THE DELAWARE TRAP: AN EMPIRICAL ANALYSIS OF INCORPORATION DECISIONS

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One of the most enduring debates in corporate law centers on why Delaware has become the dominant state in the market for corporate charters. Traditionally, two perspectives dominated the debate, the "race-to-the-top" perspective that sees competition among states as driving legal rules toward efficiency and the "race-to-the-bottom" perspective that sees competition among states as driving legal rules toward the interests of corporate managers. The two dominant perspectives have struggled to explain why approximately half of large companies incorporate in Delaware, while the other half incorporate in their home states. Whether the choices are attributable to the quality of state law, the characteristics of the companies themselves, or both has given rise to a large, but inconclusive empirical literature.

This Article uses a large dataset of corporate financings to shed new light on this mystery and uncovers strong evidence that some of the strongest factors in incorporation choice are factors unrelated to either the quality of state law or the characteristics of individual companies. Instead, the data strongly suggests that demographic markers of sophistication, such as choice of law firm and headquarters location, predict the jurisdictional incorporation choice approximately as well as state law or the business attributes of companies. Companies with more demographic markers of sophistication tend to choose Delaware incorporation, and companies with fewer demographic markers of sophistication tend to choose home-state incorporation. The finding persists even when other attributes of the

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company are controlled for, such as its industry classification, the amount of money raised, or whether the company is public or private. Indeed, the sophistication factors arguably predict Delaware incorporation as well or better than any factors documented in the vast literature on state competition for corporate charters.

The findings have important implications for the state "race-to-the-top" debate in corporate law. This Article demonstrates that the choice of legal representation is an important missing variable in models of incorporation decisions, an omission that has resulted in misleading results in some prominent studies. But the fact that the choice of law firm influences the jurisdictional choice has far broader implications. Law firms may steer companies toward states that serve law firms' own interests, without regard to the quality of legal rules or the needs of the client. When the state chosen is Delaware, as it often is, there are few alternative jurisdictions that shareholders and managers can agree on. As a result, companies inadvertently fall into a "governance trap" from which reincorporation out of state is nearly impossible. This interpretation suggests that Delaware's carefully calibrated positioning in the charter market has largely eliminated meaningful competition among the states for the quality of corporate law.

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INTRODUCTION

The organizers of every new business face two foundational legal decisions at the outset of the venture. The first is whether to organize the legal entity as a corporation, a limited liability company, or some other organizational form (the choice of entity decision).[1] The second is whether to organize the business under the laws of the business's home state or in some other state (the jurisdictional choice decision). The new business is generally free to organize under any legal entity form and under any jurisdiction, regardless of the type of business or the location of its activities.[2] These decisions are made at the inception of the entity's existence and are generally fixed for the life of the entity.[3]

The organizational choices made early in the life of a business will affect how the company is governed and how it is taxed. The jurisdictional choice decision requires a business's founders to choose a state in which to organize the entity. This decision will determine which state's law will apply

1. In most jurisdictions, many more entity forms are available; in some cases, up to twelve such entity forms are available to choose from. *See* JESSE H. CHOPER ET AL., CASES AND MATERIALS ON CORPORATIONS 704–05, 823 (7th ed. 2008). The decision is usually narrowed to either a corporation or a limited liability company. *See infra* Section II.B.

2. Roberta Romano, *The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters*, 23 YALE J. ON REG. 209, 210 (2006) ("U.S. corporations can select the legal regime for shareholder-manager relations from among the fifty states and the District of Columbia by their choice of incorporation state without having to establish any physical connection to the choice and without being exposed to extraterritorial restraints on organizational choices."); Guhan Subramanian, *The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the "Race" Debate and Antitakeover Overreaching*, 150 U. PA. L. REV. 1795, 1802 (2002) ("Corporations are not constrained by their headquarters, location of manufacturing facilities, place of business, or other operational factors in deciding where to incorporate."). However, there are exceptions to this general rule. Some businesses are required to use a particular entity, and some businesses are required to organize in a particular state.

3. There are exceptions to this general rule. Under modern corporate statutes, entities may "convert" into other entity forms or change their state of incorporation without merging the original entity out of existence. *See, e.g.*, MODEL BUS. CORP. ACT ch. 9 (2010) (AM. BAR ASS'N, amended 2016) ("Domestication and Conversion").

to the entity's governance under the "internal affairs doctrine."[4] The choice of entity decision will determine which provisions of the chosen state's law will apply to the entity, such as the state's corporation law or limited liability company act, as well as influence the company's tax treatment.[5] Each decision carries potentially significant consequences as the choices made dictate the legal regime that governs the relationships among officers, directors, and shareholders (or other equity holders) of the company.[6]

The fact that companies can choose the law that governs them has stimulated one of the most vigorous and active research programs in corporate law. The question of how businesses choose their states of incorporation is central to one of the most enduring and "classic" debates in corporate law—whether allowing businesses a choice among state laws leads to a "race for the top" or a "race for the bottom."[7] Corporate scholarship generally acknowledges that at least some states compete for incorporation "business" and the franchise fees that incorporation generates, and they compete in part through state corporate laws—the laws governing companies incorporated there.[8] Because at least some states compete to attract incorporations, the identity of those who choose the state of incorporation and the way they choose the state influence the path of corporate law. Thus, the criteria that drive these choices implicate deep questions about the effectiveness of corporate law federalism—itself one of the most important unresolved issues in corporate law.[9]

Despite the importance of the choices businesses make and the way in which they make them, scholars still have not uncovered many of the factors that influence the organizational decisions by new businesses. The standard explanation from race-to-the-top theorists (which largely coincides with the

4. *See, e.g.*, JAMES D. COX & THOMAS LEE HAZEN, BUSINESS ORGANIZATIONS LAW 66 (4th ed. 2016) ("With very limited exceptions . . . , internal affairs are governed by the law of the state of incorporation. This is customarily referred to as the internal affairs doctrine and is a mainstay of corporate law.").

5. *See, e.g.*, Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 83–88 (2001) (explaining the tax and governance tradeoffs associated with the choice of entity).

6. *See, e.g.*, VantagePoint Venture Partners 1996 v. Examen, Inc., 871 A.2d 1108, 1112–13 (Del. 2005) ("It is now well established that only the law of the state of incorporation governs and determines issues relating to a corporation's internal affairs.").

7. *See* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 14–24, 55 n.9 (1993) (describing the "classic" debate between William Cary and Ralph Winter on state corporate law).

8. *See* Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1909 (1998) (noting that commentators agree that regulatory competition "induces states to play to corporate decisionmakers").

9. *See* Subramanian, *supra* note 2, at 1797 (stating that the debate is "[o]ne of the most important questions in U.S. corporate law").

standard advice of large-firm lawyers) is that the substantive quality of Delaware's law, corporate bar, and judiciary accounts for the state's dominance.[10] A large number of studies have attempted to unravel the factors predicting choice of jurisdiction, mostly using the attributes of companies or the attributes of state law as predictive variables. Yet the variables examined in leading studies fail to account for most of the variation in firms' choices of where to incorporate.[11]

In addition, the studies have the limitation that they generally focus on public companies (where data is widely available), with less examination of private companies (where data is usually more limited).[12] This focus on public companies obscures the jurisdictional incorporation decision because public companies frequently have made their original jurisdictional choice many years in the past when their attributes were very different.[13] This makes it difficult to unravel the original factors leading to the jurisdictional choice, as those factors often change over time. As a result, scholars and policymakers are left with little reliable information about how companies choose their states of incorporation and, therefore, how the system of corporate federalism works.

This Article breaks new ground on this problem. By exploiting a very large dataset containing a diverse mixture of over 60,000 public and private companies over several years, this Article uncovers strong new evidence about how companies choose states of incorporation. The data are drawn

10. *See, e.g.*, FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 212–13 (1991) ("[Delaware's] success comes from its enabling statute, its large body of precedents and sophisticated corporate bar, and its credible commitment to be receptive to corporate needs because of the large percentage of its state revenues derived from franchise fees and taxes."). *See also* Brian J. Broughman & Darian M. Ibrahim, *Delaware's Familiarity*, 52 SAN DIEGO L. REV. 273, 289–90 (2015) (explaining the "leading explanation for Delaware's dominance" is its "substantive quality," which includes its statutes, case law, flexibility, and the experience of the Delaware judiciary). In contrast with the standard explanation, Broughman and Ibrahim argue that the "familiarity" of Delaware law is as much the reason for its continued dominance as its substantive quality. *See id*. at 309.

11. *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J. L. & ECON. 383, 403–04 (2003) (stating that existing studies "can explain only a very small part of the selection of firms that incorporate in Delaware").

12. *See* Larry E. Ribstein & Erin Ann O'Hara, *Corporations and the Market for Law*, 2008 U. ILL. L. REV. 661, 698–99 (2008) ("The academic writing on the corporate law market has so far focused on a relatively narrow slice of that market occupied by publicly held corporations.").

13. The counterargument is that public company studies are still valid because companies can reincorporate at any time, meaning that in a sense there is an ongoing "choice" of entity at all times. This is true if one believes that reincorporation is relatively inexpensive, as Bernard S. Black has argued. Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 585–87 (1990). In contrast, Roberta Romano has taken the position that the expense of reincorporation poses an obstacle in many cases. *See* ROMANO, *supra* note 7, at 34–35 (arguing that reincorporation is more expensive than Black contends).

from Securities and Exchange Commission ("SEC") filings relating to financing transactions by companies. Each data point consists of a financing transaction by a company and includes important information about the company involved, the type of transaction, and certain telltale clues about the sophistication of legal counsel involved in the financing. These financings provide new variables that have not previously been examined and that help to explain the organizational choices of businesses.

The empirical analysis of this database uncovers a set of demographic variables that may be the strongest predictors of businesses' jurisdictional choices ever documented in the scholarly literature on jurisdictional choice. In particular, the demographic markers of the sophistication of companies, especially legal sophistication, predict the incorporation decision as well as or better than leading predictors identified in existing studies. Companies with more demographic markers of sophistication tend to incorporate in Delaware, while companies with fewer demographic markers of sophistication tend to incorporate in their home states. The data strongly suggest that the sophistication variable is largely related to the sophistication of legal counsel representing the companies, which means that the identity of the company's law firm, rather than the legal needs of the company itself, may drive the jurisdictional choice. The result is robust to a wide variety of control variables, which suggests that an important, omitted variable lurks behind the scenes in the state incorporation debate.

This Article proceeds in five parts. Part I reviews the theory and background of the debate over what motivates the jurisdictional choice. The Part demonstrates the limited value of existing variables in predicting organizational choice—a limitation that has hampered the empirical literature on corporate law. The Part further points out that a number of the existing studies have suggested that a company's choice of legal counsel might have an important effect on the decision, but have not rigorously analyzed the hypothesis, with the exception of Robert Daines's important work on initial public offerings.[14]

Part II describes the dataset and lays the groundwork for the analysis by empirically evaluating the conventional wisdom from existing scholarly research. In some cases, the conventional wisdom is confirmed, such as the fact that most companies incorporate either in their home states or in Delaware. In other cases, the conventional wisdom appears to be incorrect, at least when viewed in the context of this broader database, including public

14. *See generally* Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559 (2002).

and private companies. For example, the incorporation choices of private companies in this dataset largely mirror the choices of public companies, which differs from the assumptions most scholars have about private companies.

Part III presents the empirical analysis of the incorporation decision. The key finding is that the demographic sophistication markers—especially legal sophistication—predict the state of incorporation as well as or better than any previously documented variables related to the company's attributes or the law offered by the states. Although sophistication markers correlate with the expected variables, such as the amount of money raised in the financing, they are robust to controls for those other variables and just as powerful as predictors. This Part shows that much of the effect related to sophistication is likely the legal sophistication of company counsel. Indeed, this Part argues that given the limited nature of the proxies used for firm sophistication, it is likely that firm sophistication accounts for the *majority* of the decisions about where to incorporate.

Part IV interprets these new results. The data lend themselves to two potentially divergent interpretations. One is that companies choose sophisticated or unsophisticated legal counsel; then, sophisticated legal counsel choose Delaware, and unsophisticated counsel choose local incorporation. This interpretation would indicate that law firms are the key mediators of the choice of jurisdiction. The second is that sophisticated *companies* choose sophisticated counsel and the sophisticated companies also choose Delaware, independently of the counsel. Either explanation has important implications for analyzing the federal system of corporate law. The first would lead to an agency cost interpretation of jurisdiction choice, and the second would suggest that Delaware companies themselves are different from companies in other states, which potentially undermines empirical inferences in existing studies of the value of Delaware law. As the part will demonstrate, the first explanation proves the most persuasive overall, suggesting the choice of law firm is largely determinative of the choice of jurisdiction.

Part V explores the implications of these findings. Regardless of which interpretation from Part IV prevails, the literature on the state "race" debate must account for these new findings. If law firms control the jurisdictional choice decision, this may indicate the ability of law firms to effectively serve clients may be undermined by entrenched patterns of practice that conflict with clients' needs. If clients are in control of the jurisdictional choice decision, then empirical studies on the value of Delaware law must grapple with the fact that Delaware companies are different from other companies in ways that affect empirical studies of the value of Delaware corporate law. In either case, the system has a built-in inertia favoring Delaware that makes state competition illusory.

I. THEORY AND BACKGROUND ON THE JURISDICTIONAL CHOICE DEBATE

One of the most significant debates in corporate law is whether the United States system of corporate law federalism leads to a race to the bottom or a race to the top.[15] Race-to-the-bottom theorists argue that because insiders of companies must initiate incorporation decisions, jurisdictions compete to provide legal rules that favor insiders, allowing them to extract private benefits at the expense of the corporation or its shareholders.[16] Race-to-the-top theorists argue that market constraints prevent insiders from favoring such jurisdictions and that jurisdictions actually compete to provide efficient legal rules that enhance shareholder value.[17] Although the dichotomous framing as a "race" to the "top" or "bottom" is a bit of an oversimplification of a more nuanced debate,[18] that version of the debate has dominated discussions of corporate law for decades.[19]

The legal framework underpinning the debate is the "internal affairs doctrine," which is the conflict of law rule that allows companies to choose

15. The classic articles that launched the debate are William L. Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L.J. 663, 663–68 (1974) (arguing that state competition produces a race to the bottom) and Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 254–66 (1977) (arguing that state competition produces a race to the top).

16. In addition to Cary, *supra* note 15, works commonly characterized within the race-to-the-bottom literature include, Oren Bar-Gill et al., *The Market for Corporate Law*, 162 J. INSTITUTIONAL & THEORETICAL ECON. 134 (2006); Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775 (2002), Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111 (2001), Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168 (1999), and Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992). To be fair, not all of these works contend that there is a race to the bottom, but, perhaps more accurately, that state competition "might push states in undesirable directions with respect to some important corporate issues." *See* Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 555 (2002).

17. In addition to Winter's classic article, the works commonly characterized within the race-to-the-top literature include EASTERBROOK & FISCHEL, *supra* note 10, ROMANO, *supra* note 7, and Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985).

18. *See* Marcel Kahan, *The State of State Competition for Incorporations* 8–9 (European Corp. Governance Institute, Law Working Paper No. 263, 2014), http://ssrn.com/abstract=2474658.

19. Cary, *supra* note 15; Winter, *supra* note 15. Indeed, the debate existed before Cary's influential article, appearing prominently in Justice Brandeis's oft-cited dissent in *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 557–60 (1933) (Brandeis, J., dissenting).

their own states of incorporation and thereby the corporate law that applies to them, regardless of any connection to the state.[20] The doctrine is so well established that the Supreme Court has come close to constitutionalizing it under the Dormant Commerce Clause.[21] Companies have exercised this choice under the internal affairs doctrine overwhelmingly in favor of the small state of Delaware,[22] leading to the metaphor of a "race" toward Delaware. The dominance of Delaware is manifest whether one looks at Delaware's share of public companies, initial public offering companies, or companies reincorporating from one state to another.[23] The question is what the identity of the winner, or perhaps the nature of the decision-making process, indicates about the "race."

Scholars have traditionally approached the problem in two complementary ways. The first approach looks at the results of the "race," asking whether Delaware law is better or worse than the law of other states. The idea is that if Delaware law is better, then one could plausibly argue that companies are choosing the more efficient law and that the race is to the top.[24] If Delaware law is worse than that of other states, then companies are choosing to maximize something else and the race is to the bottom. The second approach has analyzed the jurisdictional choice question by studying the factors that influence how companies make incorporation choices. In other words, how do companies choose? What characteristics of companies predict the decisions they will make? The idea is that once one knows what influences corporate choices, one has a good idea about what incentives states offer to companies.

The first approach to the problem (whether Delaware corporate law is better or worse than that of other states) has given rise to several empirical studies. Historically, most of those studies fell in one of two categories: (1) reincorporation event studies that analyzed stock price reactions to

20. *See, e.g.*, RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 303–310 (AM. LAW INST. 1971). This rule goes beyond even the relatively permissive choice of law rules, such as those for contracts, which require some connection to the law chosen. *See* Ribstein & O'Hara, *supra* note 12, at 662 (noting the different rules for choice of law in the corporate context and the contract context).

21. *See generally* CTS Corp. v. Dynamics Corp. of Am., 481 U.S. 69 (1987); Edgar v. MITE Corp., 457 U.S. 624 (1982).

22. The state's success has been so complete that scholars have begun to describe it as having a "monopoly" on corporate charters. *See, e.g.*, Mark J. Roe, *Delaware's Shrinking Half Life*, 62 STAN. L. REV. 125, 130–32 (2009).

23. *See* Romano, *supra* note 2, at 212.

24. This is debatable, however. Marcel Kahan, for example, argues that even if Delaware law increases firm value, that does not necessarily mean that firms choose Delaware for increased value. Kahan, *supra* note 18, at 43–44.

reincorporation announcements[25] and (2) Tobin's q[26] studies that analyzed the value of Delaware companies relative to those in other states.[27] The reincorporation event studies have generally suggested a small positive effect of Delaware incorporation, but have drawbacks that limit their persuasiveness.[28] The Tobin's q studies initially showed positive effects of Delaware law, but also have methodological drawbacks.[29] A more recent entrant to the debate is the "merger reincorporation" approach, which found no evidence of positive or negative value for Delaware law.[30] Overall, more studies suggest a positive value for Delaware incorporation than a negative value, but many suggest no value at all; therefore the results are inconclusive.[31] Thus, there is no definitive evidence that Delaware law increases the value of companies, there is some evidence it does not matter, and there is little evidence that it decreases the value of companies.

The second approach to the problem (what factors predict jurisdictional choice) has given rise to an extensive empirical and theoretical literature as well. Some approaches emphasize the distinction between private and public companies—that Delaware specializes in corporate law for public companies, leading private companies to incorporate in their home states because Delaware law mostly benefits public companies.[32] Others argue the

25. For a discussion of these event studies, *see* ROMANO, *supra* note 7, at 16–18.

26. Tobin's q is a financial measure used in many empirical studies and is often interpreted as an indicator of good firm performance. *See* Roberta Romano, *Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance*, 18 YALE J. ON REG. 174, 212 (2001). The measure is defined as "the ratio of the market value of a firm to the replacement cost of its assets." Kee H. Chung & Stephen W. Pruitt, *A Simple Approximation of Tobin's q*, 23 FIN. MGMT. 70, 70 (1994).

27. *See* Michal Barzuza & David C. Smith, *What Happens in Nevada? Self-Selecting into Lax Law*, 27 REV. FIN. STUD. 3593, 3618 (2014) (finding a positive Tobin's q for Delaware corporations); Robert Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 527–31 (2001); Guhan Subramanian, *The Disappearing Delaware Effect*, 20 J.L. ECON. & ORG. 32, 35–38 (2004) (applying the Tobin's q approach to show that Delaware law adds a modest, though declining, amount of value compared to other states).

28. *See* Subramanian, *supra* note 2, at 1807 (explaining that, although event studies have "relatively consistent results," they "suffer from methodological flaws" related to the fact that reincorporation decisions often coincide with other important business changes, which may alter the results).

29. *Id*. at 1808–10 (describing the result obtained by Robert Daines and subsequent tests of the value of Delaware law). *See generally* Robert P. Bartlett & Frank Portnoy, *The Misuse of Tobin's Q* (UC Berkeley Public Law Research Paper, Feb. 4, 2018), https://ssrn.com/abstract=3118020 (explaining methodological problems with common applications of Tobin's q).

30. *See generally* Robert Anderson IV & Jeffrey Manns, *The Delaware Delusion*, 93 N.C. L. REV. 1049 (2015).

31. William J. Carney et al., *Delaware Corporate Law: Failing Law, Failing Markets*, *in* THE LAW AND ECONOMICS OF CORPORATE GOVERNANCE: CHANGING PERSPECTIVES 23, 27 (Alessio M. Pacces ed., 2010) (concluding that "[t]he results over 25 years of empirical work thus remain inconclusive").

32. *See* RICHARD A. POSNER & KENNETH E. SCOTT, ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 111 (1980).

choice depends on whether the shares of the company are closely or widely held, with Delaware tending to attract more widely held firms.[33] Still another approach argues that companies reincorporate in Delaware when they are contemplating certain types of transactions, such as public offerings, mergers and acquisitions, or the enactment of antitakeover provisions.[34]

This last category, antitakeover provisions, has given rise to one of the major contemporary disputes in the Delaware debate—the role of state antitakeover statutes and favorability of the legal environment to management more generally.[35] Some studies assert that companies are more likely to stay in their home states when those states have stronger antitakeover statutes or other provisions favorable to management.[36] Another study found no evidence of any influence of antitakeover statutes at all, instead focusing on corporate flexibility as the attractive feature.[37] Finally, another study found no effect of antitakeover statutes after taking account of the company's law firm,[38] adumbrating a theme that will become relevant in this Article's analysis.

In more recent scholarship, theories have developed that sidestep the traditional "race" approach. In particular, one approach that has received a great deal of attention is the idea that network effects strongly influence the choice of jurisdiction.[39] Other theories have explored the idea that managers have heterogeneous preferences, with some preferring "strict law" and some preferring "lax law," arguing that such heterogeneity is necessary to explain the choices.[40] A third theory argues that Delaware law may serve as a "lingua

33. See Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179, 184-85, 188 (1985).

34. *See* ROMANO, *supra* note 7, at 32–36.

35. *See, e.g.*, Stephen P. Ferris et al., *The Influence of State Legal Environments on Firm Incorporation Decisions and Values*, 2 J.L. ECON. & POL'Y 1, 12 (2006) (finding that companies are attracted to states with more favorable legal environments for management).

36. *See* Bebchuk & Cohen, *supra* note 11, at 402; Subramanian, *supra* note 2, at 1846, 1852–53.

37. Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection?*, 22 J.L. ECON. & ORG. 340, 340 (2006) (finding that firms favor jurisdictions with flexible corporate law and high quality judicial systems and are not influenced by state antitakeover statutes).

38. Daines, *supra* note 14, at 1597.

39. *See, e.g.*, Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 841–51 (1995). The argument is that Delaware incorporation becomes more valuable as more firms incorporate there, which means that the value of incorporating in Delaware is more than merely the quality of the law. Jens Dammann has argued that in addition to the number of firms incorporated in a jurisdiction, the "homogeneity" of such firms may also play a role in jurisdictional choice. *See generally* Jens Dammann, *Homogeneity Effects in Corporate Law*, 46 ARIZ. ST. L.J. 1103 (2015).

40. *See, e.g.*, Michal Barzuza, *Self-Selection and Heterogeneity in Firms' Choice of Corporate Law*, 16 THEORETICAL INQUIRIES L. 295, 297, 306–13 (2015) ("Incorporating heterogeneity in

franca" that allows in-state investors and out-of-state investors to communicate a common set of legal assumptions.[41] Finally, some have argued that the competition is not between Delaware and other states, but between Delaware and federal regulation.[42]

The increasing complexity of the debate over jurisdictional choice has led toward the perspective that the concept of competition or a "race" among states may not be an accurate metaphor for the process at all. Although it is clear that Delaware competes (either with other states or the federal government), some scholars assert that nobody is vigorously competing with Delaware.[43] Indeed, there is a good argument that Delaware's competitive advantages, some related to the quality of Delaware law and some related to network effects, make it difficult or impossible to compete with Delaware.[44] Thus, theoretical and empirical literatures have failed to come to a consensus about the debate over a race to the top or race to the bottom in corporate law. And that failure is in large part due to a failure to converge on a consensus set of factors that contribute to jurisdictional choice.

But there is another hypothesis that has hovered in the background of most of the existing research without receiving direct focus from most existing studies—the role of *law firms* in incorporation decisions. There is reason to believe that lawyers play a lead role in the jurisdictional choice decision. Lawyers themselves appear to believe they play such a role, as a survey of initial public offering lawyers strongly suggested.[45] Several studies that examined other factors have expressed the suspicion that lawyers play a key role.[46] This is true even of race-to-the-top proponents, who see a large

management preferences, this Article argues that managers with a relatively strong preference for legal protection should be less inclined to incorporate in Delaware.").

41. *See generally* Brian Broughman et al., *Delaware Law as Lingua Franca: Theory and Evidence*, 57 J.L. & ECON. 865 (2014).

42. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 590 (2003) (arguing that Delaware's competition may come from the federal government rather than other states). *Cf.* Omari Scott Simmons, *Delaware's Global Threat*, 41 J. CORP. L. 217, 221 (2015) (arguing that Delaware's competition may come from other countries rather than other states).

43. *See* Bebchuk & Hamdani, *supra* note 16, at 555; Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 685–86 (2002) (noting their substantive agreement that "states do not vigorously compete for incorporations").

44. Michal Barzuza, *Market Segmentation: The Rise of Nevada as a Liability-Free Jurisdiction*, 98 VA. L. REV. 935, 939–40 (2012) (citing network externalities, existing case law, expert judiciary, and political impediments as reasons that make it unlikely Delaware would face serious competition).

45. William J. Carney et al., *Lawyers, Ignorance, and the Dominance of Delaware Corporate Law*, 2 HARV. BUS. L. REV. 123, 147 (2012) (discussing their finding, based on a survey of corporate lawyers, that "[i]n choosing the state of incorporation, lawyers matter. The lawyers and their locations were central to the choice of the state of incorporation.").

46. *See*, *e.g.*, Kahan, *supra* note 18, at 26 (indicating that instead of home state competition accounting for home state incorporation, "[i]t is more likely, as Daines argues, that the pre-existing

role for lawyers in the incorporation decision based on the lawyers' own interests.[47] In particular, several articles have suggested that the local versus national character of law firms may play a role.[48] Indeed, the role of lawyers was specifically identified in the context of initial public offering ("IPO") decisions by Robert Daines, who suggested that the distinction between local firms versus national firms was an important driving factor.[49]

This Article attempts to untangle the factors that predict firms' jurisdictional choice decisions, with special attention to this last hypothesis of lawyer prominence in the jurisdictional choice. If the choice of law firm is a prime driver of the incorporation decision, then both approaches to the jurisdictional choice debate discussed above may produce biased results. The literature on jurisdictional choice[50] may produce incorrect results if omitted variables (such as law firm choice) are correlated with the predictors examined and the jurisdictional choice. Additionally, the literature on the value of Delaware law[51] may lead to incorrect conclusions if Delaware companies are simply demographically different from other companies. Thus, the analysis in this Article has potentially significant implications for the state of knowledge on the jurisdictional choice debate and therefore the corporate federalism debate.

The next Part will introduce the data used to examine the predictors of jurisdictional choice. It turns out that lawyers, and specifically the sophistication of lawyers, will play a significant role in this incorporation decision, as discussed in Part III. However, there may be more to the story, as demographic factors related to the company itself also have significant predictive value in the jurisdiction choice. The analysis clarifies that existing studies have overlooked very important factors that influence the choice of state of incorporation—factors that may lead existing studies to draw faulty inferences.

relationships between managers and (locally based) lawyers account for the 'Delaware or headquarter state' incorporation pattern.").

47. Romano, *supra* note 17, at 273–79.

48. *See, e.g.*, Barzuza, *supra* note 40, at 300–01; Bebchuk & Cohen, *supra* note 11, at 399 (arguing that the identity of a company's law firm "might significantly affect the choice of incorporation state").

49. Daines, *supra* note 14, at 1600 ("Lawyer identity appears to explain more of the variation in firm [state incorporation] decisions than any other factor, including the substance of the state's legal rules.").

50. *See supra* notes 32–38 and accompanying text.

51. *See supra* notes 25–31 and accompanying text.

II. THE DATA

This Part describes the novel dataset of financing disclosures developed for this Article's jurisdictional choice analysis. Section II.A describes the dataset itself and how it was collected. Section II.B conducts an initial analysis of the data, confirms certain well-established findings from the existing literature, and corrects some often-repeated misconceptions. This Part lays the groundwork for the detailed empirical analysis that follows in Part III.

A. THE DATA SOURCE

This Article draws upon a rich source of reliable information that has been largely ignored by scholars[52]—filings made with the Securities and Exchange Commission under Regulation D.[53] Regulation D is probably the most commonly used exemption from the Securities Act of 1933;[54] it is used for private capital-raising and is relied on by over 10,000 public and private companies each year.[55] Companies raising funds in reliance on Regulation D are required to file a Form D within fifteen days of the first sale of securities.[56] As a result, a large number of the forms have been filed and they are easily accessible on the SEC website, providing a treasure-trove of information. Included in the forms is data on the state of organization of the company, the officers and directors, the amount of money raised, the use of proceeds, and the number and type of investors, as well as the company's revenue.[57]

The data reveal important information on the organization of private companies not available through other sources. The Form Ds provide a very broad swathe of companies with diverse characteristics, while focusing on the "right type" of private companies for understanding entrepreneurial choices. The private companies are the "right type" because they are engaged in raising external funds (demonstrated by the very nature of filing the Form D, which is triggered by the sale of securities), which largely excludes single-shareholder corporations or wholly owned subsidiaries of other companies

52. *But see* Rutherford B. Campbell, Jr., *The Wreck of Regulation D: The Unintended (and Bad) Outcomes for the SEC's Crown Jewel Exemptions*, 66 BUS. LAW. 919, 926–42 (2011) (analyzing data related to Form D filings and critiquing the limitations of Regulation D vis-à-vis state "blue sky laws").

53. 17 C.F.R. §§ 230.500–.508 (2018).

54. 15 U.S.C. §§ 77a–77mm (2018).

55. This figure excludes filings by various types of "pooled investment funds," which also file under Regulation D. Including these funds more than doubles the number of filings. Unreported results on file with the author.

56. *See* 17 C.F.R. § 230.503(a) (2018).

57. *See id*. § 239.500 (setting forth the information required in a Form D).

for which the quality of corporate law is less important. In addition, Form D filers are also probably better advised than the average company, as they are specifically availing themselves of Regulation D protection.

Another important reason Form D companies are ideal candidates for studying the incorporation choice is that Form D filers are generally in earlier stages than public companies and are therefore closer in time to the original jurisdictional choice.[58] As a result, these companies have not transitioned to the "separation of ownership and control" model that characterizes public companies in the famous Berle-Means paradigm.[59] That is important because the separation of ownership and control creates agency problems between managers and shareholders that complicate the incorporation decision, which is why some of the best studies have examined IPO firms rather than seasoned public companies.[60] The use of private, pre-IPO companies is even better because it comes at a stage even earlier in the company's evolution and closer to the original incorporation decision. The Form D dataset therefore bridges the truly private companies in previous studies[61] (which may tend to have a large number of single-shareholder corporations) and the public companies that have been the focus of almost all of the literature on jurisdictional choices.

The Form D dataset also contains a seemingly mundane detail that turns out to have strong predictive value. The Form D asks for information about the filing company's revenue, which one would expect to have important predictive value for Delaware incorporation (and it does). However, the mundane detail is that companies are permitted to "decline to disclose" this revenue information simply by checking a box on the form. Remarkably, almost half of the companies that file the form disclose this information, even though they are not required to. As discussed in Parts III and IV, this detail turns out to hold significant predictive value for the jurisdiction choice—as strong as many of the predictive variables documented in the existing literature. Companies that decline to disclose their revenue signal

58. Overall, approximately 74% of the corporations in the dataset had been incorporated within the previous five years. Over 50% had been incorporated within the previous two years. In contrast, among the (relatively small) number of public corporations in the dataset, 60% were older than five years. Thus, analyses of public companies are relatively distant from the original incorporation decision.

59. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 3–10 (Transaction Publishers rev. ed. 1991) (setting out the classic discussion of the separation of ownership and control).

60. *See, e.g.*, Daines, *supra* note 14, at 1569 (explaining that firms going public, as opposed to those already public, are "relatively free from the agency costs" that result from the separation of ownership and control).

61. *See* Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J.L. ECON. & ORG. 79, 81–82, 110 (2011).

information about the sophistication of their legal counsel, and that sophistication predicts incorporation choices.

The data were collected from the SEC's "EDGAR" system.[62] A computer script collected all Form D filings from EDGAR's indices to filings[63] filed between July 1, 2009 and June 30, 2016.[64] The collection process yielded 270,300 total filings, including 160,648 original Form D filings and 109,652 amendment filings, representing filings by 108,830 distinct companies.[65] The script extracted all items of information from each form using the form's XML tags. In some cases, companies filed more than one Form D during the period. The script retained only the earliest filed form because that form is closest in time to the company's organization (and therefore its jurisdictional choice).

The dataset excludes a number of filings that are not relevant to the questions addressed in this Article. The dataset excludes data for all firms located or incorporated outside the United States, which have a different set of organizational choices and considerations than do U.S. firms. In addition, because the focus is on operating businesses rather than funds, the dataset excludes firms classified as "Pooled Investment Funds," which include hedge funds, private equity funds, venture capital funds, and mutual funds.[66] The above restrictions (particularly the elimination of pooled investment funds and multiple filings by the same firm) greatly reduced the overall size of the dataset to 63,369 total entries, each of which is a distinct legal entity.

The data contained in the Form D filings yielded a number of variables related to the companies making the filings. Specifically, the dataset includes the state and zip code of each company's "principal place of business" (headquarters). Similarly, the dataset contains a field for the state of incorporation, type of entity (for example, corporation or LLC) and date of organization. The dataset records the number of executive officers and directors of the company and the extent of the overlap between the two. The dataset includes a variable for whether the company was a reporting company under the Securities Exchange Act of 1934[67] (a "public"

62. *Filings & Forms*, SEC, https://www.sec.gov/edgar.shtml (last visited May 17, 2018).

63. *See EDGAR Full Index*, SEC, https://www.sec.gov/Archives/edgar/full-index (last visited May 17, 2018).

64. The data includes Form Ds filed through June 30, 2016, the approximate date on which the data was downloaded.

65. Entities are identified by CIK number. Separate CIK numbers does not necessarily mean that two entities are unrelated. Generally, each entity will have its own CIK number, even if they are affiliates.

66. However, note that the findings of this Article are qualitatively similar when such funds are included.

67. 15 U.S.C. §§ 78a–78qq (2012).

company).[68] The dataset also includes a variable for the broad industry category of the company's business. For about half of the companies, the approximate revenue of the company is disclosed (more about this variable below). Finally, the dataset contains a variable for whether the company was organized within the last five years or more than five years ago.

The Form D filings also contained many useful variables related to the financing transaction for which the form was filed. These variables include the dollar amount of securities offered and sold, the number of investors, the type of securities offered, the amount of "sales compensation" paid to brokers and finders, if any, and the amount of the offering used as payments to executive officers, directors, or promoters. In addition, the dataset includes some legal variables related to the financing; specifically, the Rule relied on under Regulation D (Rule 504, 505, or 506) and the type of investors in the offering (accredited or non-accredited investors).[69]

Finally, the dataset includes three pieces of information that serve as proxies for the legal sophistication of the issuer or its counsel. First, the dataset records whether the issuer checked the "Decline to Disclose" box for its revenue. The issuer is not required to disclose its revenue and there is generally no reason to do so. Yet, as is discussed below, about half of all companies do disclose their revenue range, most likely out of unfamiliarity with prevailing financing practices followed by major firms. Second, the dataset also includes a "pure" proxy for the legal sophistication of the party preparing the form: the use of conformed signatures[70] in the signature block. Conformed signatures have no business or financial significance in the offering, but are markers for lawyers steeped in "deal culture," where they are commonly used in electronic filings by public companies. Third, Form D contains a box for "minimum [amount of] investment accepted from any outside investor."[71] Counsel that are experienced in filing Form Ds tend to enter zero in this line when the investment has been completed at the time of

68. Companies were identified as "public" if they had filed a Form 10-Q or S-1 during the 2009–2016 period prior to the date of filing the Form D. This is a very broad definition of "public" company because, as will be discussed below, many reporting companies are "shell companies," "penny stock" issuers, "blank check companies," and the like.

69. The definition of an "accredited investor" is contained in Securities Act Rule 501(a). 17 C.F.R. § 230.501(a) (2018). In general, an accredited investor is one who the SEC defines as falling within Congress's definition of "any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe." 15 U.S.C. § 77b(a)(15)(ii) (2012).

70. Conformed signatures are a typed representation of a signature used on electronically filed documents. Most commonly, conformed signatures are denoted by "/s/" preceding the signatory's name.

71. *Form D*, SEC, https://www.sec.gov/files/formd.pdf (last visited May 17, 2018).

filing.

B. COMPARING THE DATA WITH RESULTS FROM EXISTING LITERATURE

The dataset described above contains a rich source of information about tens of thousands of companies. In theory, analyzing this data to uncover the factors that drive firms' jurisdictional choice decisions could be very complex. A company's choice of jurisdiction potentially entails the pairwise comparison of fifty states' corporate statutes—a total of 1,225 individual state-to-state comparisons along potentially hundreds of relevant factors. In practice, however, the choices appear to be driven by very simplistic heuristics. The existing literature strongly suggests that, at least for publicly traded companies,[72] and venture-backed companies,[73] the vast majority of businesses organize either in the jurisdiction in which they are located or in Delaware. Moreover, a 2011 paper has largely confirmed this pattern with respect to private companies as well.[74]

The data collected in this Article provide strong support for the pattern that incorporation choices are limited to Delaware versus home state incorporation, at least for private companies. As set forth in Table 1 below, overall, 94.3% of private corporations in the dataset incorporated either in Delaware or their respective home state.[75] The picture for public corporations is a bit more complicated, with only 69.6% incorporated in Delaware or the home state. The primary reason for this difference is the incursion of Nevada into the public company market, with 22.3% of all "public" corporations incorporating in Nevada. For a variety of reasons, the Nevada phenomenon is not as significant as it appears. First, most of the Nevada companies are essentially shell companies with no significant operations.[76] Second, a larger study of public corporations found a

72. Daines, in his 2002 article, found that 97% of public companies were incorporated either in their home states or Delaware. Daines, *supra* note 14, at 1562. Other studies have found similar results. *See, e.g.*, Bebchuk & Hamdani, *supra* note 16, at 579 (documenting Delaware having an 80–90% share of out-of-state incorporations and suggesting that this share is growing).

73. *See* Broughman et al., *supra* note 41, at 872 (reporting that 96.5% of a sample of venture-capital-backed companies organized in either their home state or Delaware).

74. *See* Dammann & Schündeln *supra* note 61, at 106 (reporting from a broad sample of private companies figures between 50% and 83% depending on the size of the company).

75. The small difference with Daines is not due to the fact that Daines examined public companies and this study examines private companies because the incorporation figure among the public companies in the sample is actually lower. The difference is the result of the recent incursion of Nevada into public company incorporations.

76. Scholars have noted the Nevada phenomenon of the last decade or so, explaining that Nevada has attracted "a particular segment of the interstate market for incorporations—firms with a preference for strong management protection that is not satisfied by Delaware law." Barzuza, *supra* note 44, at 938. One paper suggests Nevada attracts firms that are prone to financial reporting failures. Barzuza & Smith,

significantly lower figure of an 8% share for companies incorporated in Nevada.[77] When Nevada corporations are excluded, the ratio of Delaware to headquarters state incorporations is very similar for public and private corporations—about two to one.

TABLE 1. State of Incorporation by Public or Private Status

	Not Incorporated in Headquarters State			*Incorporated in Headquarters State*
	Delaware Incorporation	*Nevada Incorporation*	*Other State Incorporation*	
Private Corporations	64.0%	2.5%	3.1%	30.3%
Public Corporations	48.7%	22.3%	8.1%	20.9%

Furthermore, the table makes clear that the state incorporation decision is not the result of a comprehensive, fifty-state survey of corporate law, but rather a choice between Delaware incorporation and home-state incorporation, with a Nevada option for certain types of public companies. These results for public companies largely mirror the results from the existing literature.

The results contrast sharply with the existing literature, however, in terms of Delaware's share of private companies. The conventional wisdom is that Delaware has a much lower share of total incorporations among private companies than among public companies and that a "dominance by a single state exists only for publicly held firms in the U.S. federal system,"[78] as "the market for closely held firms looks quite different from the market for publicly held firms."[79] Indeed, an influential article by Marcel Kahan and Ehud Kamar makes the private company preference for home-state incorporation a key piece of an argument about Delaware's pricing scheme for corporations.[80]

supra note 27, at 3594. Although the growth of Nevada's share of reporting companies appears impressive, most of the Nevada "public" companies incorporated in Nevada are "penny stock companies" with little significance. Indeed, the annual reports of 69% of Nevada public companies contain text referring to "penny stock," "blank check company," or "shell company," all terms used by the SEC to refer to securities with abuse potential. *See* 17 C.F.R. § 240.3a51-1 (2018) ("penny stock"); *id*. § 230.419(a)(2) ("blank check company"); *id*. § 240.12b-2 ("shell company"). By comparison, the percentage was 25% among Delaware public companies.

77. Barzuza & Smith, *supra* note 27, at 3594.

78. Ribstein & O'Hara, *supra* note 12, at 702.

79. *Id.*

80. *See* Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86

There had not been much empirical investigation of this assertion about private companies until an article by Jens Dammann and Matthias Schündeln collected data on private companies' incorporation choices.[81] Using a new data set, the authors found results supporting this conventional wisdom: the vast majority of privately held corporations incorporated where they were located, not in Delaware.[82] Indeed, corporations in their dataset were only more likely to incorporate in Delaware than elsewhere when the companies were very large (over 5,000 employees).[83]

The data from Table 1, however, indicate that private companies' incorporation choices are not much different from those of public companies when Nevada is excluded. Privately held companies that file Form D incorporate in Delaware in proportions similar to publicly traded companies. Indeed, even the small differences evident in Table 1 mostly disappear when other variables are controlled, as the more detailed analysis in Part III demonstrates. What accounts for the conventional wisdom's assumption of a dramatic difference between private and public companies' jurisdictional choices? The conventional wisdom was based on comparing one type of private company against a very different type of public company. The private company data often included very small companies that had not recruited outside investors, whereas public companies, by their nature, had recruited outside investors.[84] When the same selection process is used for public and private companies, even a process as non-substantive as the filing of a Form D, those differences largely disappear.

The results of this analysis are actually quite surprising given the current state of research on privately held corporations. On one hand, corporate lawyers have known for a long time that the majority of *publicly traded* companies incorporate in Delaware. On the other hand, until recently,

CORNELL L. REV. 1205, 1225–30 (2001).

81. *See generally* Dammann & Schündeln, *supra* note 61 (evaluating the incorporation decisions of privately held companies).

82. *Id.* at 79.

83. *See id*. at 84.

84. The fact that the data from this study is drawn from Form Ds also has import upon the appropriate interpretation of the result. There is nothing inherent in the use of Form D that should govern a company's state of incorporation. Indeed, the filing of a Form D is a requirement to rely on Regulation D, which is one of the most widely used and general exceptions to the registration requirements of the federal Securities Act of 1933. One explanation is that the companies filing Form Ds in this dataset are different, in the sense that they have sought outside capital. Thus, one theory is that outside capital may be one of the major influencers of the jurisdictional choice decision. Companies that raise capital using Form D tend to incorporate in Delaware more than corporations in general. It is also possible, however, that the very fact of filing a Form D and the legal sophistication it entails might be what makes such companies different. A clue is the fact that most companies do not file a Form D. Some companies decide not to file the Form D because there seem to be no consequences to failing to do so.

there was little evidence of where *privately held* companies incorporated. The conventional wisdom about private companies making different incorporation decisions made sense given the assumption that the governance attributes of the company drive the jurisdictional choice decision. After all, public companies and private companies often face different corporate law problems. But it turns out that in the Form D dataset, public and private companies choose similar governance regimes. This fact is the first hint from the data that the assumptions about incorporation choices are flawed and that company-specific needs may not actually dictate the incorporation choice. These questions are the focus of the detailed empirical analysis of Part III and the interpretation of Part IV.

III. EMPIRICAL ANALYSIS

The preliminary results identified in Part II suggest that some of the assumptions about how companies make incorporation decisions may merit revisiting. This Part uses empirical analysis of the novel Form D dataset to identify the variables that predict Delaware incorporation. Section II.A describes the methodology used in the analysis. Section II.B presents the main results. The analysis uncovers some novel predictors of the Delaware incorporation choice that existing scholarship has overlooked.

A. METHODOLOGY

The discussion above has shown that the relevant choice facing firms is between Delaware incorporation and home-state incorporation. Accordingly, to model the jurisdictional choice, a dichotomous choice model—such as logistic regression[85]—is appropriate to model the choice between Delaware incorporation and other-state incorporation.[86] The dependent variable in the logistic regression is equal to one if Delaware is the jurisdiction of incorporation and zero otherwise.[87]

The independent variables break down into three broad sets of predictors: (1) "business" predictors; (2) "legal" predictors; and (3) "demographic" predictors. The business predictors are the industry category, the dollar amount of securities sold, the type of security sold, whether the

85. Logistic regression, also called "logit," is one of several statistical methods employed when a binary dependent variable is used in an analysis. *See* J. SCOTT LONG, REGRESSION MODELS FOR CATEGORICAL AND LIMITED DEPENDENT VARIABLES 34 (1997).

86. The results are not qualitatively different if only based on the choice between Delaware and the home state.

87. The number of companies headquartered in Delaware is so small that any "in-state" effect of these companies is minimal and does not change the results.

company has independent (non-officer) directors, the number of investors, the company's revenue range, and whether the company is a public company. The legal predictors are the specific rule exemption relied on within Regulation D, the "Decline to Disclose" checkbox, the use of conformed signatures in the signature block, whether securities may be sold to only to accredited investors, and whether the "minimum investment amount" is listed as zero.[88] The demographic predictors are the mean income in the company's zip code from Internal Revenue Service ("IRS") data[89] and whether the company is more than five years old. Finally, indicator variables for the state location of the company's headquarters are used in some of the models. This last variable straddles the line between a "legal" variable and a "demographic" variable, as more fully discussed below.

The "legal" variables merit some additional explanation. The "Decline to Disclose" and "conformed signatures" variables are both proxies for the unknown identity of the company's legal advisors. As discussed in Section II.A,[90] the Form D filing requests the issuer to disclose the range of its revenue, but allows the issuer to "Decline to Disclose" the information simply by checking a box. There is no penalty for not providing the information,[91] and the voluntary inclusion of information in this context typically would not serve the issuer's interests.[92] Large national law firms generally automatically check "Decline to Disclose" as a matter of best practice.[93] Yet about half of companies disclose their revenue, suggesting their counsel are unfamiliar with or reject these best practices. As a result, the checking of this box is a reliable proxy for the "deal culture"

88. Most of the predictors share "legal" and "business" characteristics, however. For example, the amount raised may be influenced not only by business considerations, but also by the specific exemption relied on (Rule 504 has a $1 million limit on the amount of securities sold and Rule 505 has a $5 million limit). Similarly, the "Decline to Disclose" decision could occasionally be a conscious choice driven by business considerations. Thus, the grouping into "legal" or "business" factors is not perfect. This is one reason for including the "conformed signature" variable, in order to ensure that there was at least one purely legal variable.

89. *SOI Tax Stats - Individual Income Tax Statistics - 2014 ZIP Code Data (SOI)*, IRS, https://www.irs.gov/statistics/soi-tax-stats-individual-income-tax-statistics-2014-zip-code-data-soi (last visited May 17, 2018).

90. *See supra* note 70 and accompanying text.

91. Filers have failed to disclose this information from the very beginning, as criticized in an Office of Inspector General Report in 2009. *See* OFF. INSPECTOR GEN., SEC, REGULATION D EXEMPTION PROCESS 19 (Mar. 31, 2009), https://www.sec.gov/about/offices/oig/reports/audits/2009/459.pdf.

92. One might argue that disclosing revenue information would generate interest and perhaps publicity around the offering, which might benefit the issuer, for example, by attracting the interest of investors or potential acquirers. This explanation in unconvincing, *see infra* Section IV.C.

93. This was confirmed by the author with several partners in major law firms who regularly make Form D filings.

sophistication of the law firm that handled the financing.

The "conformed signatures" variable is included as an even purer measure of "deal culture," as its use literally has no business implications. Lawyers in national practices, particularly those who regularly file electronic reports with the SEC, routinely use "conformed signatures" in documents filed with the SEC and are likely to be familiar with the custom. Under half of the Form D filings contain a conformed signature in the signature block, but those that did were much more likely to "Decline to Disclose" as shown in Table 2 below. The upper-left corner denotes the 9,681 filings that show both hallmarks of deal culture sophistication, and the lower right shows the 6,767 that show neither hallmark of deal culture sophistication. It is clear that filers using conformed signatures are much more likely to decline to disclose than those who do not use conformed signatures, and that filers who decline to disclose are much more likely to use conformed signatures than those who do not decline to disclose.[94] In other words, the two measures of sophistication are correlated, although certainly not perfectly so.

TABLE 2. Two Markers for Deal Culture Sophistication in Corporations

	Declined to Disclose Revenue	*Disclosed Revenue*
Conformed Signatures	9,681	3,457
No Conformed Signatures	8,175	6,767

These measures are designed to have little substantive connection with the nature of the business or with each other, but to have a significant connection with the culture of legal advisors. They are intended to serve only as "markers," or proxies, for the unobservable identity of the company's legal advisors. To be clear, it need not be the case that the upper left box is "correct" legal practice and the lower right box "incorrect." All that is necessary is that the measures serve as proxies for the characteristics of the legal advisors involved in representing the company.

The variables used in the analysis in Section III.B are collected together in Table 3, below, together with descriptive statistics.

94. To test this relationship, a Chi-Squared test was used, which was significant at $p<0.001$.

TABLE 3. Descriptive Statistics (Corporations)

Variable	*Description*	*Mean*	*Median*	*Standard Deviation*
	Legal Variables			
Decline to Disclose	Equal to 1 if the company checked "Decline to Disclose," and 0 otherwise	0.636	1	0.481
Conformed Signatures	Equal to 1 if the signature block of the Form D contained at least one conformed signature, 0 otherwise	0.468	0	0.499
Rule 504	Equal to 1 if any box indicating reliance on Rule 504 was checked, 0 otherwise	0.067	0	0.250
Rule 505	Equal to 1 if the box indicating reliance on Rule 505 was checked, 0 otherwise	0.046	0	0.209
Rule 506	Equal to 1 if any box indicating reliance on Rule 506 was checked, 0 otherwise	0.926	1	0.262
Only Accredited Investors	Equal to 1 if the box in Item 14 is not checked, indicating that securities may only be sold to accredited investors	0.892	0	0.310
Minimum Investment Amount	Equal to 1 if the minimum investment amount in Item 11 is listed as 0	0.365	0	0.481

	Demographic Variables			
Log(HQ Zip Code Income)	The log of the mean adjusted gross income for the zip code, as calculated from IRS data	4.74	4.63	0.736
Company > 5 Years Old	Equal to 1 if the box for year of incorporation/organization “over five years ago” was checked, zero otherwise	0.266	0	0.442
	Business Variables			
Log(Amount Sold)	The log of the “Total Amount Sold” box in Item 13(a)	12.023	13.305	4.86
Industry Category	34 indicator variables, one for each industry group in Item 4 of the Form D	…	…	…
Type of Security Sold	16 indicator variables, one for each combination of type of securities offered in Item 9 of the Form D	…	…	…
Independent Directors	An indicator variable equal to 1 if there are directors listed in Item 3 who are not also executive officers, 0 otherwise	0.621	1	0.485
Log(Number of Investors)	The logged entry of the total number of investors who have invested in the offering in Item 14	1.743	1.609	1.141
Revenue Range	8 indicator variables for the revenue range of the issuer disclosed in Item 5 (including “Decline to Disclose”)	…	…	…
Public Company	An indicator variable equal to 1 if the company has filed a 10-Q or S-1 during the period prior to the Form D	0.115	0	0.320

	State Law			
Headquarters State Dummies	50 indicator variables, one for each state and the District of Columbia	…	…	…

The descriptive statistics in Table 3 reveal some interesting patterns. Some of the legal variables divide the companies roughly in half. For example, although most companies check the "Decline to Disclose" box, nearly 40% unnecessarily disclose the company's revenue. Similarly, about half of the companies use conformed signatures and about half do not. In contrast, almost all of the filings relied on Rule 506 of Regulation D, with Rules 504 and 505 rarely serving as the basis for the securities offering.[95] Similarly, almost all of the offerings were limited to accredited investors, with only about 10% including other investors. Thus, there are some legal hallmarks of sophistication present in virtually all filings, while other markers of sophistication divide the companies roughly in half. As will be discussed in Section III.B, that half-and-half division of markers of legal sophistication will largely predict the incorporation choice of the companies.

B. RESULTS

The results of the main analysis are presented in Table 4, below. Table 4 presents the results of five models, which test the sets of variables individually and then together. In each model, Delaware incorporation is the dependent variable. Model 1 presents the results of the regression with only the "legal" variables. Model 2 presents the results of the regression with the demographic variables added (logged zip code average income and age of company). Model 3 presents the results of the regression with only the business variables (logged dollar amount sold, industry category, type of security sold, presence of independent, non-executive-officer directors, logged number of investors, and revenue range). Model 4 presents the full model with all of the above variable categories included.

The models are designed to show the effects of the three sets of variables ("legal," "legal and demographic," and "business" variables) separately for comparison purposes, and then together with full control variables. Model 5 adds headquarters state dummy variables, which are designed to capture any residual state-by-state effects, as discussed in more

95. The lack of use of Rules 504 and 505 has previously been documented in another study on Form Ds. *See* Campbell, *supra* note 52, at 922–23 (noting the lack of use of Rule 504 and 505 and attributing the dominance of Rule 506 to its preemption of state Blue Sky Laws).

detail in Section III.B.4.

In the table, variables with positive coefficients (the first number in each box) are associated with an increased probability of Delaware incorporation compared to home-state incorporation. Numbers with negative coefficients are associated with a decreased probability of Delaware incorporation. So, for example, in Model 1 all legal variables are associated with an increased probability of Delaware incorporation, except variables "Rule 504" and "Rule 505," which are associated with a decreased probability of Delaware incorporation. The stars next to the coefficients denote the level of statistical significance (if any) for each variable, with one star indicating the traditional 5% level and additional stars indicating higher levels of statistical significance.

TABLE 4. Logistic Regression Analysis of Jurisdictional Choice Decision
Dependent Variable: Delaware Incorporation

Variable	*Model 1: Legal Variables Only*	*Model 2: Legal Variables and Demo-graphic Variables*	*Model 3: Business Variables Only*	*Model 4: Legal, Demo-graphic and Business Variables*	*Model 5: Plus State Dummy Variables*
Intercept	-1.517 *** (0.089)	-3.561*** (0.131)	-2.923 *** (0.216)	-5.013*** (0.263)	-4.071*** (0.036)
			Legal Variables		
"Decline to Disclose"	0.942*** (0.029)	0.839*** (0.030)	…	0.603*** (0.090)	0.670*** (0.094)
Conformed Signatures	0.096*** (0.028)	0.128*** (0.029)	…	0.092*** (0.032)	0.117*** (0.031)
Rule 504	-0.433*** (0.081)	-0.504*** (0.083)	…	-0.383*** (0.086)	-0.436*** (0.089)
Rule 505	-0.176* (0.073)	-0.208** (0.074)	…	-0.255*** (0.077)	-0.280*** (0.079)
Rule 506	0.312*** (0.082)	0.284*** (0.084)	…	0.238** (0.087)	0.233* (0.090)
Only Accredited Investors	0.809*** (0.047)	0.757*** (0.048)	…	0.558*** (0.052)	0.558*** (0.055)

Minimum Investment Amount of Zero	0.903*** (0.029)	0.915*** (0.030)	…	0.612*** (0.052)	0.605*** (0.034)
			Demographic Variables		
HQ State Dummy	…	…	…	…	Included
Log(HQ Zip Code Income)	…	0.515*** (0.021)	…	0.469*** (0.022)	0.312*** (0.025)
Company more than 5 Years Old	…	-0.837*** (0.031)	…	-0.925*** (0.037)	-0.968*** (0.038)
			Business Variables		
Log (Amount Sold)	…	…	0.084*** (0.004)	0.064*** (0.004)	0.0634*** (0.004)
Industry Category	…	…	Included	Included	Included
Type of Security Sold	…	…	Included	Included	Included
Independent Directors	…	…	0.300*** (0.031)	0.280*** (0.033)	0.276*** (0.0344)
Log (Number of Investors)	…	…	0.078*** (0.016)	0.091*** (0.016)	0.0794*** (0.017)
Revenue Range	…	…	Included	Included	Included
Public Company	…	…	-0.484*** (0.047)	-0.350*** (0.050)	-0.352*** (0.053)
-2LL	32,032	30,492	30,041	27,941	26,116
Pseudo R^2	0.137	0.178	0.190	0.246	0.296
AIC	32,048	30,512	30,161	28,077	26,354

Notes: *** p-value less than 0.001, ** p-value less than 0.01, * p-value less than 0.05. Standard errors in parentheses. N=27,188. Null deviance 35,871. Pseudo R^2 is McFadden's.

1. Legal Variables

Table 4 shows the strong predictive value of the legal variables on Delaware incorporation. The "Decline to Disclose" variable is strongly predictive by itself in Model 1 and remains strongly predictive (albeit with a smaller coefficient) when all control variables are introduced in Model 4. Companies that decline to disclose their revenue are much more likely to incorporate in Delaware. Even controlling for all other variables in Model 5, companies that decline to disclose revenue have almost twice the odds of other companies of incorporating in Delaware.[96]

In addition to the "Decline to Disclose" variable, the other "legal" variables were also highly significant. The use of conformed signatures predicted an increased rate of Delaware incorporation, although not as strongly as "Decline to Disclose." Reliance on either Rule 504 or 505 is associated with less sophisticated offerings and predicts a lower probability of Delaware incorporation. Reliance on Rule 506 is associated with more sophisticated offerings and predicts a higher probability of Delaware incorporation. Limiting the offering to accredited investors, also typical of more sophisticated offerings, is strongly associated with Delaware incorporation in all models. Likewise, a minimum investment amount of zero strongly predicts Delaware incorporation.

In short, there is clearly a cluster of legally sophisticated offerings in which Delaware incorporation is very likely and a diffuse group of other, less sophisticated offerings in which Delaware incorporation is less likely. To give a sense for how much predictive power the legal variables have, note that among the 6,911 filings in which all markers for legal sophistication were present ("Decline to Disclose" checked, conformed signatures used, Rule 506 used, accredited investors only, and minimum investment amount of zero), the rate of Delaware incorporation was 84.1%. In contrast, among this group, the next highest state (California) had only a 3.8% share. In the 515 offerings in which no markers for legal sophistication were present, the rate of Delaware incorporation was 18.9%. But in this latter category of unsophisticated offerings, the next highest state (California) nearly equals Delaware's share of incorporations, with 16.7%. Thus, in the most sophisticated offerings, Delaware incorporation is virtually always used,

96. This figure is based on the odds ratio, which is a common means of summarizing the effect of a variable in a logistic regression. An odds ratio of one means that the event is equally likely in both groups, whereas an odds ratio greater than one means that the event is more likely in the group represented by the independent variable (here, those that check "Decline to Disclose"). *See, e.g.*, LAWRENCE S. MEYERS ET AL., APPLIED MULTIVARIATE RESEARCH: DESIGN AND INTERPRETATION 230 (2006) (discussing technique).

while in the least sophisticated offerings, Delaware incorporation is present less than 20% of the time.

2. Demographic Variables

The addition of the two demographic variables in Model 2 substantially increases the predictive power of the model. Companies incorporated in lower-income zip codes incorporate in Delaware in much smaller proportions than companies in higher-income zip codes. The 1,358 companies headquartered in zip codes with average incomes less than $50,000 incorporated in Delaware at a 45% rate. The 5,704 companies headquartered in zip codes with average incomes greater than $200,000 incorporated in Delaware at an 80% rate. As discussed below,[97] the fact that Delaware incorporation is closely tied to geography (independently of state lines) has important implications for empirical studies of corporate law.

The age of the corporation (greater than or less than five years old) also affects the probability of Delaware incorporation. Older companies are less likely to be incorporated in Delaware (48%) than newer ones (68%). This effect is considerably less than the average income of the zip code, but still significant.

The inclusion of demographic variables does not substantially weaken the effects of the legal variables. Indeed, the effects of a few of the legal variables are slightly strengthened by inclusion of the demographic variables. This is important because it shows that the legal sophistication variables are not simply picking up demographic features of the corporations (measured by zip code income). The legal variables and the demographic variables each strongly predict the incorporation choice, even when the other group is controlled.

3. Business Variables

The conventional wisdom about incorporation choices suggests that business variables would influence the choice of Delaware incorporation and indeed most of them do. For example, as the total dollar amount of securities sold increases, the rate of Delaware incorporation increases, and as the company's revenue increases, the rate of Delaware incorporation increases.[98]

97. *See infra* Section V.C.

98. The finding that larger company size translates into higher rates of Delaware incorporation has been noted in previous studies. *See* Subramanian, *supra* note 2, at 1841. Interestingly, the mechanism Subramanian suggests for this relationship is that larger corporations choose New York City lawyers who choose Delaware incorporation. *See id.* at 1836. This posits a causal relationship between the state of incorporation and a law firm's identity, for which this study provides strong evidence.

In general, as the type of security sold becomes more complex, the rate of Delaware incorporation increases, with almost all forms of convertible securities, options, or warrants tending to predict Delaware incorporation, and the simple description of "equity" or "debt" tending to predict incorporation in other states.[99] As the number of investors in the offering increases, the rate of Delaware incorporation increases, consistent with the general notion that Delaware law is favorable to more widely held companies.

The presence of non-management directors on the board (independent directors) is also predictive of Delaware incorporation. In the context of private companies, non-management directors likely signal outside investors with board seats. Companies likely have outside investors with board seats when the company has received a professional investment round, such as from a venture capital fund.

Finally, the industry group is strongly connected to Delaware incorporation, with technology, pharmaceuticals, and computer companies tending to incorporate in Delaware at much higher rates than more traditional industries. The previous literature had not established this finding either in general,[100] or in private companies specifically.[101] The strong predictive value of these industries toward Delaware incorporation is likely because venture-capital-backed companies tend to favor Delaware incorporation among portfolio companies.[102]

The most surprising result in the business variables section is that the "Public Company" variable, however, does not correlate with Delaware incorporation. Public companies in the dataset are no more likely to incorporate in Delaware than are private companies. The proportion of public and private companies incorporated in Delaware companies are almost identical when other variables are controlled. This result is surprising because many commentators have argued or assumed that Delaware

99. Convertible securities are likely markers for venture capital financings, although certainly not limited to that context.

100. *See* Subramanian, *supra* note 2, at 1836 ("[T]o my knowledge no one has argued that the demand side of the corporate charter market differs meaningfully by industry."). It is interesting that many of the articles analyzing incorporation choice control for industry (therefore suspecting it might play a role), yet tend not to note any significant results. *See id. Accord* Daines, *supra* note 14, at 1595; Dammann & Schündeln, *supra* note 61, at 93.

101. *See, e.g.*, Dammann & Schündeln, *supra* note 61, at 85 n.10 (noting that the authors' analysis of industry as a predictor did not find "any one [industry] sector driving the results").

102. *See, e.g.*, Thomas J. Boulton, *Venture Capital and the Incorporation Decisions of IPO Firms*, 62 J. ECON. & BUS. 477, 492 (2010) (finding that venture-backed IPO companies were more likely to incorporate in Delaware than non-venture-backed IPO companies).

corporate law is calibrated to the needs of public companies.[103]

4. Effect of State Law

Model 5 includes dummy variables for the headquarters location of the companies in the fifty states or the District of Columbia. The inclusion of state-fixed effects is designed to capture any residual effect of state legal environments. If, as many existing studies argue, differences among state laws influence the choice to incorporate in Delaware, then these variables would pick up those effects. This is because, as established in Part II, the incorporation choice is between Delaware and the headquarters state, so the relative attractiveness of Delaware and the headquarters state will be measured by the coefficient on the headquarters state. If a state has an unfavorable corporate legal environment, it will have a positive coefficient (pushing companies toward Delaware). If a state has a favorable corporate legal environment, it will have a negative coefficient (pulling companies away from Delaware).

The effect of the state dummy variables is relatively modest, casting doubt on state corporate law as a significant driver of jurisdictional choice. Although many states have highly significant coefficients, the overall effect of the headquarters state indicator variables is far less than the legal sophistication variables or the demographic variables. This indicates that once other relevant variables have been controlled, the headquarters state loses much of its predictive power. In addition, the effect of several states commonly cited in existing literature is eliminated or even reversed when the other variables are controlled. For example, California is often described in many studies as a state companies flee from because of its corporate law.[104] But when the other variables are controlled, California companies are actually slightly more likely to incorporate in-state than companies in other states, suggesting these prior studies' findings showing state law effects were merely reflecting legal sophistication and demographic variables.[105]

This is important because, as discussed more fully in Part V, many studies of incorporation choice use headquarters state law as a predictive variable on the assumption that the headquarters state effect reflects the good or bad state corporate law. To the extent that the other predictors introduced in this study (especially zip code income) reduce the predictive power of state identifiers, state law characteristics may have been confounded with

103. *See* POSNER & SCOTT, *supra* note 32, at 111; Kahan & Kamar, *supra* note 80, at 1225–30.

104. *See*, *e.g.*, Bebchuk & Cohen, *supra* note 11, at 386–87, 396, 411.

105. These findings reflect the results of an unreported regression on file with the author.

other demographic characteristics in prior studies, accounting for those prior studies' purported state law effects.

C. COMPARISON TO THE ENTITY CHOICE DECISION

The empirical analysis above shows the strong effect of legal sophistication and demographic variables in the jurisdictional choice decision, an effect at least as strong as the business variables. It is possible, however, that the business variables are imperfectly controlled and the truly explanatory business variables are correlated with the legal variables. In such a case, the legal variables might simply reflect a spurious relationship actually based on the business variables with which they are correlated.

In order to address this possibility, Section III.C performs the same analysis of the same variables on the other organizational choice—the choice of entity between a corporation and another entity (such as a LLC). The choice of entity is made at the same time as the choice of jurisdiction and should involve many of the same factors as the choice of jurisdiction. If the legal and demographic variables in Table 4 merely reflected unmeasured business variables, then an analysis of the choice of entity form should reflect this same pattern. However, as Table 5 shows, the predictors of entity choice differ sharply from the predictors of jurisdictional choice.

Because the choice of entity is largely between a corporation, limited liability company, or other entity, this choice is also modeled as a logistic regression, with the choice of "Corporation" as one and LLC or other entity as zero. The results are set forth in Table 5, below. Like the analysis underlying Table 4, in Table 5, variables with positive coefficients are associated with an increased probability of a corporation entity choice. Numbers with negative coefficients are associated with a decreased probability of a corporation entity choice.

TABLE 5. Logistic Regression Analysis of Entity Choice Decision
Dependent Variable: Corporation

	Model 1-Legal Variables Only	*Model 2-Legal Variables and Demographic Variables*	*Model 3-Business Variables Only*	*Model 4-Legal, Demo-graphic and Business Variables*	*Model 5-Plus State Dummy Variables*
Intercept	-0.979*** (0.053)	-0.862*** (0.079)	-0.199 (0.148)	-0.615*** (0.179)	-0.364 (0.240)

			Legal Variables		
"Decline to Disclose"	0.169*** (0.019)	0.219*** (0.020)	…	-0.133 (0.077)	-0.173* (0.078)
Conformed Signatures	0.442*** (0.019)	0.403*** (0.019)	…	0.143*** (0.024)	0.154*** (0.025)
Rule 504	0.455*** (0.050)	0.483*** (0.052)	…	0.195** (0.060)	0.161** (0.061)
Rule 505	-0.083 (0.044)	-0.066 (0.045)	…	-0.154** (0.053)	-0.175** (0.055)
Rule 506	-0.144** (0.050)	-0.096 (0.052)	…	-0.151* (0.061)	-0.127* (0.062)
Only Accredited Investors	0.129*** (0.029)	0.138*** (0.030)	…	-0.057 (0.037)	-0.107** (0.026)
Minimum Investment Amount of Zero	1.285*** (0.019)	1.280*** (0.020)	…	0.718*** (0.025)	0.642*** (0.026)
			Demographic Variables		
HQ State Dummy	…	…	…	…	Included
Log(HQ Zip Code Income)	…	-0.086*** (0.013)	…	0.010 (0.016)	-.104*** (0.018)
Company > 5 Years Old	…	1.490*** (0.027)	…	0.834*** (0.034)	0.869*** (0.035)
			Business Variables		
Log (Amount Sold)	…	…	0.019* (0.003)	0.012*** (0.003)	0.008** (0.003)
Industry Category	…	…	Included	Included	Included
Type of Security Sold	…	…	Included	Included	Included
Independent Directors	…	…	0.619*** (0.023)	0.517*** (0.023)	0.547*** (0.024)

Log (Number of Investors)	…	…	-0.005 (0.012)	0.009 (0.013)	0.020 (0.013)
Revenue Range	…	…	Included	Included	Included
Public Company	…	…	3.560*** (0.106)	3.231*** (0.107)	3.216*** (0.109)
-2LL	76,571	72,867	52,599	50,972	48,984
Pseudo R^2	0.092	0.136	0.376	0.395	0.419
AIC	76,587	72,887	52,719	51,108	49,222

Notes: *** p-value less than 0.001, ** p value less than 0.01, * p-value less than 0.05. Standard errors in parentheses. N=61,391. Null deviance 84,303. Pseudo R^2 is McFadden's.

The results for the choice of entity are very different from those for the choice of jurisdiction, with different sets of variables playing more or less important roles than in the jurisdictional choice decision. In Table 5, the business variables are clearly dominant, with the demographic and legal variables playing relatively minor roles. Model 3, which includes only the business variables, is clearly more explanatory than Model 1 (legal variables) or Model 2 (legal and demographic variables), and nearly as good as the full Model (Model 5). The most important single variable is the industry category, which predicts the corporation versus LLC decision quite well, whereas industry category predicts the Delaware versus non-Delaware decision only modestly.

The legal variables, in contrast, do not predict the organizational choice well. Although the legal variables are significant in Model 1, they do not predict organizational choice nearly as well as jurisdictional choice. In addition, several of them lose significance, or even reverse sign, when control variables are added in Model 4 and Model 5. In the jurisdictional choice results, the legal variables were robust to the introduction of all control variables. Similarly, the main demographic variable, zip code income, has only a weak predictive effect on the entity choice, whereas it had a very strong influence over the jurisdictional choice.

Overall, comparing the two tables demonstrates that the choice of jurisdiction (Delaware versus home state) is strongly associated with legal sophistication and demographic factors, whereas the choice of entity is strongly associated with business factors (particularly industry category). These results largely negate the objection that weaknesses in the business controls in the jurisdictional choice analysis account for the influence of the legal and demographic variables over firms' jurisdictional choice decisions. Companies make the two decisions (jurisdictional choice and entity choice) at the same time, and the decisions have similar effects, so the difference in predictors is notable. Part IV will interpret these results and attempt to explain the causal factors that likely underlie the jurisdictional choice decision.

D. POTENTIAL BIASES OF VARIABLES

The limitations of data available for this study introduce certain statistical considerations that should be discussed. Some of these tend to strengthen the main results presented above and some suggest caution in interpretation of those results.

1. The Legal Sophistication Variables

The measures of legal sophistication used in this analysis are admittedly crude and incomplete. They are proxies for firm sophistication and derive from a small number of details in a particular type of SEC filing. As a result, the legal sophistication variables likely only produce a noisy proxy for the actual sophistication of legal counsel handling the filing. Furthermore, because the Form D is sometimes filed years after the company's organization, in some cases the law firm handling the Form D filing may not be the law firm that advised the company when it organized. This further attenuates the link between the Form D filing measures of sophistication and the original incorporation decision. Each of these factors creates statistical noise in the measures of legal sophistication.

However, the fact that the legal sophistication measures produced strong results in the presence of noise actually strengthens the results. The noisiness of the predictors suggests that the true size of the legal sophistication effect is larger—possibly much larger—than the analysis in Section III.B suggests. This is because noisy predictor variables produce attenuation bias, which biases the coefficients toward zero.[106] In other words, it is possible that the legal sophistication variables are more predictive, even far more predictive, than the results presented in Section III.B suggest. In contrast, the business variables, although possibly incomplete, are measured directly and with greater precision. Thus, it is likely that the legal and demographic variables play an even larger role than the figures suggest.

106. *See, e.g.*, JOHN FOX, APPLIED REGRESSION ANALYSIS, LINEAR MODELS, AND RELATED METHODS 131–34 (1997) ("Measurement error in an independent variable tends to attenuate its regression coefficient and to make the variable an imperfect statistical control.").

2. Other Variables and "Fit" Issues

In addition to finding important new predictors—legal sophistication and demographics—this study found different effects from certain variables than those identified in the existing literature. One reason that other studies have found different explanatory power in their variables for Delaware incorporation is likely because of the samples used. Most prior studies used data derived exclusively from public companies. While another prior study used data derived exclusively from venture-capital-backed companies.[107] In those cases, the study's data represented a relatively narrow slice of somewhat homogenous companies. The data in this study derives from a single source: Form D filings. Although Form D filings are more diverse than either public companies or venture-capital-backed companies, they too exclude certain types of companies (those not raising outside funds in particular).

Because different studies rely on different slices of companies, there is the potential for a restriction of range in interpreting the relative explanatory power of competing studies. For this and other reasons, measures of "fit" cannot be directly compared between studies. Furthermore, because many of the companies in this study are private, a smaller number of business variables are available as predictors than in studies of public companies. Therefore, it is possible that the business predictors would take on greater significance in the jurisdictional choice if data were available. It is also possible, however, that the legal and demographic characteristics would take on greater significance if better data were available for those predictors.

E. SUMMARY

This Part's analysis has shown the importance of jurisdictional choice predictors that have gone unnoticed in much of the existing literature. In particular, a company's legal sophistication and its demographic characteristics explain the jurisdictional decision as well as the business factors, such as the size of the offering, the size of the company, the number of investors, and the type of industry. These new factors in the jurisdictional choice decision pose interpretive challenges (for example, why do legal sophistication and zip code income predict jurisdictional choice?). These challenges are taken up in Part IV, below. These findings also have important implications for studies of the jurisdictional choice decision and therefore corporate law in general, as taken up in Part V.

107. Broughman et al., *supra* note 41, at 867.

IV. INTERPRETATION

The results from Part III demonstrate a clear relationship between the sophistication of a company's legal representation and the jurisdictional choice decision. They also show a clear relationship between zip code demographics and jurisdictional choice. However, no matter how strong the correlation between the two variables, the causal relationship may not reflect that statistical correlation, due to endogeneity or other factors. For example, there may be a confounding variable that leads companies to choose sophisticated counsel and also to choose Delaware incorporation. Similarly, there may be a confounding variable that causes both demographics and jurisdictional choice. In these cases, there could be a relationship between sophisticated counsel or demographics and Delaware incorporation without the sophisticated counsel or demographics playing a *causal* role in the Delaware incorporation choice.

To the extent that such other factors are controlled in the regression, they would not undermine the causal relationship between lawyers and Delaware incorporation. For example, companies raising larger amounts of money may be more likely to use sophisticated counsel, headquarter in wealthier zip codes, and incorporate in Delaware, independently of their counsel or zip code. But the amount of money raised is controlled in the regression, so that effect would not account for the results. However, if there are factors that are not effectively controlled that contribute to sophisticated counsel, zip code demographics, and Delaware incorporation, then the causal relationship between the predictors and Delaware incorporation would be undermined.

This Part attempts to interpret the results in light of these considerations. Section IV.A addresses the interpretation that lawyers themselves are the primary causal agents of the incorporation decision. Section IV.B addresses the interpretation that "Delaware companies are just different," which is possibly suggested by the effect of zip code demographics. As will be described in Part V, either explanation has important (but different) implications for the study of corporate law federalism, implications that the existing literature has not explored in light of these results.

A. LAWYERS AS THE CAUSAL AGENTS

The most straightforward interpretation of the results is that more sophisticated lawyers choose Delaware incorporation for their clients and less sophisticated lawyers choose local (home state) incorporation for their clients. This explanation would treat lawyers themselves as the causal agents in the jurisdiction choice decision, an explanation that meshes well with the intuition of many previous studies, as well as much of the existing evidence.

The magnitude of the legal sophistication predictors, especially when compared to more traditional predictors, such as offering size, indicates that legal counsel has a strong influence in the incorporation decision. Indeed, as discussed above,[108] there are reasons to believe the legal sophistication of the companies or their counsel have even stronger predictive value than the results suggest. This is because the legal sophistication predictors used in the Model are, at best, very imperfect predictors of law firm sophistication. Because these measures of sophistication capture only a small part of the variation among lawyers (indeed, only a small part of the variation in terms of lawyer sophistication), it is likely that the actual effect of lawyers is larger. It is also likely that some of the other variables, such as those contained in the "business" category, are actually correlated with the choice of lawyers, which then influences the choice of jurisdiction.[109] Thus, the influence of lawyers is probably significantly greater than even the numbers in this study suggest.

The interpretation that lawyers drive the process of jurisdictional choice is supported by comparing Table 4 with Table 5. The legal sophistication and demographic variables have much less predictive power in Table 5 (choice of entity) than they do in Table 4 (choice of jurisdiction). Indeed, some of them even switch direction in Table 5 depending on what other variables are controlled, while they are all consistently in the same direction in every Model in Table 4. The reason for the difference between the two is likely that there are solid business reasons for choosing a corporation or an LLC, such that the same legal advisor could recommend a corporation to one client and an LLC to another. In contrast, the business reasons for choosing one state versus another are more difficult to explain. After all, in the traditional "race-to-the-top" or "race-to-the-bottom" formulation, all companies should choose one state regardless of characteristics. Yet that does not play out according to the data. Rather, Part III's analysis strongly suggests that jurisdictional choice is driven more by legal "culture" and demographics than by the client's business needs.[110]

108. *See supra* Section III.D.1.

109. Indeed, in at least one previous study, the author used a business variable (sales) with the intent that it serve as a proxy for lawyer identity. *See* Subramanian, *supra* note 2, at 1836.

110. It is always possible, of course, that this analysis has failed to control for the relevant business variables that would show a strong relationship with Delaware incorporation. However, those variables are likely to correlate with the existing variables and, to that extent, are already partially included in the "business variables" category.

The legal sophistication interpretation also helps to explain why this study found similar proportions of Delaware incorporation between public and private companies, whereas another study found dramatically lower rates of Delaware incorporation among private companies.[111] This is because the mere filing of a Form D, which is a quintessentially legal task, skews the pool in this dataset toward sophistication of counsel. If sophisticated counsel, in turn, steer companies toward Delaware incorporation, then it makes sense that this study found much higher rates of Delaware incorporation. The fact that one observes higher rates of Delaware incorporation in this more legally sophisticated pool further bolsters the interpretation that counsel play a pivotal role.

This interpretation that lawyers play an important, even pivotal, role in decisions about where to incorporate meshes with the untested intuition in many existing articles.[112] For example, Bebchuk and Cohen hypothesized that the identity of the law firm might be an important factor in the company's incorporation choices.[113] The same picture emerges when IPO lawyers are asked about their role in the jurisdictional choice.[114] The survey revealed that most lawyers recommend either Delaware or the state where the lawyers practiced and one reason given was that the lawyers are not familiar with the law of other states.[115] Another reason given was that the lawyers believed financial markets prefer Delaware incorporation.[116] In each of these accounts, it is clear that lawyers believe that they are an important determinant of the incorporation choice, even if they are attempting to reflect the perceived preferences of others.

There are two other studies, however, that foreshadowed the results of this Article. In the first, John Coates examined the role of lawyers in the implementation of takeover defenses in IPO firms.[117] He found that IPO

111. Dammann & Schündeln, *supra* note 61, at 85.

112. *See, e.g.*, Ribstein & O'Hara, *supra* note 12, at 680 (explaining how lawyers encourage states to "compete for choice-of-law business").

113. *See* Bebchuk & Cohen, *supra* note 11, at 399 ("[T]he identity of the law firm involved in a firm's IPO and/or subsequent corporate affairs . . . might significantly affect the choice of incorporation state."). Bebchuk and Cohen made this argument as an extension of the findings of John Coates, who had established that lawyers, rather than the law itself, were behind many IPO companies' antitakeover choices. *See* John C. Coates IV, *Explaining Variation in Takeover Defenses: Blame the Lawyers*, 89 CALIF. L. REV. 1301, 1303 (2001).

114. Carney et al., *supra* note 45, at 147 ("In choosing the state of incorporation, lawyers matter. The lawyers and their locations were central to the choice of the state of incorporation.").

115. *Id*. at 124–25.

116. *Id*. at 137 ("[L]awyers will choose Delaware because of their belief that investors' ignorance of other states' laws means that the investors will pay more for stock in Delaware companies.").

117. *See generally* Coates, *supra* note 113.

firms adopted takeover defenses "primarily based on the takeover experience of the corporate lawyers working for the company at the time of the IPO."[118] The effects were so strong that he found "[t]he characteristics of the lawyers working on the IPO were more predictive of defenses being adopted (or not adopted) than were testable company characteristics, such as a company's size, location, or industry."[119] This Article's analysis shows that the exact same thing is true of a company's incorporation decision.

In the second study, Robert Daines examined the role of lawyers in the jurisdiction choice of IPO companies.[120] Daines's study examined the very relationship analyzed in this paper (for a different set of companies) and persuasively demonstrated that IPO lawyers are largely responsible for incorporation decisions.[121] Indeed, like Coates, Daines found that lawyer identity was a better predictor than other variables.[122] The results in this Article are a strong validation of Daines's conclusions from fifteen years ago.

Thus, there is strong evidence that lawyers are, in fact, the causal agent that drives much of the incorporation decision. Still, however strongly the legal sophistication variables point toward a causal effect of counsel for the company, endogeneity in the form of a confounding variable is always a concern in observational studies.[123] Indeed, the strong influence of the demographic variable of zip code income suggests a potential confounder. Accordingly, an alternative interpretation is discussed below.

B. Delaware Companies Are Just Different

The Analysis in Part III controls for many variables related to each company that might explain the choice of jurisdiction. But it is impossible to ensure that all variables have been controlled, and it is possible that a different causal mechanism is responsible for the results. In particular, it is possible that a confounding variable, such as the sophistication of the company itself, is responsible for the results.[124] One could imagine that especially sophisticated or ambitious companies might choose Delaware on

118. *Id*. at 1303.
119. *Id*.
120. Daines, *supra* note 14, at 1562.
121. *Id*. at 1600 ("Lawyer identity appears to explain more of the variation in firm [state incorporation] decisions than any other factor, including the substance of the state's legal rules.").
122. *Id*.
123. *Accord* Fox, *supra* note 106, at 134.
124. It is also possible that the causation is reversed, such that "[f]irms may be choosing their lawyers based on their incorporation choices." Ribstein & O'Hara, *supra* note 12, at 701.

their own initiative[125] and also (independently) choose sophisticated law firms.[126] In that case, the choice of firm would not cause the choice of Delaware, but the results might look like those obtained in Part III.

The interpretation that Delaware companies may differ from other companies is supported by the strong connection between higher-income zip codes and Delaware incorporation. Zip code is a strong predictor of many types of outcomes, ranging from mortality[127] to teen birth rate[128] to the use of seatbelts.[129] Yet in such cases it usually is not plausible that location itself caused the outcome, only that an unobserved characteristic of residents of the zip code has a causal effect. It is possible that such companies choose Delaware and sophisticated law firms for similar (unobserved) reasons, but without one decision causing the other.

It is important to note that the strong predictive value of income in the zip code does not necessarily mean that legal counsel *does not* drive the incorporation choice. It is likely that companies located in more affluent zip codes tend to choose more expensive national law firms and that those national law firms are more likely to recommend Delaware incorporation. Therefore, it is possible that the zip code variable is simply absorbing the unmeasured sophistication of the law firm, since the law firm sophistication measures are inexact, as discussed above.[130]

Finally, if Delaware companies themselves really are "different" and that difference accounts for both the "Decline to Disclose" and Delaware outcomes, then the results suggest a tremendous irony. The companies reveal more about themselves by "declining to disclose" than they would have by disclosing. The SEC's decision to allow companies to decline to disclose information about their revenue range ended up revealing far more about the companies than the revenue range would have. This raises the question of whether voluntary disclosure of other things could reveal information about

125. For example, it is possible that an emergent company might choose Delaware incorporation in an attempt to signal that the startup is high quality, *see, e.g.*, Broughman & Ibrahim, *supra* note 10, at 299, and that the startup chooses a national law firm for the same reason.

126. This possibility was explored in Daines's work, as he acknowledged that it is possible "some firms have plans or characteristics that make it desirable to have national lawyers and, for similar reasons, also find it desirable to be in Delaware." Daines, *supra* note 14, at 1593 n.110.

127. *See, e.g.*, Avis J. Thomas et al., *ZIP-Code-Based Versus Tract-based Income Measures as Long-Term Risk-Adjusted Mortality Predictors*, 164 AM. J. EPIDEMIOLOGY 586, 589 (2006) (finding that household income by zip code correlated strongly with mortality).

128. *See, e.g.*, Douglas Kirby et al., *Manifestations of Poverty and Birthrates Among Young Teenagers in California Zip Code Areas*, 33 FAM. PLANNING PERSP. 63, 64 (2001).

129. *See, e.g.*, E. Brooke Lerner et al., *The Influence of Demographic Factors on Seatbelt Use by Adults Injured in Motor Vehicle Crashes*, 33 ACCIDENT ANALYSIS & PREVENTION 659, 661 (2001).

130. *See supra* Section III.D.1.

companies.

Thus, this second interpretation, one that focuses on company sophistication, rather than law firm sophistication, as the causal factor, may warrant further study. One important reason is that if Delaware companies are demographically and behaviorally different from other companies, then quantitative studies of the value of Delaware law based on stock prices may have significant bias.[131]

C. OTHER INTERPRETATIONS

There are a few other potential interpretations of the relationship between the legal sophistication variables and Delaware incorporation. Unlike the two interpretations in Sections IV.A and IV.B, each of these alternative interpretations lacks strong support, but are sufficiently appealing at a surface level to warrant discussion.

First, one might argue that "Decline to Disclose" is just a proxy for very large revenue, which in turn might itself drive Delaware incorporation. As Table 4 demonstrates (and conventional wisdom would suggest), larger companies are more likely to incorporate in Delaware, so perhaps "Decline to Disclose" companies have high revenue and that high revenue causes Delaware incorporation rather than legal sophistication. This interpretation does not fit well with the data, however. Among companies that did disclose revenue, the amount of funds raised closely tracks the revenues disclosed. For example, companies with revenues of one dollar to $1 million raised a median amount of $140,000, whereas companies with revenues over $100 million raised a median amount of about $22 million. The amount of money raised by companies that "declined to disclose" was about $1 million. Thus, it is unlikely that the "Decline to Disclose" variable is driven by high (undisclosed) revenue.

Another possibility is that the "Decline to Disclose" variable is a proxy for a company's penchant for secrecy or nondisclosure. If Delaware were a state that protected secrecy more than other states, then that could drive the results. There are several problems with this intuitive explanation. First, the "Decline to Disclose" effect is present even for publicly held companies, for which the information is already available. Second, Nevada incorporation is negatively related to "Decline to Disclose," and Nevada promotes its corporate law as the most protective of secrecy.[132] Third, the other legal

131. *See infra* Section V.B.

132. *See* Brian Grow & Kelly Carr, *Special Report: Nevada's Big Bet on Secrecy*, REUTERS (Sept. 26, 2011), http://graphics.thomsonreuters.com/11/09/ShellGamesNevada.pdf.

sophistication variables (conformed signatures, etc.) have no connection to secrecy and also point in favor of Delaware incorporation. Finally, companies with the greatest penchant for secrecy may simply decline to file Form Ds at all.[133] Thus, there is little merit to the "penchant for secrecy" interpretation of the data.

A related alternative interpretation would flip the analysis on its head. Instead of asking why a company would keep information secret, one might ask why a company would voluntarily disclose information that is not required. One possibility is that the company wants to use the Form D to send a message, such as to potential investors, customers, or acquirers that the company has significant revenue. However, this explanation is unpersuasive when examined more closely. Indeed, half of the companies that disclose their revenue have zero revenue. Such a disclosure could not serve to generate interest in an offering among customers or for an acquisition. Indeed, one would expect that the public disclosure of zero revenue would make persuading potential customers to buy a product somewhat difficult. Furthermore, as discussed above, the relationship is present even among public companies, for which the information about revenues is already publicly available. Thus, this interpretation is unpersuasive.

Each of these competing explanations has surface plausibility, but fails to align neatly with the data. The more compelling explanation, therefore, is that either the sophistication of the lawyers or the sophistication of the company itself drives the Delaware incorporation decision.

V. IMPLICATIONS

The findings in this paper suggest neither the quality of state law or the business needs of companies satisfactorily explains jurisdictional choices. Other factors, unrelated to legal rules, appear to substantially influence the decision as well. The first set of factors centers on the role of lawyers as the causal agent in the jurisdictional choice. The second set of factors centers on

133. Anecdotal evidence suggests that many issuers decline to file Form Ds, as there is apparently no significant consequence for failing to file. This has long been noted by the SEC and others. *See, e.g.*, SEC, *supra* note 91, at vii ("Currently, issuers do not face any tangible consequences for failing to file a Form D."). The SEC also appears to be aware that lack of compliance with the filing obligation is "widespread." *See* Amendments to Regulation D, Form D and Rule 156, 78 Fed. Reg. 44806, 44818 n.85 (proposed July 10, 2013) (to be codified at 17 C.F.R. pts. 230, 239). The SEC proposed a rule that would provide consequences for failing to file a Form D, but the initiative appears to have stalled. *See id.* at 44808 (proposing to "amend Rule 507 of Regulation D to disqualify an issuer from relying on Rule 506 for one year for future offerings if the issuer, or any predecessor or affiliate of the issuer, did not comply, within the last five years, with all of the Form D filing requirements in a Rule 506 offering").

the role of client demographics in the jurisdictional choice. As noted above,[134] the two categories are not necessarily mutually exclusive, as client demographics could influence the choice of lawyers, which in turn could influence the jurisdictional choice. Both explanations differ from the standard account of jurisdictional choice, which assumes that companies choose their states of incorporation based on the nature of state law or their individualized business needs.

This Part explores the implications of the findings for the federalism debate in corporate law. No matter which explanation of the findings is adopted, serious implications follow for empirical analyses of the jurisdictional choice decision. Section V.A divides the implications of the findings into three accounts of the choice process: (1) an agency cost account of lawyer choice; (2) a sociological account of lawyer culture; and (3) a "Delaware is different" theory of selection effects. Section V.B then discusses the implications of these theories for the federal system of corporate law. Section V.C argues that law firms' initial decisions, combined with the mutual vetoes of managers and shareholders over reincorporation, means that companies that initially choose Delaware fall into a "governance trap" from which escape is difficult.

A. AGENCY COSTS AND THE FEDERAL SYSTEM

This Section explores three mechanisms of jurisdictional choice and the implications that flow from them. The first mechanism is an agency cost explanation, in which jurisdictional choice may serve the interests of law firms rather than clients. The second mechanism is a "cultural" explanation, in which the jurisdictional choice is not the object of a rational, conscious choice, but the result of patterns of law firm practice. The third explanation focuses on the possible client role in the decision, with the idea that Delaware companies are "just different" in terms of their attributes.

Lawyers choosing states of incorporation for early-stage companies may choose the state that they believe is best suited to the client's needs. But the client's needs may not dictate a particular state (other than perhaps the home state for cost reasons) because state corporate laws are relatively homogenous. Whether or not the client's needs suggest a particular state, it is likely that the lawyer's decision is affected by agency costs between lawyers and their clients, leading lawyers to act in their own best interests. It is often recognized in the corporate literature that lawyers might align with

134. *See supra* notes 124–33 and accompanying text.

managers, who may have an agency cost problem.[135] But if lawyers drive the incorporation choice relatively free from even management monitoring, then agency costs might develop between lawyers and managers as well.[136] In such cases, the lawyers might choose the state of incorporation that favors their own interests, rather than those of managers or shareholders.

The agency cost between lawyers and companies might have the following effects, as described in Daines's analysis. Large national law firms, if they recommended in-state incorporation, would need to specialize in many states' laws.[137] This is expensive and undermines economies of scale. As a result, they concentrate on Delaware. In contrast, small local firms are inherently focused on their state's law.[138] It is expensive for them to retain dual fluency, but not as expensive as for a national firm to maintain fifty-state fluency. Accordingly, one might expect large national law firms to overwhelmingly recommend Delaware incorporation, while local law firms will disproportionately (but not uniformly) recommend in-state incorporation.[139] The local law firm will further have an incentive to recommend in-state incorporation to "lock in" future business from the company against competition from national firms.[140]

This idea—that lawyers steer clients toward Delaware because it benefits the law firms themselves—is not new, and it even comes from the race-to-the-top side of the debate.[141] Although the agency cost account has a strong underpinning, it is also possible that the decision is based less in conscious rational choice than in demographics and culture. National law firms might recommend Delaware incorporation because Delaware is part of their firm culture, while local firms recommend local incorporation because local incorporation is part of their firm culture. Indeed, it may be possible that the national firms recommend Delaware in part because they do not

135. *See, e.g.*, Subramanian, *supra* note 2, at 1836 n.143 ("In theory, outside counsel should be aligned with management (and thus subject to the same potential agency problems) because outside counsel of an acquired firm often does not stay on post-integration.").

136. Daines, *supra* note 14, at 1580 ("Entrepreneurs may not be able to monitor or verify their lawyer's recommendation about domicile, perhaps giving lawyers some slack to seek their own, rather than the clients' interest.").

137. *Id*. at 1584–85.

138. *Id.* at 1581 ("If firms hire local lawyers, it is very likely that these lawyers, in turn, know local corporate law.").

139. *See id.* at 1595 (concluding, based on empirical evidence, that "local lawyers advise firms to incorporate locally, while national lawyers advise firms to incorporate in Delaware").

140. *Id*. at 1584–85.

141. *See*, *e.g.*, ROMANO, *supra* note 7, at 43–44 (race-to-the-top proponent describing benefits of Delaware incorporation for lawyers).

know any other law well,[142] and the local firm may have the same reason for recommending local incorporation.[143]

Finally, there is a temptation to think that perhaps the national firms recommend Delaware because of their sophistication (rather than self-interest) and the local firms recommend local incorporation because of lack of sophistication or self-interest. After all, the "Decline to Disclose" variable appears to be closely linked to law firm sophistication in "deal culture." But the explanation that more sophisticated lawyers choose Delaware *because* they are more competent is unsatisfying as a causal explanation. The reputation of Delaware is not a secret and is well known to every lawyer who has taken a business associations class.[144] It is improbable that local firms have never heard that Delaware is widely considered by legal practitioners to have a superior legal environment. Thus, although sophistication likely drives the "Decline to Disclose" variable, allowing us to discern (with considerable noise) who represented the company, it is unlikely that that sophistication actually drives the Delaware decision. Instead, it is likely that law firm self-interest or culture is the actual causal mechanism.

B. Implications for the "Race-to-the-Top" Debate

The interpretations advanced in Part IV have profound implications for the "race debate" in corporate law. The key issue that divides race-to-the-top and race-to-the-bottom theorists is whether managers are "able to pursue private benefits of control to the detriment of shareholders," or whether "market forces align managers' interests with shareholders' interests."[145] Whether the best interpretation is that lawyer sophistication or demographic factors drive the incorporation choice, it seems that both sides in the "race" debate are focusing on the wrong issue. This is because neither the choice of lawyer nor demographic characteristics of the company are likely to correlate with managerial preferences as to the private benefits of control.

The fact that the decision about where to incorporate seems to be driven in large part by the sophistication of the law firm counseling the company or the company's demographics makes the notion of this type of state competition rather unlikely, at least for early-stage companies. Instead, much of the "competition" may be between national and local counsel, with the former choosing Delaware and the latter choosing local incorporation.

142. *See* Carney et al., *supra* note 45, at 134–37.
143. Daines, *supra* note 14, at 1586 (explaining that there are more "benign interpretations" of the local lawyer's preference for local law that are based on the local lawyer's own "imperfect information").
144. *Cf*. Carney et al., *supra* note 45, at 124 (noting "Delaware's dominance" in corporate law).
145. Subramanian, *supra* note 2, at 1812.

Similarly, the demographics of the company's location, including its influence on choice of counsel, may influence the incorporation choice as much as, or more than, the quality of the corporate law in the home state versus in Delaware.

These new influences in the incorporation decision pose major challenges to studies that evaluate incorporation decisions based on state legal factors. For example, many papers analyze the headquarters states with the highest and lowest rates of Delaware incorporation.[146] Based on the "race" metaphor, one could reasonably assume that headquarters states with higher rates of Delaware incorporation have less attractive corporate law (because companies choose Delaware instead). But because law firm sophistication and company demographics correlate with Delaware incorporation and state geography, one cannot reliably draw inferences from states that companies tend to "flee" from. The reason is that in many cases, these are exactly the states where national counsel tend to be located. As a result, it could be that the reason California and New York lose many companies to Delaware is not because of their laws; instead, it may simply be that national law firms tend to be located in California and New York and are inclined to recommend Delaware incorporation.[147]

As an example, consider the Bebchuk and Cohen analysis, which concluded that "amassing antitakeover statutes makes states more successful in the incorporation market—both in retaining in-state firms and in attracting out-of-state incorporations."[148] Bebchuk and Cohen used an index of antitakeover statutes among the states and found that the index value (the number of antitakeover statutes) strongly predicted the states that retained the most firms. The implication is that managers gravitate toward states with stronger antitakeover statutes.

The Bebchuk and Cohen index value, when taken by itself, strongly predicts incorporation success in this Article's database as well. However, this fact is actually highly problematic for the Bebchuk and Cohen analysis, rather than supportive of it. The reason for this is that most of the companies in this Article's database are not publicly traded corporations (the normal targets of hostile takeovers). Indeed, the Bebchuk and Cohen antitakeover

146. *See, e.g.*, *id.* at 1819–26 (analyzing the "win/lose" percentages of various states by headquarters state and reincorporation direction); Bebchuk & Cohen, *supra* note 11, at 395 (tabulating inflow and outflow data in a table entitled "Migration and Emigration in the Market for Corporate Law").

147. Some of the studies suffer from another problem, which is that the large states from which companies tend to "flee" also account for such a large percentage of the total data, so the results may depend largely on them. *See* Daines, *supra* note 14, at 1597.

148. Bebchuk & Cohen, *supra* note 11, at 421.

index predicts incorporation choices for private firms in this database almost as well as for public firms, even though private firms generally are not vulnerable to takeovers. Moreover, and even more troubling, the Bebchuk and Cohen antitakeover index strongly predicted the organization choices of private LLCs in this Article's dataset, even though LLCs are not targets of hostile takeovers and are not even governed by the corporate codes analyzed by Bebchuk and Cohen.

Table 6 presents results for logistic regression analyses including the Bebchuk-Cohen antitakeover index value as an explanatory variable, first alone and then together with the legal and demographic variables. The table presents results for both privately held LLCs (an entity type irrelevant to the Bebchuk-Cohen antitakeover hypothesis) and publicly traded corporations (the entity type directly relevant to the Bebchuk-Cohen antitakeover hypothesis). As the table indicates, the Bebchuk-Cohen index is highly predictive for private LLCs and for public corporations, but the influence of their index declines when the legal and demographic controls are introduced for public corporations and actually increases when controls are introduced for private LLCs. Indeed, the odds ratio of the Bebchuk-Cohen variable is actually stronger for private LLCs than for public corporations in Model 2 (with legal and demographic controls).

TABLE 6. Comparison with Bebchuk-Cohen Results

	Private LLCs Only		*Public Corporations Only*	
Variable	*Model 1-Bebchuk-Cohen Only*	*Model 2-Bebchuk-Cohen Plus Legal Variables and Demographic Variables*	*Model 1-Bebchuk-Cohen Only*	*Model 2-Bebchuk-Cohen Plus Legal Variables and Demographic Variables*
Intercept	-0.466*** (0.023)	-4.897*** (0.138)	0.197** (0.060)	-3.677*** (0.436)
Bebchuk-Cohen Index	-0.040*** (0.007)	-0.060*** (0.008)	-.091*** (0.019)	-0.045* (0.021)
Decline to Disclose		0.716*** (0.029)	…	0.665*** (0.082)
Conformed Signatures		0.246*** (0.030)	…	-0.050 (0.083)

Rule 504		-0.567*** (0.097)	…	-0.137 (0.372)
Rule 505		-0.580*** (0.078)	…	0.350 (0.307)
Rule 506		0.116 (0.095)		0.959** (0.337)
Only Accredited Investors	…	0.925*** (0.051)		0.493*** (0.121)
Minimum Investment Amount of Zero	…	0.610*** (0.032)		0.728*** (0.080)
Log(HQ Zip Code Income)		0.635*** (0.020)		0.361*** (0.055)
Company > 5 Years Old		-0.571*** (0.059)		0.155 (0.080)
	N=28,492	N=27,622	N=3,241	N=3,107

This is the reverse of what the Bebchuk-Cohen Theory would predict. The Bebchuk-Cohen index values should not predict jurisdictional choices for private LLCs, to which antitakeover statutes are irrelevant. Thus, the results in Table 6 demonstrate that the Bebchuk-Cohen results were likely not attributable to antitakeover statutes of the states, but rather the result of other factors (such as law firm choice and demographics) that differ from state to state. Moreover, including the Bebchuk-Cohen index does not significantly diminish the predictive value of the "Decline to Disclose" or zip code income variables.

The analysis does not undermine the results of all studies based on state law, however. An example is Marcel Kahan's excellent analysis of the effect of legal rules versus corporate flexibility in incorporation decisions.[149] His study analyzes the factors that enter into companies' choices regarding states of incorporation, using data about the states' attributes as predictors.[150] He concludes that corporate flexibility and higher quality judicial systems are the primary draw, rather than antitakeover statutes.[151] But because the factors

149. *See generally* Kahan, *supra* note 37.
150. *See id.* at 340–43.
151. *Id.* at 363–64.

identified in this study (sophisticated law firms and high income zip codes) vary dramatically among the states, it is possible that controlling for the factors in this study would change the results. Although including the legal and demographic factors reduced the size of Kahan's effects, Kahan's findings largely survived the inclusion of the demographic variables developed in this paper.[152]

The findings in this Article also have important implications for studies about the value of Delaware law relative to other states. As mentioned above, a number of prominent studies attempt to use data derived from market prices, such as Tobin's q, to estimate the value of Delaware law. But if Delaware companies are different from other companies in significant, but difficult-to-measure ways, the results of these studies may simply be capturing that difference. Indeed, the strong demographic effect of zip code income levels, which remains unexplained, suggests that Delaware companies may be different from companies in other states in unknown ways. And if it is the case that firms incorporating in Delaware are different in kind from other firms, then results from Tobin's q (and other market value studies) may not actually reflect the value of Delaware law.

One might draw the inference from the discussion above that law firms are regularly disserving their clients in making incorporation choices, whether those choices are attributable to agency costs or to law firm culture. If law firms choose incorporation states based on their own interests or cultural predilections rather than client needs, then the results might suggest an attorney-client agency problem. And that would be true if states' corporate laws actually were different in economically consequential ways. But state-to-state variations in corporate law are actually rather minimal,[153] so it probably does not matter much to individual companies whether law firms make the jurisdictional choice decision based on the law firm's own self-interest or the best interests of the client. Corporate law has converged to such an extent that there is probably no economically consequential difference between incorporating in one state or another.[154] Thus, whether

152. The results are contained in unreported regressions on file with the author. Notably, Kahan's results also predicted Delaware incorporation for LLCs, as did Bebchuk and Cohen's results. *Id. Accord* Bebchuck & Cohen, *supra* note 11, at 420–22. However, "corporate flexibility," as measured by Kahan, may plausibly apply to LLCs, whereas Bebchuk and Cohen's antitakeover index cannot apply to LLCs.

153. *See, e.g.*, William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 729–34 (1998) (arguing that corporate law is relatively similar from state to state); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1066–67 (2000) (arguing that state corporate law is relatively uniform).

154. This proposition was tested in the joint work between Jeffrey Manns and the author. *See* Anderson & Manns, *supra* note 30, at 1083–84 (finding no empirical evidence that that the stock market

law firms or clients make the decision about where to incorporate and how that decision is made probably do not matter much to clients in individual cases.

C. THE DELAWARE TRAP

Although it may not matter much on an individual company level whether lawyers or companies make the initial jurisdictional choice, the same is not true for the overall functioning of the system of corporate federalism. Scholars have long observed that managers, like shareholders, have a veto power over reincorporation decisions.[155] As a result, no change in incorporation state can occur unless both managers and shareholders prefer the new state over the status quo state. Because much of corporate law divides the interests of managers and shareholders, this mutual veto greatly limits the number of states to which a corporation can move, depending on the status quo state. If, as the analysis in this Article shows, the lawyers often choose the original jurisdiction of incorporation, then they also directly influence whether and where the company can move.

The result of this mutual veto between managers and shareholders is that so long as lawyers choose a state of incorporation in the area squarely between the preferences of managers and shareholders (the "contract curve"), that choice will persist because one group will object to a move in either direction.[156] Indeed, there is evidence that Delaware is exactly that state, at least on the most salient issue dividing managers and shareholders: antitakeover protections.[157]

To be clear, it is not necessary that lawyers make this calculation intentionally. In fact, the original jurisdictional choice is likely at least partially the result of a default decision-making process characterized by "mutual abdication" between the lawyers and the businesspeople.[158] In the vast majority of cases, the initial choice of jurisdiction for an early-stage

placed positive value on Delaware law as opposed to other states' law).

155. *See* Bebchuk, *supra* note 16, at 1458–61 (explaining that managers and shareholders have a mutual veto over reincorporation, which encourages Delaware to cater to managers' interests to maintain its share of corporations).

156. In public choice theory and microeconomics, the set of points joining the ideal points of two parties is called the "contract curve," and there is no other point to which those two parties could agree to move. *See, e.g.*, DENNIS C. MUELLER, PUBLIC CHOICE III 88 (2003) (explaining that points on the contract curve cannot lose to any other point in a committee of two).

157. Fisch, *supra* note 153, at 1062–67 (explaining that "Delaware has opted for a middle ground and adopted a moderate antitakeover statute").

158. *See* Anderson & Manns, *supra* note 30, at 1089 (arguing that lawyers and businesspeople both appear to believe Delaware incorporation is important to the other group, leading to a "mutual abdication" in favor of Delaware incorporation without either group considering the merits of the decision).

company is a rote detail that lawyers perform with little attention or scrutiny from the client. The result of this seemingly insignificant initial choice, however, is that the company is lured into a "Delaware trap" from which escape is unlikely. This is true even if both shareholders and managers are dissatisfied with the incorporation choice—so long as they are not dissatisfied *in the same way*.

Assuming that the preceding analysis is correct, it is not surprising that there is not much variety in state corporate law. So long as lawyers initially choose jurisdictions on the contract curve like Delaware, companies are trapped in the original jurisdiction because no alternative will satisfy the dual constituencies of shareholders and managers.[159] The reincorporation possibility becomes even scarcer if lawyers are making incorporation choices based on their own self-interest, as states would need to cater to the lawyers' interests too.[160] If companies are unable to reincorporate, there is little incentive for states to offer robust alternatives to Delaware law. The consequence is a stagnant menu of relatively homogenous state corporate law with little innovation, even though innovation might benefit shareholders.[161] As a result, the system of corporate law competition that was once the "genius" of American corporate law[162] has mostly faded away. In short, as with pre-IPO takeover defenses, the blame for the sluggish competition in American corporate law may ultimately lie with the lawyers.[163]

CONCLUSION

The factors influencing how companies choose jurisdictions of incorporation have remained elusive despite decades of sustained scholarly and empirical effort. This Article argues that the key to unraveling this mystery is examining the role of legal counsel at a company's earliest stages.

159. A poignant example of this problem is North Dakota's attempt to lure corporations away from Delaware with a new "shareholder-centric statute;" an attempt that has failed. *See* Christopher M. Bruner, *Managing Corporate Federalism: The Least-Bad Approach to the Shareholder Bylaw Debate*, 36 DEL. J. CORP. L. 1, 24–25 n.116 (2011) (noting that North Dakota has succeeded in attracting only one corporation and that corporation was affiliated with the statute's proponent, Carl Icahn).

160. *See* Daines, *supra* note 14, at 1602 (explaining that if lawyers affect decisions about where to incorporate, then states "would not simply craft laws to suit managers' preferences, but would rationally cater to lawyers").

161. *See* Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. REG. 139, 147–56 (2003).

162. ROMANO, *supra* note 7, at 1.

163. *See* Coates, *supra* note 113, at 1383 (arguing that in the context of antitakeover defenses "lawyers largely determine key terms in the 'corporate contract,' due to agency costs between owner-managers and their lawyers").

The data analyzed in this Article offer strong evidence that one of the most important factors in the incorporation decision is the company's choice of law firm near the time of its founding. Indeed, this choice of law firm may be the most important factor. Sophisticated law firms, which often have fifty-state practices, tend to recommend Delaware incorporation, while less sophisticated firms, which often have single-state practices, recommend local incorporation. The surprising fact is not that law firms play a role in deciding the state of incorporation—after all, that is a legal decision. The surprising fact is that the choice of law firm largely determines the choice of jurisdiction, which suggests that firms mechanically choose jurisdictions by default. These decisions, made in obscurity during the blizzard of paperwork at a company's founding, end up determining the company's future governance regime.

The fact that lawyers play a key role in choosing the state of incorporation affects the scholarly interpretation of the system of corporate federalism as well as the functioning of the system itself. Studies of state corporate law are missing an important variable if they do not account for the company's legal advisors, potentially leading to incorrect inferences.[164] The functioning of the system of corporate federalism itself is potentially affected by the role of legal counsel in establishing "sticky" status quo jurisdictions that cannot be easily changed. As a result, it is likely that Delaware has a built-in advantage that makes state competition illusory, which this Article terms "the Delaware trap." Thus any efforts to assess the system of corporate federalism, as well as any proposals to reform that system, must place the legal advisors at the center of the analysis.

164. This is similar to the conclusion John Coates drew in his well-known study of antitakeover provisions in IPO firms. *See id*. at 1384 ("For academics studying private law empirically, a related implication is that lawyers or law firms may generally need to enter empirical models as a control or explanatory variable whenever the goal is to study something requiring legal advice or implementation."). Because the choice of jurisdiction of incorporation certainly falls in this category, this study supports Coates' assertion.