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The States as a Laboratory: Legal Innovation and State Competition for Corporate Charters

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Abstract

Corporate law is an arena in which the metaphor of the "states as a laboratory" describes actual practice, and, for the most part, this is a laboratory that has worked reasonably well. The goal of this paper is to map out over time the diffusion of corporate law reforms across the states. The lawmaking pattern we observe indicates a dynamic process in which legal innovations originate from several sources, and a period of legal experimentation that tends to identify a statutory formulation that is adopted by the vast majority of states. Delaware and the Model Act quite often work in tandem. But there are occasions when they advance differing legal rules, accounting for some of the diversity in corporation codes that we observe.

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I. Introduction

Corporate law, the legal rules governing relations between managers and shareholders of for-profit corporations, is an arena in which the metaphor of the "states as a laboratory" describes actual practice, and, for the most part, this is a laboratory that has worked reasonably well. The goal of this paper is to map out over time the diffusion of corporate law reforms across the states. The law-making pattern we observe indicates a dynamic process in which legal innovations originate from several sources, and a period of legal experimentation that tends to identify a principal statutory formulation that is adopted by a majority of states. It is difficult to imagine that such dynamism could be generated by the centralized lawmaking process that exists at the national level.

The development of corporate law has been left to the states with sporadic federal intervention: the New Deal laws regulating the issuance of securities through a mandatory disclosure regime applying to publicly-traded corporations (the Securities Act of 1933 and the Securities Exchange Act of 1934), and substantive regulation of the terms of cash takeover bids (the 1968 Williams Act amendments to the 1934 Act), and, most recently, of audit committees and executive loans (in the Sarbanes-Oxley Act of 2002). Federalism has succeeded in this domain because the states have sorted out amongst themselves who has exclusive jurisdiction over corporate law to minimize conflict, by adopting an "internal affairs" jurisdictional rule in which the governing choice of law rule is the corporation's statutory domicile. This contrasts with other potential conflict rules: physical domicile (the rule in most of continental Europe), or the domicile of the buyer or seller of its securities (the U.S. states' securities law rule, the site of the securities transaction), which would subject firms operating across state lines to multiple legal regimes in the absence of federal regulation.

Accordingly, U.S. corporations can select the legal regime for shareholder-manager relations from among the 50 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. A firm's statutory domicile is established by a simple paper filing in the office of the chosen domicile's Secretary of State, and by maintaining a surrogate presence through a designated agent for the service of process (typically the lawyer or firm handling the incorporation documents).

The states' agreement on the internal affairs jurisdictional rule has had important consequences for the development of corporate law. The ease of selecting a domicile whose exclusive jurisdiction is legally recognized has resulted in considerable experimentation and innovation in corporate law, as states have sought to retain locally-domiciled firms by offering up-to-date codes to meet changing business conditions. The output of this competition has been, for the most part, welfare-enhancing, a contention perhaps best illustrated by the fact that consumers of corporate law (investors and managers, and their lobbying organizations) have not perceived a need to advocate replacing the states' authority with either the federal government, or purely private contracts and self-regulating organizations, despite some academic support for both of those alternatives.

II. Key Features of U.S. Corporate Law

Three key features that form the backbone of U.S. corporate law provide the context for evaluating the pattern of corporation law innovation that is the subject of this paper. First, U.S. corporate law is premised on shareholders being the parties in whose interest firms are to be managed. Second, state corporate law is, for the most part, enabling (in contrast to the federal securities laws, which are mandatory in application). Corporation codes consist of default rules that supply standard contract terms for corporate governance where the parties fail to specify alternative arrangements. These defaults can be customized to meet specific organizational requirements (such as increasing the votes required above the statutory default to a supermajority, for a firm with a blockholder who wants to retain veto control). Third and perhaps most important, one state has dominated the market for incorporations of public firms for almost a century. About one-half of the largest corporations are incorporated in Delaware, the majority of firms going public for the first time are incorporated in Delaware, and the overwhelming majority of firms that change their domicile mid-stream reincorporate in Delaware.[1]

It is not fortuitous that the dominant incorporation state is a small state by nearly all measures. Because a corporate charter is a relational contract -- it binds the state and firm in a multi-period relationship, in which performance under the contract is not simultaneous – a state needs a mechanism to commit to firms that it will maintain its code and otherwise not undo existing rules to firms' disadvantage, if it is to obtain more than a minimal incorporation fee from firms. As a small state, a substantial portion of Delaware's tax revenue – an average of 17 percent over the past several decades– is derived from incorporation fees.[2] Moreover, as a small state with limited indigenous revenue sources, there is no ready substitute to which Delaware can turn to maintain the level of services it provides its citizens in the absence of a vigorous incorporation business. This financial dependency on incorporation fees has made Delaware highly responsive to the requirements of corporations for an updated legal regime, and, as a consequence, it has enabled Delaware to commit to firms that it will stay the course and maintain an up-to-date code. Because it would lose a major revenue source if the number of domestic incorporations markedly declined, as a hostage to its own success, Delaware is able to make a credible commitment of corporate law responsiveness, and firms, aware of this situation, select it as their domicile in droves.[3]

In addition to a reputation for responsiveness created by dependence on franchise fee revenues, Delaware has made a substantial investment in assets that have no alternative use at any comparable value besides the corporate chartering business, assets that can be characterized as relation-specific legal capital (that is, legal capital specific to the corporate chartering relation). These assets are a comprehensive body of corporate case law and judicial expertise in administering corporate law (a specialized trial court, and a Supreme Court for which possession of such expertise is considered in the appointment process, in contrast to that of other states), assisted by administrative expertise in expedited processing of corporate filings. Because the value of its investment in those assets would be diminished if it were to lose out to another state in the chartering market, Delaware has an incentive to be responsive to firms' legal needs as that will maintain the assets' value (the future cash flows from incorporation revenues); thus, Delaware's legal capital functions as an additional credible commitment device.

III. The Laboratory of State Competition for Charters

Despite Delaware's overwhelming dominance in the chartering market, there is evidence that states respond to changes in the business environment in competition with Delaware, in enacting legal reforms, in order to maintain their level of local incorporations, which is why this is an area where the metaphor of "the states as a laboratory" is apt. Three principal indicia of state competition have been noted in the literature. First, corporate law innovations diffuse across states in an S-shaped curve (the proportion of adopters increases with time), similar to technological innovations, a pattern that is interpreted in the economic literature as a sign of competition.[4] Second, state franchise revenues are significantly positively related to the responsiveness of a state's corporate legal system to firm demands (responsiveness is measured as a function of the rate and extent to which legal innovations considered desirable by reincorporating firms are enacted), and the effect remains even if Delaware is excluded from the analysis.[5] Finally, firms migrate from states with low levels of responsiveness (using the same measure or a similar measure of quickness to adopt an innovation) to those with higher levels.[6]

This paper focuses on the first facet of competition, the diffusion of legal innovation, because it is this dimension of charter competition that best exemplifies the theme of "taking the metaphor [of federalism as a laboratory of democracy] seriously." The diffusion pattern suggests that states can be characterized as if they were searching for the most suitable corporation laws in a changing business environment, so as to induce firms to incorporate locally (the modus operandi for the states' activity, most typically, is corporate lawyers, acting in their self-interest, and not government officials).[7] That is, given Delaware's leading position, other states are engaged in what can be best described as a form of “defensive” competition, in which the local bar advocates law reform so as to be able to offer a local domicile choice to their clients. The other two indicia of competition will not be discussed, although it should be noted that all three features are interrelated, as it should be for a well-functioning charter market: namely, after Delaware, states that are early to adopt corporate law innovations are more likely to succeed in the chartering market (they retain more locally-domiciled firms).

A. The Diffusion of Corporate Law Reforms

In the diffusion process of corporation laws, at the outset there is often variation (different states enact different statutes to solve a particular perceived problem). But eventually one of the variations comes to dominate as the preferred solution (it is enacted by the vast majority of states). To illustrate how the corporate law innovation process has operated, three sets of important initiatives will be examined: the “modernization” of corporation codes associated with the 1967 revision of Delaware’s corporation code; the adoption of statutes limiting directors’ liability in the late 1980s, which began with three distinct approaches to resolving a perceived crisis in the directors’ and officers’ (D&O) liability insurance market but concluded in an extraordinarily short time frame with virtually all states enacting the approach selected by Delaware; and the adoption of statutes making hostile takeovers more difficult during the same time period (late 1980s), an area in which innovations were rapidly copied but considerable statutory variety still remains.

1. The Drive for Greater Organizational Flexibility and Delaware’s 1967 Code Revision

In 1967, Delaware undertook a major revision of its corporation code, which ushered in an era in which many firms reincorporated there from states that tended to lag behind in code-updating.[8] A major feature of the revision was to enhance organizational flexibility, continuing the trend of the earliest statutory innovations in the late 19th century, that relaxed strictures on capital structure and corporate combinations and had placed New Jersey at center stage in the corporate charter market.[9] In an earlier publication I traced the adoption of several of the important innovations that appeared in Delaware’s

1967 revision across the 50 states. The tracked provisions were selected from commentary on the code identifying the major improvements and survey responses of firms that had changed domicile, which indicated what types of code provisions were of interest to reincorporating firms. These tended to be provisions that increased organizational flexibility, and in particular, provisions reducing the cost of acquisitions.

Table 1 provides information on the diffusion across the states of six statutory innovations associated with modern statutes and the 1967 Delaware revision.[10] The interval over which the spread of the provisions throughout the states was tracked –from the initial state's adoption of the provision through 14 years after the Delaware code revision– ranges from 96 to 14 years. Table 2 indicates where Delaware stood in the innovation process for each provision, and Figure 1 tracks the diffusion progress of the six statutes from the initial adoption through 14 years after the Delaware code revision. Two facts are worth noting with regard to these data. First, Delaware is not always the pioneering innovator, but of the more recent innovations, when not first it has been second or third in adopting the initiative. Second, the innovations spread across the states gradually over time, as a few states followed the pioneers early on, but most states responded years later. The path of the diffusion of the statutes follows an S-shaped (ogive) cumulative distribution, similar to other studies of legal innovation.[11] [tables 1 and 2 and figure 1 about here]

Delaware's position, which is close to, but not always at, the top of the list as an innovator, in conjunction with the gradual diffusion of provisions, suggests a pattern of experimentation regarding corporate initiatives. More specifically, Delaware would appear to behave, on occasion, as if it waited until another state acted, in order to calibrate more precisely what the preferred response to changing business conditions ought to be, and that other states followed suit in a more languid fashion, responding after the innovators' legislation proves sufficiently successful to be actively sought by firms (whose demand for legislative revision is typically communicated by legal counsel).[12]

Of course, the fact that there has been innovation by the states in corporate law does not of itself demonstrate that a national regime would not innovate at a similar rate. William Carney offers some suggestive, relevant data on the issue: he compared the substantive content of the eight European Union (EU) company law directives to U.S. state corporation codes.[13] The EU-level directives are equivalent to a national regime, as they are rules adopted by the central administrative government, that the member states must incorporate into their codes, the goal being corporate law harmonization across the nations of the EU. Carney finds that of 131 provisions, the vast majority (95) do not appear in any U.S. state code.[14] Most of those provisions are mandatory terms that have long been abandoned by U.S. states as they adjusted their codes to enhance organizational flexibility at the turn of the 19th century, or provisions directed at protecting interests other than shareholders, features either long gone from, or never contained in, U.S. state codes.

While it is altogether possible that a U.S. centralized regime would not replicate the tendency of the EU directives that is at odds with the focus of legal rules adopted in the laboratory of the states, it is, in my judgment, more probable that it would tend in that direction. Lending credence to this conjecture is the fact that the U.S. federal securities laws are closer to the approach of the EU than the states to corporate law: they are mandatory rules that apply to all firms without permitting customization. Most important, where the SEC has sought to regulate matters of corporate governance, it has followed a mandatory rather than enabling approach. For example, the agency has used its authority over stock exchange rules to regulate corporate governance by “encouraging” exchanges to prescribe governance practices in listing requirements but refusing to approve rules that were not uniform across exchanges (despite differences in the set of firms listed on particular exchanges, related to financial listing requirements, which suggest that firms’ governance needs will differ across exchanges).[15]

2. The D&O Insurance Crisis and Limitations on Directors’ Liability

A more telling example of the extent of state-level experimentation and diffusion of innovation in reaction to changing business conditions, which fleshes out the pattern in the 1967 statutory revision data, is the states' response to turbulence in the D&O insurance market in the mid-1980s. By 1984, the market for D&O liability insurance had changed dramatically from the beginning of the decade: firms seeking to renew polices (or enter the market) found premiums skyrocketing at the same time as coverage was shrinking and deductibles increasing. The tight insurance market continued into 1986. Many factors contributed to the market's turbulence, including the expansion of directors' liability.[16] The most important case in this regard was a 1985 Delaware decision, *Smith v. Van Gorkom*, that held outside directors had violated their duty of care when agreeing to a merger at a substantial premium without sufficiently informing themselves of the firm's value.[17]

The disruption in insurance markets raised concern that firms would have difficulty retaining quality outside (non-employee) directors, who many investors, particularly activist institutions, consider a key governance device in constraining managers to act in the shareholders' interest. This concern was magnified by the *Van Gorkom* decision. As a consequence, states sought to mitigate the perceived insurance crisis by limiting outside directors' liability for negligence; the idea was that lowering liability would relieve firms' potential problems in director recruitment created by inadequate or expensive D&O insurance.

By 1987, 35 states had modified their corporation codes to reduce directors' exposure to shareholder litigation and the D&O insurance market was beginning to stabilize. The story of how this came about is an excellent case study of the successful operation of federalism as a laboratory for legal reform: early experimentation was followed by most states settling on one solution (the one chosen by Delaware). In the first two years of legislative responses, three different approaches were implemented: reducing the standard of culpability, permitting charter amendments to limit or eliminate liability, and statutory damage caps.[18] But in a rapid diffusion process, the bulk of the states selected the limited liability charter amendment approach as the solution to their common problem.

The first state to respond to the insurance crisis was Indiana, which lowered the standard of care for directors from negligence to willful misconduct or recklessness in April 1986.[19] By changing the statutory standard for a fiduciary breach, Indiana's solution to the insurance crisis applied automatically to all firms incorporated in the state. The Indiana solution is therefore self-executing. At the time, Delaware was considering how to respond to the D&O insurance market crisis and the *Van Gorkom* decision, and it chose not to follow Indiana's example. Instead of altering the standard of culpability for all firms' directors, it left the decision up to individual firms' shareholders, authorizing the inclusion in corporate charters of provisions limiting or eliminating directors' personal liability for negligence.[20] The Delaware approach has not differed much in practical effect from Indiana's, as the vast majority of firms have sought and obtained shareholder approval for a charter provision eliminating directors' liability for negligence.[21]

At the same time that the Indiana and Delaware legislatures were crafting their responses, the American Law Institute (ALI), was promoting a different alternative, a statutory limit on directors' liability that would be commensurate with their compensation.[22] One state, Virginia, adopted the ALI approach a year after Indiana and Delaware acted, and capped damages at the greater of $100,000 or the compensation the individual received from the corporation the year before the alleged misconduct.[23] This third approach to the insurance crisis is procedurally self-executing paralleling the Indiana approach, but substantively a limited version of Delaware's approach to the problem: namely, a charter provision limiting directors' liability can be cast as a limitation on damages. In practice, the two approaches have not coincided: firms have opted to eliminate directors' liability entirely rather than to cap it.

Although at the time of enactment, some commentators speculated that the Indiana statute would become the template for other states,[24] the Delaware statute turned out to be the model. Twenty-nine of the first 35 states to enact a provision addressing the D&O crisis followed Delaware's lead and adopted a charter amendment provision.[25] The second most popular approach, adopted by four states over the same time period, was Indiana's relaxation of the culpability standard. The ALI's damage cap solution never caught on, despite the prominence of many of the members of the organization in the legal profession, with Virginia remaining the sole state to follow its approach. Within five years, Delaware's charter amendment solution to the perceived D&O insurance market crisis had been adopted by 39 states, while the number following one of the other two approaches had risen only to six (and one of those states had also enacted the Delaware statute).[26] Moreover, Virginia amended its statute to include a charter amendment provision, in addition to the statutory damages default provision. The inclusion in 1990 of the Delaware approach in the Model Business Corporation Act no doubt solidified the trend.[27] Today, 46 of 50 states have a limited liability charter provision (the other 4 have a relaxed culpability standard). The diffusion of initiatives to limit liability is summarized in Tables 1 and 2 and graphed in Figure 2. [figure 2 about here]

The diffusion process of the limited liability statute, as evident in Figure 2, was far more rapid (thus the S-shape is far steeper) than the earlier innovations plotted in Figure 1. Using the same cut-off as applied to the diffusion of the 1967 Delaware reforms, 49 states had enacted one of the statutory forms of limitations on director liability within 14 years of the first statutory formulation (the remaining state acted two years thereafter) . Firms' demand for the limitation of directors' liability was, without question, the impetus for the rapid diffusion: commentaries by practitioners in several states refer to concern that firms would reincorporate if the state did not adopt a limited liability statute similar to the Delaware provision.[28] In addition, the perceived insurance crisis provided a reason for states to respond quickly to that concern, with the easiest response the selection of the leading incorporation state's tried solution.

Given that the Delaware statute offers the greatest flexibility of response, subject to shareholder approval, it is not altogether surprising that it came to dominate state choices. The Delaware approach, in contrast to that of Indiana, leaves the decision on liability to individual firms and investors, not legislators. This characteristic makes it appealing to investors, since their consent is required. Evidence that investors find the solution attractive is that charter amendments limiting liability are uniformly approved by shareholders with the support of institutional investors, although those same investors often vigorously oppose other management initiatives, such as the adoption of takeover defenses.[29] In addition, one study found significantly positive stock price reactions to the adoption of limited liability charter amendments by firms that had been performing poorly (firms which might therefore be the most vulnerable to litigation), consistent with the view that for such firms investors consider the provisions useful for attracting higher quality outside directors.[30] It should further be noted that the success of the Delaware approach would not have been predicted by proponents of the view that state competition is a "race to the bottom," that is, that federalism functions to produce laws that entrench managers and exploit shareholders. From that perspective, the self-executing Indiana approach ought to have predominated in the laboratory of state lawmaking because, in contrast to the Delaware statute, it offers directors absolution from liability for negligence immediately upon legislative action, without the need for firms to obtain their shareholders' consent.

There was even greater experimentation in handling limitations on director liability than would be suggested from the figure and tables, which track the adoption of provisions permitting charter limitations of liability without adjusting for nuances of differences in statutes. In modeling their legislation after the Delaware statute, several states further refined the provision by, for example, making the language more precise, eliminating the specific exception for breaches of the duty of loyalty, covering officers as well as directors, and applying the limitation to third-party litigation as well as shareholder actions.[31]

This active shaping of liability limits, producing variety amidst a rapid diffusion of an innovative solution to a common problem across the states, is an exemplar of the advantages of federalism. States engaged in efforts to identify, and then hone, an appropriate response to the insurance crisis, and in a relatively short time came up with a response offering organizational flexibility and individualization. It is difficult to imagine as rapid a response to a problem in a centralized regime. To provide a straightforward comparison, the Delaware legislature's action, which reversed *Smith v. Van Gorkom,* occurred within a year and a half of the decision.[32] By contrast, the average interval for reversals of U.S. Supreme Court decisions involving statutory interpretation in the comprehensive study by William Eskridge of the 1967-90 Congresses was twelve years, with 68% of the reversals occurring more than two years after the decision.[33]

3. Takeover Statutes

There is even greater variation across state codes in the regulation of takeovers than there is in liability limitations. Two factors have contributed to the high degree of variation: Supreme Court jurisprudence and efforts to protect specific companies from unwanted bids. Tables 1 and 2 and Figures 3 and 4 depict the diffusion process of first and second generation takeover statutes. First generation takeover statutes, which took the form of direct regulation of bids, are so-called because after they were invalidated by the Supreme Court in 1982 in *Edgar v. MITE* as a burden on interstate commerce due to their extraterritorial application,[34] they were superceded by a subsequent generation of statutes. As Figure 3 shows, before the Supreme Court decision in *MITE*, the statutory innovation of first generation statutes moved quickly through the states, albeit not as rapidly as the limited liability charter amendment provision, in a neat S-shaped fashion, being adopted by 37 states in 13 years. [figure 3 about here]

States did not abandon their regulatory efforts following the *MITE* decision, however. Instead, they reformulated their regulatory strategy to approximate more closely conventional corporate law rules, through regulation of shareholder voting and business combinations with hostile bidders. As corporate law was traditionally characterized as a domain left to the states in the allocation of federal authority, it was thought that takeover regulation framed along the lines of corporate code provisions would be less likely to be found objectionable by the Supreme Court than the original statutes, which had hewed rather closely to a securities regulation approach. Consistent with that strategy, most post-*MITE* statutes (which are referred to as second or third generation statutes), are enabling in form, establishing a default rule from which firms can opt-out, in contrast to the mandatory first-generation statutes. Because shareholders receive large premiums in takeover contests, and managers have a potential conflict of interest concerning a bid's success – they may not retain their posts upon the control change – many commentators consider such statutes, which are intended to reduce the success of a bid opposed by management, to favor managers at the shareholders' expense.[35]

The uncertainty regarding the constitutionality of state takeover regulation created by *MITE* led states to experiment with new regulation, as legal counsel differed in their assessment of what form of regulation would be found acceptable by courts. Ohio was the first state to act, enacting a takeover statute in November 1982, only a few months after *MITE* was decided. Its innovation, a "control share acquisition" statute, restricts an unwanted bidder's ability to vote shares acquired in a tender offer without the approval of a majority of the disinterested shareholders. Within a year of Ohio's new regulation, there were two other innovations: Maryland enacted a "fair price" statute, which fixes the minimum price to be paid in the second phase of two-step acquisitions, and Pennsylvania adopted a "redemption rights" statute which, similar to the London takeover panel's prohibition of partial bids, requires any purchaser of a specified percent of the shares of a company to acquire all of the remaining shares at the same price. At the same time, Pennsylvania adopted an "other constituency" statute, which permits directors to consider the interests of non-shareholders in business decisions; this statute received less attention among commentators as a template than the redemption rights provision, which is a variant of the fair price provision, because it seemed it would be less effective for defeating a bid (it did not alter bid terms or raise the bar regarding shareholder approval) and arguably was only a clarification rather than modification of the common law.[36]

Figures 3 and 4 plot the diffusion of second generation takeover statutes. Figure 3 traces the diffusion across the states of each state's adoption of any post-*MITE* takeover statute. As Figure 3 shows, the diffusion of a second generation statute occurred more rapidly than the first generation statutes. Figure 4 breaks down the diffusion process of second and third generation statutes by statute type. As can be observed, the redemption rights innovation was a failure: it was adopted by only three other states, one of which later repealed it. The fair price provision, by contrast, thrived, particularly in a further permutation, New York's 1985 innovation, a "business combination freeze" statute, that imposes a moratorium for a specified term of years before a successful unwanted bidder can engage in the transactions requiring a fair price under fair price statutes with the target company. After New York's innovative refinement, only two states enacted a fair price statute that was not also part of a business combination freeze statute (compared to 12 enacting the New York provision). [figure 4 about here]

Some business combination freeze statutes do not, however, contain a fair price provision governing post-moratorium transactions; this was an innovation introduced by Delaware in 1988. Before Delaware's legislation, business combination freeze statutes were adopted without a fair price provision only when the enacting state already had a fair price statute on the books, which rendered superfluous including a fair price component in the business combination freeze law. To isolate the pattern of innovation in joining the fair price and business combination freeze statutory approaches, Figure 4 separately tracks the three statutory forms: New York-type statutes that have a fair price component, Delaware-type business combination freeze statutes that have no fair price component, and business combination freeze statutes adopted without a fair price provision because the enacting state already had a fair price statute.[37]

The influence of the Supreme Court on the statutory variation is apparent in Figure 4: the diffusion pattern exhibits a take-off in adoption and a winnowing of experimentation after 1987, the year in which the Supreme Court upheld the constitutionality of Indiana's control share acquisition statute in

CTS v. Dynamics Corporation of America.[38] The largest number of adoptions in 1987 also took the form of the Indiana statute, as legislatures followed the regulatory recipe approved by the Court.[39] The number of states adopting the control share acquisition statute continued to increase in the years immediately following *CTS* as well (21 of 27 such statutes were enacted between May 1987-1989). Over time, however, business combination freeze and other constituency statutes came to be adopted more widely than the control share acquisition statute.

The Supreme Court decision upholding the Indiana statute, in sum, led to an explosion in legislative activity on takeovers as states perceived that there was a constitutionally acceptable solution to their concerns. They initially focused on the regulatory strategy that had been explicitly approved by the Supreme Court. Lower level courts reviewing other states' control share acquisition and business combination freeze statutes followed the Supreme Court's lead (as legislatures undoubtedly anticipated) and upheld the parallel statutes, with the exception of provisions (treated as severable) with extraterritorial reach (those encompassing corporations incorporated in another state): such provisions retained what the Court held to be a critical flaw in the first generation statute struck down in *MITE,* and were invalidated.[40] These decisions encouraged interest groups and corporate management to lobby for legislation in states that had not yet responded with a second generation statute. The diffusion process of takeover innovations throughout the period of constitutional uncertainty and its resolution was not a random process: states were consciously learning, copying and refining each other's statutes.[41] Members of the corporate bar and the managers of the corporations they represented were intensely interested and involved in the legislative process.[42]

The second principal source of variation in second generation takeover statutes is the firm-specific feature of much of the legislation. Statutes were often enacted to assist an in-state target in deterring an unwanted bid.[43] Pennsylvania's redemption rights innovation, for instance, was adopted to aid the Scott Paper Corporation in preventing a hostile takeover by a non-management shareholder:

Brascan Ltd. (a Canadian company) was trying to increase its 23.7% holdings, and neither a fair price provision along the lines of Maryland's innovation, nor Indiana's control share acquisition statute, would have protected the target corporation as effectively as the redemption rights provision did.[44] Firm-specific takeover statutes also help to explain why some states adopt multiple second generation takeover statutes. For instance, several years after its adoption of the redemption rights provision that was targeted to assist Scott Paper, Pennsylvania adopted a control share acquisition and a business freeze statute. Further legislation was, no doubt, considered necessary because the redemption rights provision was of little value for protecting targets whose unwanted bidders' offers were for 100 percent of the shares (such bids were unaffected, hence undeterred, by that statute).

One other aspect of the firm-specificity of takeover statutes should be noted in order to grasp better the dynamics of legislation in this context: hostile takeovers implicated one interest group not otherwise active in lobbying on corporation statutes, labor unions, who typically sought restrictive action because they believed successful out-of-state bidders would eliminate local jobs. Management of a unionized firm therefore often found an important ally to influence lawmakers in this context. Union support might sway legislators concerned about local employment levels to enact a protective statute, especially when confronted with a concrete set of potential victims in the case of a specific bid, despite an absence of systematic empirical evidence that hostile takeovers result in production-level job losses.

While the five-year interval between the two Supreme Court decisions and legislatures' desire to protect specific targets help to explain the considerable diversity in takeover statutes that is lacking in other corporate law contexts, there is another key difference in the diffusion process of takeover statutes compared to other corporate laws. In contrast to the statutes earlier discussed, Delaware has not been at the forefront as a pioneering innovator in takeover regulation. Rather, it has been a laggard. It was slow, given its usual responsiveness to changing business conditions, to adopt a first-generation statute, acting eight years after Virginia's innovation (the thirteenth state rather than among the first handful of states) to respond to the uptake in hostile bids in the late 1960s and early 1970s. And it was even slower – the thirtieth state – to enact a second generation statute post-*MITE* (tenth among those enacting a business combination freeze statute, which was one of the last second generation statutory innovations).

Moreover, Delaware's business combination freeze statute was less restrictive on several dimensions than the predecessor states' statutes, as was also true of its first generation statute. There are a number of reasons for Delaware's more accommodating approach to hostile takeovers, which I have discussed in detail elsewhere,[45] but one bears repeating here: firm-specific takeover legislation does not have a dominant role in Delaware's political process as occurs in other states: as a statutory domicile, local job loss is not an overriding issue, and no one firm is therefore able to dictate the form, or timing, of legislation.[46]

Despite its relative position as a laggard, Delaware's role as an innovator whom other states copy is not, however, completely inconsequential even in the takeover setting. The dimensions on which Delaware's second generation statute is less restrictive of hostile bidders – its statute's lack of fair price restrictions, its shorter moratorium (three years compared to New York's five-year freeze)[47] and its innovative exemption of hostile bidders who acquire 85% of the shares – appear to have had an influence on other states' legislation. Figures 4 and 5 indicate that of business combination freeze statutes enacted after the Delaware legislation, a majority of states followed Delaware's three- rather than five-year moratorium and its elimination of a fair price requirement post-moratorium. Namely, the ratio of five to three year moratorium statutes went from 7:2 prior to Delaware's action, to 6:3 in the year of Delaware's action, to 3:10 thereafter,[48] a complete reversal of the previous tendency. Similarly, before the Delaware legislation, all business combination freeze states had a fair price requirement, passed either as a component of the statute or integrated with a pre-existing fair price statute. But after Delaware pioneered the strategy of a business combination freeze statute with no fair price requirement, close to half of the states adopting a business combination freeze statute (10 of 23) also chose to not include a fair price component, and of the states including such a component, about half (6 of 13) already had fair price statutes. This is another reversal of the prior lawmaking trend, since before Delaware acted only three of nine states adopting the New York package of a business combination freeze and fair price statute had preexisting fair price provisions. [figure 5 about here]

The third innovation in Delaware's statute that was less restrictive than the predecessor statutes, the exemption for hostile bidders acquiring 85%, had an influence on other states, but to a lesser extent, and is therefore not plotted in a figure. Six of 23 post-Delaware enacters of a business combination freeze statute adopted such an out (four copied Delaware's 85% exemption and the other two set the exemption at 90%, which Delaware considered and rejected as a threshold too difficult to attain).

While the rapid progress of takeover statutes across the states serves as a reminder that state competition need not be for the better, the data suggest that Delaware's leading role in charter competition still has a salutary effect, from the shareholders' perspective, on statutory experimentation. That is because Delaware's action would appear to have had a dampening effect on restrictive takeover regulation, as several states followed its less constraining approach on different statutory dimensions. This effect – albeit less pronounced – parallels Delaware's impact on responses to the D&O insurance crisis, in which following its lead, most states left the decision limiting liability to firms' shareholders. Because states often use Delaware as the benchmark in drafting their codes, and far more public companies are incorporated in Delaware than elsewhere, the significance of its code provisions' being decidedly less managerialist than other states' provisions is consequential and at odds with the assertion that Delaware's role in the making of corporation codes is for the worse.

Figure 4 also plots the progress of two additional takeover statutes – other constituency statutes and poison pill validation statutes – that have diffused throughout the states independently of the principal post-*MITE* experimentation among the control share acquisition statute and the variants of a fair price requirement. These two statutes, whose adoption takes off after 1988, were not part of a post-*MITE* experimentation strategy because their constitutionality was never in question: they are not impositions of structural requirements on bids, but rather, instructions to courts, concerning the scope of review of management action to fend off an offer, a jurisprudential area the Supreme Court had expressly left to the states.[49] As a consequence, other constituency and poison pill validation statutes have been adopted by a large number of states, but over a longer interval than the principal set of second generation statutes, which went in and out of fashion as the constitutionality of state takeover regulation was being adjudicated. They also appear not to be perceived as adequate in and of themselves for protecting local firms from unwanted bids, because the vast majority of these statutes were adopted in conjunction with one of the other four patterns of second generation statutes earlier discussed (26 of 31 other constituency and 27 of 28 poison pill validation statutes were adopted either simultaneously with, or after, one of the other four second generation statutes was enacted).

In Delaware, which has neither an other constituency nor a poison pill validation statute, the state supreme court has upheld poison pill defenses, rendering statutory validation unnecessary, while it has rejected the broad discretion accorded directors under other constituency statutes, by requiring any consideration of nonshareholder interests to provide a benefit to the shareholders, and by rejecting the propriety of such considerations in a takeover auction.[50] Because many state courts follow Delaware decisions, it would seem that the strategy of legislatures enacting other constituency statutes was to preempt or constrain their state courts from following the Delaware court's approach. In contrast to the business combination freeze statute, in this instance, it is plausible to contend that Delaware's less restrictive approach to takeovers did not have a strong influence on other states. However, state courts still have considerable leeway to evaluate the discretion accorded boards under the statutes, and except for Connecticut, the statutes would appear to be little more than symbolic politics because they have no enforcement mechanism (that is, nonshareholder constituents have no standing to sue boards to require their interests to be considered in responding to a bid).[51]

While states' enactment of takeover statutes is problematic from the perspective of their potential to reduce the effectiveness of an important disciplinary device of managers (the market for corporate control), in assessing the output of the states in the takeover context, the key question from the standpoint of federalism is whether a national regulatory regime, in which the experimental laboratory of the states was absent, would be markedly different and for the better. There is good reason to believe that a national regime would be at best the same, and quite probably worse. First, federal takeover regulation (the Williams Act) had the same structure as first generation takeover statutes (whose pioneer, Virginia, enacted legislation the same year that Congress did). Second, and more important, prior to the Supreme Court's clarification in *CTS* that the states still had a role in takeover regulation, numerous bills and hearings were held in Congress to legislate in the takeover area, and the pattern of activity replicated that of the states: the vast majority of proposed bills regulated bidders and permitted defenses – the same strategy of state statutes – and there was a high degree of firm specificity in the source of legislative interest – the proponents of bills and holders of hearings were often from states in which a target was fighting off a hostile bid.[52] In addition, the congressional activity, which had increased significantly after *MITE*, substantially declined after *CTS*.[53] Moreover, the one bill that came out of a committee for debate on the chamber floor after *CTS* had a provision explicitly upholding state regulatory authority over takeovers.[54] This pattern of activity suggests that, had the Supreme Court ruled otherwise, Congress would most likely have enacted takeover regulation that mimicked the states' second generation statutes.

Finally, there is the potential for more restrictions on takeovers under a federal regime than at present because in that circumstance there is no safety valve, as exists in the laboratory of the states whereby firms have a choice among states with restrictive laws, Delaware's more bidder-friendly regime, and states with no takeover statutes at all. Delaware's incentive to obtain chartering revenue results in a distinctive political process in which it produces more flexible takeover statutes than the typical state choosing to regulate bids (and correspondingly it influences other states to follow its lead and enact less restrictive laws). With no similar incentive operating at the federal government level, the most educated guess regarding the legislative output is that Congress's takeover regulation would replicate at best, the average state's regime (which is more restrictive than Delaware's). Yet under such a national corporation code, firms would not have the option to choose a regime less restrictive than the average (hence more satisfactory from shareholders' perspective), as is currently true of the laws offered by Delaware (which apply to approximately half of the largest public companies in the nation) and by states with no takeover statutes.

B. Role of the Model Business Corporation Act

An important contributing factor to the diffusion process of corporate law is the activity of the bar in devising, and revising, a model statute, the Model Business Corporation Act, which states can follow, in place of, or in addition to, looking to Delaware. The Model Act is a product of the Committee on Corporate Laws of the American Bar Association's (ABA) Corporate and Business Law Section, whose members are, in general, attorneys in large firms whose clients are public corporations. The first Model Act, which was derived from the Illinois statute, was produced in 1950, and there have been several major revisions, most prominently in 1969 and 1984, although incremental changes have been made after each revision.[55] States may follow the Model Act closely, but a state may also modify provisions in the Model Act or adopt only parts of it, and, indeed, some state codes are an amalgam of provisions in the Model Act, the Delaware statute, and other states' codes as well.[56] This affects the diffusion process, for, as would be expected, states differ in the speed with which they respond to changes in the Model Act, which is affected by whether they adopt amendments to the Model Act piecemeal or through complete recodifications, in addition to the fact, as mentioned, that there is some variance across states regarding which provisions of the Model Act are adopted.[57] The drafters currently count 30 states as having corporation statutes based on either the 1969 or 1984 Model Act revisions.[58]

The Model Act is a source of statutory innovation, but the degree of originality varies considerably: sometimes the Model Act drafters copy Delaware's innovations (or those of other states) and sometimes in doing so they modify the innovation in response to problems identified ex-post in implementation, while at other times they are indeed the innovator.[59] The state-wide pattern of adoption of the four provisions previously identified with the 1967 modernization of the Delaware code (which were not in the Model Act at the time) suggests, however, that even though the Model Act was not the first to adopt the initiatives, it was influential in their diffusion. This is not the case with regard to the states' rapid legislative response to the D&O liability insurance crisis of the 1980s, or takeover regulation.

1. The Model Act and the 1967 Delaware Code Modernization

Of the tracked provisions related to Delaware's 1967 code modernization, the initiatives limiting appraisal rights[60] and clarifying indemnification rights appeared for the first time in the 1969 Model Act revision. By contrast, a merger vote exemption was first included in 1984, and nonunanimous shareholder action without a meeting is still not provided for in the Model Act. The indemnification initiative was, in fact, a joint product of the ABA Corporate Laws Committee and the Delaware Corporate Law Revision Committee, which was created in 1963 by the state legislature to undertake a comprehensive review of the state's corporation code and drafted the 1967 revised code. As a consequence, the language of the Delaware and Model Act revised indemnification provisions was identical.[61] Most of the state adoptions of the two provisions related to Delaware's 1967 code modernization that were included in the 1969 Model Act revision (appraisal rights exemption and indemnification clarification) occurred, in fact, after 1969 and not after Delaware's action in 1967.[62]

Although not all states mentioned the Model Act as the source of indemnification provisions that tracked the Delaware and Model Act provision in their official statutory comments or annotations, it is plausible to assert that the Model Act's influence on adoption was greater than Delaware's because enactments picked up only after the Model Act revision was published, and not immediately following

Delaware's legislation. The diffusion pattern of the other three provisions provides further support for the view that the Model Act was influential in the diffusion of the Delaware 1967 reform initiatives. The 1967 initiative absent from the Model Act (nonunanimous shareholder action without a meeting) had few adoptions through the endpoint of the collection of the data in the table (1975). Still, Delaware did influence other states: today the number of states permitting nonunanimous shareholder action without a meeting stands at 24, despite the absence of such a provision in the Model Act.[63]

In addition, there were somewhat fewer states adopting the merger vote exemption than the appraisal exemption in the period before the Model Act was revised to include the merger vote exemption (22 compared to 26 states). Currently, however, the totals are 37 and 32 states, respectively. That differential provides further evidence of the Model Act's impact on the diffusion process, because the appraisal exemption was removed from the Model Act during this time frame, and the relative rate of its adoption slowed compared to the merger vote exemption provision that was added to the Model Act in the same interval. These data suggest a more subtle role for Delaware's influence on the diffusion process: the Model Act drafters in all probability added the merger vote exemption provision and reintroduced the appraisal exemption provision because they appeared in Delaware's code and had been adopted by a number of states.

The import of the Model Act is more ambiguous regarding the longer-standing initiatives on cumulative voting and staggered boards. The Model Act was revised to take a permissive approach to cumulative voting in 1955;[64] 16 states already had such a code provision at that time, and five years later, by 1960, only four more had followed its lead. While the number of states that moved to permit, rather than require, cumulative voting nearly doubled (30) by 1981, to the extent that those states were affected by the Model Act, it cannot be considered a rapid-inducing agent of change (today only eight states still mandate cumulative voting). There is even more attenuation in impact regarding staggered boards. A provision permitting board classification was included in the first Model Act of 1950, at which time 33 states already had an analogous provision in their corporation codes. In the decade following, only two more states adopted such a provision and the number was at 40 in 1968, the year before the Model Act was revised. It is therefore difficult to attribute the post-1960 increase to states' adoption of the revised Model Act (today all 50 states permit staggered boards).

2. The Model Act and 1980s Initiatives Limiting Director Liability and Regulating Takeovers

In contrast with its relation to the 1967 Delaware code initiatives, the Model Act was not a factor in the diffusion of the limited liability reform initiative. A limited liability charter amendment provision was not included in the Model Act until 1990, despite the enactments of the Delaware and Indiana alternatives in 1986 (and a damages cap in Virginia in 1987).[65] The majority of states did not, however, wait for guidance from the Model Act to respond to the issue. Thirty-six states had already adopted the Delaware approach before the Model Act was amended (21 of which were Model Act states), while only nine states did so thereafter.[66] Moreover, all but one of the states enacting one of the other statutory responses to the D&O crisis before the Model Act was revised in 1990 were Model Act states.

The Model Act contains no takeover statutes and consequently, when such provisions are included in state codes there is often an official comment indicating that there is no analogue in the Model Act. The intensive legislative activity regarding takeover regulation, that completely ignores the posture of the Model Act, parallels the states' reaction to the D&O insurance crisis. Taken together, the diffusion of these two types of statutes would suggest either that the relative importance of the Model Act as a template for state codes has dramatically declined in the 1980s from earlier decades, or that the impact of the Model Act on the diffusion process is minimal when business conditions lead local interest groups and elites (managers or the corporate bar) to press vigorously for legislative action.[67] It should also be noted in this regard that the number of states identified as Model Act states has remained essentially unchanged since 1971 (29 in 1971 compared to 30 in 2002).[68]

The absence of a takeover statute in the Model Act appears to have had some beneficial influence (to the extent, as many commentators contend, that shareholders are disadvantaged by the presence of such statutes): of the seven states with no second generation takeover statute, five are Model Act states. This translates into a larger proportion of Model Act states having no such takeover regulation compared to non-Model Act states (17 percent compared to 10 percent).[69] However, the reason why these states have no takeover statutes is, most plausibly, not because the state legislatures are following the Model Act's lead on the issue because they are more shareholder-oriented than other states, but rather, because they have a very small number of local public corporations. Those five states had a total of 16 domestically-incorporated local corporations in 1999, according to domicile classifications by Lucian Bebchuk and Alma Cohen.[70] In such circumstances, not only is it not worth the local bar's time and effort to draft a more specialized state statute as opposed to adopting the ABA's off-the-shelf corporation code, but also, there is limited local demand for a takeover statute (there are so few local publicly-traded firms that it is highly likely that none had a need for protective legislation).

One means of evaluating whether the difference between the diffusion pattern of the 1967 initiatives and the limited liability and takeover statutes in the 1980s reflects a new and permanent change in the influence of the Model Act is to examine the diffusion of more recent initiatives that would not have been of intense interest to managers. In an important study of the impact of the Model Act on the diffusion of corporate law reforms, William Carney identified a subset of provisions of recent origin related to organizational flexibility, introduced by either Delaware or the Model Act, that meet those requirements.[71] Figure 6 updates his data for two of those provisions, a 1990 innovation of Delaware that permitted electronic proxy voting, and an innovation in the 1984 revised Model Act that established plurality shareholder voting on matters other than the election of directors; both of these initiatives are efforts at facilitating institutional flexibility in the shareholder voting process, and the effect of managerial lobbying does not appear to have been a factor in their adoption.[72] In 1996, the Model Act was revised, paralleling the Delaware statute, to permit electronic proxy voting. Delaware has never adopted plurality voting for shareholder action apart from the election of directors, and instead retains majority voting (abstentions count as no votes), which was the approach of the 1969 Model Act.

As Figure 6 shows, all but four states now have adopted an electronic proxy voting provision, with the bulk of the adoptions coming a few years after the provision's inclusion in the Model Act. Thus, the Model Act's impact here appears to be similar to its relation to the 1967 Delaware initiatives: while not the innovator, it seems to be a catalyst of legislative action (more state codes were modified after the initiative was included in the Model Act). This suggests that the limited liability and takeover statutes are distinctive statutory settings, and the Model Act's function as a transmission belt for innovations that enhance organizational flexibility and have no self-evident shareholder-manager conflict has remained relatively intact up to the present. [figure 6 about here]

Of course, this pattern is only suggestive, and not conclusive of the Model Act's influence. Because over time there should be an increase in the number of states adopting a provision that is of value to firms, the source of the upswing in the electronic proxy statute adoptions may simply be the passage of time, rather than the Model Act's endorsement.[73] But the facts are not consistent with such an hypothesis: the number of states adopting plurality voting has steadily increased over time, rising to a majority, but it is still far less than the number adopting electronic proxy voting (only 31 states compared to 46), while the time period over which the diffusion of plurality voting has taken place is over a decade longer. This suggests that more than time (or the Model Act) is necessary to explain a provision's adoption by an increasing number of states: the substantive content in conjunction with the presence of a viable alternative may well matter. In the context of plurality voting, the non-adopting states all follow the same approach to shareholder voting as that followed by Delaware (affirmative majority of votes), which was also the approach of the 1969 Model Act.[74] In my judgment, the differing adoption patterns of these two voting initiatives provide evidence of a "states as laboratory" effect. While there are some states that adopt Model Act revisions in entirety ("Model Act" states), the many non-Model Act states appear to pick and choose from alternative approaches, and thus the Model Act's interaction with the Delaware statute (sometimes in tune, sometimes out of tune), contributes to experimentation and innovation in corporate law.

Additional support for the laboratory interpretation of the effect of the Model Act can be drawn from further data in Carney's study. Carney examined the diffusion of 142 provisions of the Model Act, and found that 30 of those provisions had not been widely adopted (adopted by 25 states or less). Carney separately examined those provisions to ascertain whether the variation in corporation codes at a given point in time is due to the fact that reforms diffuse across the states slowly, with uniformity being the end product. He concluded that the data were consistent with the view that the limited level of adoption across the states of those 30 provisions was related to their relative newness, because 27 of them were introduced in the 1984 revision of the Model Act or later.[75] Another, not mutually exclusive, explanation for the variation could be related to the content of Delaware's corporation code and the laboratory explanation of Model Act diffusion. Namely, to the extent that Delaware's approach is at odds with that of the Model Act, then there could be variation across the states not simply due to differential rates of code modernization: rather, states might not be copying the Model Act in order to opt for what they consider to be a preferable alternative (that found in Delaware's code, for instance).

To determine the plausibility of the alternative explanation, I checked whether the 30 Model Act provisions that Carney found were not widely adopted were present in Delaware's code. Delaware had, in fact, no analogous provision for 24 of the 30 provisions.[76] The absence of most of these provisions from Delaware's code is consistent with the conjecture that their absence from many other states' codes is not solely a matter of timing. Those states could have opted for an alternative approach (Delaware's) to the Model Act.

While the current count of states with provisions replicating the 30 Model Act provisions is higher by a few more states than the count in Carney's study, most of the provisions (all but three of the provisions whose adoption the ABA tallies) are still found in less than 25 state codes. One of the three now in a majority of states was also in a majority in Carney's count, and two of the three now in a majority of states are provisions also appearing in Delaware's code (a circumstance where the laboratory, or competing legal regimes explanation is inapplicable).[77] One must, however, be cautious when undertaking such a comparison: Delaware may not have a statute identical to a Model Act provision because the subject has already been adjudicated by its courts. In fact, Model Act provisions quite often codify Delaware judicial opinions, as the Model Act is of greatest value as a template for states where there are not a sufficient number of firms for issues to be adjudicated by courts.[78] But there is another datum lending plausibility to the laboratory interpretation that non-widespread adoption suggests a difference in Delaware's approach: six of the 30 provisions have been eliminated from the Model Act since the Carney study, and none of the eliminated provisions were in Delaware's code. The failure of many states to have copied the Model Act version of, at least, those provisions would not appear to be related to the timing of code updating because many of the states had codes in sync with that of Delaware. The differential numbers of adopters and non-adopters may well have been a contributing factor toward the Model Act's elimination of those provisions.

In sum, the Model Act is a conduit through which innovations in corporate law are introduced and transmitted across the states. Because Model Act initiatives are often reactions to initiatives undertaken by other states (primarily Delaware), the Act functions more often as a catalyst of transmission rather than of innovation. A set of states (25-30) use the Model Act as a screen for code updating, as it brings to their local bar and legislature's attention recent statutes devised by more innovative states (or the ABA committee). In this regard, the Model Act would appear to have greater influence on the diffusion of corporate law reforms than Delaware, which would appear primarily to affect the diffusion process by spurring revisions to the Model Act. But the import of the Model Act needs to be placed in a larger context, the structure of the chartering market. Because more publicly traded firms are incorporated in Delaware than in all of the Model Act states put together,[79] Delaware is, without doubt, by far the most important actor, in terms of practical effect, in the making of corporate law.

IV. Conclusion

This paper has examined the diffusion of corporate law reform initiatives across the states over the past several decades. One observes a typical pattern of experimental variation at first regarding the statutory form thought to be best suited for handling a particular problem, and an eventual settling upon one format with an endpoint of relative uniformity across the states. Moreover, the leading domicile state, Delaware, has strong incentives to innovate to maintain its preeminent market position, and it has, in fact, been a consistent innovator (either the pioneer, or one of the earlier adopters, of reform initiatives, except in the context of takeover regulation) in the diffusion process. An additional contributing factor to the diffusion process has been the activity of the national bar association, in producing and publicizing a statutory template, the Model Business Corporation Act, which, in fact, has often incorporated Delaware's solutions to problems.

In the past two decades, the diffusion process has been extremely rapid, with code changes transmitted across a majority of states in only a few years. This may be due, at least in part, to the personal interest of corporate managers in the particular initiatives (restricting takeovers and limiting liability). But in the takeover context there are several significant differences in the diffusion process compared to other statutes: Delaware is a laggard, and states have adopted multiple statutes, making codes less uniform on this regulatory dimension. The statutory diversity, which originated in uncertainty regarding the statutes' constitutionality, is often connected to legislatures' efforts to protect specific local firms from a hostile takeover. This is also a reason for Delaware's distinctiveness: because it is firms' statutory (rather than physical) domicile, target managers cannot align with organized labor as effectively as they can in other states to prod the Delaware legislature to restrict bids to obtain the potential benefit of saving many local jobs. In addition, Delaware has not been a leader in the takeover context because takeover regulation is considered questionable from the perspective of maximizing firm value, which is a key objective for Delaware's legislation, as that is an important ingredient for its successful chartering business.

The dynamic production of corporation laws is an exemplar of how federalism's delegation of a body of law to the states can create an effective laboratory for experimentation and innovation. How transferable this success is to other areas of law, no doubt, depends on whether the states would have incentives to get things right, as they do in the corporate chartering context, where there is a direct financial connection: innovation enhances revenues from charter fees and the local corporate bar's income from servicing local clients.[80] This paper does not have the space to detail how the product of this ongoing innovative process has improved social welfare by maximizing firm value; I refer the reader instead to other work collecting the evidence that supports the proposition.[81]

Table 1. Diffusion of Selected Corporate Law Statutes.

Statute	No. States	First adoption	Interval (years)
Indemnification	42	1961	20
Merger vote exemption	22	1963	18
Appraisal exemption	26	1967	14
Action by majority without meeting [a]	11	1949	26
Cumulative voting	30	1892	89
Staggered board	45	1887	94
Limited liability charter amendment	46	1986	16
1st generation takeover statute	37	1968	13
2nd generation takeover statute [b]	43	1982	17
Fair price [c]	27	1983	8
Control share acquisition	27	1982	8
Business combination freeze [c]	33	1985	12
Other constituency [d]	31	1983	16
Redemption rights	3	1983	7
Poison pill validation	28	1986	15

Notes:
[a] This count is as of 1975, compared to 1981 for the other initiatives related to the modernization of corporation codes in the late 1960s.
[b] This row tallies the number of states with any second generation statute.
[c] Of the 27 fair price provisions, 13 were enacted as part of the requirements of a business combination freeze statute. The table treats these 13 statutes as separate fair price statutes, as well as separate business combination freeze statutes because that has been the approach taken in the literature counting up takeover statutes by state,[82] although, in my view, that is inappropriate double-counting of the statutes.
[d] This count does not include Virginia, which has a statute phrasing directors' discretion in terms of considering the "continued independence" of the corporation when determining what is in its best interest, rather than the interest of specific non-shareholder constituents, as is the phrasing of other states' statutes, and consequently, most articles do not include the Virginia statute in this category.[83]

Table 2. Delaware's Position in the Diffusion Process.

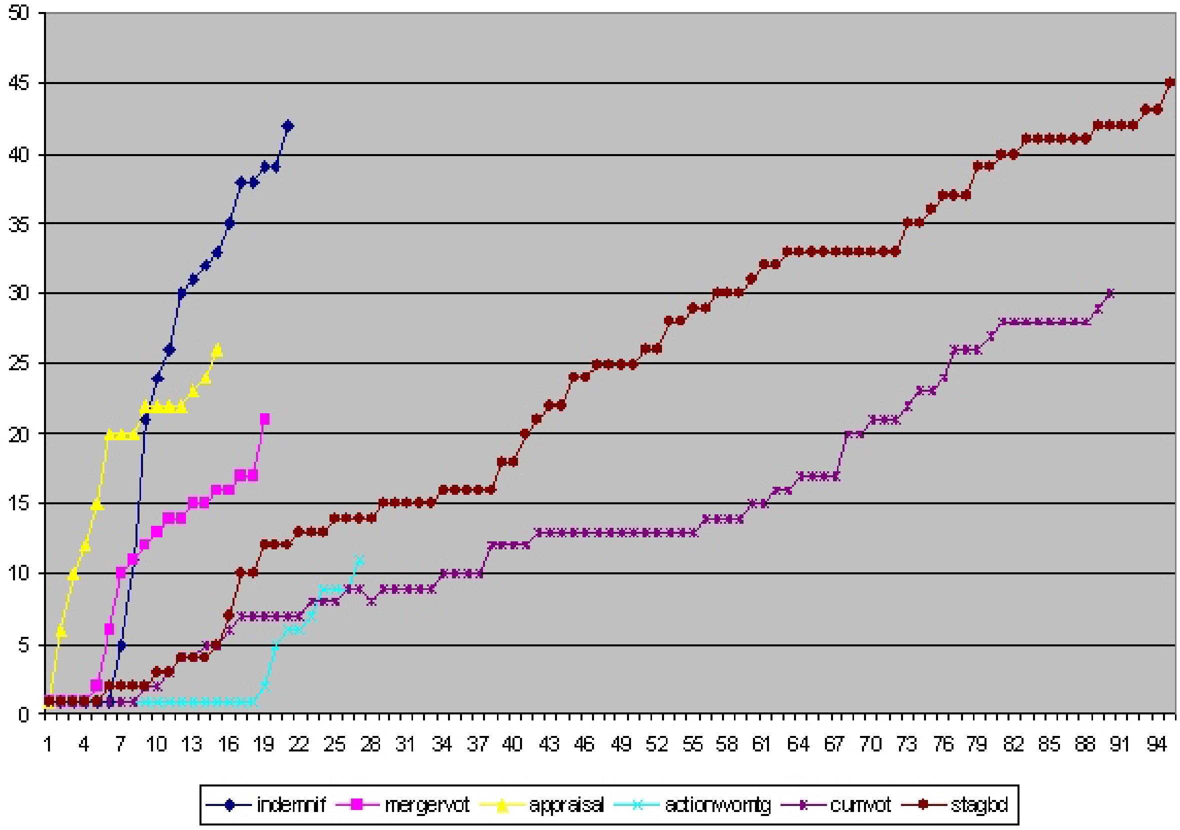
Statute	Year DE adopted	DE's Rank	Pioneering State
Indemnification	1967	3	New York
Merger vote exemption	1967	2	Ohio [a]
Appraisal exemption	1967	1	Delaware
Action by majority without meeting	1967	2	Nevada
Cumulative voting	1917	9	New York
Staggered board	1898	4	Pennsylvania
Limited liability charter amendment	1986	1	Delaware
1st generation takeover statute	1976	13	Virginia
2nd generation takeover statute: Business combination freeze Business combination freeze with no fair price provision	1988	30 10 4 (1)	Ohio New York Kentucky (Delaware) [b]

Notes:

[a] First merger vote exemption statute had higher threshold (1/6) than Delaware, whose threshold was adopted by most other states.

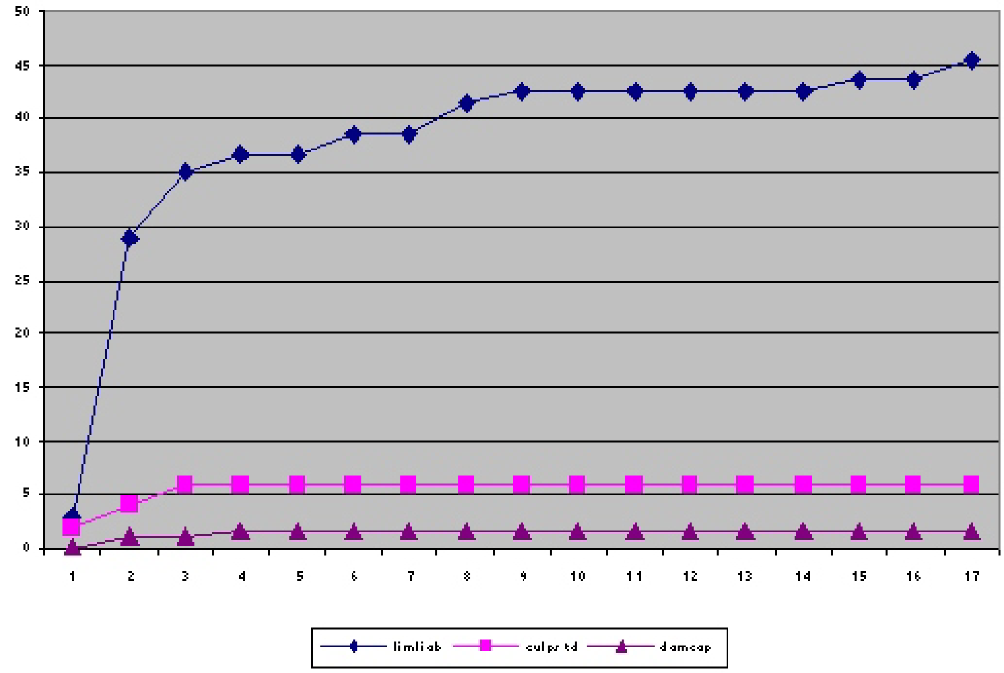
[b] Kentucky was the first state (1986) whose business combination freeze statute did not have a fair price provision but Kentucky had already adopted a separate fair price statute two years earlier (1984). That is also true of the two other states (Washington and Wisconsin) enacting a business combination freeze statute without a fair price provision before Delaware. Delaware was the first state without a preexisting fair price statute to enact a business combination freeze statute without a fair price requirement.

Figure 1. Diffusion Process: Six Statutes associated with the 1967 Modernization of Delaware's Corporation Code,



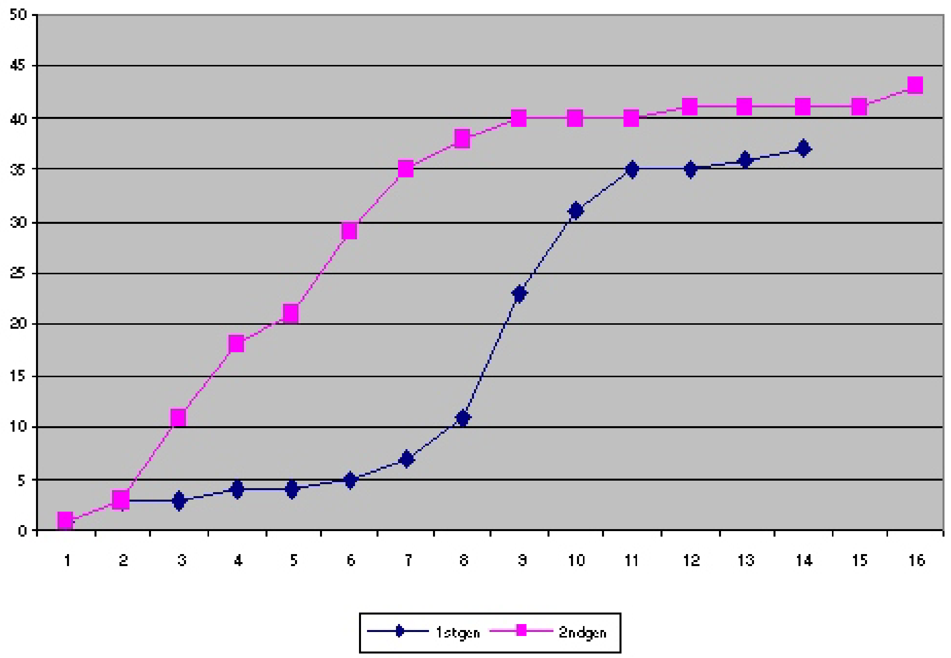
Key:
Indemnif = Indemnification clarification and expansion (42 states, first adoption 1961)
Mergervot = Merger vote exemption (22 states, first adoption 1963)
Appraisal = Appraisal rights exemption (26 states, first adoption 1967)
Actionwomtg = Action by majority without a meeting (11 states, first adoption 1949)
Cumvot = Cumulative voting not required (30 states, first adoption 1892)
Stagbd = Staggered board permitted (45 states, first adoption 1887)
Last year tracked is 1981 all statutes but actionwomtg, which is tracked through 1975

Figure 2. Diffusion Process: Statutes Limiting Liability.



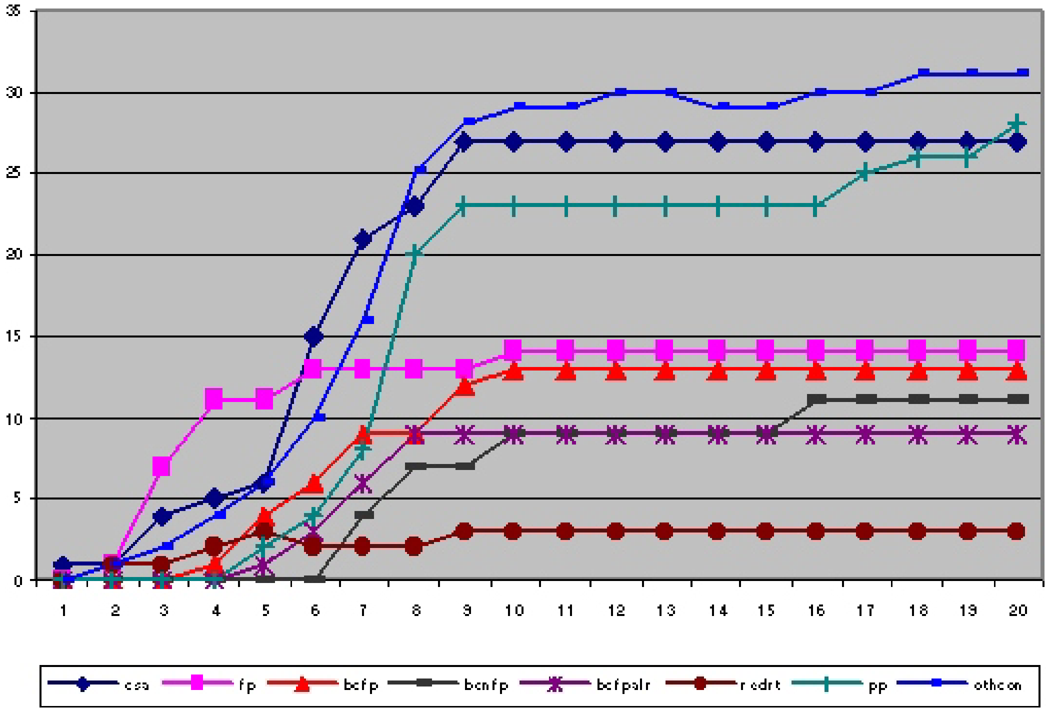
Key:
Limliab = Limited liability charter amendment (45.5 states, first adoption 1986)
Culpstd = Relaxation of culpability standard (6 states, first adoption 1986)
Damcap = Damages cap (1.5 states, first adoption 1987)
(Connecticut statute permitting damages cap charter amendment allocated across two statutory types, as indicated in note 26.)

Figure 3. Diffusion Process: Takeover Statutes



Key:
1stgen = First generation takeover statute (37 states, first adoption 1968)
2ndgen = Second generation takeover statute (43 states, first adoption 1982)

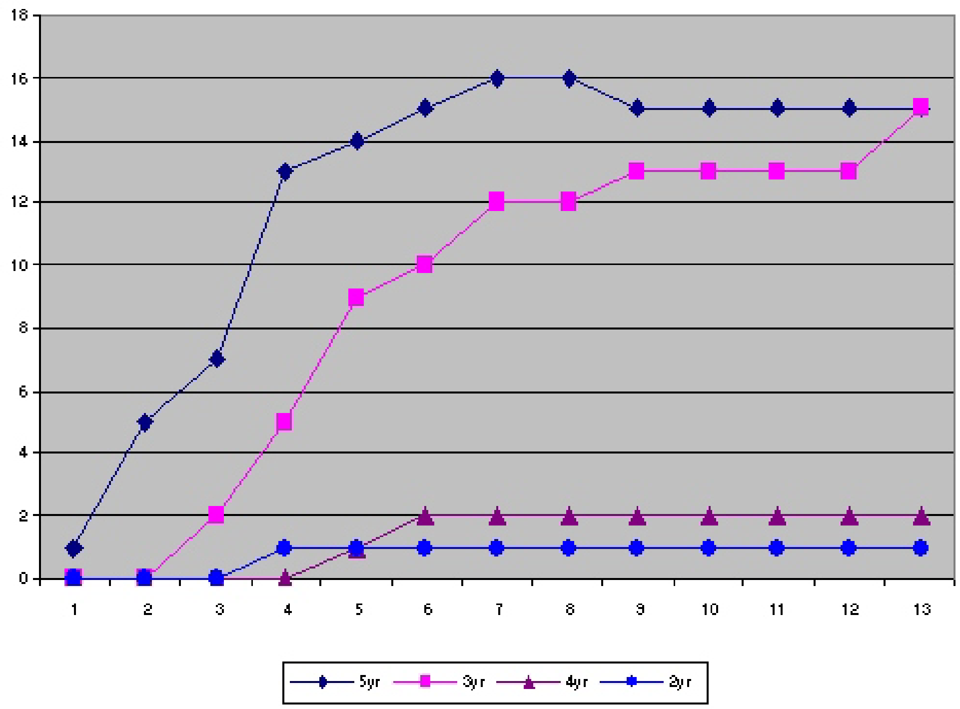
Figure 4. Diffusion Process: Second Generation Takeover Statutes.



Key:
csa = Control share acquisition statute (27 states, first adoption 1982)
fp = Fair price statute (14 states, first adoption 1983)
bcfp = Business combination freeze with fair price provision (13 states, first adoption 1985)
bcnfp = Business combination freeze with no fair price provision (11 states, first adoption 1988)
bcfpalr = Business combination freeze in state with preexisting fair price provision (9 states, first adoption 1986)
othcon = Other constituency statute (31 states, first adoption 1983)
redrt = Redemption rights (3 states, first adoption 1983)
pp = Poison pill validation (28 states, first adoption 1986)

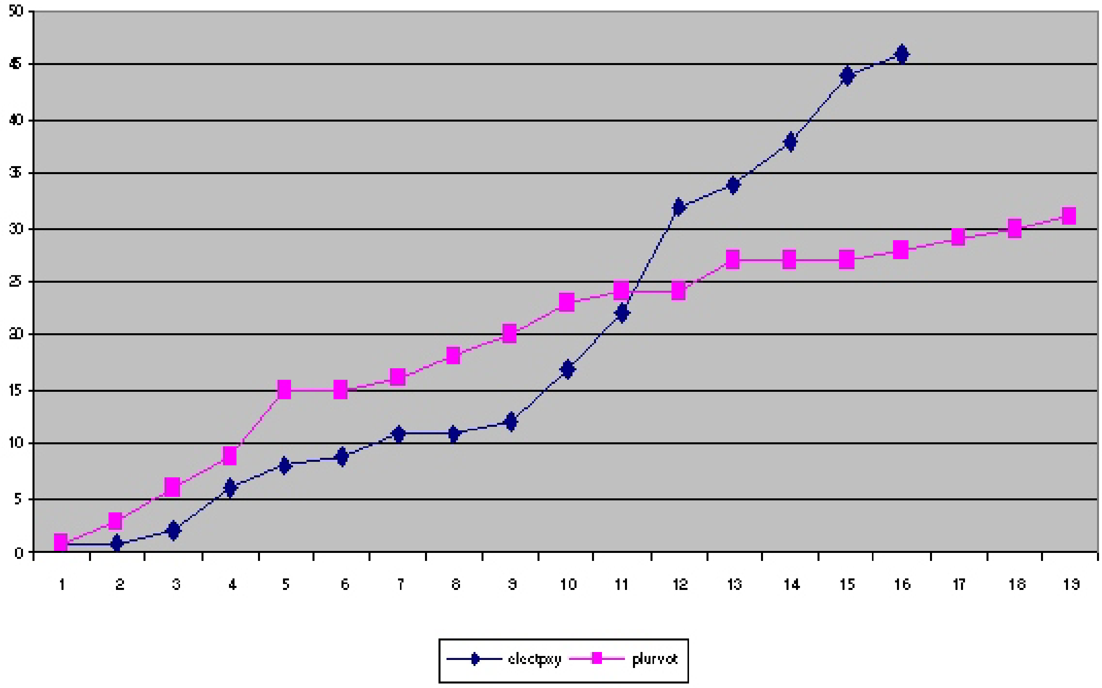
Note: *CTS* decision (1987) is year 6; enactment of business combination freeze with no fair price provision by Delaware (1988) is year 7

Figure 5. Diffusion of Business Combination Freeze Statutes



Key:
5yr = Five year moratorium (15 states, first adoption 1985)
3yr = Three year moratorium (15 states, first adoption 1987)
4yr = Four year moratorium (2 states, first adoption 1989)
2yr = Two year moratorium (1 state, first adoption 1988)

Figure 6. Diffusion Process: Recent Delaware and Model Act Innovations



Key:
Electpxy = Electronic Proxy Voting (46 states, first adoption 1988; includes Texas statute adopted in 2003, although effective date is 2006)
Plurvot - Plurality Voting (31 states, first adoption 1985)

1. E.g., Robert Daines, "The Incorporation Choices of IPO Firms,"*New York University Law Rev*iew, vol.77 (2002), pp. 1559-1611, p. 1571 (IPO firms); Curtis Alva, "Delaware and the Market for Corporate Charters: History and Agency," *Delaware Journal of Corporate Law,* vol. 14 (1990), pp. 885-920, p. 887 (largest firms); Robert Daines."Does Delaware Law Improve Firm Value?," *Journal of Financial Economics,* vol. 62 (2001), pp. 525-58, p. 538 (NYSE firms); Roberta Romano "Law as a Product: Some Pieces of the Incorporation Puzzle," *Journal of Law, Economics, and Organization,* vol. 1 (1985), pp. 225-83, pp. 244, 261 (reincorporating firms and largest firms).

2. Roberta Romano, *The Advantage of Competitive Federalism for Securities Regulation* (Washington, D.C.: AEI Press, 2002), pp.131-32.

3. This analysis was introduced in Romano, "Law as a Product," and relies on Oliver Williamson's work on transaction specific assets. E.g., Oliver E. Williamson, "Credible Commitments: Using Hostages to Support Exchange," *American Economic Review,* vol. 73 (1983), pp. 519-40.

4. Romano, "Law as a Product," pp. 233-35; William J. Carney,"Federalism and Corporate Law: A Non-Delaware View of the Results of Competition,"in *International Regulatory Competition and Coordination*, edited by Joseph McCahery, William W. Bratton, Sol Picciotto, and Colin Scott, (Oxford: Clarendon Press, 1996), pp. 153-83.

5. Romano, "Law as a Product," pp. 236-41.

6. Ibid., pp. 246-47; G. Moodie, "Forty Years of Charter Competition: A Race to Protect Directors' from Liability?," Havard Law School John M. Olin Center for Law, Economics, and Business Fellows' Discussion Paper No. 1 (2004)

7. Romano, *The Advantage of Competitive Federalism,* p. 80.

8. See Romano, "Law as a Product."

9. For a description of New Jersey's corporate initiatives in the late 19th century, see Christopher Grandy, "New Jersey Corporate Chartermongering, 1875-1929," *Journal of Economic History*, vol. 49 (1989), pp.

677-92, at p. 681.

10. These include three statutory innovations tracked in my prior paper, "Law as a Product" and three additional statutes that I tracked at that time but did not include in the study because the diffusion process for those laws began before the data for that paper's statistical analysis were available: (1) the explicit elaboration of an indemnification standard for directors and officers; (2) the elimination of acquirers' shareholders' vote in mergers involving a specified percentage of the corporation's stock; (3) elimination for publicly-traded corporations of appraisal rights (the right to obtain cash, at a price determined by a court, rather than the merger consideration); (4) the right of shareholders to take action without a meeting by a majority vote; (5) the ability to stagger the board of directors into classes for election rather than elect the full board at the annual meeting; and (6) the ability to eliminate cumulative voting (a voting rule for directors that facilitates minority representation on the board by permitting shareholders to cumulate their votes on one candidate rather than spread them evenly across each seat up for election).

11. E.g., Virginia Gray, "Innovation in the States: A Diffusion Study," *American Political Science Review,* vol.67 (1973),1174-85 (education, social welfare and civil rights); Sharon M. Oster and John M. Quigley, "Regulatory Barriers to the Diffusion of Innovation: Some Evidence from Building Codes," *Bell Journal of Economics,* vol.8 (1977), pp. 361-77 (building code regulation).

12. See, e.g., Andrew Moore, "State Competition: Panel Response," Cardozo Law Review vol. 8 (1977), pp. 779-82, 780 (1987) (describing how Delaware legislative reform derives from proposals of the bar), Jonathan R. Macey and Geoffrey P. Miller, "Toward an interest-group theory of Delaware corporate law," *Texas Law Review* vol. 65 (1987), pp. 469-523 (emphasizing importance of corporate bar in influencing Delaware corporate law); Alva, "Delaware and the Market for Corporate Charters," pp. 898-901, 904-16 (detailing key role of bar in Delaware legislative process, and its initiation of legal innovations in the 1980s); William J. Carney, "The Production of Corporate Law," *Southern California Law Review*, vol. 71 (1998), pp.715-80 (discussing role of corporate bar in other states, which he

considers less active than Delaware bar due to reduced incentives and collective action problems).

13. Carney, “Federalism and Corporate Law, ” p. 169

14. Ibid. It is possible that the mandatory rules in place in the EU are appropriate for EU firms, which, in contrast to U.S. firms, tend to have more concentrated ownership structures, but that justification has not been advanced as the rationale for the rules that Carney examines (they are not, for example, rules involving the protection of minority shareholders).

15. See Roberta Romano, “The Sarbanes-Oxley Act and the Making of Quack Corporate Governance,” Yale ICF Working Paper No. 04-37 (2004), notes 29,82 and 410 (board composition and committee structure listing requirements); Roberta Romano, *Foundations of Corporate Law* (New York: Foundation Press, 1993), p. 215 note 6 (voting listing requirements after federal court struck down direct regulation of voting); Stuart L. Gillan, Jay C. Hartzell and Laura T. Starks, “Industries, Investment Opportunities, and Corporate Governance Structures,” University of Delaware College of Business & Economics Center for Corporate Governance Working Paper No. 2002-003 (2003) (governance characteristics vary with industry); April Klein, “Economic Determinants of Audit Committee Independence,” *Accounting Review*, vol. 77 (2002), pp. 435-52 (board and audit committee composition vary with firm characteristics).

16. See Roberta Romano, “What Went Wrong with Directors’ and Officers’ Liability Insurance?,” *Delaware Journal of Corporate Law,* vol.14 (1989), pp. 1-33.

17. 488 A. 2d 858 (Del. 1985). It should be noted that *Van Gorkom* was decided after the D&O crisis is thought to have begun, so it is best considered a contributing, rather than causal, factor for the market disruption.

18. The classification of experimentation includes only completely new approaches to the problem that entailed limiting liability, as discussed in Romano, “What Went Wrong.” It excludes other initiatives that were incremental to existing rules and the limit on liability derived from other constituency statutes, that

provide boards with discretion to consider non-shareholder interests, sometimes explicitly limited to decisions regarding control changes, which statutes are discussed in the next section as they are more closely associated with takeover regulation than the D&O insurance crisis. For classification of all state responses see James J. Hanks, "Evaluating Recent State Legislation on Director and Officer Liability Limitation and Indemnification," *Business Lawyer*, vol. 43 (1988), pp. 1207-54, p. 1209-10.

19. P.L. 149-1986, codified at Ind. Code Ann. §23-1-35-1(e). The statute became effective April 1, 1986. Leo Herzel and Daniel Harris, "Uninsured Boards Mount Weak Defense," *National Law Journal (*Apr. 21, 1986), p. 19.

20.S. 533, 65 Del. Laws c. 289 (1986), codified at Del. Code Ann. tit. 8, §102(b)(7). The provision was enacted in June 1986.

21. See, e.g., Michael Bradley and Cindy A. Schipani, " The Relevance of the Duty of Care Standard in Corporate Governance," *Iowa Law Review*, vol. 75 (1989), pp. 1-74, p.62 (94 percent of Delaware firms continuously trading on New York or American Stock Exchanges from 1982-86 adopted a limited liability charter provisions),

22. See American Law Institute, *Principles of Corporate Governance: Analysis and Recommendations*, § 7.17 (Tent. Draft No. 7, 1987); and American Law Institute, Principles of Corporate Governance (Discussion Draft No. 1, June 3, 1985). The American Law Institute is an organization, whose members are practicing lawyers, judges and legal academics, that produces documents for guidance to courts and legislatures, which are drafted by academics, with review by the institute's members, and express the drafters' view of the appropriate substantive rules in a field of law.

23. Acts 1987 c. 59, codified at Va. Code Ann. §13.1-692.1.

24. E.g., Herzel and Harris, "Uninsured Boards" ("Indiana has just enacted a new corporation statute that may become a model for other states as well.")

25. Ibid. p. 30.

26. Carney, “Federalism and Corporate Law,” p.181. The Connecticut statute is a hybrid of the Delaware and ALI approach: it permits firms to adopt charter amendments to limit directors’ liability for damages to an amount not less than the compensation the individual received from the corporation during the year of the violation. P.A. 89-322, currently codified at Conn. Gen. Stat. Ann. § 33-636(b)(4). Figure 2 therefore counts it as one-half limited liability charter amendment and one-half damages cap.

27. Committee on Corporate Laws, “Changes in the Revised Model Business Corporation Act - Amendment Pertaining to the Liability of Directors,” *Business Lawyer*, vol. 45 (1990) p. 695. The impact of the Model Act on the diffusion process is discussed in part III.B, *infra*.

28. E.g., Edgar F. Hansell, Bradford L. Austin and Gregory B. Wilcox, “Director Liability under Iowa Law - Duties and Protections, *Journal of Corporation Law*, vol. 13 (Winter 1988), pp. 369-429, p. 391 (“The Iowa legislature, in part to avoid corporate flight from Iowa to reincorporate in Delaware and to take advantage of the new limited liability provisions, adopted legislation that became effective as of July 1, 1987, similar to that of Delaware”); Robert H. Roshe, “Note, New York’s Response to the Director and Officer Liability Crisis: A Need to Reexamine the Importance of D&O Insurance,” *Brooklyn Law Review*, vol. 54 (1989), pp. 1305-55, p. 1318, n. 81 (“the New York legislature was concerned that legislation was necessary to deter corporations from reincorporating into states which offered laws more favorable to the protectionist needs of directors and officers in light of the corporate liability crisis,” citing N.Y. Governor’s memorandum in support of proposed legislation in 1987, to adopt Delaware’s statute beyond state’s prior expansion of indemnification provisions); ibid. (quoting California lawyer as stating, in another journal article: “[s]ince July [of 1987] California corporations have been reincorporating in Delaware at a rapid pace. If the exodus of corporations from California continues, the legislature may consider amending the [California] Corporations Code to follow Delaware’s lead” - which it did); *Comment*, S.D. Codified Ann. § 47-2-58.8 (2000) (“The [South Dakota] provision contains the same exceptions as Delaware but also authorizes adoption of liability-limiting provisions for the

benefit of directors of insurance companies (against policy holders), depository institutions (against depositors), and rural water systems (against members). This is an extraordinary departure from mainstream liability-limiting charter option statutes, and seems like a cynical display of charter-mongering.")

29. There is an extensive literature on the subjects of institutional investor activism which indicates that altering directors' limited liability has not been on their agenda. For a literature review see Roberta Romano, "Less is More: Making Institutional Investor Activism a Valuable Mechanism of Corporate Governance," *Yale Journal on Regulation*, vol. 18 (2001), pp. 174-251.

30. See Yaron Brook and Ramesh K.S. Rao, "Shareholder Wealth Effects of Directors' Limited Liability Provisions," *Journal of Financial and Quantitative Analysis*, vol. 29 (1994), pp. 481-97.

31. See Hanks, "Evaluating Recent State Legislation," pp.1211-15.

32. The Delaware legislature acted similarly rapidly, in 18 months, to clarify the definition of voting stock in D.G.C.L. §203 after it came into question in a chancery decision, *In re Digex, Inc. Shareholders Litigation*, 489 A. 2d 1176 (Del Ch. Dec. 2000).

33. William Eskridge, "Overriding Supreme Court Statutory Interpretation Decisions," *Yale Law Journal*, vol. 101 (1991), pp. 331-455. None of the cases in the study involved the federal securities laws; but consistent with those data, in the Sarbanes-Oxley Act of 2002, Congress overturned a U.S. Supreme Court decision on the statute of limitations for securities violations that had been decided ten years earlier, *Lampf v. Gilbertson*, 501 U.S. 350 (1991).

34. 457 U.S. 624 (1982) (invalidating Illinois statute). The first state takeover statute was adopted by Virginia in 1968, the same year the Williams Act, a federal statute regulating takeovers, was enacted, and the form was similar: delaying the success of a hostile bid by requiring bidders to register their offers with the government in advance. A plurality of the Supreme Court also considered the Illinois statute to be preempted by the Williams Act.

35. E.g., Frank H. Easterbrook and Daniel R. Fischel, *Economic Structure of Corporate Law* (Cambridge: Harvard University Press, 1991), pp. 220-22. Takeover statutes and other defensive tactics, might, however, benefit shareholders by enhancing management's ability to negotiate a higher price which dispersed shareholders are not able to do. Moreover, a recent paper concludes that takeover statutes have had no effect on takeovers. See Marcel Kahan, "The Demand for Corporate Law: Statutory Flexibility, Judicial Quality , or Takeover Protection?," New York University Law and Economics Research Paper No. 04-17 (2004).

36. See Charles Hansen, "Other Constituency Statutes: A Search for Perspective," *Business Lawyer,* vol. 46, (1991), pp. 1355-76, p. 1357 (quoting Pennsylvania legislative history as intending to codify other state court decisions permitting consideration of nonshareholder interests). Some commentators also considered the statute to be a response to the D&O insurance crisis, rather than hostile takeovers. See Hanks, "Evaluating Recent State Legislation."

37. The last category also includes states that adopted a business combination freeze statute with a fair price provision while simultaneously eliminating an independent fair price statute that had been previously adopted.

38. 481 U.S. 69 (1987).

39. Legislators frequently stated for the legislative record in 1987 that they were copying the Indiana statute because its constitutionality had been upheld by the Supreme Court. See, e.g., Russell D. Garrett, "Third Generation Anti-Takeover Statutes in Oregon and Indiana after Dynamics: Target Corporations Control the Ship and Raiders Are Foiled," *Willamette Law Review*, vol. 24 (1987), pp. 73- 100, p.89.

40. Compare the decisions in *Amanda Acquisition Corp. v. Universal Foods Corp.*, 877 F. 2d 496 (7th Cir. 1989) (upholding Wisconsin's business combination freeze statute) and *Tyson Foods v. McReynolds*, 865 F. 2d 99 (6th Cir. 1989) (invalidating Tennessee's control share and business combination freeze statutes to the extent they applied to a corporation not incorporated in-state; the target Holly Farms was

headquartered in Tennessee but incorporated in Delaware).

41. E.g., Comment, Notes to 1985 Amendment, Georgia Statutes Annotated § 14-2-232 (Georgia fair price provision compared to numerous states); Garrett, "Third Generation Anti-Takeover Statutes"(Oregon control share acquisition statute compared to Indiana statute); Historical Notes and Commentary, Baldwin's Ohio Revised Code Annotated, R.C.T. XVII, ch. 1704 (Ohio business combination freeze statute compared to Wisconsin statute).

42. See, e.g., Romano, "Political Economy."

43. For lists matching targets with statutes see Carney, "Production of Corporate Law, "p.750-51; Henry N. Butler, "Corporation-Specific Anti-takeover Statutes and the Market for Corporate Charters," *Wisconsin Law Review,* vol. 1988, pp. 365-383; Roberta Romano, "The Future of Hostile Takeovers: Legislation and Public Opinion," *University of Cincinnati Law Review*, vol. 57 (1988), pp. 457-504; Roberta Romano, "The Political Economy of Takeover Statutes," *Virginia Law Review,* vol. 73 (1987), pp. 111-99, pp.137-8.

44. Romano, "Political Economy of Takeover Statutes," p. 137 n. 66.

45. See, e.g., Romano, "Future of Hostile Takeovers;" Romano, *The Advantage of Competitive Federalism,* pp. 96-98, Roberta Romano *The Genius of American Corporate Law* (Washington, D.C.: AEI Press, 1993), pp. 59-60.

46. The Delaware bar considered and rejected a control share acquisition statute after the *CTS* decision (corporate law reforms in Delaware originate with the state bar committee). See, e.g., Alva, "Delaware and the Market for Corporate Charters," pp. 904-09. Several months later, representatives of Boeing Corporation, the target of a hostile bid, sought legislative relief from Delaware state officials, and they were referred to the bar committee, as the source of all corporate legislation. Delaware adopted the business combination freeze statute several months after that referral, but the statute did not take the form that Boeing had proposed. Ibid., p. 909-10.

47. It should be noted that Delaware was not the first state to reduce New York's five-year moratorium period to three years; two states had previously done so.

48. The falling ratios do not include the impact on one of the states (Minnesota) that had enacted a five-year moratorium before the Delaware legislation, and reduced it to a four-year moratorium, one year after Delaware acted.

49. In *Schreiber v. Burlington Northern, Inc.*, 472 U.S. 1 (1985), the Supreme Court held that defensive tactics were not "manipulative" conduct covered by the federal securities laws and hence their legality was left to state fiduciary duty law. In some states, legislatures adopted poison pill validation statutes after local courts invalidated the defense.

50. See, e.g., *Moran v. Household International, Inc.*, 500 A. 2d 1346 (Del. 1986) (upholding poison pill); *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A. 2d 173 (Del. 1985) (invalidating defensive action that benefitted bondholders).

51. The absence of an enforcement mechanism is consistent with event studies' failure to find systematic price effects for other constituency statutes, in contrast to the negative effects found for control share acquisition statutes. For a review of the event studies of state takeover statutes see Romano, *Genius*, pp. 60-67.

52. Romano, "Future of Hostile Takeovers," pp. 470-74, 481-85.

53. Ibid., pp. 479-81.

54. See S.B. 1323 § 36, 100th Cong. 1st Sess. (1987); 133 Cong. Rec. S7594 (June 4, 1987) (introduction of S.B. 1323 by Senator Proxmire); 134 Cong. Rec. S8101 (June 17, 1988) (start of debate over S. B. 1323). The only variance in the bill from state law on the permissibility of firm-level defenses was that it would have required a shareholder vote to adopt a poison pill during a takeover contest.

55. See Carney, "Production of Corporate Law," p. 725 and American Bar Association Section of Business Law, *Model Business Corporation Act Annotated* (3d ed. 1998, 2000/01/02 Supp.), vol.1, p.

xxvi. The ABA Corporate Law Committee took on the task of drafting a national corporation law in 1940, and upon completing a draft in 1943 turned to drafting a model act for state use, which was published in 1946; the 1950 revision of that draft statute is now considered the first Model Act. Melvin Aron Eisenberg, "The Model Business Corporation Act and the Model Business Corporation Act Annotated," *Business Lawyer*, vol. 29 (1974), pp. 1407-28, 1407-08.

56. For example, annotations to provisions in the New Jersey statute refer to sources in the Model Act, Delaware and New York state statutes, and annotations to provisions in the Texas statute refer to sources in the statutes of Illinois, Ohio, Oklahoma and New York, among others, as well as the Model Act.

57. For information on when various states have adopted model act provisions, and how many states have particular provisions, see Carney, "Production of Corporate Law." The *Model Business Corporation Act Annotated* provides, for each section, a comparison of all state statutes.

58. *Model Business Corporation Act Annotated*, vol. 1, p. xxvii.

59. For some recent innovations by the Model Act drafters see Carney, "Production of Corporate Law," pp. 747-48. As noted in the text, the limited liability provision in the Model Act was a response to Delaware's innovation.

60. The appraisal rights exemption for publicly traded firms that was included in the 1969 Model Act revision was eliminated in 1978 amendments to the Act, but was reintroduced in 1999. *Model Business Corporation Act Annotated*, vol. 3, p. 13-29.

61. *Model Business Corporation Act Annotated*, vol. 2, p. 8-291. It should be noted that the indemnification provision in the original 1950 Model Act was modeled on the provision in Delaware's code at that time, which was selected for its "brevity and simplicity," and was the type found in most state statutes; given its generality, it obviated a need for a specific charter or bylaw provision. American Bar Association Committee on Corporate Law, *Model Business Corporation Act Annotated* (American Bar Foundation, 2d ed. 1971), vol.1, p. 218.

62. About the same number of states adopted the provisions before 1969 (that is, following Delaware), as did so during 1969 (the Model Act revision was published by the ABA by mid-year).

63. *Model Business Corporation Act Annotated*, vol. 2, pp. 7-35 to 7-39.

64. Eisenberg, "The Model Business Corporation Act," p. 1414; *Model Business Corporation Act Annotated* (2d ed.), vol. 1, p. 522. It should be noted that because many states had constitutional provisions requiring cumulative voting, this reform was more difficult to implement than other corporate law revisions that were replaced statutes.

65. The Model Act provision refined the language of the statutory exceptions in the Delaware statute, and permitted application to inside as well as outside directors. See Committee on Corporate Laws, "Amendment Pertaining to the Liability of Directors." The inclusion of inside directors was not an innovation of the Model Act: several states had already done so, including Louisiana, Maryland and Nevada. See Hanks, "Evaluating Recent State Legislation," p. 1210.

66. Of those nine states, only five are currently identified as Model Act states but one, Maine, cannot be said to have been affected by the 1990 Model Act revision because it had enacted an Indiana-style culpability statute in 1988 and its adoption of a limited liability charter amendment provision in addition to that statute was in 2002, more than a decade later. In addition, all but one of the states that enacted instead the alternative of a relaxed culpability statute are currently identified as Model Act states, and those states did not repeal their culpability provisions when the Model Act took a different (the Delaware) tack.

67. Carney interprets the more rapid diffusion of takeover and limited liability statutes across the states, compared to the 1967 reform initiatives, as due to their sponsorship by corporate managers (compared to the corporate bar), whom he considers better organized politically because of a greater personal interest in the issues, although he notes that he cannot rule out technological change that improved the spread of information in the 1980s as an alternative explanation. Carney, "Production of Corporate Law," p. 749.

68. In 1971, the ABA identified 29 states whose corporation codes either "used [the Model Act] as the basis" or employed it "to great extent." *Model Business Corporation Act Annotated* (2d ed.), vol. 1, pp. 3-4. In 2002, it identified 25 states as having adopted "all or substantially all" of the 1984 Model Act revision and 5 states as having statutes "based on" the 1969 version. *Model Business Corporation Act Annotated*, vol. 1, p. xxvii.

69. Delaware's influence on takeover regulation is uncorrelated with Model Act status. Of the states with business combination freeze statutes that are patterned after Delaware (no parallel fair price provisions), five are Model Act states and four are not. In addition, four of those Model Act states, and three of the non-Model Act states, also have either a control share acquisition or redemption rights statute, and thus they are all more restrictive of bids than Delaware.

70. Their dataset consists of 6,530 publicly traded firms identified from the 1999 Compustat database, a database with information from the financial statements of over 24,000 active and inactive public U.S. and Canadian firms. Lucian A. Bebchuk and Alma Cohen, "Firms' Decisions Where to Incorporate," *Journal of Law and Economics*, vol.46 (2003), pp. 383-425, pp. 392-93 (table 3). Four more firms were incorporated but not physically located in those five states. The 25 Model Act states with takeover statutes had 681 local incorporations (836 incorporations). Ibid. One of those states had fewer incorporations than the five states with no takeover statutes and another six had about the same number (between three and six local incorporations).

71. Carney, "Production of Corporate Law," pp. 744-48. Carney was interested in testing a hypothesis slightly different from that in this paper, which his data confirmed: that Model Act initiatives would be more widely adopted than initiatives of a single state.

72. Carney examined two Delaware, one North Carolina, and four Model Act innovations. I do not include the other Delaware innovation in Carney's comparison, which related to mergers, since an appropriate comparison for my purpose (which differs from Carney's) requires minimizing the possibility

of selection effects – that is, I need a provision that could be of use to all firms, so that all states could be motivated to adopt it – and in my prior research on firms' domicile changes, I found that Delaware was favored by firms planning to engage in mergers. Romano, " Law as a Product." I also use only one Model Act initiative of the four that Carney examined, the one closest to the subject of the Delaware initiative, to facilitate a comparison of relative influence: both had similar organizational benefits, improving the efficiency of the voting process by facilitating the accomplishment of a quorum. Carney, "Production of Corporate Law," pp. 745-46; *Model Business Corporation Act Annotated*, vol. 2, pp. 7-157 - 7-158. It should be noted that Delaware was not actually the pioneer for electronic proxy voting: New Jersey permitted electronic transmissions of proxy votes in 1988. At the time of Carney's study, the Delaware initiative had not been adopted by many states (but he correctly anticipated a future increase because the Model Act had just been amended in 1996 to permit electronic voting), whereas the Model Act initiative had more adoptions, although it was still low for a Model Act provision (fewer than half of the states had adopted plurality voting).

73. I have not tested whether the observed pattern is not random as an indication of the Model Act's influence, because the appropriate benchmark for such a test would be to compare the pattern to a formal model predicting when a state would adopt a provision in the absence of the Model Act.

74. Although the language in three state statutes, "majority of votes cast", could be considered equivalent in effect to plurality voting (if abstentions are not construed to be "cast" votes), this does not appear to be the common interpretation, as the Model Act drafters stated that there was no counterpart in any state code to the Model Act provision when it was introduced. *Model Business Corporation Act Annotated*, vol. 2, p. 7-161.

75. More specifically, he based his conclusion on the fact that when the 27 newer provisions were deleted from his set of provisions, there was a higher degree of uniformity for the remaining provisions (enacted in 77 percent, rather than 74 percent, of the states). Ibid., p.734.

76. The 30 provisions are identified in Table 5 of his article. Carney, "Production of Corporate Law," pp. 774-76. I checked both the Delaware statute and the statutory comparison sections in the *Model Business Corporation Act Annotated* for this inquiry. It should be noted that in a few instances, the comparisons in the official annotation to the Model Act stated that there were no analogous provisions in the Delaware code but there were actually similar provisions. For example, two of these instances involved provisions fixing distribution record dates, that are part of a larger legal capital scheme in the Model Act that has no counterpart in Delaware's code. Because that larger schema was the basis for the official statutory comparison, Delaware was reported as lacking the provisions, although it actually has record date provisions with similar effect (they are not related to any legal capital provisions).

77. I took on face value the counts of adopters that are provided in the official statutory comparisons sections in the *Model Business Corporation Act Annotated* (although a count is not provided for all provisions). The few provisions where the current count for adopters was lower than Carney's count were provisions that had been eliminated from the Model Act since Carney wrote his article but whose presence in state codes was still tracked in the statutory comparisons.

78. See Michael P. Dooley and Michael D. Goldman, "Some Comparisons Between the Model Business Corporation Act and the Delaware General Corporation Law", *Business Lawyer*, vol. 56 (2001), pp. 737-66. While this is clearly true for a few provisions - such as the Model Act provision that officers owe a duty of good faith and care (adopted by only 28 states, *Model Business Corporation Act Annotated*, vol. 2, pp. 8-266 - 8-266A), I did not research whether this is true for others (such as the provision mandating notice to exercise cumulative voting rights). But for six provisions there is explicit statutory language in Delaware's statute at odds with the Model Act language, not counting the Model Act provisions with which the Delaware code differed and that were eliminated after the publication of the Carney study.

79. Bebchuk and Cohen, "Firms' Decisions" (in 1998, over a majority – 3,771 – of a sample of 6,530 firms in the Compustat database were incorporated in Delaware); Daines, "Incorporation Choices" (more

than a majority of IPO firms incorporated in Delaware); Romano, “Law as a Product”(half of largest firms incorporated in Delaware). The three states with the next largest numbers of incorporations after Delaware (and the only other states with over 200 domestic incorporations) in Bebchuk and Cohen’s sample, California, New York and Nevada, are also not Model Act states.

80. As earlier noted, evidence connecting legal innovation with chartering revenues and with reincorporations and retention of local incorporations is provided in Romano, “Law as a Product,” pp. 236-42, 246-47; and Moodie, “ Forty Years of Charter Competition.” For a discussion of the financial incentives of states to compete for charters see Roberta Romano, “Is Regulatory Competition a Problem of Irrelevant for Corporate Governance?” Yale Law School Law and Economics Research Paper No. 307 (2005), pp. 14-18, 22-24.

81. Romano, *The Advantage of Competitive Federalism*, pp. 64-83.

82.See Bebchuk and Cohen, “Firms’ Decisions,” pp. 383-425, p. 407; Guhan Subramanian, “The Influence of Antitakeover Statutes on Incorporation Choice: Evidence on the ‘Race’ Debate and Antitakeover Overreaching.” *University of Pennsylvania Law Review*, vol. 150 (2002), pp. 1795-1873, p. 1828. It should be noted that the yearly statute totals in this paper are not identical to those in the Subramanian study because I correct for several errors in that study’s identification of enactment years.

83. It is not included in the state statute counts in Bebchuk and Cohen, “Firms’ Decisions,” and Subramanian, “Influence of Antitakeover Statutes,” nor in the comprehensive review article on these statutes, Hansen, “Other Constituency Statutes.”

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