation and self-selection by firms according to their agency costs. The story of the market for corporate law, and of firms' choice of law, is more complicated than the literature assumed. Specifically, the market for corporate law is affected by market segmentation.

In order to make sense of the state of the market, we need to better understand differences among firms. Insofar as differences among firms were not thought relevant to their choices of law, the demand side of the market was imperfectly understood. This Article presents an analytical base from which additional investigations into differences among firms will be necessary.

Nevada's story should make us consider other policy questions in corporate law. Heterogeneity in firms' choice of legal terms is

[185] See, e.g., Comment letter from Cravath, Swaine & Moore LLP et al., supra note 16, at 2, 5–8.

widespread.[186] While there is still much more to do, and much data to explore, I hope this Article advances our understanding of how variations in agency costs affect firms' choice of law.

[186] In other work, I have analyzed heterogeneity in agency costs and its signaling effects in cross-listing decisions. See Barzuza, supra note 111, at 1–2 (showing that if private benefits are heterogeneous and unobservable controlling shareholders that extract high private benefits choose not to cross-list).