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Price Discrimination in the Market for Corporate Law

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Price Discrimination in the Market for Corporate Law

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Preliminary Draft

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Abstract

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

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Introduction

The competition among states in selling their corporate laws to firms, and the emergence of Delaware as the clear winner in this race, has for long been the subject of extensive legal scholarship.¹ According to conventional wisdom, states compete in the market for incorporations by tailoring their laws to the taste of corporate decision makers. Since Delaware has for many years been more successful than any other state in achieving this, its law is taken to epitomize what corporate decision makers want.²

With this analytical framework in hand, the spectrum of opinions about state competition and the quality of law it produces seems to have covered all possible views. Some commentators claim that competition for incorporations is bad because corporate legal rules unduly benefit managers at the expense of shareholders.³ Others argue that it is good because it induces states to devise corporate laws that maximize firm value.⁴ Other commentators still contend that it is sometimes good and sometimes bad, depending on the issue involved.⁵ And yet others suggest that it does not really matter.⁶

One question that has remained surprisingly unexplored in the

¹ See, e.g., See William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 *Yale L.J.* 663, 666 (1974); Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 *J. Legal Stud.* 251, 256 (1977); Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 *J.L. Econ. & Org.* 225 (1989); Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991); Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 *Nw. U. L. Rev.* 913 (19__); Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 *Harv. L. Rev.* 1435, 1461-70 (1992); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*, 99 *Colum. L. Rev.* (forthcoming 1999); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 *Nw. U. L. Rev.* 542 (1990); Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 *Va. L. Rev.* 757 (1995).

² See generally Roberta Romano, *The Genius of American Corporate Law* (1993).

³ See, e.g., Carey, *supra* note __.

⁴ See, e.g., Winter, *supra* note __; Fischel, *supra* note __; Romano, *supra* note __.

⁵ See Bebchuk, *supra* note __; Bebchuk & Ferrell, *supra* note __.

⁶ See Black, *supra* note __.

literature, however, is the contradiction between the prolonged dominance of Delaware in the market for incorporations and the assumption that this market is competitive and thus serves the interests of corporate decision makers. To be sure, commentators have acknowledged Delaware's dominance and discussed the competitive advantages that give rise to it.⁷ But apart from passing references to the fact that these advantages furnish Delaware with market power, little has been said about the uses to which this power can be put.⁸ Recently, the simple view underlying this first generation of state competition scholarship has been giving way to a more realistic one, which takes account of the complexities of the market for incorporations. The thrust of the second generation of state competition scholarship is that, if the market paradigm is to be taken seriously, it must reflect the various imperfections that characterize markets in reality. Thus, Michael Klausner, by himself and with one of us, has argued that, as a result of network and learning externalities, competition for incorporations among states may not yield optimal law either to shareholders or to managers.⁹ Building on this work, the other of us has shown that a particular type of suboptimal law likely to develop is one that grants courts overly broad discretion in corporate matters because such law secures to Delaware a dominant position in the market by excluding other states from its network externalities.¹⁰

⁷ See, e.g., Klausner, *supra* note __, at 841-847 (network and learning externalities); Black, *supra* note __, at 590 (expert judiciary); Romano, *supra* note __, at 240-241 (credible commitment).

⁸ An important exception is the recognition by various commentators that Delaware has market power and can charge a premium for its law. See Romano, *supra* note __, at __; Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 *Tex. L. Rev.* 469, 483 (1987); see also Melvin Aaron Eisenberg, *The Structure of Corporation Law*, 89 *Colum. L. Rev.* 1461, 1512-13 (1989) (noting that Delaware has market power).

⁹ See Klausner, *supra* note __, at 842-47; see also Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "The Economics of Boilerplate")*, 83 *Va. L. Rev.* 715, 750-51, 760-61 (1997) (expanding the analysis and empirically testing presence of network and learning benefits); Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior and Cognitive Biases*, 74 *Wash. U. L.Q.* 347 (1996) (relating network and learning effects to agency problems and cognitive biases).

¹⁰ See Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 *Colum. L. Rev.* 1908 (1998) (arguing that legal indeterminacy prevents other states from offering tapping Delaware's learning and network externalities through emulation of Delaware law, accentuates the judicial

This Article argues that another way by which Delaware may exploit its market power is price discrimination. Price discrimination entails charging different prices to different consumers, according to their willingness to pay, in order to increase one's profits. In this Article, we identify two features of Delaware law that amount to price discrimination: the formula for its franchise tax, and the litigation-intensive structure of its corporate law.

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

In Part II, we discuss the two ways in which Delaware price discriminates. First, we show that Delaware uses its uniquely structured franchise tax to charge a higher incorporation price to public corporations than to nonpublic ones and, among public corporations, to charge a higher price to larger corporations and to corporations with a higher ratio of authorized to issued shares. Second, we show that Delaware corporate law is litigation-intensive. This feature of corporate law has the effect of charging a higher price to Delaware corporations that have a greater involvement in corporate disputes. As we will argue, both these practices are effective methods of price discrimination because they track important proxies for the values firms place on a Delaware incorporation.

In Part III, we analyze the normative implications of Delaware's price discrimination. We argue that Delaware's franchise tax probably increases social wealth, at least inasmuch as it discriminates between public and nonpublic firms. By contrast, Delaware price-discriminatory substantive law probably reduces social welfare.

I. Delaware' Market Power and the Theory of Price Discrimination

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

A. Delaware's Market Power

Delaware is the most important domicile for publicly-traded United

expertise that has developed in Delaware, and makes Delaware's commitment to corporate chartering more credible).

States corporations. At present, about half of all public corporations are incorporated in Delaware. No other state accounts for more than 5 percent of the public companies.¹¹ Moreover, most companies not incorporated in Delaware are incorporated in the state where they are headquartered.¹² These facts by themselves suggest that there is something special about Delaware in the market for incorporations. In this Section, we argue that Delaware's preeminence is due to market power. We first present some empirical evidence of Delaware's market power. We then examine Delaware's competitive advantages that lend it market power.

1. Evidence of Delaware's Market Power

In competitive markets, producers have to sell their goods at a price equal to the marginal cost of production and earn zero economic profit.¹³ By contrast, producers with market power have the ability to charge for a product for more than its marginal cost and, consequently, earn a positive profit.¹⁴ The ability to earn such profits over an extended period of time is therefore significant evidence that a producer has market power.¹⁵

On this metric, it is evident that Delaware possesses substantial market power. Over the past thirty-five years,¹⁶ Delaware has

¹¹ See John C. Coates IV, *An Index of the Contestability of Corporate Control: Studying Variation in Legal Takeover Vulnerability* (unpublished manuscript, July 17, 1999, on file with authors); see also Delaware Division of Corporations, available in <<http://www.state.de.us/corp/index.htm>> (visited May 29, 1999) (reporting that 50 percent of the companies listed on the New York Stock Exchange are chartered in Delaware). [add old data from the Larcom book]

¹² See Robert Daines, [title].

¹³ See *infra* TAN.

¹⁴ See Dennis W. Carlton & Jeffrey M. Perloff, *Modern Industrial Organization* 137-38 (2d ed. 1994).

¹⁵ See Abba Lerner, *The Concept of Monopoly and the Measurement of Monopoly Power*, __ *Rev. Econ. Stud.* __ (1934) (using price markup to quantify market power). See Joe S. Bain, *The Profit Rate as a Measure of Monopoly Power*, __ *Q.J. Econ.* __ (1941) (using profit margin to quantify market power).

¹⁶ Delaware's market power probably dates back to before the last few decades. Although we do not have data on the costs Delaware incurred in serving chartered firms for the first half of the century to estimate Delaware's profits, the available data on Delaware's tax revenue strongly suggest that its market power was well established already then. Between 1915 and 1934, Delaware's corporate revenue averaged 35.8% its total revenue, and

appropriated for its chartering business less than 3 percent of its franchise tax revenue and thus earned profit margins of several thousand percent.¹⁷ In dollar terms, Delaware's net franchise tax profits from its incorporation business were \$340 million in 1996 on outlays of less than \$10 million, and averaged \$265 million per year on average outlays of \$7 million in the years 1990 to 1995, \$113 million per year on average outlays of \$3.3 million in the 1980s, \$55 million per year on average outlays of \$0.66 million in the 1970s, and \$14 million per year on average outlays of \$0.25 million in the 1960s.¹⁸ Even if Delaware's economic profits are somewhat lower, they are clearly substantial and have persisted for several decades.¹⁹

2. The Sources of Delaware's Market Power

Several reasons account for Delaware's ability to charge a premium price for a Delaware incorporation. First, Delaware has considerable expertise in handling corporate disputes and processing corporate

Delaware significantly increased its share of incorporations among publicly traded companies. See Larcom, at 167, 175-176. (1914 was a watershed year that marked the replacement of New Jersey by Delaware as the most popular corporate jurisdiction following the New Jersey's enactment of a strict antitrust statute in 1913.) One would be hard pressed to believe that Delaware's cost of serving its chartered firms was even nearly as high. This is not to say that Delaware's market power was never challenged. In the 1940s, over thirty states revised their law to match Delaware's, and the percentage of franchise tax revenues declined from a high of 42.5% in 1929 to a low of 7.2% in 1955. See William Cary, *Corporations* 10 (1969); Seligman, at 279. In the 1960s, Delaware launched an ambitious program of modernizing its entire corporate statute and marketing it aggressively to corporate counsel all over the country. [cite] Since then, Delaware has steadily increased its incorporation revenues up to its current level at over 21% of the state budget.

¹⁷ See Romano, *supra* note __, at 242. These data overstate the real appropriations for corporate chartering since they include all state outlays on the Chancery Court, which hears some noncorporate cases, and the Supreme Court, which mostly hears noncorporate cases. See Kamar, *supra* note __, at __.

¹⁸ [update] See Romano, *supra* note __, at 242 (data on 1960s and 1970s); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 *Yale L.J.* 2359, 2429 (data on 1980s and 1990s). As we explain below, most of Delaware's franchise tax revenue represent the price for being incorporated in Delaware, rather than for doing business in Delaware. See *infra* TAN.

¹⁹ Unlike accounting profits, economic profits are based on the opportunity costs of inputs. [cite]

filings.²⁰ The caseload of judges on Delaware's Court of Chancery consists mostly of corporate disputes, and members of the court decide cases without juries.²¹ Members of the court thus have had ample opportunity to develop substantial expertise on matters of Delaware corporate law.²² They also enjoy a reputation for handling cases efficiently. As a result, Delaware's Chancery Court is one of the most highly regarded state trial courts in the country.²³ Similarly, the Division of Corporations in the Department of the State of Delaware enjoys a reputation for the high quality and efficiency of its filing and taxpaying services.²⁴

Furthermore, Delaware boasts an well-developed corporate case law, and legal advice on Delaware corporate law is easily available.²⁵ Because many corporate disputes arise under Delaware law, Delaware case law is more extensive than the law of other states. The presence of a large number of precedents helps corporate actors plan transactions and reduces legal risk.²⁶ Moreover, most national law firms can expediently advise their clients on matters of Delaware corporate law. Thus, legal advice on Delaware law is often be more readily available than advice on the corporate law of other states, again making it easier to plan transactions.²⁷

²⁰ Delaware's market share may also enable it to enjoy scale economies in rendering administrative and adjudicatory services.

²¹ See Kamar, at 1959 (reporting that, of the 10,416 cases filed in the Delaware Court of Chancery from January 1, 1980 through November 1, 1998, 7409 were corporate cases).

²² [Allen]

²³ See William H. Rhenquist, *The Prominence of the Delaware Court of Chancery in the State-Federal Joint Venture of Providing Justice*, 48 *Bus. Law.* 351 (1992).

²⁴ [cite]; Carter S. Cowles, Delaware Secretary of State, Division of Corporations Imaging System, in *5 Court Technology Reports* (National Center for State Courts, 1995), available in <http://www.ncsc.dni.us/ncsc/ctr/appndx_1.htm> (visited Aug. 5, 1999) (describing the virtues of the Delaware Division of Corporations imaging system as a model for state courts).

²⁵ These benefits relate to the existing case law and availability of legal advice (learning benefits), as well as the benefits from case law to be developed in the future and the continued availability of legal advice (network benefits). See Klausner, *supra* note __, at __.

²⁶ See Romano, *supra* note __, at 277; Kamar, *supra* note __, at 1923-24.

²⁷ See Klausner, *supra* note __, at 846.

A third advantage of a Delaware incorporation derives from the familiarity with Delaware law by members of the financial community. Familiarity with the law reduces the cost of analyzing and pricing its effect on a firm's securities. Although corporations do not directly bear these costs, lowering them can benefit corporations by reducing their cost of capital.²⁸

Finally, Delaware is said to have made a valuable commitment to remain responsive to corporate needs in structuring its law. Delaware's commitment derives primarily from the substantial revenue generated by Delaware's franchise tax, and the concomitant pressure to maintain this revenue stream.²⁹ Companies value this commitment inasmuch as it reduces the likelihood of having to incorporate elsewhere should Delaware law become less attractive in the future.³⁰

The significance of these advantages must be assessed in light of the fact that entry into the market for incorporations is confined to states and foreign countries. Moreover, several states and most foreign countries have special competitive disadvantages -- an inconvenient geographic location, nonautomatic recognition of their judgments in United States courts, a different language, or a negative political reputation -- that render them unlikely to be able to pose a threat to Delaware.³¹ Of the remaining ones, none has made a determined

²⁸ See Klausner, *supra* note __, at 785-86.

²⁹ See Romano, *supra* note __, at 277-278. Delaware's commitment is further enhanced by the dependence of the local corporate bar on incorporations. See *id.* at __; cf. E. Merrick Dodd, Jr. & Ralph J. Baker, 1 *Cases on Business Associations: Corporations* 42-43 n.7 (1940). Another, less known, aspect of Delaware's investment in legal capital is its developed industry of corporate service companies. According to Delaware law, all chartered firms must be represented in the state by a local registered agent. See Delaware General Corporation Law, § 102(2). The Delaware Division of Corporations refers firms without Delaware offices to a list of 98 registered agents. See Delaware Division of Corporations, Registered Agents, available in <<http://www.state.de.us/corp/agents/agt2.htm>> (visited June 15, 1999). The annual fees registered agents charge to chartered firms range from __ to __.

³⁰ Compare Romano, *supra* note __, at 246-49 (arguing that reincorporation costs tie firms to their domicile) with Black, *supra* note __, at 586-88 (arguing that reincorporation costs are low and a credible commitment is therefore not a significant advantage).

³¹ See Romano, at 240-41 (discussing the geographic advantage of Delaware); Melvin Eisenberg, *The Modernization of Contract Law: An Essay for Bill Carey*, 37 *U. Miami L. Rev.* 187 (1983) (arguing that large states lack incentive to compete for incorporations).

effort to compete with Delaware.³² This may be due to an assumption on their part that Delaware's competitive advantages are unerodable, to political constraints, or to inattentiveness. Whatever their reasons, the lack of a serious competitor enhances Delaware's ability to charge a premium price for its product.

B. The Theory of Price Discrimination

There are various ways in which Delaware can utilize its market power to increase its profit. Most simply, it can price a Delaware incorporation above marginal cost. That Delaware is in fact doing this is well established.³³ We argue, however, that Delaware not only charges a premium for incorporations, but also tailors the premium to firms in accordance with the benefit they derive from a Delaware incorporation. In order to inform our discussion of Delaware's price discriminatory, we provide below a brief analysis of how price discrimination generally works.

1. Competitive and Non-Discriminatory Monopoly Pricing

In perfectly competitive markets, producers sell their products at a price equal to their marginal cost. Because any product on the market has many perfect substitutes, competition among producers drives the price down to the lowest level where it pays to manufacture goods for sale, which is the cost of producing the last unit sold, or marginal cost.³⁴

The flexibility producers have in pricing their products is significantly greater when they possess market power. Market power exists whenever a producer offers a product that has no substitute in the market, and it is costly for others to develop such a substitute.³⁵

A producer with market power need not fear competition by rivals

³² For example, none of the three states most often mentioned as competing with Delaware in the market for incorporations -- Nevada, Pennsylvania, and Virginia -- has instituted a specialized court modeled after Delaware's chancery court. For a discussion of Pennsylvania's failed attempt to create such a court, see *infra* TAN.

³³ See *supra* note __.

³⁴ Competitive pricing does not depend on actual existence of perfect substitutes in the market. It suffices that such substitutes can potentially be offered by new producers facing no entry barriers. See Carlton & Perloff, *supra* note __, at 108-110.

³⁵ Substitutes fall on a continuum reflecting the degree to which they resemble the product they replace. The farther the substitutes from the product in the eyes of consumers, the more market power its producer has.

offering an identical product, can raise price above marginal cost, and earn substantial economic profits.

2. Price Discrimination

While monopoly pricing is more profitable to producers than competitive pricing, a producer with market power can further increase its profits by engaging in price discrimination. Price discrimination entails charging a higher price to consumers with a high willingness to pay and a lower price to consumers with a low willingness to pay.³⁶

Economists distinguish between three types of price discrimination: first degree, second degree, and third degree.³⁷ For ease of exposition, we start by explaining first degree price discrimination, then take on third degree price discrimination, and conclude with second degree price discrimination.

In first degree, or perfect, price discrimination, a producer charges each consumer a price that extracts all its consumer surplus.³⁸ Perfect price discrimination is thus the most profitable type of price discrimination. To engage in perfect price discrimination, a producer has to know the demand function of each consumer. As producers are unlikely to possess such knowledge, perfect price discrimination is better viewed as a benchmark for evaluating other pricing schemes than as a real-world practice.³⁹

³⁶ Price discrimination is distinguishable from regular price differences that exist in competitive markets is that price discrimination results in the sale of similar goods at prices that are in different ratios to marginal costs of production. See George Stigler, *Theory of Price* __ (1987).

³⁷ Our discussion of these pricing schemes follows the traditional classification to first, second, and third-degree price discrimination. See A.C. Pigou, *The Economics of Welfare* __ (4th ed. 1920). Accessible discussions of the literature on price discrimination can be found in Jean Tirole, *The Theory of Industrial Organization* 133-52 (1988); Carlton & Perloff, *supra* note __, at 431-82.

³⁸ In markets where consumers purchase no more than one unit of the good, like the market for corporate charters, this is done by charging to each consumer a price equal to the personal surplus from consumption of a single unit. When consumers choose not only whether to purchase the good, but also how many units to purchase, the profit-maximizing strategy is to set the price per unit equal to marginal cost, and charge to each consumer an additional lump sum equal to its surplus. This drives consumers to purchase exactly the same quantity of the good they would purchase in a competitive market, but leaves them with none of the surplus. [cite]

³⁹ Examples that have been argued to come close to perfect price discrimination are to be found in the aircraft industry, where the small number of buyers and high cost of producing each unit of the product both

Third degree price discrimination is essentially an imprecise version of perfect price discrimination. The condition for third degree price discrimination is that the producer be able to divide consumers into groups with average different willingness to pay on the basis of some exogenous signal. Unlike perfect price discrimination, however, the producer cannot distinguish between consumers within the same group.⁴⁰ The producer then charges a uniform low price to consumers in the low-willingness-to-pay group, and a uniform high price to those in the high-willingness-to-pay group.⁴¹ For example, a museum may know that students generally have a lower willingness to pay for admission than other adults, and offer discounted student admission.

In second degree price discrimination, the producer also knows that a certain group of consumers has a higher willingness to pay than another. Unlike the case of third degree price discrimination, however, the producer cannot tell to which group an individual consumer belongs. An airline, for example, may know that business travelers have a higher willingness to pay than leisure travelers, but does not know whether a particular flyer is a business or leisure traveler. To distinguish between different groups of consumers, the producer can offer different product packages that will induce each consumer to select the package targeted to its type. For example, the airline can offer a lower round-trip fare if for passengers that stay over a Saturday night. Since leisure travelers, unlike business travelers, rarely mind staying over a weekend, this device enables the airline to charge a higher price to business than to leisure travelers.⁴²

3. Applicability to the Market for Incorporations

makes individualized bargaining and pricing worthwhile, or in the individualized prices railroads charge for identical freights intended for different uses. See Louis Philips, *The Economics of Price Discrimination* 158 (1983). For a study suggesting that [county?] doctors employ perfect price discrimination, see Reuben Kessel, *Price Discrimination in Medicine*, 1 *J.L. & Econ.* 20 (1958).

⁴⁰ Specifically, since differences between members of each group are unobservable, the producer ignores them in its pricing and treats each group as a separate market

⁴¹ See, e.g., Tirole, *supra* note __, at __.

⁴² In this case, business travellers are given a quantity discount that induce them to purchase the unrestricted air tickets rather than the cheaper tickets. See generally Michael Mussa & Sherwin Rosen, *Monopoly and Product Quality*, 18 *J. Econ. Theory* 301 (1978). An equivalent method of second degree price discrimination is by offering quantity discounts, which induce consumers with a high willingness to pay to purchase more of the good. [cite]

Since Delaware has market power in the market for incorporations, it may be able to derive higher profits if it engages in price discrimination, rather than charges a uniform price to all firms incorporating in Delaware. To engage in effective price discrimination, a producer must be able to limit resale by consumers paying the lower price to those who would pay the higher price, and have some ability to distinguish between consumers according to their willingness to pay. The first condition for price discrimination -- the ability of a producer to limit resales -- is clearly met in the incorporation market since Delaware has full control over who becomes a Delaware corporation. How Delaware distinguishes among corporations according to their willingness to pay is analyzed in the next Part.

II. How Delaware Price Discriminates

In this Part, we examine two ways in which Delaware relies on its dominant position in the market for incorporations to engage in price discrimination. First, Delaware employs a schedule of franchise tax that results in higher charges to publicly traded companies than to nonpublic companies. Moreover, among public companies, larger companies, and companies with a higher ratio of authorized to issued shares, pay a higher tax than smaller companies, and companies with a lower ratio of authorized to issued shares. Second, the structure of Delaware's corporate law generates a heightened level of litigation.

This further increases the costs to firms that are more involved in legal disputes, and the profits Delaware derives from these firms. The status of a company as publicly traded, its size, the relative number of unissued shares, and the degree of its involvement in legal disputes are all proxies for the value it assigns to a Delaware incorporation. By charging a higher price to firms that value a Delaware incorporation more highly, Delaware engages in third degree price discrimination.

A. Price Discrimination Through Franchise Tax

In this Section, we examine Delaware's franchise tax. After showing that the structure of Delaware's franchise fee is unique, we argue that it results in higher charges to firms that value incorporation in Delaware more highly. The design of Delaware's franchise tax, its uniqueness, and its effect strongly suggest that it is intended to effect price discrimination.

1. The Uniqueness of Delaware's Franchise Tax

Annual franchise taxes are the most significant charges states levy on

incorporated firms.⁴³ Most states employ one of two methodologies to determine the amount of annual franchise taxes a corporation must pay. First, twenty states and the District of Columbia charge corporations a flat annual fee, ranging from \$10 to \$200, with a median rate of \$31.25. The annual cost of incorporating in these states is thus

⁴³ States also charge companies initial incorporation fees as well as fees for specific services the state provides. These fees, however, tend not to result in substantial revenues. Thirty states charge flat initial incorporation fees (ranging from \$50 to \$300 and with a median fee of \$95) and an initial filing fee payable by a foreign corporation that is at least as high. Twenty states and the District of Columbia charge incorporation fees based on the number of authorized shares or the amount of authorized stated capital. For many of these states, even corporations with a large number of shares pay relatively small initial charges, though the some the fee could be substantial. For example, Ohio (which assesses the highest fee) would charge a company with 100 million authorized shares a fee of \$252,600. Even this fee is small, however, compared to Delaware's \$150,000 annual franchise tax payable by companies with 30 million shares of authorized stock. See 1 Corporation Practice Guide [page numbers], at ¶¶10,001--10,061 (1998).

In addition to these fees, which are payable by chartered firms, states also charge corporate income taxes to firms conducting business in their jurisdiction. Since corporate income taxes are unaffected by the question where the firm is chartered, they are unrelated to our discussion. [cite]

insubstantial.⁴⁴ Second, twenty-three states base their franchise tax on the portion of some measure of the company's value (such as assets, equity, or income) that is attributed to business activity conducted instate, and charge foreign corporations conducting business instate an

⁴⁴ Moreover, each of these states charges its chartered companies an annual fee that is either the same as or lower than the fee it charged to companies that do business instate but are chartered elsewhere. Thus, for a company that conducts business in one of these states, there is no additional cost to incorporating in that state. The table below presents a listing of states and the annual fees charged to domestic and foreign corporations.

States with Fixed Annual Franchise Fees

State	Fee to Domestic Firm	Fee to Foreign Firm
Alaska	50	100
Arizona	45	45
Colorado	31.25	125
Connecticut	75	300
District of Columbia	100	100
Florida	150	150
Hawaii	25	25
Indiana	30	30
Iowa	30	30
Maryland	140	140
Michigan	15	15
Montana	10	10
New Jersey	200	200
New Mexico	50	50
North Dakota	25	25*
Oregon	30	220
South Dakota	10	10*
Utah	10	10
Vermont	15	100
Washington	50	50
Wisconsin	25	50

* Foreign companies pay additional fee based on number of authorized or issued shares.

Source: 1 Corporation Practice Guide [page numbers], at ¶¶10,001-10,061 (1998).

equivalent fee.⁴⁵ Since domestic and foreign corporations are taxed equally on the in-state portion of their tax base, corporations face no additional cost to incorporating in one of these states.⁴⁶

The seven remaining states -- Alabama, Delaware, Georgia, Nebraska, Rhode Island, Virginia, and West Virginia -- employ methodologies which

⁴⁵ Some of the states employing this method also charge a small annual flat fee. The table below lists the states employing this methodology, their tax base, and their allocation method.

States with Apportioned Annual Franchise Fees

State	Tax Base	Apportionment Method
Arkansas	Capital Stock	Property
California*	Income	Property/Payroll/Sales
Idaho*	Income	Property/Payroll/Sales
Illinois	Paid-In Capital	Property and Business
Kansas	Equity	"Attributable to"
Kentucky	Capital	Property/Payroll/Sales
Louisiana	Equity	Sales and Property
Maine*	Income	Property/Payroll/Sales
Massachusetts	Property and Income	Property/Payroll/Sales
Minnesota*	Income	Property/Payroll/Sales
Missouri	Capital	Property
Mississippi	Equity	Property and Receipts
Nevada	Employees	Employees
New Hampshire	Income	Compensation/Interest/Dividends
New York	Income and Capital	Property and Payroll
North Carolina	Equity	Property/Payroll/Sales
Ohio	Income or Value	Property and Business
Oklahoma	Capital	Property and Business
Pennsylvania	Capitalized Income	Property/Payroll/Sales
South Carolina	Capital	Property/Payroll/Sales
Tennessee	Equity	Property/Payroll/Sales
Texas	Capital	Receipts
Wyoming	Assets	Assets

* Annual franchise tax is equivalent to corporate income tax.

Source: 1 Corporation Practice Guide [page numbers], at ¶¶10,001- 10,061 (1998).

⁴⁶ For example, Arkansas charges an annual franchise tax of 0.27% on a corporation's capital stock, multiplied by the ratio of the corporation's property in Arkansas to the corporation's total property. See Corporation Practice Guide, *supra* note __, at ¶10,014. Since Arkansas corporations and foreign corporations doing business in Arkansas pay this 0.27% tax rate on the portion of their capital stock allocated to Arkansas, the state of incorporation does not affect the tax they pay.

could theoretically result in higher annual fees to a domestic than a foreign corporation.⁴⁷ However, in each of these states, with the exception of Delaware, this difference is likely to be modest. In four states, the annual franchise tax is capped: Georgia's at \$5000, Nebraska's at \$11,995, Virginia's at \$850, and West Virginia's \$2500.⁴⁸

Rhode Island's tax, while uncapped, is very low. For example, a company with 100 million authorized shares with a par value of \$0.1 would pay an annual tax of \$237.50. Alabama's tax is uncapped and set at a fairly high rate. But since the tax is based on the aggregate par value of the company's capital stock, companies can avoid paying a large fee by assigning a small par value to their shares. For example, while a company with of 100 million authorized shares with a par value of \$0.1 would pay a tax of \$100,000, the tax would decline to \$10,000 if the par value is \$0.01 rather than \$0.1.

This leaves Delaware. Delaware corporations calculate their annual franchise taxes in two ways, the actual tax payable being the lower of the resulting two figures.⁴⁹ The first basis for the annual franchise tax is the number of authorized shares. For corporations with more than 10,000 authorized shares, the fee amounts to \$90 for the first

⁴⁷ Alabama, Georgia and Nebraska, allocate the tax base only when determining the tax payable by foreign companies. Domestic corporations pay tax based on their total capital (Alabama and Nebraska) or net worth (Georgia), although Nebraska charges a lower percentage tax rate to domestic companies than to foreign ones. See Corporation Practice Guide, *supra* note __, at ¶¶10,011, 10,021, 10,038). West Virginia charges two types of annual taxes: the first allocates the tax base to business activity conducted instate and to that conducted elsewhere, and taxes domestic and foreign firms equally on the instate portion of the tax base; the second, on stated capital, resembles the tax charged by Nebraska. See *id.* at ¶10,059. (In the case of Nebraska and West Virginia, only companies that conduct relatively little business in the state would face an additional charge to incorporating in the state. Companies that conduct a lot of business in the state would pay less if they are incorporated in the state since the tax rate for domestic companies is lower than the rate for foreign companies.) Rhode Island charges domestic and foreign companies a fee based on the authorized capital. See *id.* at ¶10,050. Virginia charges domestic and foreign corporations an annual fee based on the number of authorized shares. See *id.* at ¶10,057. (These fees represent additional costs to firms that are chartered in Rhode Island or Virginia without conducting business in those states.

⁴⁸ See *id.* at ¶¶10,021, 10,038, 10,057, 10,059. West Virginia's cap applies only to the latter tax. See *id.* at ¶10,059.

⁴⁹ See Delaware General Corporation Law, Del. Code Ann. tit. 8, § 503(a) (1991).

10,000 shares plus \$50 for each additional 10,000 shares.⁵⁰ The second basis for the annual franchise tax is the so-called "assumed par value capital" (APVC) of the firm. Ordinarily, the APVC is the product of two figures: the assets of the company; and the ratio of authorized to issued shares.⁵¹ For companies with an APVC that exceeds \$1 million, the fee is \$200 for the first \$1 million plus \$200 for each additional \$1 million in APVC. The maximum fee is \$150,000 per year. Foreign companies pay a flat filing fee of \$50 per year.⁵²

Delaware's method of assessing annual franchise taxes is thus unique in two respects. First, Delaware is the only state where the additional charge for incorporating will often to be substantial. The marginal fee for incorporating in Delaware can go up to \$149,950. This maximum marginal fee would be payable by any corporation that has more than 30 million authorized shares and an APVC above \$750 million. As we discuss below, a large number of public companies satisfy these criteria.⁵³ No other state regularly charges a marginal fee in nearly that magnitude.

Second, no state but Delaware uses a system where the annual franchise tax is the lower of two figures: one based on the number of authorized shares, and the other on the unusual combination of total assets and the ratio of authorized to issued shares. Indeed, only two states, Virginia and West Virginia, base their tax on the number of authorized shares, and none use any variable resembling Delaware's APVC.⁵⁴

⁵⁰ See Delaware General Corporation Law, Del. Code Ann. tit. 8, § 503(a)(1) (1991). Firms with more than 3000, but not more than 5000, authorized shares pay \$50, and firms with more than 5000, but not more than 10,000, authorized shares pay \$90. See *id.* Additionally, Delaware companies pay a filing fee of \$20. See *id.* at §__.

⁵¹ See Delaware General Corporation Law, Del. Code Ann. tit. 8, § 503(a)(2) (1991). If the firm has shares with a par value that is higher than the firm's gross assets divided by the number of issued shares, the APVC of these shares is the number of authorized shares times their par value. See *id.* This scenario, however, is uncommon. Since the par value of the shares has no economic significance, firms typically set it at a very low level, if only to economize on franchise tax expenditures. Similarly, the calculation of APVC by companies with no par value shares is different from that described in the text. See *id.* In practice, however, this type of shares is rare.

⁵² See Delaware General Corporation Law, Del. Code Ann. tit. 8, § 391(a)(8) (1991).

⁵³ See *infra* TAN.

⁵⁴ See *supra* TAN.

2. Delaware's Franchise Tax and Price Discrimination

In this Section, we argue that the peculiar tax schedule that Delaware employs is designed to price discriminate between corporations that assign a high value to being incorporated in Delaware and corporations that assign a low value to being incorporated in Delaware. We first examine the incidence of Delaware's franchise tax for different types of firms. We then show how this incidence results in third degree price discrimination.

(a) The Incidence of Delaware's Annual Franchise Tax

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

These criteria assure, for one, that nonpublic companies have to pay only minimal annual franchise taxes. Companies with 3000 or fewer authorized shares pay the minimum fee of \$30, regardless of their APVC.⁵⁵ Virtually all nonpublic companies can achieve any desired equity allocation among their owners with 3000 shares.⁵⁶ Thus, there is no business reason why they would have to pay more than the minimum fee.⁵⁷

Companies with publicly traded shares, by contrast, have a number of authorized shares and an APVC that yields a substantially higher franchise tax. Public companies need a large number of outstanding shares to create a wide distribution of share ownership and thus a liquid public market. A liquid public market, of course, is one of the main benefits of being publicly traded.⁵⁸ The necessary number of outstanding shares is further increased by the fact that shares are

⁵⁵ See Delaware General Corporation Law, Del. Code Ann. tit. 8, § 503(a) (1991).

⁵⁶ [cite book on business planning]

⁵⁷ Moreover, nonpublic companies do not need to have a substantial number of authorized but unissued shares to raise new capital or finance acquisitions. First, nonpublic companies generally do not raise new capital or finance acquisitions by issuing new shares (except, of course, when they go public). Second, even if they wanted to issue additional shares, nonpublic companies can easily obtain shareholder approval for a charter amendment increasing the number of authorized shares.

⁵⁸ See Yakov Amihud & Haim Mendelson, Liquidity, Asset Prices and Financial Policy, *Fin. Analysts J.*, Nov.-Dec. 1991, at ___.

traded in blocks of 100.⁵⁹ Finally, public companies often have a substantial number of authorized but unissued shares, which can be used to raise new capital or fund acquisitions without having to obtain shareholder approval.⁶⁰

Public companies also have a large APVC. Recall that the APVC is in most cases the product of the company's assets multiplied by the ratio of authorized to issued shares. Even for a company that has issued all of its authorized shares, the APVC is at least as high as the company's assets, which are typically much greater in public companies than in nonpublic ones. Moreover, as we noted above, public companies often have a large number of unissued authorized shares, further increasing their APVC relative to that of nonpublic companies.

To place the fees payable by public companies in perspective, we calculated the franchise tax payable by a random sample of Delaware companies the stock of which is listed on the New York Stock Exchange, traded on NASDAQ National Market, and traded over the counter (OTC).

This method of data selection ensured that our sample spans the spectrum of firm sizes for public companies, since New York Stock Exchange companies tend to be larger than NASDAQ companies, and the latter tend to be larger than OTC companies. As Table 1 shows, the annual franchise taxes payable by public companies are multiple orders of magnitude above the minimum tax of \$30. Indeed, most Delaware companies listed on the NYSE pay the maximum franchise tax of \$150,000 a year, and hardly any companies listed on the New York Stock Exchange or traded on the NASDAQ National Market pay less than \$10,000 in franchise tax. Even unlisted companies traded only over the counter pay on average over \$20,000 in annual franchise taxes.

Table 1: Franchise Tax Estimates of Companies by Listing

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

Most of Delaware's franchise tax revenues, in turn, originates from publicly traded companies. As of 1997, between 10,000 and 12,000 United States companies had publicly traded stock, of which 3000 were traded on the New York Stock Exchange, 4200 on the NASDAQ National

⁵⁹ See John M. Dalton, How the Stock Market Works 74 (1988).

⁶⁰ [cite to proxy solicitation statement]

Market, 800 on the NASDAQ SmallCap market, 750 on the American Stock Exchange, and the remainder on regional exchanges or over the counter.⁶¹ In fiscal 1997, Delaware received \$314 million in annual franchise tax revenues from 5050 firms paying \$10,000 or more. To pay at least \$10,000 in annual franchise taxes, a company must have had at least 1.99 million authorized shares and at least \$50 million in APVC. Thus, virtually all firms that paid such franchise taxes should have been publicly traded corporations. By contrast, revenues from the 211,600 firms that paid less than \$10,000, most of which are nonpublic, were only \$35 million.⁶²

(b) Price Discrimination

The unusual incidence of Delaware's franchise tax -- where public companies pay a much higher tax than nonpublic companies and, among the former, corporations with more assets and a higher ratio of authorized to issued shares pay a higher tax than corporations with fewer assets and a lower ratio -- is the earmark of price discrimination. Consider first the distinction between public and nonpublic corporations. Charging public corporations a higher tax than nonpublic corporations is an effective method for third degree price discrimination because the value of a Delaware incorporation is substantially higher for public corporations than for nonpublic ones.

Indeed, all of the competitive advantages that Delaware enjoys over other states are more meaningful to public companies. First, public corporations are more likely than nonpublic ones to benefit from Delaware's expert judiciary because they are more likely to be involved in corporate disputes.⁶³ Many nonpublic corporations have only a single shareholder. Such companies are rarely involved in corporate disputes, which mostly concern conflicts among shareholders or conflicts between dispersed shareholders and managers. And even compared to nonpublic

⁶¹ About 13,200 companies were required to file annual reports with the Securities and Exchange Commission. See *Directory of Companies Required to File Annual Reports with the Securities and Exchange Commission* (1997). This figure, however, includes some foreign companies and companies that have publicly traded securities other than stock. For data on companies listed on the various markets, see <http://www.nasd.com/mr3a.html> and <http://www.nasd.com/mr3b.html>.

⁶² See *infra* Table 3.

⁶³ If a corporation incorporates in Delaware, Delaware courts will have jurisdiction over disputes arising under Delaware corporate law. See Del. Code Ann. tit. 10, §§3113, 3114 (1991). A plaintiff, however, can also bring a corporate dispute in another court as long as that court has subject matter and personal jurisdiction.

companies with more than one shareholder, public companies, which have thousands of shareholders and the potential to be subject to entrepreneurial class and derivative actions, are more likely to be involved in corporate disputes.⁶⁴

At this point, it bears mention that most of Delaware's corporate litigation concerns public companies. For example, out of 78 Delaware Chancery Court opinions on corporate law that were decided in 1990, 65 involved public corporations, and only 13 involved nonpublic corporations.⁶⁵ Thus, even though less than 5 percent of Delaware corporations are public, public companies accounted for over 80 percent of the opinions related to corporate law. Put differently, the likelihood for a public corporation to be involved in one of these cases was more than 80 times higher than the respective likelihood for a nonpublic corporation.

Second, public corporations are more likely than nonpublic ones to benefit from Delaware's highly developed case law and from the ease of obtaining legal advice on Delaware law. The legal problems facing public corporations differ from those facing nonpublic corporations. For example, the rules on hostile takeovers are significant only to public corporations. And even though both public and nonpublic corporations may face problems of self-dealing, the factual context of the self-dealing and the availability of cleansing devices, such as approval by disinterested directors, differ greatly. The product of many years of litigation involving predominantly public corporations, Delaware case law relates mostly to these firms and thus is more valuable to them.⁶⁶ Similarly, that most national law firms have

⁶⁴ Public companies are also more likely than nonpublic ones to benefit from Delaware's expert judiciary because they are larger. The effect of firm size on its benefit from quality adjudication is discussed *infra* TAN.

⁶⁵ In the same year, all six opinions related to corporate law that were decided by the Delaware Supreme Court involved public corporations. These figures were obtained from a review of all 105 opinions dated 1990 in the DE-CS Westlaw database that contain the search term "Chancery". Twenty-one documents were excluded because they were not related to corporate law or were summary affirmances. The database includes both reported and unreported opinions.

⁶⁶ See *supra* TAN; see also Tara J. Wortman, Note, Unlocking Lock-Ins: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes, 70 N.Y.U. L. Rev. 1362, 1374-79 (1995) (arguing that rules well suited for public corporations, such rules giving high degree of deference to management, can have adverse effects on nonpublic corporations); Barry D. Baysinger & Henry N. Butler, The Role of Corporate Law in the Theory of the Firm, 28 J.L. & Econ. 179 (1985) (describing specialization among state corporate laws); Richard A. Posner

specialized in Delaware law is more important to public than to nonpublic corporations, since their expertise relates to disputes involving public corporations.

Third, only public corporations are likely to derive significant benefits from the familiarity of investors, traders, and analysts with Delaware corporate law. Such familiarity makes it is easier for companies to sell, and for investors to trade, shares governed by Delaware law than by the law of another state.⁶⁷ For nonpublic companies, the shares of which are not traded, the familiarity of the financial community with Delaware law is irrelevant.

Finally, Delaware's commitment to remain responsive to corporate needs is relevant mostly to public firms. The commitment of the state to corporate needs is important inasmuch as companies incur costs in changing their state of incorporation. Commentators differ about the extent and impact of these costs with respect to public firms.⁶⁸ With respect to nonpublic firms, however, it is clear that most would incur only trivial costs in changing their state of incorporation and thus should place no significant value on Delaware's commitment.

Empirical evidence confirms that public companies value Delaware law more than nonpublic companies. Delaware is the state of incorporation for about half of the public companies in the United States, but only about 6 percent of nonpublic companies.⁶⁹ That Delaware's market share among public companies substantially exceeds its share among nonpublic companies, even though Delaware charges public companies a much higher franchise tax than nonpublic companies, suggests that a Delaware incorporation is more valuable to public companies.⁷⁰

& Kenneth E. Scott, *Economics Of Corporation Law And Securities Regulation* [111? 511?] (1980) (same). Arguably, the expertise of Delaware's judiciary is also to some extent specific to disputes involving public corporations.

⁶⁷ See Klausner, *supra* note __, at 785-789 (discussing network benefits related to familiarity with corporate contract terms); Kahan & Klausner, *Economics of Boilerplate*, *supra* note __, at 727 (discussing learning and network benefits related to familiarity with corporate contract terms).

⁶⁸ See *supra* note __.

⁶⁹ See *Statistical Abstract of the United States*, Tables 855 and 877 (reporting United States incorporations data), [cite]; 1997 *Incorporating Statistics*, *The Corporate Edge*, Spr. 1998, available in <www.state.de.us/corp/graphs97.htm> (reporting Delaware incorporations data). Indeed, many companies change their state of incorporation to Delaware shortly before they go public. See Romano, *supra* note __, at 252.

⁷⁰ Given Delaware's extremely high profit margin, see *supra* TAN, it is evident that Delaware's franchise tax rates are not based on Delaware's costs

For similar reasons, among public corporations, the value of incorporation in Delaware increases with the size of the company.

Principally, larger public companies benefit more from Delaware's developed law and its expert judiciary because they tend to be involved more in corporate legal disputes.⁷¹ Table 2 presents data on the frequency of corporate lawsuits from 1989 to 1998 by public companies participating in the Towers Perrin Directors and Officers Liability Survey.⁷² As Table 2 shows, the frequency of corporate litigation for the largest public firms is about 15 higher than the frequency for the smallest public firms. In a Chi-square test, the differences in the average number of lawsuits are significant at a 1 percent level.

Moreover, the stakes of legal disputes -- and the corresponding benefits of litigating in Delaware -- are likely to be higher for larger corporations than for smaller ones.

Table 2: Frequency of Corporate Lawsuits Among Public Firms

Total Assets (in \$1 millions)	Number of Firms	Number of Firms Involved in Litigation	Percentage of Firms Involved in Litigation	Number of Lawsuits	Average Number of Lawsuits Per Firm
assets # 100	236	4	1.7	4	0.017
100 < assets # 400	156	4	2.6	4	0.026
400 < assets # 1000	123	9	7.3	10	0.081

in servicing public and nonpublic corporations.

⁷¹ Arguably, larger public companies also derive higher benefits from investors' familiarity with Delaware law (since they have fewer investors), from Delaware's commitment (since obtaining shareholder approval for a reincorporation is more costly), and from lawyers' familiarity with Delaware law (since they are more likely to retain the services of national law firms).

⁷² To focus on lawsuits arising under state corporate law, the data include only shareholder lawsuits, brought in federal or state court, that were characterized by surveyed companies as relating to golden parachute or executive compensation; repurchase or bid to repurchase securities; breach of duty to minority shareholders; general breach of fiduciary duty; and shareholder suits, other than suits brought exclusively in federal courts, that relate to challenge to takeover defense measure; bid or threat by another company to take over the surveyed company; bid or threat by the surveyed company to take over another company; merger and acquisition where the surveyed company is the survivor; merger and acquisition where another company is the survivor; and divestiture or spinoff. For additional information on the survey, see Towers Perrin, 1998 Directors and Officers Liability Survey: U.S. and Canadian Results 8-9, 62-72 (1999).

1000 < assets # 2000	118	18	15.3	21	0.178
2000 < assets	235	34	14.5	57	0.243

Source: Mark Larsen, Tillinghast -- Towers Perrin

In addition, large public companies benefit from Delaware's rich body of precedents and readily available legal advice more than small public companies because the size [and number] of the transactions they undertake is typically higher. The large stakes involved in their operation induce large public companies to avail themselves of the services of pricy national law firms more often, and the value added to their stock from using that advice tends to be higher.⁷³

Consistent with these arguments, empirical evidence indicates that larger public corporations are at least as likely to incorporate in Delaware as smaller public corporations, even though they face higher annual franchise taxes.⁷⁴ This, again, shows that larger public companies value a Delaware incorporation more highly than smaller ones. By charging a higher franchise tax to larger public companies than to smaller companies, Delaware engages in third degree price discrimination.

Lastly, public companies with a higher ratio of authorized to issued shares value a Delaware incorporation more than those with a lower ratio. The principal reason why public firms would have authorized but unissued shares is to be able to raise capital in a second offering or to finance a stock for stock acquisition without having to obtain shareholder approval.⁷⁵ Empirical evidence shows that firms planning acquisitions value Delaware law more highly than others. According to Roberta Romano, the initiation or expansion of a mergers and acquisitions plan is the most common reason why public companies reincorporate in Delaware.⁷⁶ Moreover, of the companies that

⁷³ The commitment of Delaware to continued responsiveness to corporate needs may also be worth more to large public corporations than to small public corporations to the extent that the costs of reincorporation increase in firm size.

⁷⁴ See Daines, *supra* note __, at __.

⁷⁵ Another use for authorized and unissued shares is to structure a poison pill. However, a relative small number of blank-check preferred stock is sufficient to structure an effective pill. See Coates, *An Index of the Contestability of Corporate Control*, *supra* note __. [discuss use of shares for white knight]

⁷⁶ See Romano, *supra* note __, at 256 (finding that this reason accounts for 35% of the reincorporations into Delaware that are not related to a public offering).

reincorporate as part of a mergers and acquisitions plan, 95 percent move into Delaware. By comparison, only 71 percent of the total number of reincorporating companies, and 89 percent of the companies reincorporating in preparation for a public offering of securities, choose Delaware as their destination. This evidence suggests that a Delaware incorporation is particularly valuable for public companies that plan mergers and acquisitions, which tend to have a higher ratio of authorized to issued shares.⁷⁷

In conclusion, all three factors that determine the franchise tax a company must pay in Delaware are related to the value it places on a Delaware incorporations. Public companies value a Delaware incorporation more highly, and pay a higher franchise tax, than nonpublic companies. Larger public companies value a Delaware incorporation more highly, and pay a higher franchise tax, than smaller public companies. And public companies with a higher ratio of authorized to issued shares value a Delaware incorporation more highly, and pay a higher franchise tax, than companies with a lower ratio. In each case, Delaware's franchise tax structure tracks some imperfect proxy for the need for corporate law, and thus constitutes third degree price discrimination.⁷⁸

B. Price Discrimination Through Increased Litigation

In this Section, we argue that the structure of Delaware law leads to a high level of litigation which, in turn, has a price discriminatory effect. Specifically, we claim that Delaware law increases litigation because it is based on standards requiring judicial application after the fact; because these the standards it employs are fact intensive; because it is fraught with ambiguities concerning which legal test applies; and because its precedents are narrow.

We do not suggest, of course, that Delaware judges intentionally

⁷⁷ [address 20% issue]

⁷⁸ Conceptually, Delaware may also be viewed as engaging in second degree price discrimination which, in contrast to third degree price discrimination, is premised on inducing consumers to self select rather than imposing on them different prices. After all, firms choose by themselves whether to go public, how many assets to hold, how many shares to issue, and what ratio of authorized to issued shares to retain. However, since the economic implications of these decisions seem to dwarf their franchise tax implications, firms cannot realistically be expected to adjust their behavior in order to reduce tax liability. Tailoring the costs of incorporation to these firm characteristics is thus best analyzed as a case of third degree price discrimination.

instituted these features to increase the state's profits.⁷⁹ Rather, our claim is more limited. On the positive side, we argue that Delaware corporate law fosters litigation, that Delaware profits from handling corporate litigation in its courts, and that the cost of this litigation falls primarily on firms that value Delaware law most. On the analytical side, we argue that this structure falls squarely within the contours of price discrimination. Even if the system was not created for that purpose, the fact that it has this effect may well have made it easier for the litigation-intensive system to persist.

1. Delaware Law and the Level of Litigation

(a) Use of Fact-Intensive and Standard-Based Tests

Delaware corporate law tends to rely on fact-intensive, standard-based tests. By fact-intensive, we mean that Delaware law considers a wide array of factual circumstances relevant to the resolution of legal disputes. As a result, Delaware law is factually complex. By standard-based, we mean that the relation between a certain set of facts and the outcome of a legal dispute is determined *ex post*, through judicial interpretation of standards, rather than *ex ante*, through promulgation of rules.⁸⁰

Commentators are in wide agreement that Delaware law is fact intensive and standard based.⁸¹ To illustrate this aspect of Delaware law,

⁷⁹ For other factors that may motivate judges in general and Delaware judges in particular, see Kamar, at 1940-43; Richard A. Posner, *What Do Judges and Justices Maximize? (The Same Thing Everybody Else Does)*, 3 *Sup. Ct. Econ. Rev.* 1 (1993); Frank H. Easterbrook, *What's So Special About Judges?*, 61 *U. Colo. L. Rev.* 773, 775-78 (1990). [It important to note in this regard that judges decide cases based on arguments presented by litigants. Legal counsel for parties to corporate disputes, whose benefit from litigation is evident, thus have direct influence on court decisions.]

⁸⁰ See Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 *Duke L. Rev.* 557 (1992); see also Colin S. Diver, *The Optimal Precision of Administrative Rules*, 93 *Yale L.J.* 65, 67-68 (1983); Isaac Ehrlich & Richard A. Posner, *An Economic Analysis of Legal Rulemaking*, 3 *J. Legal Stud.* 257, 258-59 (1974); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 *Harv. L. Rev.* 1685, 1687-88 (1976).

⁸¹ See Bebchuk & Ferrell, *supra* note __, at __ ("uncertainty tilt"); Bernard Black & Reinier Kraakman, *Path-Dependent Competition for Corporate Charters: Manager Choice, Shareholder Veto* 7 (unpublished manuscript, Apr. 1999, on file with authors) (describing Delaware law as "vague" and "litigation-intensive"); John Coates IV, "Fair Value" as an Avoidable Rule in Corporate Law: Minority Discounts in Conflicts transactions, 107 *U. Pa. L. Rev.* 1251, 1287 (1999) (labeling Delaware law on minority discounts in appraisal proceedings as "a mess"); Klausner, at 776; Kamar, *supra* note __, at __; Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law*

consider the entire fairness test.⁸² The entire fairness test is one of the most important features of corporate law, and applies, at least initially, to all self-dealing transactions.⁸³ Here is the classic

statement of the test:

The concept of fairness has two basic aspects: fair dealing and fair price. The former embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained. The latter aspect of fairness relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. . . . However, the test for fairness is not a bifurcated one as between fair dealing and price. All aspects of the issue must be examined as a whole since the question is one of entire fairness.⁸⁴

Work?, 44 UCLA L. Rev. 1009, 1015 (1997) (claiming that Delaware corporate law is made up of "fact-intensive, normatively saturated descriptions" of conduct and "of process-descriptions that are not reducible to rules"); William T. Allen, *Ambiguity in Corporation Law*, 22 Del. J. Corp. L. 894, 903 (1997) (noting the practice of contextualism suffuses Delaware's corporate jurisprudence). [cite practitioners]

Admittedly, the Delaware General Corporation Law regulates some aspects of corporate law with a fair amount of detail. For example, it contains detailed and precise rules on how to perfect appraisal rights. See Delaware General Corporation Law, §262. However, even where the code contains relatively precise language, Delaware courts have not necessarily followed the code when they found the results objectionable. See, e.g., *Weinberger v. UOP*, 457 A.2d 701 (Del. 1983) (adopting non-literal interpretation of §262(h)); *Speiser v. Baker*, 525 A.2d 1001 (Del. Ch. 1987) (adopting non-literal interpretation of §161(c); *Schnell*, [cite]. For an example of a corporate legal regime that offers clarity where Delaware law does not, see *City Code on Takeovers and Mergers*, in Peter F.C. Begg, *Corporate Acquisitions and Mergers: A Practical Guide to the Legal, Financial, and Administrative Implications* ___ (3d ed. 1991) (setting rules governing the behavior of bidders and targets in takeovers); *Bebchuk & Ferrell*, manuscript at 40 (praising the clarity that these rules afford, and contrasting it with the uncertainty in Delaware takeover jurisprudence). [footnote in the normative implications part commentators who think the law is too fuzzy]

⁸² For additional examples of fact-intensive standards in Delaware law, see *Kamar*, supra note __, at 1915-17.

⁸³ The entire fairness test technically also applies in cases involving the duty of care, if the plaintiff has proven that the directors had been grossly negligent. See *Cede & co. v. Technicolor, Inc.*, [cite]

⁸⁴ *Weinberger*, __ A.2d at __.

The entire fairness test thus involves a multi-factor, multi-dimensional balancing test. What constitutes fair price depends on multiple factors. What constitutes fair dealing depends on multiple factors. And the relationship between the fair price and the fair dealing prong -- "not a bifurcated one", but rather "examined as a whole" -- approaches the transcendental.⁸⁵

(b) Ambiguity About the Applicable Legal Test

A related feature of Delaware corporate law is the tendency to be ambiguous in explaining which legal test applies to which context.⁸⁶ Sometimes this ambiguity is due to two seemingly conflicting statements in the same opinion (intra-decisional ambiguity); sometimes it is due to statements in one opinion contradicting seemingly clear statements

⁸⁵ Alternatives to the Delaware approach abound. For example, some industrialized countries rely on mandatory approval by a defined portion of the disinterested shareholders instead of judicial review. See, for example, Ontario Securities Commission Policy Statement 9.1 -- Disclosure, Valuation, Review and Approval Requirements and Recommendations for Insider Bids, Issuer Bids, Going Private Transactions and Related Party Transactions, 14 O.S.C.B. 3345 §§ 20, 30-33 (1991) (Canada) [Various changes to this policy are currently under review. Make sure to have the version when it comes out]; London Stock Exchange Listing Rules, § 11.4, available in <http://www.listing.co.uk/oblig/contab07_02.html> (Britain) [Get citation]

⁸⁶ Consider also the opening remarks by Herbert Wachtell in the *QVC* oral argument:

Now I would respectfully submit that this case may be viewed through different prisms of this Court's precedents. It can be viewed as a *Revlon* case. It can be viewed as a *Unocal* case. It can be viewed as a *Household-Barkan* case, involving what are [sic?] the permissible use of a rights plan. It can be viewed as [a] *Van Gorkom-Technicolor* case, having to do with the fundamental duties of due care of a Delaware -- But these, as this Court has emphasized, are not watertight compartments. They all are founded on the same fundamental duties of care and loyalty. And I submit that no matter which of these prisms or combination of prisms this case is viewed through, one reaches the identical conclusion, that the Paramount board, in the face of the \$90 QVC tender offer, could not use Paramount's pill and other corporate mechanisms to block that offer and cram down upon the shareholders the partial front-end loaded Viacom offer, having a far lower market value, and without ever having made a meaningful evaluation of the relative economic values of the two offers.

[cite] In other words, Wachtell believed that identifying the applicable legal standard (if a single one could be identified) was much less important than highlighting the relevant facts. (Consistently, his winning brief devoted 22 of 50 pages to the statement of facts, whereas Paramount's devoted to the facts only 8 of 39 pages.) [cite]

in an earlier opinion (inter-decisional ambiguity).⁸⁷

As an example of intra-decisional ambiguity, consider again the entire fairness test. While the entire fairness test initially applies to all self-dealing transactions, Section 144 of Delaware General Corporation

Law provides that the test changes if the transaction is approved by disinterested directors or shareholders.⁸⁸ Here is the Delaware Supreme Court's recent answer to the question whether the resulting test is the business judgment rule, or the entire fairness test with the burden of proof shifted to the plaintiff.

The Court of Chancery *properly* began its consideration of Section 144 with the following comment:

. . . [A]s construed by our Supreme Court recently compliance with the terms of Section 144 does not restore to the board the presumption of the business judgment rule; it simply shifts the burden to plaintiff to prove unfairness.

And __ paragraphs later:

In *Oberly*, even though Section 144(a) did not apply to the action being contested, this Court relied upon the provisions in that statute to illustrate the general principle that, as to the duty of loyalty, approval of a transaction by a board of which a majority of directors is disinterested and independent "brings it within the scope of the business judgment rule."⁸⁹

Which test the Court endorsed is something of which lower courts remain unsure.⁹⁰

A well-known instance of inter-decisional ambiguity involved an important issue in hostile takeovers: does a change of control shift the test according to which defensive tactics are judged shift from the

⁸⁷ We use the term "inter-decisional ambiguity" because the possibility that a court will retreat from the seeming unequivocal statements in the first opinion renders the applicable legal test ambiguous.

⁸⁸ See Delaware General Corporation Law, Del. Code Ann. tit. 8, § 144 (1991).

⁸⁹ *Cede & Co. v. Technicolor*, [cite].

⁹⁰ See *Cooke v. Oolie*, 23 Del. J. Corp. L. 775 (Del. Ch. 1997) (holding that such an approval shifts the burden of proving fairness); *Lewis v. Voglestein*, 699 A.2d 327 (Del. Ch. 1997) (holding that such an approval reinstates the business judgment rule); *In re Wheelabrator Tech., Inc. Shareholders Litig.*, 663 A.2d 1194 (Del. Ch. 1995) (holding that such an approval reinstates the business judgment rule and remanding for what this means).

less exacting *Unocal* test⁹¹ to the more exacting *Revlon* test?⁹² In 1989, when Paramount tried to acquire Time, the Delaware Supreme Court rejected Paramount's argument that *Revlon* applied as follows: [T]he Chancellor found the original Time-Warner merger agreement not to constitute a "change of control" and concluded that the transaction did not trigger *Revlon* duties. The Chancellor's conclusion is premised on a finding that "[b]efore the merger agreement was signed, control of the corporation existed in a fluid aggregation of unaffiliated shareholders representing a voting majority -- in other words, in the market." The Chancellor's findings of fact are supported by the record and his conclusion is correct as a matter of law. However, we premise our rejection of plaintiffs' *Revlon* claim on different grounds, namely, the absence of any substantial evidence to conclude that Time's board, in negotiating with Warner, made the dissolution or breakup of the corporate entity inevitable, as was the case in *Revlon*.

Under Delaware law there are, generally speaking and without excluding other possibilities, two circumstances which may implicate *Revlon* duties. The first, and clearer one, is when a corporation initiates an active bidding process seeking to sell itself or to effect a business reorganization involving a clear break-up of the company. However, *Revlon* duties may also be triggered where, in response to a bidder's offer, a target abandons its long-term strategy and seeks an alternative transaction also involving the breakup of the company.⁹³ As irony has it, five years later Paramount was the target of a hostile bid by QVC. Even though Paramount had clearly embarked on a change of control before QVC made its bid, it argued, citing *Time*, that it was not subject to *Revlon* duties.⁹⁴ The Delaware Supreme Court disagreed.

After quoting the above passage from *Time*, the Court explained: The Paramount defendants have misread the holding of *Time-Warner*. Contrary to their argument, our decision in *Time-Warner* expressly states that the two general scenarios discussed in the above-quoted paragraph are not the only instances where "*Revlon* duties" may be

⁹¹ See *Mesa Petroleum Corp. v. Unocal Corp.*, 493 A.2d 946 (Del. 1985).

⁹² See *McAndrews & Forbes Holdings, Inc. v. Revlon, Inc.*, 501 A.2d 1239 (Del. 1985); see also Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. Corp. L. 583 (1994).

⁹³ *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140, ___ (Del. 1989).

⁹⁴ See Oral Argument, *Paramount Communications, Inc. v. QVC Network, Inc.* at 39-40 (Justice Veasey: "The September 12th merger agreement did transfer control to Mr. Redstone." Mr. Baskin (counsel for Viacom): "That is correct." Justice Veasey: "No dispute about that.")

implicated. The Paramount defendants' argument totally ignores the phrase "without excluding other possibilities."⁹⁵

A change of control, the Court held, does trigger *Revlon*.⁹⁶

In presenting these examples, we do not mean to join the chorus of commentators who have accused the Delaware Supreme Court of inconsistency.⁹⁷ Rather, we view ambiguity about the applicable legal test as a natural outgrowth of Delaware's fact-intensive and standard-based approach to corporate law. Which test applies is in itself a fact-intensive inquiry. A holding in one case that a certain test applies does not mean that the same test applies in a different case with different facts.

(c) Narrow Breadth of Precedents [footnote?]

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

We do not intend any limitation on the historic powers of the Chancellor to grant such other relief as the facts of a particular case may dictate.⁹⁸

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

⁹⁵ *Paramount Communications, Inc. v. QVC Network, Inc.*, 637 A.2d 34, ___ (Del. 1994).

⁹⁶ *Id.* at ___. [Other examples: Weinberger limit of remedy; *Unocal* other constituents; damages for breach of candor; *Malone v. Brincat*]

⁹⁷ See, e.g., Peter Blackman, *Move Over Delaware! Making New York Incorporation Friendly*, N.Y.L.J., Dec. 16, 1993, at 5 (statement by a law professor that the *QVC* case had "muddied up" legal standards); Randall Mikkelsen, *Paramount, Davis Two-Time Losers in Key Cases*, Reuters Business Rep., Dec. 13, 1993 (*QVC* decision constitutes "break with precedent"). Indeed, one of us has previously argued that the criticism of the Delaware Supreme Court's takeover jurisprudence is undeserved. See Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. Corp. L. 583, 584 (1994).

⁹⁸ *Weinberger v. UOP*

clear.⁹⁹

In my view, our inability to foresee now all of the future settings in which a board might, in good faith, paternalistically seek to thwart a shareholder vote, counsels against the adoption of a per se rule.¹⁰⁰

[T]his case does not involve the validity of a "dead hand" provision of limited duration, and nothing in this Opinion should be read as expressing a view or pronouncement on that subject.¹⁰¹

(d) "The Essence of Delaware Law"

Maybe the best evidence that the examples we presented are not isolated anomalies, but rather characteristic of Delaware law, is the following anecdote, told to us by William Allen, the former Chancellor of Delaware and now a professor in the law and business schools at New York University.

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

⁹⁹ [cite]

¹⁰⁰ *Blasius v. Atlas*, at 661-662

¹⁰¹ *Carmody v. Toll Brothers, Inc.*, 723 A.2d 1180, 1195 n.52 (Del. Ch. 1998). But see *Quickturn Design Sys., Inc. v. Shapiro*, 721 A.2d 1281 (Del. 1998) (holding all dead-hand pills invalid). But then again, winning a proxy fight in the absence of a poison pill does not allow the newly elected directors to automatically accept the dissident's bid, as they are still "required to discharge their unremitting fiduciary duty to manage the corporation for the benefit of [the firm] and its stockholders". *Quickturn*, 721 A.2d at 1292.

came to appreciate fully the force in Sam's exaggerated brevity.

(e) The Effect on the Level of Litigation

Each of the features of Delaware corporate law we discussed has the effect of increasing the level of Delaware litigation. Because the law is fact intensive, there are many potential factual disputes that need to be resolved through litigation. Because the law is standard based and there is uncertainty about which test applies, litigation may ensue even absent factual disputes. And because precedents are narrow, uncertainties are only slowly resolved over time.¹⁰²

Our argument that the structure of Delaware corporate law results in an increased level of litigation may appear to conflict with the widely-held view that Delaware law is more certain and predictable than the corporate laws of other states.¹⁰³ This appearance is mistaken. One important reason why Delaware corporate law is considered -- accurately, in our view¹⁰⁴ -- to be more predictable than those of other states is that Delaware boasts a larger stock of corporate law precedents.¹⁰⁵ Nevertheless, given the substantial body of Delaware corporate law precedents, Delaware law is much less predictable than it could be.

2. Increased Litigation and Price Discrimination

We shall now analyze how a high level of corporate litigation in Delaware results in price discrimination. In the first two Subsections, we examine two ways in which Delaware gains from increased litigation: through indirect fiscal benefits to the state, and through

¹⁰² Delaware complements the fact-intensive nature of its law and the narrow breadth of its precedents with a liberal approach towards director and officer liability insurance and indemnification, negligible court fees, absence of security for expenses, extraterritorial reach, and generous fee awards to plaintiffs' attorney. All of these features further encourage litigation. See __

¹⁰³ For pronouncements of this perception, see Roberta Romano, Law as Product, *supra* note __, at 273-281; Roberta Romano, The State Competition Debate in Corporate Law, 8 *Cardozo L. Rev.* 709, 720-725; Klausner, at 843-847 (arguing that interpretative network externalities increase value of Delaware law); others? practitioners?

¹⁰⁴ See Kamar, at 1923-24 (noting the significance of network and learning externalities to accumulated precedents that reduce uncertainty).

¹⁰⁵ [cite]

direct benefits to residents who provide litigation-related services.¹⁰⁶

In the third Subsection, we discuss why these benefits are price-discriminatory. Finally, we discuss the relation between price discrimination through franchise taxes and price discrimination through increased litigation.

(a) Indirect Fiscal Benefits to Delaware

Increased corporate litigation stimulates Delaware's economy. Because Delaware is the incorporation state of choice for public companies, Wilmington, its largest city, has become home to some of the nation's most respected law firms. These law firms derive a substantial amount of their revenues from representing and advising clients in corporate disputes. The revenues are in turn used to pay salaries to associates and support staff, lease office space, purchase supplies, and remunerate partners. In addition, lawyers and witnesses from other states who come to Delaware to participate in corporate litigation spend funds in Delaware on hotels, meals, and other goods and services.

All of these transactions generate revenues for Delaware from its personal income tax, corporate income tax, and business and occupational gross receipts tax.¹⁰⁷ Moreover, as lawyers, employees, suppliers, and service providers spend their income in Delaware, their expenditure produces a trickle-down effect, resulting in additional tax receipts.

(b) Direct Benefits to Delaware Residents

Apart from generating tax revenues, the business that increased litigation creates for Delaware residents providing litigation-related services benefits these residents directly.¹⁰⁸ To be sure, if the level

¹⁰⁶ Delaware does not charge significant court fees to corporate litigants. The filing fee for a new civil action with three or more defendants, which is the category under which most corporate lawsuits fall, is \$200; the fee for filing and recording any pleading is \$1 per page, up to a maximum of \$50. See Delaware State Chancery Court Rules, § 3 (1995). High fees could induce plaintiffs to bring corporate lawsuits in other courts (see *supra* note __) and eliminate all profits Delaware derives from these suits.

¹⁰⁷ Delaware personal income tax rate ranges from zero to 6.4%. Delaware corporate income tax rate is __%. Delaware business and occupational gross receipts tax rate ranges from 0.096% to 1.92%. See Financial Overview, in State of Delaware Governor's Recommended Budget: Fiscal Year 2000, available in <<http://www.state.de.us/budget/>> (visited June 2, 1999).

¹⁰⁸ The presence of these benefits also strengthens Delaware's commitment to remain responsive to corporate needs as groups of citizens that benefit from Delaware incorporations will favor such responsiveness. See Kamar, *supra* note __, at 1936. In addition, they induce Delaware corporate lawyers to

of litigation were to drop, some Delaware residents who presently provide litigation-related services would become engaged elsewhere. And unless the present providers of litigation-related services have market power, they would, in the long term, obtain the same profits in their new employ.

Nevertheless, in the short term, a drop in the level of litigation could impose substantial losses.¹⁰⁹ Some providers of litigation-related services have made specific investments that would be lost if they had to change their occupation.¹¹⁰ In addition, many Delaware residents would face substantial transaction and relocation costs -- such as the cost of selling one's home, moving one's family, and enduring temporary unemployment -- if they had to change jobs. Moreover, several factors suggest that Delaware corporate law firms have market power that enables them to earn profits not available elsewhere.¹¹¹ First, Delaware's corporate bar is dominated by a small number of Delaware firms [data]. Until recently, these firms were the only ones who had extensive files containing unpublished letter rulings by the Delaware Chancery Court. [confirm] Finally, these firms have also developed a reputation for quality and knowledge of the local judiciary that new entrants may find difficult to match.¹¹² It is difficult to quantify the significance of the benefits Delaware

provide free services to Delaware to keep Delaware's corporate law current. See S. Samuel Arsht, *A History of Delaware Corporation Law*, 1 Del. J. Corp. L. 1, 17-21 (1976) (describing the work of the Delaware Bar Association Standing Committee on the General Corporation Law).

¹⁰⁹ Conversely, Delaware providers of litigation-related services could obtain short-term benefits if the level of litigation were to rise.

¹¹⁰ See Romano, *supra* note __, at __.

¹¹¹ Law practice in Delaware appears to be rather lucrative. The average annual income of full-time Delaware lawyers in 1990 was \$117,276, higher (even before adjusting for differences in the cost of living) than the income of lawyers in the cities of New York (\$111,572), Chicago (\$90,762), Los Angeles (\$106,407/111,483 - check which figure is the right one), or Washington (\$92,259). See *Earnings by Occupation and Education: 1990* (United States Bureau of Census, 1994), available in <<http://govinfo.library.orst.edu/earn-stateis.html>> (visited Aug. 5, 1999).

¹¹² To be sure, many non-Delaware firms have a reputation for quality, including the quality of their corporate litigation, that matches the reputation of Delaware firms. Delaware corporate firms, however, obtain a lot of business through out-of-state lawyers (either by advising them on Delaware law or by referral of their clients). While out-of-state lawyers are willing to give business to local Delaware firms, they would presumably be reluctant to give such business to a Delaware branch of a national firm.

residents derive from a thriving litigation industry. Some indication that these benefits are substantial, however, may be found in recent events in Pennsylvania. In 19__, Pennsylvania's legislature passed the (then and now) strictest antitakeover provisions; and in the mid 1990s, it deliberated several bills to establish a Chancery Court in which experienced judges chosen on merit would hear only corporate and business disputes.¹¹³ An avowed aim of the legislation was to compete with Delaware for incorporations.¹¹⁴

Pennsylvania would not have derived significant franchise taxes from such incorporations. Pennsylvania's annual franchise tax depends on where a company's property is located, where its sales are made, and where its employees are based, rather than where it is incorporated.¹¹⁵

Indeed, according to William Clark, head of the Chancery Court Coalition, the Pennsylvania treasury was indifferent to the proposal to set up an expert corporate court. By contrast, Pennsylvania law firms actively supported the Chancery Court proposal.¹¹⁶ This suggests that Pennsylvania's attempt to compete with Delaware was motivated by the benefits from generating additional litigation-related business, not those from additional franchise tax revenues.¹¹⁷

¹¹³ See Thomas A. Slowey, Pennsylvania Chancery Court is a Sound Proposal, Pa. L. Weekly, May 2, 1994, at 6; John L. Kennedy, Chancery Court Proposal Sent to Full Senate, Pa. L. Weekly, May 17, 1993, at 6. The legislation was never enacted, at least in part due to political opposition to merit selection. See *id.* A revised proposal to create a specialized commercial (as opposed to corporate) court is still pending. This proposal, however, is not seen as an effort to attract incorporations. Telephone Interview with William H. Clark, head of the Chancery Court Coalition, June __, 1999 [hereinafter, Clark Interview].

¹¹⁴ See Clark Interview, *supra* note __.

¹¹⁵ [cite] To be sure, it is conceivable that Pennsylvania would raise its fees once it attracted incorporations. However, there is no indication that it was planning to do so.

¹¹⁶ See Clark Interview, *supra* note __; Clifford E. Haines, A Chancery Court Could Assist Pa., Philadelphia Bus. J., March 31, 1997, available in <<http://www.amcity.com/philadelphia/stories/1997/03/31/editorial3.html>> (visited Aug. 12, 1999) (editorial by Chancellor of the Philadelphia Bar Association); Board of Governors of the Philadelphia Bar Association Resolution of April 24, 1997, Support for Legislation Creating a Commerce Court in Pennsylvania, available in <<http://www.philabar.org/pbg/resoluti/4249702.html>> (visited Aug. 12, 1999).

¹¹⁷ See also Romano, *supra* note __, at 241 (speculating that income to Delaware residents from servicing Delaware corporations considerably outdistances tax collections).

(c) Increased Litigation and Price Discrimination

How increased litigation works to price discriminate between corporations is simple. The costs of increased litigation fall primarily on Delaware corporations that are involved in corporate lawsuits. These corporations, in turn, are the ones assigning the highest value to a Delaware incorporation. In a legal system based on corporate governance by adjudication, involvement in litigation reflects the degree to which a firm is using the law. Firms that are involved in litigation more than others are thus more affected by the existence of a well-developed corporate law, the access to expert legal counsel, and the availability of a specialized judiciary that are associated with incorporation in Delaware.¹¹⁸ The cost of increased litigation then falls mainly on firms that value Delaware law most. Charging a higher price to higher-value consumers, of course, is exactly what price discrimination is about.

(d) How Litigation-Intensive Law Complements Franchise Tax
Discrimination

As we have argued, Delaware's franchise tax structure also has the effect of charging higher prices to firms that are likely to be more heavily involved in corporate disputes and thus value Delaware incorporation more highly. This raises the question of how, given the franchise tax, the litigation-intensive structure enhances Delaware's overall price discrimination.¹¹⁹

¹¹⁸ Our argument does not assume that heavy reliance on litigation is an immutable element of corporate law. Indeed, we argue that Delaware corporate law relies on litigation more than the minimum possible, and likely more than is optimal. See *infra* TAN. But given the reliance of Delaware law on litigation, the extent to which firms are involved in litigation reflects their use of the law. Similarly, in systems that are not based on adjudication, but rather on regulation, administrative action, or private contracting, the use of these other means of legal ordering should reflect how much a particular firm needs the law.

¹¹⁹ It is fairly evident that, given Delaware's corporate law, the franchise tax enhances Delaware's overall price discrimination. Franchise taxes are an efficient way for Delaware to profit from incorporations: all of the franchise tax revenues benefit Delaware, and Delaware's cost in collecting tax and providing incorporation-related services are small. By contrast, a significant portion of the costs companies incur in conducting corporate litigation benefits out-of-state parties (such as New York lawyers who often represent companies in such litigation, liability insurance carriers, and expert witnesses). Moreover, of the revenues that do stay in Delaware, only a fraction represents profits, since the costs Delaware residents incur in providing litigation-related services are high, and some of what is left after deducting these costs is competed away. Thus, Delaware's profits from an additional dollar spent on corporate litigation are significantly lower than

The proxies used by Delaware for tax discrimination between firms imperfectly track the likelihood of being involved in corporate disputes. For example, although larger public companies are likely to be more heavily involved in corporate litigation than smaller public firms, asset size is obviously an imprecise predictor of actual litigation activity.

By contrast, the costs resulting from a litigation-intensive system of corporate law directly track involvement in litigation. Firms pay these costs only to the extent they are actually involved in corporate disputes; and the extent to which they are involved in corporate disputes strongly correlates with the benefits they derive from Delaware's well-developed legal system and its expert judiciary.¹²⁰ Thus, Delaware can derive greater profits from engaging in price discrimination both through the franchise tax and through a litigation-intensive legal structure than solely through the franchise tax.

III. Efficiency Effects of Price Discrimination

Our analysis to this point focused on how Delaware gains from price discrimination. It did not address the social desirability of this behavior, which depends on the aggregate benefits of price discrimination to Delaware and to corporations. Below we shall analyze separately the efficiency effects of franchise tax price discrimination, and of price discrimination through a litigation-intensive legal structure. [Add a one-sentence summary of our conclusions.]

A. Franchise Tax Discrimination -- VERY TENTATIVE

From an economic standpoint the amount of tax firms pay to Delaware represents a pure wealth transfer and so does not affect social welfare. Franchise tax discrimination, however, does implicate social welfare insofar as it affects the number and type of firms that incorporate in Delaware. Compared to a uniform monopoly tax rate, franchise tax discrimination enhances social welfare to the extent that it causes more firms, or firms that derive greater value from a Delaware incorporation, to incorporate in Delaware; it reduces social wealth to the extent that it causes firms that could benefit from a

its profits from an additional dollar in franchise tax revenues.

¹²⁰ The combination of several methods of price discrimination in order to fine-tune the pricing mechanism and increase its effectiveness is common in commerce. For example, airlines regularly charge different fares for first-class and couch tickets, and within each class -- for advance-purchase and last-minute tickets.

Delaware incorporation to incorporate elsewhere.¹²¹ In theory, either effect can dominate.¹²²

To determine the net welfare effect of franchise tax price discrimination, one first has to assess what uniform tax Delaware would charge if it could not tax discriminate. Any intermediate uniform tax between the current maximum of \$150,000 per year and the current minimum of \$30 per year is likely to lead both some non-Delaware firms (that would be charged a lower tax under a uniform tax structure than under a price discriminatory one) to enter Delaware and some Delaware firms (that would be charged a higher tax under a uniform tax structure than under a price discriminatory one) to exit Delaware. The higher that uniform tax, the stronger is the latter effect relative to the former, and the more likely it is that franchise tax discrimination enhances social welfare.¹²³

Table 3 presents a stratified report of Delaware's franchise tax revenues. As Table 3 shows, the overwhelming majority of Delaware corporations pay the minimum rate of \$30 a year, and over 80 percent pay less than \$100 per year.¹²⁴ This is consistent with our assessment that non-public firms that incorporate in Delaware have to pay only the

¹²¹ No welfare effect is associated with current Delaware firms that would remain in the state under the hypothetical flat tax rate. These firms would merely share with Delaware a different portion of their consumer welfare than they do today.

¹²² [cite] The only instance where the two effects would cancel out would be if all firms had linear demand for Delaware law. See Tirole, *supra* note ___, at 139. There is, of course, no reason to expect this particular shape of demand to represent reality.

¹²³ The reason is twofold. First, it is desirable that as many firms as possible benefit from the advantages of incorporating in Delaware. [cite] Second, each additional firm that incorporates in Delaware enhances the advantages of incorporation in Delaware for all other firms. Cf. Jerry A. Hausman & Jeffrey K. MacKie-Mason, *Price Discrimination and Patent Policy*, 19 RAND J. Econ. 253 (1988) (arguing that the ability of patent holders to engage in third-degree price discrimination can increase social welfare by enabling them to open new markets and achieve economies of scale or learning).

Note that increasing the number of Delaware firms is desirable regardless of whether Delaware law favors managers or shareholders. Firms that consider Delaware incorporation are choosing between Delaware and other states that balance the interests of managers and shareholders similarly. Incorporation in Delaware thus does not affect the total number of firms governed by law favorable to managers or shareholders. It does, however, increase the number of firms benefitting from the improved services that Delaware offers.

¹²⁴ This confirms our assessment that most nonpublic firms can incorporate in Delaware with a \$30 annual franchise tax. See *supra* TAN.

minimum \$30 annual franchise tax. A uniform tax rate above \$30 is thus unlikely to result in significant entry into Delaware by nonpublic firms. The main source of additional entry are thus the approximately [5000] public firms that are not presently incorporated in Delaware.

[Insert Table 3 here]

Table 3 also shows that some 1600 Delaware firms pay annual franchise taxes of \$100,000 or more. Even assuming, conservatively, that all firms presently paying less than \$100,000 would exit Delaware if it charged a uniform rate of \$100,000, Delaware's franchise tax revenues at that rate would be \$160 million. To earn comparable revenues, Delaware would have to charter, for example, 320,000 firms at a uniform rate of \$500; 160,000 firms at a uniform rate of \$1000; or 16,000 firms at a uniform rate of \$10,000.

Even if none of the present Delaware firms exited and all non-Delaware public firms entered at such rates, Delaware would have to charge a tax of about \$700 to earn \$160 million in franchise tax revenues. More plausibly, however, most of the 180,000 nonpublic firms presently paying less than \$100 a year would exit Delaware if their rates rose to \$700. Otherwise, Delaware's present tax scheme substantially undercharges these firms. It is therefore unlikely that Delaware could charge a uniform rate low enough for most present nonpublic firms to remain in Delaware, yet high enough to result in revenues of \$160 million. In other words, if Delaware had to choose between setting low rate and keeping nonpublic firms, and setting a high rate and losing them, the profit-maximizing choice would be the latter. This suggests, at a minimum, that Delaware's price discrimination between public and nonpublic firms is efficient.¹²⁵

¹²⁵ This analysis ignores the fact that the number of Delaware corporations may itself, through network and learning effects, affect the value of a Delaware incorporation. Other things being equal, this effect will reduce the profit-maximizing uniform tax Delaware would charge for an incorporation. We do not think that this omission affects our overall conclusion. We already assume that all non-Delaware public corporations would incorporate in Delaware at a uniform tax rate of \$700. Given that this rate is substantially above the rate nonpublic corporations presently pay to incorporate in Delaware, network and learning effects would likely not suffice to increase incorporations by such firms. As to our estimate of Delaware's revenues under a uniform rate of \$100,000, it is true that network and learning effects could induce some firms that presently pay \$100,000 or more to exit Delaware. However, since we conservatively assumed that all firms presently paying less than \$100,000 (including, for instance, firms presently paying \$99,950) would exit if they had to pay \$100,000, and since Delaware companies would enjoy significant learning and network benefits even if only

Whether Delaware's price discrimination among public firms is efficient is more difficult to assess. As Table 3 suggests, a large number of Delaware's public firms pay franchise taxes between \$20,000 and \$100,000. If Delaware had to charge a uniform price to all public firms, it is plausible that a price within that range would maximize Delaware's franchise tax revenues. For example, again assuming conservatively that all public Delaware firms presently paying less than \$50,000 would exit Delaware if charged that rate, that rate would yield to Delaware \$125 million in franchise tax revenues from present Delaware firms. If a uniform \$50,000 rate attracted 1000 non-Delaware firms, Delaware's revenues would be \$175 million. This figure is in the same order of magnitude as our conservative revenue estimate with a uniform rate of \$100,000 and over 20 percent above the revenues Delaware derives from firms paying the maximum rate of \$150,000. The present price discriminatory rate structure for public companies, compared to a uniform rate of \$50,000 would likely result in both exit and entry by a significant number of public firms. The net effects of price discrimination among public firms are thus indeterminate.¹²⁶

B. Price Discrimination Through Increased Litigation

Assessing the social welfare implications of Delaware's litigation-intensive law warrants consideration of additional effects. Unlike franchise tax discrimination, the efficiency implications of which depend predominantly on the effects on entry into and exit out of Delaware, price discrimination through litigation-intensive law also affects the very quality of the product Delaware is selling. And unlike franchise tax price discrimination, the efficiency implications of which we concluded to be positive (with regard to discrimination between public and nonpublic firms) or indeterminate (with regard to discrimination among public firms), price discrimination through litigation-intensive law is likely to reduce social wealth.

Recall that several features of Delaware law contribute to its litigation intensity: Delaware law is standard based, it is fact specific, there is ambiguity about the applicable legal test, and precedents are narrow. Assessing whether the prevalence of standards, the degree of fact specificity, the extent of ambiguity, and the narrowness of precedents are optimally calibrated in Delaware law, by

the 1600 public companies presently paying that amount remained in Delaware, we believe that it is more likely that our estimate is too low than too high.

¹²⁶ This analysis again ignores learning and network effects. See supra note ___. Inclusion of such effects would not render the net effect of price discrimination among public firms more determinate.

figuring out what the optimal corporate law would like and comparing the existing law with that model, is a task beyond this Article. Determination of these optimal levels is a complex task, which depends on many factors, including the cost of creating and applying different legal rules and standards, the frequency in which different types of disputes occur, the social value of certainty in legal outcomes, the cost of obtaining legal advice, the effect of imperfect legal tests on primary behavior, and the significance of learning through experience.¹²⁷

But while a direct assessment of the optimality of Delaware law is a complicated endeavor, it is still possible to assess its optimality through examination of the degree to which Delaware as a state is motivated to offer optimal law. This indirect evaluation method leads us to conclude that Delaware would have better incentives to devise an optimal legal regime if the legal structure did not have the effect of price discrimination.¹²⁸

In the absence of a price discriminatory effect to the structure of Delaware law, an inferior legal regime would force Delaware to lower the price it charges for its law by an amount commensurate to the losses Delaware corporations suffer as a result. These incentives, however, are weaker if the costs of an inferior legal regime are borne predominantly by companies that derive a higher net benefit from a Delaware incorporation. In that case, an inferior legal regime would not force Delaware to reduce the price it charges for incorporation commensurately. Rather, Delaware would have to reduce its price only to the extent that an inferior legal regime imposes costs on the marginal Delaware firms -- the firms that derive the lowest net benefit from being incorporated in Delaware. These costs, however, would be well below the average costs to Delaware firms.

Thus, at the margin, Delaware would not necessarily maximize its profits by offering a regime that is optimally litigation-intensive. It could potentially do better by offering a legal regime that is more litigation-intensive than is optimal, since its gain from doing so might well exceed the decline in franchise tax proceeds that would

¹²⁷ [cites]

¹²⁸ Even absent the price discriminatory effect of litigation intensiveness Delaware would not necessarily offer optimal law. For example, excessive reliance on litigation may also benefit Delaware by making its law uncopyable, thereby entrenching its dominance in the market for incorporations. See Kamar, *supra* note ____.

follow.¹²⁹ Given this incentive structure, and given the fact that Delaware law is in fact highly litigation-intensive, it is likely that Delaware law is more litigation-intensive than is optimal.¹³⁰

Conclusion

This Article is an additional chapter in the story of the various imperfections that characterize the market for corporate law and cast doubt on the received wisdom that the desirability of such a market depends entirely on the degree to which corporate decision makers are motivated to incorporate in the jurisdiction that maximizes the value of the corporation. Against this overly simplified description, we argue that Delaware relies on market power in the market for incorporations to increase its profits through price discrimination.

Two features of Delaware law constitute price discrimination. First, Delaware's uniquely structured franchise tax results in higher charges to public firms than to nonpublic firms, and among public firms, higher charges to larger firms with a higher ratio of authorized to issued shares than to smaller firms with a lower ratio. Each of these factors is correlated with the value a firm places on a Delaware incorporation. Public firms value a Delaware incorporation more highly

¹²⁹ The gain from litigation may exceed the decline in franchise tax proceeds because, as we noted earlier, actual use of the court system is a more accurate proxy for the need of firms for Delaware law than the best available bases upon franchise tax could be assessed -- number of authorized shares, the ratio of authorized to issued shares, and total size of assets. See *supra* TAN. Note that we limit our claim to saying that at the margin Delaware *could* benefit from increasing its litigation-intensiveness, rather than saying that it *would* benefit from doing so. The reason is that firms lose from litigation more than Delaware gains. If the degradation of Delaware law due to excessive litigation and the attendant decline in franchise tax proceeds are sufficiently large, Delaware would be better off forgoing the opportunity to price discriminate through increased litigation. Cf. Kamar, *supra* note __, at 1922-23 (making a similar claim regarding the ability of Delaware to benefit from preserving its market power by offering overly indeterminate law).

¹³⁰ [add cites] That producers with market power may offer suboptimal products in order to price discriminate is well known. The classic example is that of producers offering to consumers with a low willingness to pay a good of lower quality than these consumers would care to pay for in order to drive consumers with a high willingness to pay to purchase a higher quality good at a higher price. See Mussa & Rosen, *supra* note __. Indeed, producers may even incur costs in damaging their product to be able to engage in this type of price discrimination. Interestingly, this practice can sometimes improve the welfare of both the producer and all of its consumers. See Raymond J. Deneckere & R. Preston McAfee, *Damaged Goods*, 5 *J. Econ. & Mgmt Strategy* 149 (1996).

than nonpublic firms. Larger public firms value a Delaware incorporation more highly than smaller public firms. And, if to a lesser extent, firms with a higher ratio of authorized to issued shares appear to value Delaware law more highly than firms with a lower ratio of authorized to issued shares.

Second, Delaware's substantive corporate law tends to be standards based and fact intensive, it is often ambiguous what legal test is applicable, and the scope of precedents tends to be narrow. Each of these factors makes Delaware law more litigation intensive. A high level of litigation intensity has the effect of raising cost to firms involved in corporate disputes, and raising the profits Delaware and its residents derive from such disputes. We do not claim that Delaware judges intentionally made Delaware law litigation intensive in order to increase Delaware's profits through price discrimination. We suggest, however, that the price discriminatory effect of litigation intensive features facilitates their persistence.

Finally, we assess the efficiency implications of Delaware's price discrimination. We show that price discrimination between public and nonpublic firms is likely to enhance social welfare. The effect of price discrimination among public firms by size and ratio of authorized to issued shares is indeterminate. By contrast, price discrimination through litigation intensive law is likely to reduce social wealth.