VIRGINIA LAW REVIEW *IN BRIEF*

VOLUME 99 FEBRUARY 2013 NUMBER 1

RESPONSE

HOW LAX IS NEVADA CORPORATE LAW? A RESPONSE TO PROFESSOR BARZUZA

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INTRODUCTION

UNITED States law famously allows corporations to choose the applicable corporate law by incorporating in the state of their choice.[1] In theory, this allows states to compete for corporate charters. But to what extent do states actually compete?

Delaware clearly makes substantial efforts to attract corporations. It is debated, however, whether this is true for other states. Prominent corporate law scholars such as Professors Lucian Bebchuk, Assaf Hamdani, Marcel Kahan, and Ehud Kamar have argued that states other than Delaware have not made significant efforts to entice incorporations.[2] By contrast, Professor Roberta Romano has asserted that competition in the charter market is alive and well as evidenced, inter alia, by Nevada's efforts to become the "Delaware of the West."[3]

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[1] E.g., Roberta Romano, The Advantage of Competitive Federalism for Securities Regulation 63 (2002) [hereinafter Romano, Advantage].

[2] See Lucian A. Bebchuk & Assaf Hamdani, Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters, 112 Yale L.J. 553, 556 (2002) (arguing that "[n]o state . . . has been giving Delaware a run for its money"); Marcel Kahan & Ehud Kamar, The Myth of State Competition in Corporate Law, 55 Stan. L. Rev. 679, 684 (2002) (arguing that "[o]ther than Delaware, no state is engaged in significant efforts to attract incorporations of public companies").

[3] Romano, Advantage, supra note 1, at 77–78; Roberta Romano, Law as a Product: Some Pieces of the Incorporation Puzzle, 1 J.L. Econ. & Org. 225, 246 (1985); see also Guhan Subramanian, The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on

In *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*,[4] Professor Michal Barzuza makes an important contribution to this debate. She undertakes the first in-depth study of Nevada's role in the charter market and offers a number of novel, interesting, and provocative conclusions.

Her analysis has three main components. To begin, Professor Barzuza shows—very persuasively—that over the last decade or so Nevada has actively competed for corporate charters, managing to gain a non-trivial 6.66% share in the market for out-of-state incorporations in 2008.[5]

Moreover, Professor Barzuza offers a simple explanation for how Nevada has achieved this success; namely, by offering extremely lax law. Of course, Nevada has long enjoyed a reputation for offering pro-managerial norms.[6] Professor Barzuza's assessment is much more drastic. According to her, Nevada has adopted "a no-liability corporate law."[7]

Finally, Professor Barzuza's article analyzes the implications that her analysis has for the debate on regulatory competition. Most importantly, she argues that the rise of Nevada as a liability-free jurisdiction implies a previously unrecognized cost of regulatory competition: such competition allows those firms most in need of strict norms—the scoundrels of corporate America—to find refuge in Nevada, where the law is particularly lax, letting them exploit minority shareholders and impose costs on society as a whole.[8]

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the "Race" Debate and Antitakeover Overreaching, 150 U. Pa. L. Rev. 1795, 1856 (2002) (noting that "Nevada has been a successful, if small, player in the corporate charter marketplace").

[4] Michal Barzuza, Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction, 98 Va. L. Rev. 935 (2012).

[5] Id. at 948–49.

[6] See, e.g., Subramanian, supra note 3, at 1856 (arguing that Nevada owed its success in the charter market to promanagerial takeover law and lax rules on personal liability for directors and officers). It is noteworthy that Nevada's reputation as a jurisdiction with permissive law is not limited to corporate law. For example, Nevada has long had a reputation for offering permissive divorce laws. See, e.g., F. H. Buckley & Larry E. Ribstein, Calling a Truce in the Marriage Wars, 2001 U. Ill. L. Rev. 561, 570 (noting that "[d]ivorce laws were always more lax in western states such as Nevada, which sought migrants from more restrictive eastern states").

[7] Barzuza, supra note 4, at 940.

[8] Id. at 997. Professor Barzuza also voices the concern that Nevada may ultimately cause Delaware to loosen its own corporate law. If Delaware responds by making its own law laxer than it has hitherto been. Id. That seems unlikely. As Professor Barzuza herself explains in some detail and quite persuasively, Delaware is ill-positioned to compete in a race for laxity. Id. at 967.

There is much in Professor Barzuza's rich analysis that is convincing, including many aspects to which this brief Essay cannot respond. In particular, I am wholly persuaded that Nevada is making active efforts to compete in the charter market. By contrast, I am not convinced that Nevada's law on director and officer liability is shockingly lax and that this implies a substantial drawback of regulatory competition.

Admittedly, Nevada offers directors and officers more far-reaching protections than Delaware. Nevada law does not seem excessively lax, however, when compared to the law of states *other* than Delaware. This is particularly true with respect to the protections that Nevada law affords to corporate directors (rather than officers). In various states, and even under the Model Business Corporation Act ("MBCA"), corporations can achieve a similar level of protection for their directors by adopting exculpation clauses. Nor is Nevada alone in offering liability protection for corporate officers. Rather, several states allow such protections via exculpation clauses. In sum, despite marketing itself as the bad boy among corporate law jurisdictions, Nevada does not offer corporate directors and officers substantially more protection from liability than they can obtain under the law of other states. This does not imply, of course, that Nevada's move to laxity is unimportant. However, its main significance lies in the fact that it changes the legal default and thus imposes a more manager-friendly regime on *existing* Nevada corporations. Accordingly, the rise of Nevada does not show that regulatory competition in corporate law is undesirable. In particular, if the liability regime that Nevada offers for directors is not laxer than what can be achieved under the MBCA, then there is no reason to believe that we would end up with a more stringent regime in the absence of regulatory competition.

The structure of this Essay is as follows: Part I surveys various pieces of circumstantial evidence that tend to show Nevada law is not considerably more lax than the law of other states. Part II enters into a detailed comparison between Nevada law and the Model Business Corporation Act to show that not much more is allowed by Nevada than by the latter. Part III discusses the legal policy implications of Nevada's corporate law and argues that the rise of Nevada does not cast the desirability of regulatory competition into doubt.

I. THE CIRCUMSTANTIAL EVIDENCE

Even without analyzing the details of the liability regimes involved, there are reasons to doubt the claim that Nevada's law is lax enough to be substantially less efficient than the law of most other states.

To begin, it is important to keep in mind that shareholders—directly or indirectly—have a measure of control over where the corporation is incorporated. If an existing corporation from another state reincorporates in Nevada, the merger necessary for reincorporating is subject to shareholder approval.[9] Moreover, to the extent that corporations choose Nevada as their initial public offering ("IPO") state, investors can refuse to buy the shares. If Nevada law truly was outrageously lax, shareholders would likely withhold their approval or decline to buy shares except at a steep discount.

To her credit, Professor Barzuza acknowledges this issue. She argues that the IPO market does not necessarily prevent inefficient governance arrangements and that there are various ways of procuring shareholder approval even of those measures that are not in the interest of shareholders.[10] These arguments become less persuasive, however, the more outrageous one considers Nevada law. For example, one technique for obtaining shareholder approval is for the board to bundle a measure that the shareholders like with a measure that harms the shareholders' interests, and then ask shareholders to approve the bundle.[11] Even theoretically this tactic works only as long as the shareholders expect to gain more from the beneficial measure than they lose from the measure they dislike. If Nevada truly offered liability-free corporate law, then it is difficult to see what measure could possibly be liked enough by the shareholders to get them to approve of a reincorporation in Nevada. '

Second, as Professor Barzuza acknowledges, Tobin's Q—the ratio of market value to book value—is not lower than the average for Nevada firms, although it is lower than that of firms incorporated in Delaware.[12] Admittedly, there are various ways of explaining this finding, including the possibility that Tobin's Q is simply not a very reliable indicator. However, the most obvious explanation is that Nevada law is not all that more inefficient than the corporate law of other states. Given the im-

[9] Lucian A. Bebchuk & Ehud Kamar, Bundling and Entrenchment, 123 Harv. L. Rev. 1549, 1555 n.7 (2010).
[10] Barzuza, supra note 4, at 978–80.
[11] Bebchuk & Kamar, supra note 9, at 1556–57.
[12] Barzuza, supra note 4, at 992.

portance that the fiduciary duties are thought to have, this suggests that Nevada's liability regime simply may not be radically different from that of other states.

Third, it is worthwhile to ask whether Nevada truly has an interest in offering inefficient liability-proof corporate law—a move that hurts local businesses as much as firms in other states. Delaware's controversial and arguably inefficient case law on takeovers concerns only public corporations, almost none of which are headquartered in Delaware. By contrast, Nevada's rules on the liability of officers and directors apply to all corporations, including those that are privately held. Accordingly, much of the impact of those rules is local. In fiscal year 2011, IRS data reported over 73,000 corporations headquartered in Nevada.[13] Given that the vast majority of privately held corporations are formed in the state where the firm is headquartered,[14] it is very likely that most of these 73,000 corporations are subject to Nevada law. They form the backbone of a nontrivial state economy with a Gross Domestic Product ("GDP") of around $130 billion.[15] Given the potential damage caused by adopting corporate governance provisions that are inefficient, the revenue that Nevada derives from attracting public corporations—estimated at least "several million dollars"[16]—seems inconsequential. While lawmakers and courts may not always act in an enlightened fashion, it is difficult to see what reason they could have to damage Nevada's economy for what amounts to peanuts.

In sum, even without a detailed analysis of the legal provisions at issue, there is reason to doubt that Nevada corporate law is as shockingly lax as it is made out to be.

II. NEVADA COMPARED TO OTHER STATES

Let us now turn to an analysis of the relevant provisions in Nevada corporate law to determine whether they offer rules that are substantially more promanagerial than the norms available in other states. I will start

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[13] Internal Revenue Service, 2011 Data Book 6 tbl.3 (2012), available at http://www.irs.gov/pub/irs-soi/11databk.pdf.

[14] Jens Dammann & Matthias Schündeln, The Incorporation Choices of Privately Held Corporations, 27 J.L. Econ. & Org. 79, 84 (2011).

[15] Bureau of Economic Analysis, Widespread Economic Growth Across States in 2011, at 11 tbl.4 (2012), available at http://www.bea.gov/newsreleases/regional/gdp_state/2012/pdf/gsp0612.pdf.

[16] Barzuza, supra note 4, at 948.

with the liability of corporate directors before turning to corporate officers.

A. Directors

Under Nevada law, the mere breach of a fiduciary duty is not sufficient for the director to be held personally liable. Rather, such personal liability also requires that the breach of duty "involved intentional misconduct, fraud or a knowing violation of law."[17] In addition, though, a different provision of Nevada's corporate law makes it clear that directors can also be held liable for unlawful distributions.[18] How does this compare to the law of other states?

1. The Delaware Approach

Delaware's law on director liability certainly seems stricter. Under Delaware law, the liability of directors can be limited only for duty of care violations, but never for violations of the duty of loyalty.[19] Moreover, Delaware precludes any attempt to limit the personal liability of directors for transactions from which the director derived an improper personal benefit.[20] Various other states have copied this approach,[21] and a few have imposed even stricter limitations on charter provisions seeking to limit the liability of directors.[22]

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[17] Nev. Rev. Stat. § 78.138(7) (2011).

[18] Id. § 78.300.

[19] Del. Code Ann. tit. 8, § 102(b)(7) (2012).

[20] Id.

[21] Alaska Stat. § 10.6.210(1)(N) (2012); Ark. Code Ann. § 4-27-202(b)(3) (2011); Colo. Rev. Stat. § 7-108-402 (2012); 805 Ill. Comp. Stat. 5/2.10(b)(3) (2012); Kan. Stat. Ann. § 17-6002(b)(8) (2011); Ky. Rev. Stat. Ann. § 271B.2-020(2)(d) (West 2012); La. Rev. Stat. Ann. § 12:24(C)(4) (2013); Mass. Gen. Laws ch. 156B, § 13(b)(1½) (2012); Minn. Stat. § 302A.251(4) (2013); Mo. Rev. Stat. § 351.055(2)(3) (2012); N.J. Stat. Ann. § 14A:2-7(3) (West 2012); N.D. Cent. Code § 10-19.1-50(5) (2012); Okla. Stat. tit. 18, § 1006(B)(7) (2013); Or. Rev. Stat. § 60.047(2)(d) (2011); R.I. Gen. Laws § 7-1.2-202(b)(3) (2012); S.C. Code Ann. § 33-2-102(e) (2011); Tex. Bus. Orgs. Code Ann. § 7.001(b)–(c) (West 2012).

[22] Some states list additional categories in which the personal liability of directors cannot be excluded. See Cal. Corp. Code § 204(a)(10) (West 2013); Conn. Gen. Stat. § 33-636(b) (2012). In New Mexico, the personal liability of directors cannot even be eliminated in case of mere negligence if the director received more than $2000 annually or owned shares in the corporation. N.M. Stat. Ann. § 53-12-2(E)(2)(a) (2008).

2. The MBCA Approach

Not all states are as strict as—let alone stricter than—Delaware. Rather, many other states have adopted statutes that take a more promanagerial approach to the question of director liability. The most common type of exculpation statute for those states that have not chosen to follow Delaware is the one included in the Model Business Corporation Act.[23] How does the MBCA's approach compare to Nevada law?

By default, directors subject to the MBCA are liable for all fiduciary duty violations;[24] however, the Act allows far-reaching deviations in the corporate charter from this principle. Within certain limits, the charter can eliminate "the liability of a director to the corporation or its shareholders for money damages for any action taken, or any failure to take any action, as a director . . . ."[25] So what exactly are the limits to which the MBCA subjects exculpation clauses, and how do they compare to Nevada law?

First, under the MBCA, directors remain liable for unlawful distributions.[26] As stated previously, this is true under Nevada law as well.[27]

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[23] Exculpation statutes modeled on the Model Business Corporation Act include Ariz. Rev. Stat. Ann. § 10-202(B)(1) (2012); D.C. Code § 29-302.02(b)(4) (LexisNexis 2012); Haw. Rev. Stat. § 414-222(a)–(b) (West 2011); Idaho Code Ann. § 30-1-202(2)(d) (2012); Iowa Code § 490.202(2)(d) (2012); Mich. Comp. Laws § 450.1209(1)(c) (2012); Miss. Code Ann. § 79-4-2.02(b)(4) (West 2012); Mont. Code Ann. § 35-1-216(2)(d) (2011); Neb. Rev. Stat. § 21-2018(2)(d) (2011); N.H. Rev. Stat. Ann. § 293-A:2.02(b)(4) (2012); S.D. Codified Laws § 47-1A-202.1(4) (2012); Vt. Stat. Ann. tit. 11, § 2.02(b)(4) (2012); Wyo. Stat. Ann. § 17-16-202(b)(iv) (2011). A few states have adopted exculpation provisions that can be situated somewhere between the Delaware approach and the MBCA approach. For example, New York generally follows the Delaware approach, but does not explicitly preclude exculpation clauses for all duty of loyalty violations. N.Y. Bus. Corp. Law § 402(b) (Consol. 2012). The same is true for Georgia. Ga. Code Ann. § 14-2-202(b)(4) (2012). Tennessee has also adopted a Delaware-style exculpation statute but it does not contain a general ban on exculpation clauses for transactions from which the director derives an improper personal benefit. Tenn. Code Ann. § 48-12-102(b)(3)(A) (2012). Alabama's exculpation statute is modeled on the MBCA, but also contains a general ban on exculpation clauses for duty of loyalty violations. Ala. Code § 10A-2-2.02(b)(3) (2012). Other states have adopted even more idiosyncratic approaches. For instance, in Maryland, the personal liability of directors can be eliminated except to the extent that the director received an improper personal benefit or was involved in active and deliberate dishonesty. Md. Code Ann., Cts. & Jud. Proc. § 5-418(a) (LexisNexis 2012).

[24] Nevada is not alone in sharply limiting the liability of directors and officers by default. For a similarly promanagerial rule see, e.g., Va. Code Ann. § 13.1-692.1(A) (2012).

[25] Model Bus. Corp. Act § 2.02(b)(4) (2011).

[26] Id.

[27] Nev. Rev. Stat. § 78.300 (2011).

Second, the charter cannot eliminate the liability for "an intentional infliction of harm on the corporation or the shareholders" or "an intentional violation of criminal law."[28] These limitations also have a parallel in Nevada law. While the wording of the relevant Nevada provision is slightly different, "an intentional infliction of harm on the corporation or the shareholders" would most likely constitute "intentional misconduct" within the meaning of Nevada law, and an "intentional violation of criminal law" would certainly constitute "a knowing violation of law" for which directors are liable even in Nevada.[29]

Finally, under the MBCA, the charter cannot eliminate the director's liability in the amount of a financial benefit received by a director to which he is not entitled.[30] This provision becomes relevant in self-dealing cases: even in the absence of intentional wrongdoing, a director engaging in self-dealing is liable for the benefits he has reaped from the transaction.

At first glance, this limit placed upon exculpation provisions seems to lead to a meaningful difference between Nevada law and the MBCA because the former contains no comparable statutory provision. However, the practical importance of this distinction seems dubious. In most cases, directors receiving improper personal benefits will be well aware of what they are doing and thus be subject to liability even under Nevada law. Moreover, even in those cases where directors engage in self-dealing without being culpable of intentional wrongdoing, the outcome may be the same under Nevada law and the MBCA. This is because the Nevada Supreme Court has made it clear that in self-dealing cases the plaintiff can rely on the theory of unjust enrichment if benefits were received at the expense of the corporation.[31] While the relevant case did not involve an unjust enrichment claim brought against a director, the outcome would likely be the same; Nevada corporate law only limits personal liability for damages and is thus unlikely to be applied to the unjust enrichment claim.

Therefore, when it comes to shielding corporate directors against personal liability, Nevada law hardly goes beyond what can be achieved under the MBCA via an exculpation provision.

[28] Id. § 2.02(b)(4).
[29] Id. § 78.138(7).
[30] Id. § 2.02(b)(4).
[31] In re AMERCO Derivative Litig., 252 P.3d 681, 703 (Nev. 2011).

B. Corporate Officers

With respect to corporate officers, Nevada law's corporate law is somewhat more unusual. Delaware does not allow exculpation clauses for corporate officers, and the same is true for most of the states that follow the Delaware approach.

This does not mean, however, that Nevada is alone in shielding corporate officers from personal liability. Rather, there are six other states that authorize charter provisions that limit or eliminate the liability of officers as well as directors.[32]

In any case, this distinction between the MBCA and Nevada law should not be overemphasized. First, it is up to the corporation whether and to what extent it appoints officers in the first place.[33] It is entirely legal to have the corporation managed by the board itself rather than merely under the board's supervision.

Second, there has never been a compelling reason to treat corporate officers differently from corporate directors, especially since—as pointed out above—the board itself may choose to manage the corporation. Accordingly, if one comes to the conclusion that Nevada's law on the liability of directors is not shockingly lax, then it is difficult to argue that the identical protections afforded to corporate officers are shockingly lax.

III. POLICY IMPLICATIONS

According to Professor Barzuza, the rise of Nevada highlights a previously unrecognized shortcoming of our system of regulatory competition: such competition allows the bad apples among America's directors and officers to choose a particularly lax jurisdiction where they can exploit shareholders and perhaps even impose costs on society as a whole.[34]

I have to confess that I remain unconvinced. In order to raise an argument against regulatory competition, one has to make two claims. First, one has to argue that Nevada law is inefficiently lax. Second, one has to make the case that no such laxity would have arisen in the absence of regulatory competition.

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[32] La. Rev. Stat. Ann. § 12-24(C)(4) (2013); Md. Code Ann., Corps. & Ass'ns § 2-104(b)(8) (LexisNexis 2012); N.J. Stat. Ann. § 14A:2-7(3) (West 2012); Utah Code Ann. § 16-10a-840(4) (LexisNexis 2012); Va. Code Ann. § 13.1-692.1(B) (2012).

[33] See Model Bus. Corp. Act § 2.02(b)(2) (2011).

[34] Barzuza, supra note 4, at 997.

The first prong of that argument succeeds to a degree. The Delaware premium suggests that Delaware corporate law is more efficient than that of other states; by the same token, Delaware's more stringent approach towards director and officer liability may be more efficient than Nevada's approach. In that sense, it is plausible to argue that Nevada's efforts to reduce the liability of directors and officers are suboptimal; however, even this cannot be said for certain. It may be the case that because Nevada does not have a corporate court of a similar caliber to Delaware's Chancery Court, the standard-based—and arguably more desirable—approach Delaware has taken to director and officer liability may not function as well in Nevada. As a result, Nevada's more rule-based approach may be efficient in light of Nevada's existing suboptimal judicial infrastructure.

In any case, it is the second prong where Professor Barzuza's argument breaks down. As noted above, the rise of Nevada can only form the basis for a critique against regulatory competition if no such laxity would have arisen in a federal corporate law regime. That argument seems difficult to make. As noted in Part I, the protections that directors enjoy under Nevada law do not really go beyond what can be achieved under the MBCA via exculpation provisions. The MBCA does not represent the effort of an unscrupulous state to get ahead in the charter market; rather, it was written by the Committee on Corporate Laws of the Section of Business Law of the American Bar Association and presumably reflects widely held views on what is reasonable. Accordingly, there is little reason to believe that federal law would be more stringent than the MBCA. It follows that even with respect to badly governed corporations with a preference for lax law, there is little to gain by federalizing corporate law and putting an end to regulatory competition.

CONCLUSION

Professor Barzuza has made a convincing and meticulously researched case that Delaware actively competes for public corporations, particularly by adopting lax corporate law. How the rise of Nevada will impact regulatory competition is less clear. At this point, there is little reason to argue that Nevada's rise undercuts the case for regulatory competition. Despite all of its promanagerial rhetoric, Nevada's law on director and officer liability does not go substantially beyond what can be achieved in various other states, and it is highly questionable whether a federal corporate law would prevent corporations from adopting similar rules in their charters.