

# LAWYERS, IGNORANCE, AND THE DOMINANCE OF DELAWARE CORPORATE LAW

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*Why does Delaware continue to dominate the market for incorporations even though recent research has shown that the quality of Delaware corporate law has declined substantially? In this Article, we focus on one possible explanation: the rational ignorance of lawyers and investors. Using the results of our survey of lawyers involved in initial public offerings (IPOs) as well as our analysis of companies involved in IPOs, we conclude that lawyers recommend Delaware because they are ignorant about other states' laws. Because Delaware is so dominant, law schools focus on Delaware corporate law, and a lawyer rationally learns the corporate law of only Delaware and his home state. Regardless of the quality of the laws of other states, lawyers will not recommend incorporating outside of Delaware because they are unfamiliar with those laws. Likewise, lawyers recommend only Delaware law because they believe that investors are ignorant of other states' laws.*

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## INTRODUCTION

Delaware has long been the dominant state for attracting business incorporations. In the past, companies often chose Delaware because of its excellent, clear corporate law, and its expert courts. However, our recent paper showed in detail that Delaware corporate law and its courts' decisions interpreting it have substantially declined in quality over recent decades.<sup>1</sup> For example, Delaware's protections from legal liability for officers and directors under the business judgment rule have become weaker and more indefinite.<sup>2</sup>

Our challenge to the quality of Delaware corporate law has received much attention, including at a symposium dedicated to the topic.<sup>3</sup> The paper has certainly struck a nerve in Delaware, which depends economically on businesses continuing to choose to incorporate there. In fact, a leading Delaware judge has written a spirited response to our research.<sup>4</sup>

However, despite the decline in quality of Delaware's law, the rate at which businesses incorporate in Delaware has not fallen. Delaware is still as dominant as ever. How can this be? Why do businesses continue to choose Delaware's inferior law?

This Article provides an important new solution to the puzzle by considering the rational ignorance of both lawyers and investors. First, we focus on the lawyers who advise businesses on where to incorporate. Experienced corporate lawyers are typically familiar with the law of only two states: Delaware and their home state. They rationally learn only these two states' laws, as Delaware's dominance means that they will rarely encounter issues under other states' corporate laws. Likewise, because of Delaware's dominance, Delaware corporate law is at the center of both casebooks and teaching at law schools.

In addition, lawyers who typically advise businesses on where to incorporate tend not to be experts in the law of mergers and acquisitions, the area in which the defects in Delaware's law are most severe.

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<sup>1</sup> See William J. Carney & George B. Shepherd, *The Mystery of Delaware Law's Continuing Success*, 2009 U. ILL. L. REV. 1 (2009).

<sup>2</sup> See *id.* at 12.

<sup>3</sup> Symposium, *The Mystery of the Success of Delaware Law*, 2009 U. ILL. L. REV. 1 (2009).

<sup>4</sup> See William B. Chandler & Anthony A. Rickey, *Manufacturing Mystery: A Response to Professors Carney and Shepherd's "The Mystery of Delaware Law's Continuing Success,"* 2009 U. ILL. L. REV. 95, 95-105 (2009).

Likewise, Delaware is chosen because of the ignorance of investors. Because so many corporations are incorporated in Delaware—especially most large ones—many investors are familiar only with Delaware corporate law and with businesses that are incorporated there. Even if other states' laws are superior, investors prefer incorporation in familiar Delaware.

If our bounded rationality hypothesis is true, an inevitable cycle emerges. Because so many businesses are incorporated in Delaware, law schools, casebook writers, lawyers, and investors focus on teaching and learning Delaware corporate law. Lawyers, because they are unfamiliar with other states' laws, then advise their clients to incorporate in Delaware. The cycle can continue even if Delaware law is inferior to the laws of other states.

To test our hypothesis, we report the results of a survey that we submitted to hundreds of lawyers who had represented issuers and underwriters<sup>5</sup> in initial public offerings (IPOs). The survey asked both about the lawyers' advice to their clients on where to incorporate and about the general reasons for such advice. In addition, we analyze data on thousands of companies that have engaged in IPOs.

The results suggest that an important factor influencing the choice of the state of incorporation is the ignorance of lawyers and investors about the corporate law of states other than Delaware. The survey shows that lawyers are generally ignorant of the law of jurisdictions other than their home state and Delaware. For example, a large majority of the lawyers who responded to the survey confirmed, "I *don't* recommend incorporation in states other than Delaware or my state because I am relatively unfamiliar with the details of the laws and courts of these other states."

Likewise, the results show that companies incorporate in Delaware because of investors' ignorance of other states' laws: lawyers believe that investors prefer Delaware incorporation because Delaware's law is the only corporate law that investors know. Almost all of the survey respondents agreed that, "Delaware is a better place than my state to incorporate for public companies because investors are more familiar with Delaware law." As with lawyers, investors are rational not to know about any other state's laws because relatively few businesses are incorporated in other states.

Lawyers' and investors' rational ignorance of other states' laws could cause businesses to continue to incorporate in Delaware indefinitely, even if other states' laws are superior. This rational ignorance creates a sturdy barrier to entry for other states.

Companies' continued selection of inferior Delaware law causes harms and inefficiencies. For example, because of Delaware's uneven enforcement of the business judgment rule to protect corporate officers and directors, corporate leaders may fear lawsuits and liability. They may refrain from making

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<sup>5</sup> An underwriter is an investment bank that helps companies issue securities as part of an IPO.

the risky decisions that both produce the best products and services for consumers and maximize value for shareholders. As noted by Delaware's former Chancellor William Allen, "By intruding on the protected space that the business judgment rule accords such decisions, courts create disincentives for businesses to engage in the risk-taking that is fundamental to a capitalist economy. Such intrusiveness also prolongs litigation without offsetting social utility."<sup>6</sup>

In addition, because of Delaware's persistent dominance, corporations will continue to pay higher Delaware taxes, rather than the lower taxes in other states. This harms shareholders, the consumers who may eventually absorb the taxes, and the other state governments that do not receive the taxes. The amounts at stake are large. In 2009, Delaware collected \$767 million in business-entity taxes and fees, an amount that represented 25% of the state's general fund.<sup>7</sup>

In addition, the unnecessary litigation from Delaware's unclear law will enrich Delaware's lawyers at the expense not only of shareholders, but also of consumers, onto whom the litigation costs may be passed.

We proceed as follows.<sup>8</sup> Part I describes the puzzle of Delaware's continued dominance despite its declining quality. Part II offers our proposed solution, focusing on the rational ignorance of lawyers and investors. Parts III and IV report both the results of our survey of lawyers and the analysis of our IPO data. We then conclude.

## I. THE PUZZLE: DECLINING QUALITY, CONTINUED DOMINANCE

For nearly a century, Delaware has been dominant in attracting business incorporations.<sup>9</sup> Unlike the practice in many other countries, U.S. states can compete to attract incorporations.<sup>10</sup> All U.S. states follow the English choice-of-law doctrine, the "Internal Affairs Rule." The doctrine applies the law of the incorporating jurisdiction to the governance of the corporation, regardless of the location of the corporation's headquarters or operations. A company that incorporates in Delaware will be governed by Delaware law even if all of its operations and sales are in Arizona. This contrasts with

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<sup>6</sup> William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Realigning the Standard of Review of Director Due Care with Delaware Public Policy: A Critique of Van Gorkom and Its Progeny as a Standard of Review Problem*, 96 NW. U. L. REV. 449, 450 (2002).

<sup>7</sup> DIV. OF CORPS., DEL. DEPT' OF STATE, ANNUAL REPORT 2 (2009), available at <http://corp.delaware.gov/2009ar.pdf> [hereinafter 2009 ANNUAL REPORT].

<sup>8</sup> This Article builds on the analysis in the last part of the conference volume entry, William J. Carney, George B. Shepherd & Joanna M. Shepherd, *Delaware Corporate Law: Failing Law, Failing Markets*, in *THE LAW AND ECONOMICS OF CORPORATE GOVERNANCE: CHANGING PERSPECTIVES* 23 (Alessio M. Paces ed., 2010).

<sup>9</sup> See, e.g., Carney & Shepherd, *supra* note 1, at 2.

<sup>10</sup> See *id.* at 2-3.

Europe's "Real Seat Rule," which requires incorporation at the location of the corporation's headquarters.<sup>11</sup>

When New Jersey, the first-mover in the American chartering competition, relinquished its advantage in a misguided movement at law reform in 1911, Delaware became the favored state for incorporation.<sup>12</sup> During the period from 1996–2000, 58% of all publicly held firms and 59% of Fortune 500 Industrial firms were incorporated in Delaware.<sup>13</sup> During the period from 1978–2000, 56% of all IPOs involved Delaware corporations.<sup>14</sup> Delaware's share of IPOs listed on the New York Stock Exchange increased during the 1990s, a period of enormous growth in the number of companies (mostly high-tech) going public, reaching 73–77% during parts of that decade.<sup>15</sup>

Among the traditional reasons that many businesses incorporated in Delaware were its "flexible corporate code, the responsiveness of its legislature, the wealth of legal precedent, its efficient and knowledgeable court system, and its business-like Secretary of State's Office."<sup>16</sup> Delaware's state government highlights these purported advantages repeatedly in its marketing materials.<sup>17</sup>

This dominance is puzzling. Our recent research has shown that, during recent decades, the quality of Delaware corporate law has declined substantially.<sup>18</sup> Its corporate code, legal precedent, and court system are no longer superior. Delaware law has become increasingly indeterminate, especially because it no longer provides reliable protections for officers' and directors'

<sup>11</sup> See William J. Carney, *The Political Economy of Competition for Corporate Charters*, 26 J. LEGAL STUD. 303, 315–18 (1997).

<sup>12</sup> See CHRISTOPHER GRANDY, *NEW JERSEY AND THE FISCAL ORIGINS OF MODERN AMERICAN CORPORATION LAW* 75–93 (1993); see also Carney & Shepherd, *supra* note 1, at 2–3.

<sup>13</sup> Lucian A. Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 389–91 (2003).

<sup>14</sup> Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1571 (2002).

<sup>15</sup> See *id.* at 1572.

<sup>16</sup> Demetrios C. Kaouris, Note, *Is Delaware Still a Haven for Incorporation?*, 20 DEL. J. CORP. L. 965, 1011 (1995); see also Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1810 (2002).

<sup>17</sup> The online materials for the Delaware Secretary of State claim:

Businesses choose Delaware not for one single reason, but because we provide a complete package of incorporations services. The Delaware General Corporation Law is the most advanced and flexible business formation statute in the nation. The Delaware Court of Chancery is a unique 215 year old business court that has written most of the modern U.S. corporation case law. Delaware's State Government is business-friendly and accessible. Our Division of Corporation is a model state-of-the-art efficiency and our staff provides prompt, friendly and professional service to clients, attorneys, registered agents and others. These factors have all contributed to making Delaware a premier legal home to companies around the world.

Del. Dep't of State, Division of Corps., Frequently Asked Questions, <http://corp.delaware.gov/faqs.shtml> (last visited Oct. 22, 2011).

<sup>18</sup> See Carney & Shepherd, *supra* note 1, at 2.

business decisions. Delaware courts have become increasingly intrusive in their review of directors' decisions, thus increasing uncertainty and raising transaction costs and litigation expenses for Delaware corporations.<sup>19</sup>

For example, in *Weinberger v. UOP, Inc.*<sup>20</sup> and subsequent decisions, the Delaware courts have caused broad fiduciary standards to evolve into multiple, ill-defined, open-ended rules.<sup>21</sup> The categories into which transactions can be placed, with different consequences for burdens of proof and standards of judicial review, have proliferated. Business planning for Delaware corporations is now perilous because it is difficult to predict the category into which the courts will place a given transaction. This proliferation of standards and unclear rules has caused confusion even for Delaware's expert courts, as evidenced by the Delaware Supreme Court's high reversal rate on appeals from the Court of Chancery.<sup>22</sup> If Delaware's courts themselves appear unsure of the right rules to apply, businesses cannot be expected to navigate the law's requirements successfully.

Despite the decline in the quality of Delaware's law, companies overwhelmingly continue to choose Delaware as their state of incorporation. They do this even though Delaware's fees for forming new entities are much higher than those of other states.<sup>23</sup> Delaware's large share of incorporations has not merely continued, but has actually increased. In 2005, more than 70% of all public offerings on U.S. exchanges were incorporated in Delaware.<sup>24</sup> In 2009, during the severe economic downturn, over 73% of all new U.S. IPOs were domiciled in Delaware.<sup>25</sup> By 2009, the fraction of Fortune 500 companies with Delaware incorporations had increased to 63%,<sup>26</sup> up 4% from a decade earlier.<sup>27</sup>

But why would businesses continue to choose Delaware's inferior, overpriced law? The easy response is that Delaware's continued dominance might be the result of the market power that a party with a dominant market position enjoys.<sup>28</sup> Parties with dominant market positions, such as Microsoft in the operating system market, can maintain market share for decades even if new competitors are offering better goods and services. But this answer

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<sup>19</sup> See *id.* at 11–25.

<sup>20</sup> 457 A.2d 701 (Del. 1983).

<sup>21</sup> See, e.g., *Omnicare, Inc. v. NCS Healthcare, Inc.*, 818 A.2d 914 (Del. 2003); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1985); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985); see also *Carney & Shepherd*, *supra* note 1, at 11–25 (explaining how these cases provide ambiguous guidance on fiduciary standards).

<sup>22</sup> See *Carney & Shepherd*, *supra* note 1, at 15–16.

<sup>23</sup> Franchise fees might be \$100,000 in Delaware but might be only \$5,000 in Georgia, or \$40 in Kansas. See *id.* at 63.

<sup>24</sup> DIV. OF CORPS., DEL. DEPT' OF STATE, ANNUAL REPORT 1 (2005), <http://corp.delaware.gov/2005%20doc%20ar.pdf>.

<sup>25</sup> 2009 ANNUAL REPORT, *supra* note 7, at 1.

<sup>26</sup> *Id.*

<sup>27</sup> *Bebchuk & Cohen*, *supra* note 13, at 389.

<sup>28</sup> See WILLIAM G. SHEPHERD, *THE ECONOMICS OF INDUSTRIAL ORGANIZATION* 266–68 (3d ed. 1990).

fails to unpack this black box and offer explanations for why, in this market, Delaware's market power persists, and why Delaware's high market share permits it to continue to dominate even after the quality of its law has declined.

For a solution to this puzzle, we explore the rational ignorance of lawyers and investors.

## II. A PROPOSED SOLUTION TO THE PUZZLE: THE RATIONAL IGNORANCE OF LAWYERS AND INVESTORS

The rest of this Article focuses on two groups with great influence on a business's choice of incorporation: the lawyers who advise the business and the investors to whom the business hopes to sell its stock and bonds. We show that both groups will rationally remain ignorant about the corporate law of states other than Delaware. Further, both groups will continue to prefer incorporation in Delaware, regardless of whether Delaware's law has declined in quality.

### A. *Lawyer Ignorance*

Often, it is not a company's business leaders who choose the state of incorporation. Instead, it may be lawyers: either the lawyers for the underwriter that is helping the company sell its securities or the lawyers for the company itself.<sup>29</sup> As legal experts, lawyers would be expected to know more than businesspeople about the relative quality of different states' corporate law. So a company's business leaders often delegate the decision of where to incorporate to the attorneys.

Our hypothesis is that when lawyers advise their business about selecting the state of incorporation, the lawyers suffer from bounded rationality: they are rationally unfamiliar with the laws of all but a few states. That is, they choose either Delaware or their home state not because those states have better law, but because the lawyers know little about the laws of other states.<sup>30</sup>

Lawyers are familiar only with the law of Delaware and their home state because those are the only states' laws that they learned in law school. In corporations courses, law schools generally teach only Delaware law and perhaps the law of the state where the school is located. Law schools recognize that all students need to be familiar with Delaware law because most publicly held corporations incorporate there. In addition, some lower-ranked schools may also teach their local state's law because they know that many of their students may end up practicing in that state.

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<sup>29</sup> See Daines, *supra* note 14, at 1580; see also Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 273 (1985).

<sup>30</sup> See Daines, *supra* note 14, at 1581.

However, many top-ranked law schools do not teach the specific corporate laws of states where the schools are located.<sup>31</sup> Recognizing that their students will practice in many different states, the schools teach only Delaware law and perhaps the Model Business Corporation Act (“Model Act”).<sup>32</sup> The Model Act is a model statute that has served as the basis for the corporate statutes of many states.

However, instruction in the Model Act does not provide familiarity with any state’s specific law. Although there is some uniformity among the laws of those states using the Model Act as the basis for their statutes, there are also many large and small differences due to local innovations.<sup>33</sup> Familiarity with the Model Act is insufficient to provide the necessary working familiarity with the law of any specific state that has adopted it. Apart from Delaware law, if lawyers who graduate from top-ranked schools are to learn the corporate laws of the states where they eventually practice, they must learn it on their own, after law school.

Moreover, law school instruction in the Model Act teaches little about the law of several large commercial states, where many corporate lawyers practice. For example, the Model Act varies substantially from the corporate law of California, New York, Pennsylvania, and Ohio.<sup>34</sup> Thus, most lawyers from top-ranked law schools who practice in these states have received no law school training in these states’ corporate laws; instead, they studied only Delaware law and perhaps the very different Model Act. It is no wonder then that companies that begin in these states tend to incorporate in Delaware as they grow. Although the lawyers for these companies learned about Delaware law in law school, law school taught them little about the companies’ home-state laws.

Reinforcing the dominance of Delaware law in law school instruction is the focus on Delaware law in most casebooks. Casebooks tend to contain far more Delaware cases than cases from any other state.<sup>35</sup> Again, the focus on Delaware law is rational for casebook authors. Because more businesses are incorporated in Delaware than anywhere else, it makes sense for the authors to focus on Delaware’s law.

One other characteristic of law school education may predispose lawyers to ignore Delaware’s defects. The typical law school curriculum tends to focus on the areas where Delaware law is best, not on the areas where it is

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<sup>31</sup> See *infra* text accompanying note 38.

<sup>32</sup> MODEL BUS. CORP. ACT (2008).

<sup>33</sup> See, e.g., William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 718 (1998).

<sup>34</sup> See generally MODEL BUS. CORP. ACT ANN. (2008) (discussing and comparing the provisions of the Model Act with state corporate codes).

<sup>35</sup> One of us is guilty of this emphasis. William Carney’s casebook on mergers and acquisitions contains 39 lead cases on corporate law (excluding cases interpreting contracts and those involving federal laws), of which 32 are Delaware cases. See WILLIAM J. CARNEY, CASES AND MATERIALS ON MERGERS AND ACQUISITIONS (2d ed. 2007). This fact reflects not only the dominance of Delaware, but also the complexity of its doctrine.



worst. Delaware's greatest defects are in its law governing directors' decisions regarding mergers and acquisitions.<sup>36</sup> For example, we have previously argued that the Model Act benefits from a series of safe harbors that provide far more certainty than Delaware law in critical areas.<sup>37</sup> However, most law school classes on corporations provide little information on such corporate combinations. Instead, they focus on more basic issues of how the corporation is formed and how it operates.

The backgrounds of securities lawyers may predispose them even further to favor Delaware for incorporation. Recall that, unlike some lower-ranked law schools, top-ranked law schools tend to teach only Delaware law and the Model Act. Moreover, because the stakes in IPOs are so large and because securities law is so intricate, lawyers who represent issuers and underwriters disproportionately have studied at top-ranked law schools.<sup>38</sup> Thus, many of the lawyers advising corporations on IPOs (which are often coupled with a decision to reincorporate) have studied the specific law of only one state: Delaware.

It is rational for these lawyers not to be familiar with the law of other states. They simply lack the time and incentives to learn other states' laws. These lawyers must already learn three sets of laws: Delaware law, their home state's law, and federal law. Their focus not only on the laws of Delaware and their home state, but also on the intricacies and complexities of a changing body of federal securities laws, will dissuade them from investing heavily in the nuances of laws in other jurisdictions. It would be irrational for these lawyers to neglect learning about the law that they use daily and instead to learn about other states' laws that they would seldom use.

In addition, lawyers may rationally learn the corporate law of only Delaware and their home state because of network effects.<sup>39</sup> Because so many companies are incorporated in Delaware, any securities lawyer will benefit greatly by learning Delaware law; indeed, it is essential to learn it. An attor-

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<sup>36</sup> See Carney & Shepherd, *supra* note 1, at 11–26.

<sup>37</sup> See *id.* at 34.

<sup>38</sup> We do not attempt to describe or identify top-ranked law schools here, as there are various ratings that attempt to do that, from U.S. News & World Report to data compiled by Professor Brian Leiter. We only mean to suggest that those schools that draw students broadly from the national market expect them to move largely into high-paying jobs at large corporate law firms that provide the services we describe. Nevertheless, we provide one anecdote, using the 240 lawyers listed by Wachtell, Lipton, Rosen & Katz on their web page. *Attorneys*, WACHTELL, LIPTON, ROSEN & KATZ, <http://wlrk.com/Page.cfm/Thread/Attorneys> (last visited Nov. 18, 2008). The top five schools listed by U.S. News & World Report provided 154 of those lawyers, or 64%, while the top ten schools provided 192, or 80%, based on first law degrees. *Id.* Some of the remaining lawyers who held degrees from foreign schools also held master's degrees from these top-ranked schools. *Id.* Aside from public universities in the top twenty schools (Michigan, Virginia, UCLA, and Texas), only four lawyers graduated from state universities that would be more likely to teach local law. *Id.* We recognize that a sample of one is necessarily biased, and that we chose one of the most selective law firms in the nation for our sample, but we believe it is suggestive.

<sup>39</sup> See Michael Klausner, *Corporations, Corporate Law and Networks of Contracts*, 81 VA. L. REV. 757, 761–63, 774–80 (1995).

ney who represents many corporations can economize on learning by having all her clients incorporated in one state.<sup>40</sup> In contrast, the benefits of learning other states' laws are few. Because few firms incorporate there, issues of that state's law will seldom arise in a lawyer's practice.

We see then that, if our solution to the puzzle is true, Delaware could maintain its dominance not because its law is superior, but because of network effects and path dependence. Lawyers choose Delaware for incorporation because they learned its law in law school or learned it on their own. Law schools teach Delaware corporate law, or lawyers learn it on their own, because most corporations choose it.

A cycle of mediocrity could roll along. Because so many businesses incorporate in Delaware, law schools teach only Delaware's corporate law. Lawyers, because they know only Delaware law, then advise even more businesses to incorporate there. The cycle's snowballing effect creates a high barrier to entry for new states into the market for incorporations. Regardless of how much better another state's corporate law might be, lawyers are unlikely to recommend incorporation there because they know little about it.

### B. *Investor Ignorance*

Delaware's persistence could also be attributed to investors' unfamiliarity with the laws of states other than Delaware. Even if a business and its lawyers understood that Delaware law was inferior, the business might nonetheless choose Delaware for incorporation if it concluded that investors would feel uncomfortable with incorporation in another state. The business and its lawyers might conclude that incorporation in Delaware would maximize the price of the company's stock because of investors' incorrect belief that Delaware law is best. Uninformed investors might pay more for shares in a Delaware company, even if another state's corporate law was better.

One might think that investors' lawyers would educate their clients about the virtues of the other states' laws. Suppose that we are correct that states other than Delaware have better corporate laws that might increase the profits of businesses incorporated there. Then it might seem natural for investors' lawyers—perhaps even required by their duties of professional responsibility—to educate their clients about the benefits of investing in businesses that were incorporated in these other states.

However, investors' lawyers will probably be unable to provide such advice to their clients because they too will probably be ignorant of the quality of the corporate law of other states. Just like the lawyers advising businesses on where to incorporate, lawyers advising investors will probably know little of the corporate laws of any states except Delaware and their home state. Again, lawyers may not offer a solution to the problem of Delaware's puzzling persistence. They may be much of the cause.

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<sup>40</sup> See Romano, *supra* note 29, at 274–75.

### III. EVIDENCE FROM OUR SURVEY OF IPO LAWYERS

To test the rational ignorance explanation for Delaware's dominance, we now report the results of a survey that we submitted to hundreds of lawyers who had represented issuers and underwriters in IPOs. The survey asked questions about the lawyers' backgrounds, patterns of incorporation advice, and the reasons for that advice. The answers to these questions permit examination of the influence of lawyers and investors on the choice of the state of incorporation.

After we describe the design of our survey, we explore the results that relate to the rational-ignorance hypothesis and then highlight other results.

#### A. *Survey Design*

To choose the lawyers we would contact, we chose a random sample of IPOs from each year from 1991 to 2001.<sup>41</sup> These years represented the high-water mark in the IPO surge at the end of the past century and also a period when Delaware was very dominant in the market for incorporations.<sup>42</sup>

We then obtained detailed information on each IPO from the Form S-1,<sup>43</sup> which each issuer in a public offering is required to file with the SEC.<sup>44</sup> We omitted smaller filings on Forms SB-1, SB-2, and Regulation A, because the relatively small size of these IPOs might have introduced biases.<sup>45</sup>

Among the information in our database about each IPO were the names and addresses of both the lawyer who had represented the issuing company and the lawyer who had represented the underwriter. We wanted to explore whether either lawyer might have influenced the company's decision about where to incorporate.

We created a one-page survey questionnaire that first asked questions about the lawyer's background. The questionnaire then probed the general patterns of the lawyer's advice about choosing a state of incorporation. Finally, we asked about the choice of state of incorporation for the specific IPO in our sample. The questionnaire for the underwriter's counsel is in Appendix A; the instrument for the issuer's attorney was similar.

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<sup>41</sup> We took a random sample of the IPOs that are included in the comprehensive database that we used for our analysis. *See infra* Part IV.

<sup>42</sup> *See* Bebhuk & Cohen, *supra* note 13, at 389–91.

<sup>43</sup> This data was obtained from the SEC's EDGAR database. *EDGAR Company Search*, U.S. SEC. & EXCH. COMM'N., <http://www.sec.gov/edgar/searchedgar/companysearch.html> (last visited Oct. 22, 2011).

<sup>44</sup> *See* Securities Act of 1933, 15 U.S.C. § 77 (2006).

<sup>45</sup> Smaller offerings are more likely to be marketed locally. For example, securities that are offered only to persons within the issuer's home state are exempt from federal registration requirements, *see id.* § 77a–77b, creating an incentive to market small offers only intrastate. Local lawyers for both issuers and underwriters may be less experienced at larger national offerings and thus less familiar with Delaware law.

We sent the questionnaire and a cover letter to 397 lawyers who had represented underwriters and to 502 lawyers who had represented issuers. The smaller number of underwriters' lawyers represents the fact that, compared to the lawyers for issuers, more of the underwriters' lawyers were involved in more than one IPO in our sample; we sent any attorney who had been involved in more than one IPO in our sample only one questionnaire. We received 242 completed questionnaires, 86 from attorneys for underwriters and 156 from attorneys for issuers.

*B. Lawyers Choose Delaware Because They Do Not Know Other Law*

Following the longstanding historical pattern, the lawyers in our survey overwhelmingly recommended incorporation in Delaware. More than 70% of both underwriters' lawyers and issuers' lawyers advised their client to incorporate in Delaware for the IPO in question.<sup>46</sup> Likewise, 97% of underwriters' lawyers and 83% of issuers' lawyers noted that they generally recommended incorporating in Delaware.<sup>47</sup>

The results show that an important reason why the lawyers recommended Delaware was that they were ignorant of the laws of other states. The survey asked whether the following was true: "I *don't* recommend incorporation in states other than Delaware or my state because I am relatively unfamiliar with the details of the laws and courts of these other states" (emphasis in original). Of the issuers' lawyers, 55% indicated agreement. There was agreement from 75% of underwriters' lawyers.<sup>48</sup>

Likewise, the patterns of lawyers' advice indicate that their advice is forcefully constrained by their unfamiliarity with the laws of states other than Delaware and their home state. No lawyer in our survey generally recommended incorporation in a state other than Delaware or the lawyer's home state. This was true even if the potential other state was the home state of the issuing company: 97% of underwriter's lawyers and 95% of issuer's lawyers were not comfortable with incorporating in the issuer's home state, unless the issuer's home state was Delaware or the lawyer's home state.

The only situation in which a substantial number of lawyers generally recommended incorporation in the issuing company's home state was if the issuer's home state happened also to be the lawyer's home state: 13% of issuer's lawyers recommended incorporation in the state where the issuing company was located if it also happened to be the lawyer's home state.

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<sup>46</sup> See *infra* Table 1. This finding coincides with findings from other studies. One study of IPOs during the 1990s peak found the rate of Delaware IPO incorporations to be 73–77%. See Daines, *supra* note 14, at 1572.

<sup>47</sup> See *infra* Table 2.

<sup>48</sup> See *infra* Table 4. Because we found that the jurisdiction had already been chosen for the IPO by the time the matter reached the underwriter (81% of the time), the underwriter's influence is less significant. See *infra* Table 1.

To summarize, regardless of the virtues of other states' laws, lawyers almost never recommend incorporation in these other states. The only states that the lawyers recommend for incorporation were those whose laws the lawyers already know: Delaware or their home state. That lawyers lack a license to practice law in a state other than their home state does not explain this pattern, because non-Delaware lawyers recommending Delaware incorporation are typically not licensed in Delaware.

The results provide support for the bounded rationality, rational ignorance hypothesis. In substantial part because lawyers are unfamiliar with the laws of other states, they advise incorporation in either Delaware or their home state.

The cycle then continues. Because so many lawyers recommend Delaware, the state is dominant. Because of Delaware's dominance, many law schools teach only Delaware corporate law and perhaps some of the local state's law; a school might choose to teach the local state's law if the school places most of its graduates locally rather than in a national market. Likewise, because Delaware law is so dominant, it is rational for lawyers to learn only Delaware law.

Finally, the cycle is completed. Because lawyers learn primarily Delaware law in law school and on their own, their ignorance of other states' laws continues. Knowing only Delaware law, and perhaps some local law, the lawyers are able only to advise their clients to choose to incorporate in Delaware or their home state.

The results should not be interpreted to mean that lawyers who responded to our survey are ignorant or lazy. It would be irrational, if not impossible, for lawyers to devote the substantial time and resources necessary to learn other states' laws, especially because law schools do not teach it. Corporate law is complex and intricate. It includes not only statutes, but also the judicial gloss on those statutes. This judicial gloss is especially important in Delaware, where much of the law has been developed in the judicial decisions interpreting the statutes rather than in the statutes themselves.

In addition, lawyers must be versed in non-statutory areas. Examples are the business judgment rule and the duty of loyalty, which have developed primarily through judicial decisions rather than through legislation.

Instead, it is rational for the lawyers to be familiar with the corporate laws of only a limited number of states. Indeed, for many lawyers, it is rational to learn only Delaware law and the law of their home state. They must learn Delaware law because so many businesses are incorporated there. They must generally know the law of their own jurisdiction because lawyers will inevitably deal with local businesses that are incorporated locally; many businesses initially incorporate in their home state, but then switch to Delaware incorporation when they first sell shares to the public.<sup>49</sup>

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<sup>49</sup> See Subramanian, *supra* note 16, at 1825–26; see also Daines, *supra* note 14, at 1576.

Delaware's dominance will be maintained even if its corporate law is inferior to other states' laws. Because of path dependence and lawyers' bounded rationality, lawyers will continue to recommend incorporation in Delaware. Aside from their own state's law, it is the only law they know. For each lawyer, Delaware has only to compete with the lawyer's home state, rather than with all fifty jurisdictions.<sup>50</sup>

Looked at through another lens, lawyers' bounded rationality benefits Delaware because it creates network externalities. The network externalities arise because Delaware's corporate law has become the standard, and law schools therefore teach it. Accordingly, learning Delaware law is cheaper for lawyers than learning the laws of other states. To learn other states' laws, the lawyers must learn it on their own time, outside law school.

Moreover, because of Delaware's dominance, a lawyer can spread the cost of learning Delaware law over many representations. That is, the cost per representation of learning Delaware law is low. This also means that the return in legal fees of learning Delaware law is high.

In contrast, the cost per representation of learning another state's corporate law is high, and the return in legal fees is low. The lawyer will expect to use the new knowledge only infrequently because most companies are still incorporated in Delaware.

This means that, because there are already so many Delaware incorporations and because so many others recommend Delaware law, it is profit maximizing for new lawyers to learn only Delaware law. Thus, Delaware enjoys the benefits of network effects.<sup>51</sup>

The market for incorporations is similar to the market for personal computer operating systems, which is considered a prime example of a market where pervasive network effects support the dominance of Microsoft Windows.<sup>52</sup> Because Windows is dominant, it is rational for users and computer professionals to learn only Windows. Similarly, because Delaware corporate law is dominant, it is rational for issuers and legal professionals to learn only Delaware law. This is true regardless of whether Windows or Delaware law is a superior product.

Regardless of what label is placed on it and its impacts—rational ignorance, bounded rationality, or network effects—lawyers' ignorance of the laws of states other than Delaware and their home states creates an imposing barrier to entry for other states to enter the market for incorporations. It

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<sup>50</sup> Romano described the efforts of other states as defensive moves to prevent further losses of corporations to Delaware. See Romano, *supra* note 29, at 226; see also Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 731–32 (2002); Lucian A. Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1784–86 (2002) (describing competition as bilateral).

<sup>51</sup> See Klausner, *supra* note 39, at 842–47.

<sup>52</sup> See, e.g., Timothy F. Bresnahan, *Network Effects and Microsoft* (Stanford Inst. for Econ. Pol'y Research, Discussion Paper No. 00-51, 2001), available at <http://www-siepr.stanford.edu/papers/pdf/00-51.pdf>.

would make sense for computer users to switch from Windows to another operating system only if Windows became abysmal. Only then would switching to a new operating system be worth the great costs of learning the new system.

Likewise, only if Delaware law becomes utterly defective will it be worthwhile for lawyers to learn another state's law. Only then would the benefits of the new law exceed the large costs of switching, which include conducting a multi-state search for the best law and learning the intricacies of the new state's law. If Delaware corporate law is merely mediocre, then its dominance continues; a switch is not worthwhile.

Moreover, the lawyer advising at the IPO stage will recognize that the main benefits of abandoning Delaware law will occur many years later. Recall that many of the inadequacies of Delaware law involve mergers and other changes of control. At the IPO stage, when the state of incorporation is often selected, any merger or other such transaction is many years away. By that time, the IPO-stage lawyer will probably have been replaced by a lawyer specializing in mergers or other large transactions. Because the lawyer at the IPO stage will not enjoy the later benefits of incorporating in a state other than Delaware, the lawyer has few incentives to incur the large costs of investigating these benefits and learning other states' laws.

### *C. Delaware is Chosen Because Investors are Familiar with It*

The survey reveals that lawyers' ignorance of other laws is not the only reason lawyers advise incorporating in Delaware. They also choose Delaware because they believe that investors who might purchase the company's securities are familiar only with Delaware law: 92% of underwriters' lawyers and 83% of issuers' lawyers agreed that "Delaware is a better place than my state to incorporate for public companies because investors are more familiar with Delaware law."

Investors' ignorance of other states' laws is an additional barrier to entry for states attempting to convince companies to incorporate in their state rather than in Delaware. Our results suggest that, even if lawyers were familiar enough with other states' laws to know that another state's law was superior, lawyers might still rationally choose Delaware. Even if Delaware law is worse, lawyers will choose Delaware because of their belief that investors' ignorance of other states' laws means that the investors will pay more for stock in Delaware companies. Because investors are familiar with only Delaware law, lawyers believe that the appropriate advice to their clients is to incorporate in Delaware—regardless of whether other states' laws are superior.

Again, it is rational for investors to be familiar with only Delaware law. Because most investment opportunities are in Delaware corporations, investors rationally focus on Delaware law. Because it is rational for lawyers, who are legal experts, to learn only the laws of Delaware and their home

states, it is certainly rational for investors, who are not legal experts, also to learn no other law. The same network effects that cause lawyers to focus on Delaware law make it rational for investors to do the same. With so many public companies incorporated in Delaware, it makes little sense for investors to familiarize themselves with other states' laws. This reinforces Delaware's dominance. Public companies continue to incorporate in Delaware because investors are familiar with its laws, and corporate leaders believe that investors might be willing to pay a premium for the stock of companies incorporated there.

As with the lawyers, investors' familiarity with only Delaware law can be labeled bounded rationality or rational ignorance. But the result is the same: network effects that create an additional high barrier to entry for other states into the Delaware-dominated market for incorporations. Because most companies are incorporated in Delaware, investors are most familiar with Delaware corporations. Because investors are most familiar with Delaware corporations, new businesses rationally choose to incorporate in Delaware, even if Delaware law is worse.

As we expected, lawyers will generally not be able to eliminate investors' ignorance of the laws of states other than Delaware. Just as lawyers' ignorance prevents them from helping *issuers* steer away from Delaware incorporation, *investors* will probably not be able to rely on their lawyers to correct their misperceptions about the virtues of investing in non-Delaware corporations. As we have seen, lawyers themselves know little about the corporate law of other states.

#### D. *The Specific IPO and Venture Capitalists' Small Influence*

We now explore each of the groups of questions in the survey individually, beginning with the questions about the specific IPO. As we have already mentioned, Table 1 indicates that both underwriters' lawyers and issuers' lawyers overwhelmingly recommended Delaware law for the IPO that we asked about: 71% of underwriters' lawyers and 74% of issuers' attorneys did so. Of the few IPOs where Delaware was not recommended, the issuer's lawyer recommended incorporation in the issuer's home state relatively frequently. Issuer's lawyers stated that they recommended incorporation in the issuer's home state 12% of the time, compared to 2% for underwriters' lawyers.<sup>53</sup>

The results confirm that the issuer's lawyer often began representing the issuer long before the underwriter's lawyer became involved. Only 40% of the issuing companies had already incorporated in the state that they would

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<sup>53</sup> Recollections about how frequently the issuer's lawyer recommended incorporation in the home state apparently differed between issuers' lawyers and underwriters' lawyers. While 12% of issuers' lawyers recalled recommending incorporation in the issuer's home state, 49% of underwriters' lawyers indicated that the issuer's lawyer in their IPO had recommended the issuer's home state.



TABLE 1.  
INFORMATION ABOUT THE SPECIFIC IPO

	Under- writer's lawyer	Issuer's lawyer
	% affirmative responses	
My and my law firm's advice was to incorporate in Delaware.	71%	74%
My and my law firm's advice was to incorporate in the issuer's home office location.	2%	12%
The other party or its lawyer (issuer or its lawyer if underwriter's lawyer responding; underwriter or its lawyer if issuer's lawyer responding) advised incorporating in Delaware.	30%	35%
The other party or lawyer advised incorporating in the issuer's home office location.	49%	1%
When my firm began representing the issuer, the issuer was already incorporated in the state that was later used for the IPO.	81%	40%
Venture capitalists with a stake in this corporation advised that it be incorporated in Delaware.	5%	14%

use for the IPO at the time that the issuer's lawyer began representing the company. In contrast, by the time the underwriter's lawyer became involved, 81% of the companies had already incorporated in the state that would be used for the IPO.

The results suggest that the lawyers involved in the IPO viewed the influence of venture capitalists on the choice of state of incorporation as low. Although most of the companies were ultimately incorporated in Delaware, only 5% of underwriters' lawyers and 14% of issuers' lawyers recall that venture capitalists recommended Delaware. However, our analysis of a larger sample of IPOs suggests that the presence of venture capitalists makes a greater difference than the lawyers suggest.<sup>54</sup>

#### *E. General Advice Patterns and Underwriters' Counsel's Preferences*

We now turn to the survey questions involving lawyers' general patterns of advice. Although we saw in Table 1 that just under three-quarters of the lawyers recommended incorporation in Delaware in the specific IPO about

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<sup>54</sup> See *infra* Table 5.

which we asked, even more lawyers indicated that they generally advised incorporation in Delaware. Table 2 shows that 97% of underwriters' lawyers and 83% of issuers' lawyers agreed with the following statement: "I generally advise incorporation of public corporations in Delaware regardless of the corporation's location."

The stronger pro-Delaware preference of underwriters' counsel was expected because they tend to specialize more in corporate finance and less in deal work.<sup>55</sup> Recall that the defects in Delaware's law were most apparent in how it governed mergers and other major deals. Thus, underwriters' lawyers, who do not specialize in such deals, were more likely to recommend Delaware law and less likely to be aware of its flaws.

These results contrast with the frequency of non-Delaware reincorporations, where Delaware's market share had declined to 56% in the 1990s,

TABLE 2.  
GENERAL PATTERNS OF ADVICE IN OTHER TRANSACTIONS

	Underwriter's lawyer	Issuer's lawyer
I generally advise incorporation of public corporations in Delaware regardless of the corporation's location.	97%	83%
I generally advise incorporation in my state of public corporations that are located in my state (where I work).	2%	13%
I generally advise incorporation in my state of public corporations regardless of where they are located.	0%	3%
I generally advise incorporation in a state other than Delaware or my home state.	0%	0%
I generally <i>don't</i> advise incorporation of public corporations in Delaware.	0%	4%
I generally <i>don't</i> advise incorporation of public corporations in my state.	78%	50%
I'm generally comfortable with advising issuers located in my state to incorporate here, but not issuers located in other jurisdictions.	12%	35%
I'm generally comfortable with using the issuer's home state, wherever it may be, for incorporation.	3%	5%

<sup>55</sup> See *infra* Table 3.

from 80% to 90% in earlier decades.<sup>56</sup> We suspect that this difference is explained by the types of lawyers driving the choices: Romano's work suggests that reincorporations are undertaken in anticipation of major transactions, such as mergers and acquisitions.<sup>57</sup> These are precisely the areas where we find that Delaware law is least attractive. Mergers and acquisitions lawyers may thus know more about the defects of Delaware law and may therefore recommend incorporation in other states more often.

Finally, almost no lawyer recommended incorporation in the lawyer's home state unless the issuing company was also located there. We discuss possible explanations for this in Part V below.

#### F. *The Lawyers' Practices and Their Great Sophistication*

As shown in Table 3's summary of the responses to questions about the nature of the lawyers' practices, the lawyers' ignorance of, and refusal to recommend, the laws of states other than Delaware and their home states cannot be explained by the inexperience of the lawyers in our survey. Rather, they were seasoned lawyers in securities and corporate finance. As Table 3 shows, 77% of underwriters' lawyers and 55% of issuers' lawyers devoted more than half of their time to practicing securities and corporate

TABLE 3.  
THE NATURE OF THE LAWYER'S PRACTICE

	Underwriter's lawyer	Issuer's lawyer
I practice securities and corporate finance more than any other single area of law.	88%	72%
I practice securities and corporate finance more than most other attorneys in my office.	61%	36%
I practice securities and corporate finance less than half of my time.	6%	14%
I practice securities and corporate finance less than one-quarter of my time.	3%	2%
I work on mergers and acquisitions more than half of my time.	14%	37%
I work on mergers and acquisitions less than half of my time.	81%	56%
I work on mergers and acquisitions almost never.	5%	4%

<sup>56</sup> Subramanian, *supra* note 16, at 1818–22 (noting that there were a substantial number of reincorporations in Maryland, Nevada, Massachusetts, Minnesota, and New York).

<sup>57</sup> See Romano, *supra* note 29, at 250.

finance. Indeed, securities and corporate finance was the main practice area for 88% of underwriters' lawyers and 72% of issuers' lawyers. Only 6% of underwriters' attorneys and 14% of issuers' attorneys practiced in these areas less than half the time. Even experienced securities lawyers lacked knowledge of the corporate laws of states other than their home state and Delaware.

### G. *Comparing Delaware and Other States*

The survey's final section explores why lawyers overwhelmingly advise incorporating in Delaware. As shown in Table 4, underwriters' lawyers overwhelmingly agreed with the usual reasons that are given for Delaware's primacy: investors are more familiar with Delaware law; Delaware deals well with proxies, shareholder meetings, and share transfers; Delaware law handles mergers and acquisitions well; and Delaware courts are superior for corporate disputes.

Issuers' lawyers also agreed that Delaware law is superior, although not in quite the same overwhelming numbers. Indeed, fewer than half of issuers' lawyers felt that Delaware was better than the lawyer's home state at dealing with proxies, shareholder meetings, and share transfers. The relatively more favorable view that issuers' lawyers have of their home states versus Delaware helps to explain the previous section's indication that a substantial number of issuers' lawyers recommend incorporation in the issuer's home state—as long as it is also the lawyer's home state.

A strong majority of both underwriters' lawyers and issuers' lawyers believed that Delaware law was superior for mergers and acquisitions. This is surprising considering our critique of the quality of Delaware law in this area; although Delaware law in this area may have been superior in the past, it is no longer superior.<sup>58</sup> These lawyers' knowledge of Delaware law in this area may be stale because they spend little or no time on mergers and acquisitions. Instead, these lawyers, who helped their companies with their IPOs, are experts on securities law and general business law. They may be unaware of troubling developments in the Delaware law of mergers and acquisitions.

The survey responses made clear that these lawyers do not recommend incorporation in Delaware to protect shareholder rights; fewer than 5% of both groups thought that Delaware law was superior because it was more solicitous of shareholder rights in litigation. Again, these responses may indicate that these lawyers are unaware of recent developments in Delaware law regarding shareholders. Our earlier paper demonstrated that several recent decisions of Delaware courts have created protections for minority

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<sup>58</sup> See Carney & Shepherd, *supra* note 1, at 2.

TABLE 4.  
THE LAWYER'S VIEW OF DELAWARE LAW AND THE LAW OF  
HIS HOME STATE

	Under- writer's lawyer	Issuer's lawyer
My state is a better place than Delaware to incorporate for public companies.	3%	10%
A state other than my state or Delaware is the best place to incorporate for public companies.	2%	2%
Delaware is a better place than my state to incorporate for public companies because investors are more familiar with Delaware law.	92%	83%
Delaware is a better place than my state to incorporate for public companies because Delaware law is superior in dealing with proxies, shareholders' meetings, and share transfers.	77%	48%
Delaware is a better place than my state to incorporate for public companies because Delaware law is superior in dealing with mergers and acquisitions.	86%	65%
Delaware is a better place than my state to incorporate for public companies because Delaware courts are more solicitous of shareholder rights in litigation.	4%	3%
I <i>don't</i> recommend incorporation in states other than Delaware or my state because I lack confidence in the laws of the other states.	62%	35%
I <i>don't</i> recommend incorporation in states other than Delaware or my state because I lack confidence in their courts.	65%	42%
I <i>don't</i> recommend incorporation in states other than Delaware or my state because I am relatively unfamiliar with the details of the laws and courts of these other states.	75%	55%

shareholders that are unavailable in many other states.<sup>59</sup> These lawyers appear unaware of the shareholder litigation that these decisions have generated.

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<sup>59</sup> See *id.* at 17 (discussing *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983) and similar cases).

It is no surprise that lawyers who specialize in one area of corporate law are unaware of developments in another specialized area. Just as it is rational for corporate lawyers to not devote resources to learning the laws of states other than Delaware and their home state, it is rational for securities lawyers not to devote resources to learning the latest developments in the law of mergers and acquisitions.

Finally, 98% of the respondents rejected the statement that “[a] state other than my state or Delaware is the best place to incorporate for public companies.” A relatively small number of lawyers gave as their reason that they lacked confidence in other states’ laws and courts; indeed, the inadequacy of the other states’ laws and courts was cited by only a minority of issuers’ lawyers. Instead, as we have already discussed, central reasons given for not recommending incorporation in other states were that the lawyers were unfamiliar with the other states’ laws and courts and their belief that investors were unfamiliar with other states’ laws and courts.

#### IV. FURTHER CLUES FROM DATA ON INITIAL PUBLIC OFFERINGS

To further explore our hypothesis about the importance of lawyers in the choice of state of incorporation, we analyzed a large commercial database of detailed information on IPOs. The results confirm the important role lawyers play in the incorporation decision.

##### A. *The Data and Theoretical Expectations*

Combining data from Securities Data Corporation (SDC)<sup>60</sup> with data from the SEC’s EDGAR web site, we created a database of all U.S. initial public offerings for the years 1990–2001. The data included the following information:

- the location of the issuing company’s principal corporate office
- the issuer’s state of incorporation for the IPO
- the location of the lawyer for the issuer
- the location of the lawyers for the offering’s underwriter
- whether venture capital was involved in the IPO.

Our dataset contained 4,218 IPOs.

We then analyzed the data to determine whether they were consistent with our hypothesis that lawyers’ ignorance of the laws of states other than Delaware or their home state was important to the choice of the state of incorporation. If our hypothesis was true, then we expected to observe the following patterns:

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<sup>60</sup> SDC is a leading provider of data on mergers and acquisitions, new issues, and other factors relating to the issuance of securities.

1. *The home state of the lawyer should have an influence on which state is chosen for incorporation.*

2. *If the lawyers involved with an IPO were from the same state as the issuing company's home state, the probability that incorporation would be in the issuing company's home state, rather than in Delaware, should increase.*

Both the lawyers and the issuer are comfortable with the home state's law. This is consistent with our survey results from Part III. There, 13% of issuers' lawyers recommended incorporation in the issuing company's home state, if that state was also the lawyer's home state.

3. *If the lawyer and company are from the same state, but that state is New York, then the probability of incorporation in Delaware should increase.*

We would expect a greater tendency to incorporate in Delaware if the lawyer and company are from the same state, but the state has notoriously defective corporate law. In this case, there would be a greater tendency to incorporate in Delaware.

For example, data indicate that lawyers believe that the corporate law of New York is seriously flawed.<sup>61</sup> When companies that were initially incorporated in New York eventually go public, they change their state of incorporation at much higher rates than for most other states. Indeed, New York retains only 24.5% of reincorporated companies, versus an overall average for all states of 38.1%.<sup>62</sup> It is especially important to account for the low esteem in which New York law is held because many of the issuers' lawyers, underwriters' lawyers, and issuing companies themselves are from New York.<sup>63</sup>

4. *If the lawyers are from different states than the issuer, then we would expect the probability of incorporation in Delaware to increase.*

This is the pattern seen in the survey results from the earlier parts of this Article, indicating that virtually no lawyer would recommend incorporating in a state other than Delaware if the lawyer and issuing company were from different states.

If the lawyer is from a different state than the issuer, the lawyer's self-interest counsels against recommending that the issuer incorporate in the

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<sup>61</sup> See Bebchuk, Cohen & Ferrell, *supra* note 50, at 1811–12.

<sup>62</sup> *Id.* at 1812. Other states' corporate laws are held in almost as low esteem as New York's law. For example, California retains only 27.8% of incorporations, only slightly better than New York's 24.5%. *Id.* at 1811–12. Here we focus only on New York.

<sup>63</sup> Of the 4,218 IPOs, 1,598 (37.9%) of the underwriters' lawyers were from New York, 920 (22.3%) of the issuers' lawyers were from New York, and 376 (9%) of the firms were headquartered in New York.

issuer's home state. We have seen from the survey responses that lawyers are familiar only with the laws of Delaware and their home state. If the lawyer is not from the issuer's state, to recommend incorporation in the issuer's state would be to recommend law about which the lawyer knows little. The lawyer's lack of familiarity with the issuer's state's law might cause the lawyer's advice on incorporation there to be flawed.

In addition, the lawyer's recommendation that the issuer incorporate in the issuer's own state increases the risk that the lawyer will later lose the issuer as a client for corporate advice. For example, a Georgia lawyer will recognize that if a corporation from Alabama is incorporated in Alabama, it will tend to choose advice from Alabama lawyers who are steeped in Alabama law and are knowledgeable about Alabama judges.

Likewise, if the lawyer and issuer are from different states, it may be in the lawyer's self-interest not to recommend incorporation in the lawyer's home state. A Georgia lawyer will probably refrain from even attempting to convince a corporation with headquarters in Alabama to incorporate in Georgia, for three reasons. First, this might create the danger that the client will conclude that the lawyer suggests his home state for incorporation because he is ignorant of Alabama law. The lawyer will seek to avoid appearing ignorant to retain the client's confidence and legal business.

Second, the lawyer will refrain from suggesting his home state in order to avoid a situation in which the client believes that the lawyer is selfishly suggesting incorporation in his home state in order to increase his income; incorporation in the lawyer's home state will increase the odds that the corporation will need to hire the lawyer again later to interpret the lawyer's local law.

Third, the lawyer will tend not to suggest his home state because incorporation there will increase the possibility that the corporation will be forced to litigate in a state other than its home state. Incorporation in a state creates general personal jurisdiction in that state, regardless of the corporation's level of contacts with the state.<sup>64</sup> The company's incorporation in its home state would not expand personal jurisdiction, as the presence of its headquarters already creates personal jurisdiction in its home state. In contrast, incorporation in the lawyer's home state would create personal jurisdiction there in addition to the company's home state.

Rather than recommending incorporation in the lawyer's state or the issuer's state, a lawyer from a different state than the client will tend to suggest incorporation in Delaware. Incorporation in Delaware cannot be perceived as the lawyer's selfishly choosing his home state. Likewise, the lawyer will lose less business by recommending Delaware than by recommending the issuer's home state. The lawyer can probably claim expertise about Delaware law equal to that of lawyers in the client's home

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<sup>64</sup> See RICHARD FREER & WENDY PERDUE, *CIVIL PROCEDURE: CASES, MATERIALS, AND QUESTIONS* 126–28 (5th ed. 2008).



state. As we have seen, most corporate lawyers who represent publicly traded corporations are familiar with Delaware corporate law.

### B. Results

The results are strongly consistent with our hypotheses. In choosing the state of incorporation, lawyers matter. The lawyers and their locations were central to the choice of the state of incorporation. The patterns of incorporation followed our expectations closely. This was true for a wide variety of specifications.

The data show that the choice of state of incorporation was almost always between Delaware and the issuing company's home state. In 93% of the IPOs, incorporation was in either Delaware or the home state.

The choice between Delaware and the issuer's home state followed the expected patterns. Column 1 of Table 5 reports the coefficients for a probit regression that explored the impact on the choice of state of incorporation of whether the issuing company and the underwriter's lawyer were from the same state. The coefficients indicate the variables' estimated impact on the probability that the firm will incorporate in Delaware. All of the coefficients were statistically significant at the 99% confidence level.

TABLE 5.  
INFLUENCES ON STATE OF INCORPORATION

Dependent variable is whether company is incorporated in Delaware.

	Column 1	Column 2
Variable	Coefficient, Underwriter's lawyer regression	Coefficient, Issuer's lawyer regression
Underwriter's lawyer and company from same state (with that state not New York).	-.40	-.60
Underwriter's lawyer and company both from New York.	.55	.81
Venture capital firm involved	.49	.58

The first coefficient in Column 1 indicates that, in general, if the underwriter's lawyer and the issuing company are from the same state, then the probability that the company will incorporate in Delaware decreases substantially. Conversely, if the lawyer and company are not from the same state, then the probability of incorporation in Delaware increases. This pat-

tern is consistent with our predictions. Only if the lawyer is from the issuer's home state, and is therefore familiar with that state's law, will the lawyer recommend incorporation in the home state. In contrast, if the lawyer is not from the issuer's home state, and is therefore unfamiliar with that state's law, then the lawyer recommends incorporation in Delaware.

The exception to this rule is if the lawyer and company are both from New York. In that case, as the second coefficient in Column 1 indicates, the probability of incorporation in Delaware increases. Although the lawyer is knowledgeable about the law of the issuer's home state, the lawyer recognizes that the law is flawed. Therefore, the lawyer urges incorporation in Delaware, the other state whose law the lawyer knows.

The third coefficient in Column 1 indicates that if a venture capital firm is one of the issuing company's shareholders, the probability of incorporation in Delaware increases substantially. This result is consistent with venture capitalists being primarily focused on the success of the IPO, rather than on anything that might happen to the company after the IPO, such as mergers or takeover activity. This is rational behavior for the venture capital firm because the venture capital firm almost always sells all of its stock during the IPO. It is our experience that venture capitalists tend to feel that incorporation in Delaware increases the IPO's marketability.<sup>65</sup>

This result contrasts with our inferences from the survey responses. The lawyers in the survey indicated that venture capitalists' preferences played little role in the choice of state of incorporation. These regressions indicate that the lawyers may have underestimated the venture capitalists' role, perhaps because the lawyers were so focused on their own roles.

Column 2 of Table 5 reports the results for an identical regression to Column 1, except that it examines the impact of the lawyer for the issuer, rather than of the lawyer for the underwriter. The results are similar to the results for the underwriter's lawyer: if the lawyer is from the same state as the issuer, the probability that Delaware will be chosen decreases, except when the common state is New York. However, the size of the impact for the issuer's lawyer is larger. This suggests that, although both the issuer's lawyer and the underwriter's lawyer influence the choice of state of incorporation, the influence of the lawyer on the issuer is greater. The results from our survey suggest that the greater influence of the issuer's lawyer may be due to underwriters' lawyers becoming involved in the IPOs later than issuers' lawyers, after the issuer's state of incorporation had already been decided. Table 1 indicates that 81% of the underwriters' lawyers were retained by the issuer only after the issuer had already chosen its state of incorporation. That is, only 19% of underwriters' lawyers had the opportunity to provide any input

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<sup>65</sup> One of us experienced the power of venture capitalists' views on incorporation in Delaware prior to a recent IPO. The lawyer advised incorporating in the issuer's headquarter state, only to be met by an objection from a foreign venture capitalist that "everyone knows you can't go public unless you're incorporated in Delaware." Two other venture capitalists on the board nodded their assent and the discussion was over.

on deciding the state of incorporation. In contrast, the proportion of issuers' lawyers who were hired in time to influence the choice of incorporation state was 60%, more than three times as large as the proportion for underwriters' lawyers.

These results are robust. A broad range of other specifications yielded similar results.

#### CONCLUSION

Given that Delaware corporate law has declined in certainty and flexibility, Delaware's continued dominance in attracting incorporations is puzzling. The results of our survey of IPO lawyers and our analysis of a large IPO dataset offer two related solutions. First, lawyers advise incorporation in Delaware because they are ignorant of the laws of other states. Lawyers suffer from bounded rationality regarding alternatives to Delaware: they are rationally ignorant of the corporate laws of states other than Delaware and their home state. Because so many businesses are incorporated in Delaware, it is not worth learning the laws of other states. Lawyers' rational ignorance is reinforced by the focus of legal education on Delaware law.

Second, investors are most familiar with Delaware corporations because Delaware corporations are so pervasive. Investors' comfort with Delaware corporations causes businesses to fear incorporating elsewhere. If lawyers believe that investor ignorance causes Delaware corporations to fetch a higher stock price, then even lawyers who are knowledgeable about the laws of other states will continue to advise companies to incorporate in Delaware.

These limits create powerful path dependence that helps to preserve Delaware's preeminent position regardless of the relative quality of other states' laws and courts.

## APPENDIX A

## UNDERWRITER'S COUNSEL QUESTIONNAIRE

**This IPO:**

My and my law firm's advice was to incorporate in (check the box):

- Delaware.
- the issuer's home office location.
- other (please specify): \_\_\_\_\_.

The issuer or its counsel advised incorporating in (check the box):

- Delaware.
- the issuer's home office location.
- other (please specify): \_\_\_\_\_.
- When my firm began representing the underwriter, the issuer was already incorporated in the state that was later used for the IPO.
- Venture capitalists with a stake in this corporation advised that it be incorporated in Delaware.

**General Patterns of Advice in Other Transactions:**

I generally advise (check one):

- incorporation of public corporations in Delaware regardless of the corporation's location.
- incorporation in my state of public corporations that are located in my state (where I work).
- incorporation in my state of public companies regardless of where they are located.
- incorporation in [name of state] \_\_\_\_\_ regardless of where they are located.

I generally *don't* advise (check all applicable):

- incorporation of public corporations in Delaware.
- incorporation of public corporations in my state.
- I'm generally comfortable with advising issuers located in my state to incorporate here, but not issuers located in other jurisdictions.
- I'm generally comfortable with using the issuer's home state, wherever it may be, for incorporation.

**The Nature of My Practice:**

I practice securities and corporate finance (check all applicable):

- more than any other single area of law.
- more than most other attorneys in my office.
- more than half of my time.

- less than half of my time.
- less than one-quarter of my time.

I work on mergers and acquisitions (check one):

- more than half of my time.
- less than half of my time.
- almost never.

**My View of Delaware Law and the Law of My Home State:**

- My state is a better place than Delaware to incorporate for public companies.
- A state other than my state or Delaware is the best place to incorporate for public companies.

Delaware is a better place than my state to incorporate for public companies because (check all applicable):

- investors are more familiar with Delaware law.
- Delaware law is superior in dealing with proxies, shareholders' meetings, and share transfers.
- Delaware law is superior in dealing with mergers and acquisitions.
- Delaware courts are more solicitous of shareholder rights in litigation.
- Delaware courts provide for a speedier, more-predictable resolution of corporate disputes.
- other reason (please specify): \_\_\_\_\_.

I *don't* recommend incorporation in states other than Delaware or my state because (check all applicable):

- I lack confidence in the laws of the other states.
- I lack confidence in their courts.
- I am relatively unfamiliar with the details of the laws and courts of these other states.
- other reason (please specify): \_\_\_\_\_.

