HOMOGENEITY EFFECTS IN CORPORATE LAW

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ABSTRACT

Entrepreneurs enjoy considerable freedom in choosing the rules that will govern their firms. As a general rule, they are able to select not only the state of incorporation, but also the entity type.

When making these choices, entrepreneurs have reason to care about the extent to which other firms are using a particular legal regime. Traditionally, corporate law scholarship on this topic has drawn attention to the relevance of the number of other firms using a given legal regime. Drawing on insights from network theory, Michael Klausner has famously shown that the benefits of a particular legal regime increase as more firms come to use it.

This article does not dispute that the number of other users matters, but argues that the qualitative features of a legal regime's users are relevant as well: in particular, firms benefit if the users of their chosen legal regime form a relatively homogeneous group. The benefits of such homogeneity come in two flavors. Some homogeneity benefits are ancillary to network benefits; firms profit from homogeneity because more homogeneous networks yield greater benefits. Other homogeneity benefits, however, are independent from network effects in the sense that they do not presuppose the existence of a network. In particular, firm homogeneity increases the predictability of judicial and legislative interventions, and also promises to improve the fit between such interventions and firm needs.

Homogeneity effects are of substantial practical and theoretical interest. They help to explain, or provide efficiency rationales for, a variety of otherwise puzzling or difficult-to-justify phenomena in corporate law. These include the seemingly excessive number of different entity types, the survival of important mandatory norms, and the fact that corporate mobility is observed in some environments but not in others.

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TABLE OF CONTENTS

I. INTRODUCTION

Entrepreneurs enjoy considerable freedom in selecting the rules governing their firms. As a general rule, they can choose not only the state in which their firm is incorporated,[2] but also the entity type.[3] In part, the choice of a particular legal regime is driven by the content of legal norms[4] and the quality of the institutions that enforce them.[5] However, firms also have reason to care

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2. *E.g.*, ROBERTA ROMANO, THE ADVANTAGE OF COMPETITIVE FEDERALISM FOR SECURITIES REGULATION 63 (2002) [hereinafter ADVANTAGE]; Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y.U. L. REV. 1559, 1560 (2002). Of course, in practice, firms end up choosing between their home state and Delaware. *See, e.g.*, Daines, *supra* at 1572 (showing that most IPO firms incorporate either locally or in Delaware); Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, 27 J.L. ECON. & ORG. 79, 84–85 (2011) (demonstrating that most privately held corporations incorporate either locally or in Delaware).

3. *E.g.*, Clayton P. Gillette, *Regionalizaton and Interlocal Bargains*, 76 N.Y.U. L. REV. 190, 215–16 (2001); *see* Edmund W. Kitch, *The Simplification of the Criteria for Good Corporate Law or Why Corporate Law is Not as Important Anymore*, 2 BERKELEY BUS. L.J. 35, 35 (2005).

4. Copious evidence suggests that the choice of where to incorporate is determined in part by the substantive law of the jurisdiction. *See* Lucian Arye Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J.L. & ECON. 383, 421 (2003) (showing that states amassing antitakeover statutes enjoy more success in the charter market); Dammann & Schündeln, *supra* note 2, at 107 (finding that privately held corporations are more likely to incorporate locally if their home state offers a high level of protection against veil-piercing and a low level protection for minority shareholders); Marcel Kahan, *The Demand for Corporate Law: Statutory Flexibility, Judicial Quality, or Takeover Protection*, 22 J.L. ECON. & ORG. 340, 363 (2006) (concluding that IPO firms value flexible corporate law regimes). An entirely different question and one that lies beyond the scope of this article is whether corporations prefer efficient law—as the race-to-the-top-theory asserts—or inefficiently manager-friendly law—as suggested by the race-to-the-bottom theory. For a modern version of the race-to-the-bottom view see, for example, Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Corporate Law: The Race to Protect Managers from Takeovers*, 99 COLUM. L. REV. 1168, 1170 (1999) (concluding that state competition "is therefore likely to produce troubling results with respect to some critical aspects of corporate law"); Lucian Arye Bebchuk & Allen Ferrell, *A New Approach to Takeover Law and Regulatory Competition*, 87 VA. L. REV. 111, 161 (2001) (concluding that states compete by enacting inefficiently pro-managerial takeover laws). For a modern version of the race-to-the-top view see, for example, Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 847 (1993) (arguing that regulatory "on balance" competition benefits investors); Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 177–79 (1992) (arguing that regulatory competition has the potential to benefit shareholders).

5. *See, e.g.*, Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 580–81 (2002) (noting that Delaware's courts and in particular the Chancery Court are "an important component of the quality of the system offered by Delaware"); Brett H. McDonnell, *Two Cheers for Corporate Law Federalism*, 30 J. CORP. L. 99, 106, 118 (2004) (arguing that the Delaware Chancery Court is one of Delaware's more important advantages in the competition for corporate charters); *see also* Jens Dammann & Henry Hansmann, *Globalizing Commercial Litigation*, 94 CORNELL L. REV. 1, 59 n.184 (2008) (noting widespread agreement "that the quality of Delaware's judiciary is an important factor in attracting corporations to Delaware"); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908,

about the extent to which *other* firms are using the regime in question. To use language suggested by Romano's law-as-a-product metaphor,[6] firms have cause to be interested in the jurisdiction's other customers.[7] But what aspects of a legal regime's existing users should a prospective user be interested in? Should they ask *how many* other firms are using a particular legal regime? Or should they ask *what type* of firms use a particular regime?

Traditionally, corporate law scholars have focused on the first aspect, i.e., the number of other users. In his groundbreaking work on network effects in corporate law and contracts, Michael Klausner has shown that, all else equal, a legal regime is more attractive the more users it has. Building on insights from economics,[8] Klausner famously argued that legal regimes exhibit network characteristics in such a way that the benefits arising from the use of a particular legal regime increase with the number of users.[9] When, for example, there are more corporations incorporated in a particular jurisdiction, investors are more familiar with the jurisdiction's law; this, in turn, makes it easier for corporations to sell their shares.[10] Moreover, the more firms use a particular legal regime, the greater the chance that the provisions of that regime will be clarified through future litigation,[11] allowing users to reap "interpretative network externalities."[12] Klausner's account has now gained

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1911 (1998) (pointing out that the quality of Delaware's judiciary is generally thought to be a competitive advantage). Empirical research confirms that the choice of where to incorporate is determined in part by the quality of state courts. This is true for both public corporations, Kahan, *supra* note 4, and private ones, Dammann & Schündeln, *supra* note 2, at 94–95, 107.

6. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORG. 225, 225–26 (1985).

7. Incidentally, the idea that the usefulness of a product may depend upon who else is using it is well recognized in other contexts. For example, students value top universities in part because it allows them to spend time with other highly qualified students. Henry Hansmann, *Higher Education as an Associative Good*, *in* FORUM FUTURES: 1999 PAPERS 11, 11 (Maureen Devlin & Joel Meyerson eds., 1999); Henry Hansmann, *A Theory of Status Organizations*, 2 J.L. ECON. & ORG. 119, 129 (1986). Similarly, whether fashion is cool depends on who else is wearing it. Jonah Berger & Chip Heath, *Who Drives Divergence? Identity Signaling, Out-Group Similarity, and the Abandonment of Cultural Tastes*, 95 J. PERSONALITY & SOC. PSYCHOL. 593, 594–95 (2008).

8. *See generally* Marianne Bertrand, Erzo F.P. Luttmer & Sendhil Mullainathan, *Network Effects and Welfare Cultures*, 115 Q.J. ECON. 1019 (2000); Joseph Farrell & Garth Saloner, *Installed Base and Compatibility: Innovation, Product Preannouncements, and Predation*, 76 AM. ECON. REV. 940 (1986); Joseph Farrell & Garth Saloner, *Standardization, Compatibility, and Innovation*, 16 RAND J. ECON. 70 (1985) [hereinafter Farrell & Saloner, *Standardization*]; Michael L. Katz & Carl Shapiro, *Network Externalities, Competition, and Compatibility*, 75 AM. ECON. REV. 424 (1985) [hereinafter Katz & Shapiro, *Network Externalities*]; Michael L. Katz & Carl Shapiro, *Systems Competition and Network Effects*, 8 J. ECON. PERSP. 93 (1994).

9. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 762–63, n.14 (1995).

10. *See id.* at 762.

11. *Id.* at 776.

12. *Id.* at 779.

broad acceptance in corporate law scholarship; it constitutes a staple of theoretical and empirical analysis.[13]

Obviously, the existence of network effects requires at least some degree of homogeneity in the sense of compatibility. However, in Klausner's account, that compatibility arises not because the relevant firms are substantively similar but because they use the same legal product, i.e. the same corporate law regime.[14] Indeed, network effects are the very reason why firms with heterogeneous preferences may opt to be governed by the same rule: some of these firms may find a different rule more to their liking, but choose the prevailing rule because of the network benefits if offers.[15] This reasoning reflects the focus of much of the classic economic literature on network effects, in which compatibility is chiefly analyzed in terms of product compatibility:[16] the utility of a product depends on the number of network participants, and product compatibility is a crucial factor in determining the size of the network.[17]

This article does not dispute the claim that the number of firms incorporated under a particular legal regime is an important consideration.

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13. Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 594 (2003) (arguing that network effects make it hard for other states to compete with Delaware); *see* Michal Barzuza, *Price Considerations in the Market for Corporate Law*, 26 CARDOZO L. REV. 127, 142, 146 (2004) (arguing that network effects contribute to Delaware's market power in the charter market); Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 890 (2005) [hereinafter Bebchuk, *Shareholder Power*] (asserting that the influence of network effects on the companies' choices of legal arrangements is "well recognized"); Kamar, *supra* note 5, at 1923–24 (using network theory to argue that Delaware enjoys market power in the charter market). *But see* Henry Hansmann, *Corporation and Contract***,** 8 AM. L. & ECON. REV. 1, 6 (2006) (suggesting that network theory "seems to exaggerate the demand for uniformity"); Mark A. Lemley & David McGowan, *Legal Implications of Network Economic Effects*, 86 CALIF. L. REV. 479, 570 (1998) (arguing "that network effects in corporate law will be difficult to identify as such, will be weak where they can be found, and will likely be subject to amelioration through market forces").

14. In Klausner's account, heterogeneity can be one reason for why the prevailing product is not the optimal one. As Klausner points out, "when firms are heterogeneous in their valuation of alternative terms, the contract choices of early adopting firms may bias the contracting decisions of later-adopting firms and potentially lead to suboptimal uniformity in contracts." Klausner, *supra* note 9, at 813. Differently put, later adopters may choose a certain contractual term not because they prefer that term's inherent benefits, but because that term has been adopted by many other firms, and thus offers network benefits that an inherently better term cannot offer.

15. *Id.*

16. *See, e.g.*, Farrel & Saloner, *Standardization*, *supra* note 8, at 70–71 (discussing network effects resulting from product standardization); Katz & Shapiro, *Network Externalities*, *supra* note 8, at 424 (noting that "[t]he central feature of the market that determines the scope of the relevant network is whether the products of different firms may be used together"). *But see e.g.*, Bertrand et al., *supra* note 8, at 1019–20 (focusing on social networks and distinguishing between the size (quantity) and the quality of a network).

17. Katz & Shapiro, *Network Externalities*, *supra* note 8, at 424.

However, I argue that firms should not only be concerned with the number of other users, but also their qualitative profiles. All else equal, firms benefit if the users of a particular legal regime form a relatively homogenous group. I will refer to these benefits as homogeneity benefits. The term homogeneity is intentionally broad. It encompasses homogeneity in size, ownership, and governance structure, but is not limited to these criteria.[18]

The benefits of firm homogeneity come in two flavors. Some homogeneity benefits are ancillary to network benefits in the sense that firm homogeneity does not offer advantages *per se*, but simply helps to increase network benefits. Outside the area of law, particularly in the context of social networks, it has long been recognized that networks with more homogeneous participants may yield greater benefits.[19] The same can be shown for legal networks. For example, one of the network benefits mentioned by Klausner is that available legal services will be cheaper and faster because law firms confronted with a particular legal issue may already have addressed the same issue for another client.[20] It is not difficult to see that firm homogeneity reinforces this benefit: firms are much more likely to face similar legal questions if the relevant firms have similar governance and ownership structures. Hence, firm homogeneity reinforces the legal service network externalities envisioned by Klausner. Recognizing such ancillary benefits of firm homogeneity simply amounts to a better and more comprehensive understanding of network effects.

However, there are also benefits to firm homogeneity that are quite independent of network effects in that these benefits do not depend on the existence of a network at all. Such "independent" homogeneity benefits concern the future development of a legal regime. When courts and lawmakers fashion legislative and judicial interventions, they respond to the perceived characteristics of the firms that they regulate. From a firm's perspective, therefore, being part of a homogeneous population of firms stands to confer two key advantages. First, since in these cases courts and lawmakers do not have to mediate between different types of firms with different needs, membership in a homogeneous group makes the legal changes that will affect one's firm more predictable. Second, a firm that forms part of a homogeneous population has a greater chance that future

18. I am not arguing that firm homogeneity is the only qualitative consideration that matters. There are other potential factors, but they are beyond the scope of this article.

19. *See, e.g.*, Sheen S. Levine & Robert Kurzban, *Explaining Clustering in Social Networks: Towards an Evolutionary Theory of Cascading Benefits*, 27 MANAGERIAL & DECISION ECON. 173, 182 (2006) (pointing out that even within social networks, people tend to cluster in homogenous groups because the latter can offer additional network benefits that sparse networks cannot provide).

20. Klausner, *supra* note 9, at 782.

changes in the law will be tailored to its needs rather than to those of some other type of firm. Crucially, these two benefits—greater predictability of legal changes and better fit—do not presuppose the existence of a network. Indeed, they exist even in the hypothetical case where only a single firm is subject to a particular legal regime which can then be tailored completely to that firm's needs. In such a limit case, no network effects can arise, but the population's homogeneity is absolute.

Homogeneity effects are of substantial practical and theoretical interest. They constitute an important counterweight to the bigger-is-better approach that dominates legal scholarship on network effects. If numbers were everything, then firms choosing between different legal regimes with equally attractive inherent qualities would choose the network with the greatest number of participants.[21] Moreover, those firms that are already part of the network would welcome any newcomers since every newcomer would bestow positive externalities on the other members of the network by making the network bigger.[22]

Once homogeneity benefits are taken into account, however, the situation becomes more complex. Both independent and ancillary homogeneity benefits suggest that bigger may not necessarily be better. Firms choosing between different networks may choose a smaller network over a larger one if the former is more homogenous.

Morever, homogeneity effects complicate the externalities question. A firm entering an existing network may simultaneously increase the network's size and reduce its homogeneity. In the case of ancillary homogeneity benefits, this merely means that the new entrant may fail to create meaningful positive externalities. For example, if small, privately held firms start incorporating under a legal regime traditionally used by large public corporations, these privately held firms may use a very different type of law firm than public corporations and may therefore not create any legal service externalities for existing users. However, independent homogeneity effects have much more profound implications. The existence of independent homogeneity effects suggests that new entrants making the network larger but less homogeneous may actually create negative externalities for existing users. Consider once more the case that small, privately held firms start

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21. By "inherent qualities," I mean those qualities that do not—or at least do not any longer—depend on the number or type of other users. Most importantly, the content of norms constitutes an inherent benefit in this sense, despite the fact that the present content of a legal system's norms may be the result of its past users.

22. *See, e.g.*, Klausner, *supra* note 9, at 773 (noting that "[w]hen someone begins using a technology, that user increases the size of the network surrounding the technology" and pointing out that "[t]his marginal increase in network size provides a benefit for current users and makes the technology more attractive to future users").

incorporating under a legal regime that was previously used exclusively by publicly traded corporations. In this scenario, the arrival of the privately held firms may make future changes to the law less predictable since lawmakers and courts now have to mediate between the interests of publicly traded firms and privately held ones. Due to this potential for negative externalities, firms that are already part of a network may seek to exclude other firms from that network to the extent that the latter reduce the network's homogeneity.

The analysis undertaken in this article also has substantial practical importance. In the area of corporate law, homogeneity effects have the potential to provide efficiency rationales for a number of significant phenomena, which are otherwise difficult to justify on efficiency grounds. These phenomena include the seemingly excessive number of different entity types, the mandatory nature of certain corporate law norms, and the occurrence of corporate mobility in some environments but not in others.

More generally, the existence of homogeneity effects has important policy implications. While a basic understanding of network effects may suggest that policymakers should do their best to increase the number of firms that use a particular legal regime, the potential for homogeneity effects implies a tradeoff. A greater number of users may come at the expense of greater firm homogeneity. Accordingly, depending on the circumstances, it may be in society's interest to limit the number of users, so as to maximize homogeneity.

This Article proceeds as follows. Part I focuses on "independent" homogeneity benefits, i.e. benefits of homogeneity that arise independently of network effects. This Part explains why firms selecting a legal regime have to be concerned about the possibility of future legal change. Moreover, it shows how firm homogeneity can benefit firms by reducing the uncertainty inherent in such change. Part II concentrates on "ancillary" homogeneity benefits; it explains how greater homogeneity of legal networks increases the network benefits that those networks yield. Part IV distinguishes a legal regime's inherent benefits from those related to homogeneity or network membership. Part V provides a demonstration of the explanatory power of homogeneity effects. Part VI summarizes and concludes.

II. INDEPENDENT HOMOGENEITY BENEFITS

Quite regardless of the existence of a legal network, firm homogeneity offers important benefits. When firms select a legal regime, they care not just about the present content of the law but also about future legal developments. Firm homogeneity reduces the risks inherent in the possibility of such future legal changes. It not only makes them more predictable but also increases the likelihood that future changes will fit the needs of the individual firm.

A. Legal Changes

The idea that firms selecting a legal regime care about future legal developments is hardly original; indeed, Roberta Romano stressed it decades ago. In an effort to explain the prominence of Delaware as the leading state of incorporation, Romano laid out what is known as the "hostage theory" of state competition: Delaware derives a substantial part of its revenues from franchise taxes, making it financially dependent on its corporate customers.[23] This financial dependence actually turns out to be a competitive advantage: knowing that Delaware cannot afford to drive away its corporate customers, corporations are confident that Delaware will remain responsive to their interests when they change the law.[24] In this way, Delaware has an edge over other states precisely because its financial dependence on franchise taxes renders it, "a hostage to its success in the charter market."[25]

For the purpose of this Article, it will be helpful to discuss the relevance of legal change in some more detail. Economic actors in general, and firms in particular, care about future change for two broad reasons. First, they hope to be spared "disruptive interventions"[26] by courts and lawmakers; that is, interruptions that upset the bargain struck by the parties involved or impose other burdens. Second, firms may need lawmakers and courts to "update" the law,[27] not to upset the original bargain, but rather to preserve it in light of changing circumstances. Examples of both types of interventions are readily found.

1. Disruptive Interventions

Perhaps the most famous example of a disruptive intervention in corporate law is New Jersey's 1913 enactment of the so-called "Seven Sisters Act." At the end of the nineteenth century, New Jersey, rather than Delaware, was the

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23. ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 38 (1993).

24. *Id.*

25. *Id.*

26. *See infra* Part II.A.1.

27. For an early account of how the state can use legislative intervention to update governance structures, see Oliver Williamson, *Franchise Bidding for Natural Monopolies—In General and with Respect to CATV*, 7 BELL J. ECON. 73 (1976). For an application of this concept to corporate law in particular, see Henry Hansmann, *supra* note 13, at 9–17.

leading state of incorporation.[28] Over time, aggressive pricing appeared to have diminished this position somewhat, as other states such as Delaware or New York began to be perceived as cheaper alternatives.[29] Further problems for New Jersey's role as a charter state arose in 1912 when Woodrow Wilson, then governor of New Jersey, was running for president of the United States on a platform which included a promise to get tough on trusts.[30] Theodore Roosevelt responded by criticizing Wilson's failure to do anything about trusts in his gubernatorial role.[31] Following Roosevelt's attack, Wilson apparently came to the conclusion that it was in his political interest to get active.[32] Under his stewardship, New Jersey enacted a statute—the Seven Sisters Act[33]—which effectively banned holding companies and trusts, greatly frustrating the corporations that had chosen New Jersey as their corporate domicile.[34] The story had a happy ending for Wilson who was elected president, but a sad one for New Jersey. The Seven Sisters Act drove away New Jersey's corporate customers,[35] thereby allowing Delaware to become the new destination of choice for public corporations.[36] By 1917, New Jersey had realized its mistake and repealed the act, but this atonement came too late.[37] Having been disappointed by New Jersey and thereafter welcomed by Delaware, the corporations did not return.[38]

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28. Daryl J. Levinson, *Empire-Building Government in Constitutional Law*, 118 HARV. L. REV. 915, 948 (2005); Charles M. Yablon, *The Historical Race Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880–1910*, 32 IOWA J. CORP. L. 323, 354 (2007).

29. Yablon, *supra* note 28.

30. Miller Ctr., *American President: A Reference Resource Campaigns and Elections The Campaign and Election of 1912*, UNIV. OF VA., http://millercenter.org/president/wilson/essays/biography/3 (last visited Oct. 9, 2014).

31. Wayne D. Collins, *Symposium: The Goals of Antitrust: Trusts and the Origins of Antitrust Legislation*, 81 FORDHAM L. REV. 2279, 2330 n.265 (2013).

32. Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 731 (2002); *see* Daryl J. Levinson, *Empire-Building Government in Constitutional Law*, 118 HARV. L. REV. 915, 948 (2005) (noting that the enactment of the Seven Sisters Act was politically helpful to Wilson because it strengthened his reputation as a "trust-buster").

33. Law of Feb. 19, 1913, ch. 18, 1913 N.J. Laws 32 (repealed 1917).

34. Kahan & Kamar, *supra* note 32.

35. *Id.*; Levinson, *Empire-Building Government in Constitutional Law*, 118 HARV. L. REV. 915, 948 (2005); *see* Yablon, *supra* note 28, at 325 (arguing that New Jersey "effectively took itself out of the running" by enacting the Seven Sisters Act).

36. Collins, *supra* note 31. This is not to say that the Seven Sisters Act was the only problem that New Jersey faced in the charter market. Aggressive pricing by other states of incorporation may also have played a role. Yablon, *supra* note 28, at 354.

37. Collins, *supra* note 31.

38. *Id.*

2. Updating and Improving the Law

If firms' interest in future legal change were confined to a concern with avoiding disruptive changes, matters would be very easy for both lawmakers and firms. Well-meaning lawmakers could simply refrain from applying reforms to existing firms. Firms could, when permitted, rely on so-called freeze-provisions,[39] which provide that the firm will automatically opt out of new legislation. However, not all interventions by courts and lawmakers are detrimental to the interests of existing firms. On the contrary, in some cases, it is eminently necessary for lawmakers to modernize the law and adapt it to changing circumstances.[40]

This necessity is illustrated by the history of the rules governing withdrawal rights in limited liability companies. Until 1997, LLC statutes typically provided that each member could withdraw at any time, and that such withdrawal led to the dissolution of the company.[41] The prevalence of this rule was, however, clearly contrary to efficiency considerations. Indeed, the ever-present specter of dissolution was widely acknowledged to be an obstacle to long-term planning and investments.[42] Only tax law could explain why this rule was so common. Under the so-called Kintner regulations promulgated by the Internal Revenue Service, an LLC could qualify for pass-through taxation as long as it lacked at least two of four corporate characteristics that included continuity of life, centralized management, limited liability, and free transferability of membership interest.[43] By providing for an LLC's automatic dissolution upon the withdrawal of a member, state lawmakers helped to ensure that limited liability companies avoided corporate-style continuity of life and thereby secured partnership-style taxation.[44]

However, in 1996 the Internal Revenue Service fundamentally changed its position and introduced the "check-the-box" rule, which became effective on

39. For an analysis of freeze provisions, see Eric Kades, *Freezing the Company Charter*, 79 N.C. L. REV. 111 (2000).

40. *See* Williamson, *supra* note 27; Hansmann, *supra* note 13, at 9–17.

41. *E.g.*, Jens Dammann & Matthias Schündeln, *Where are Limited Liability Companies Formed*, 55 J.L. & ECON. 741, 749 (2012).

42. *Cf.* Henry Hansmann et al., *Law and the Rise of the Firm*, 119 HARV. L. REV. 1333, 1348–49 (2006) (showing that it is typically efficient for firm owners in multi-owner firms to exclude the right to withdraw at any time in order to protect the going-concern value of the firm).

43. 26 C.F.R. § 301.7701-2. No (a)(2) (1995).

44. *E.g.*, Dammann & Schündeln, *supra* note 41, at 749; Sandra K. Miller, *What Buy-Out Rights, Fiduciary Duties, and Dissolution Remedies Should Apply in the Case of the Minority Owner of a Limited Liability Company?*, 38 HARV. J. ON LEGIS. 413, 426–27 (2001).

January 1, 1997.[45] Under this new approach, limited liability companies are treated as partnerships unless they are publicly traded or choose to be taxed as corporations.[46] With the arrival of "check-the-box," the rule that partners could, at any time, dissolve a company through their own withdrawal, had lost its usefulness.[47] Accordingly, many states changed their default rules. Those which did not left limited liability companies stuck with outdated legal rules.[48]

As this episode demonstrates, it is not always enough for lawmakers to just stand back and refrain from disruptive intervention. Rather, states are called upon to modernize the law, and they cannot meet this responsibility by remaining passive.

B. The Relevance of Legal Changes

The practical relevance of future legal change depends on how well corporations' private ordering can compensate for legislative and judicial deficits. If lawmakers and courts change the law to the detriment of firms, or if they simply fail to modernize it, firms have various options. Provided that the rules are not mandatory in nature, firms can simply opt out of rules that they dislike. Alternatively, firms can change their state of incorporation, or even their entity type.

But do these various options imply that firms can be nonchalant about the prospects for legislative or judicial change? Pointing to the costs of reincorporation, Roberta Romano has argued that, at least for public corporations, the answer is no.[49] Bernard Black has criticized Romano's argument, noting that the out-of-pocket costs of reincorporating should be trivial for both privately held and publicly traded firms.[50]

However, out-of-pocket costs such as attorneys' fees or filing fees are not the ones with which corporations should be primarily concerned. The real problem lies elsewhere: often, private ordering can occur only at the cost of upsetting the bargain struck among investors and redistributing costs and benefits among the parties.

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45. Simplification of Entity Classification Rules, 61 Fed. Reg. 66,584, 66,590 (Dec. 18, 1996) (codified at 26 C.F.R. pt. 301).

46. *Id.*

47. Dammann & Schündeln, *supra* note 41, at 749.

48. *Id*.

49. ROMANO, *supra* note 23, at 34.

50. Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 558 (1990).

When investors choose a particular legal regime, i.e., a particular entity type within a particular jurisdiction, they strike a bargain, and they expect this bargain to be upheld. All else being equal, it is in society's interest to protect that expectation since, if economic actors expect their bargain to be upset, they are less likely to enter into mutually beneficial transactions in the first place.[51]

The problem with private ordering as a response to judicial or legislative failures is then that private ordering may be available only at the expense of upsetting the original bargain. This problem is particularly conspicuous in those cases where lawmakers or courts have intervened in such a way as to redistribute costs and benefits among the parties. For example, by weakening the rights of minority shareholders, courts may substantially increase the fraction of the firm's profits reaped by the majority shareholder. Of course, the parties may theoretically be able to opt out of the relevant change by amending the charter or entering into a shareholder agreement. But why would the majority shareholder agree to such contractual changes? Rationally, he will either refuse to opt out of the new legal default, or he will consent only in exchange for being compensated. Either way, the damage is done: the distribution of costs and benefits has been changed in a lasting way.

This problem may persist even in those cases where all parties involved stand to profit from opting out of the legal default. The aforementioned rules governing withdrawal rights in limited liability companies illustrate this point. While it may well be that, in the typical LLC, all members benefit if the right to dissolve the company via withdrawal is abolished, this will not necessarily prevent some members from refusing to agree to this contractual abolition, in the hopes of extorting financial concessions.

In sum, private ordering is a highly imperfect solution to legislative or judicial shortcomings. The problem is not just that *ex post* private ordering may involve transaction costs. Rather, the main problem is that such private interventions often cannot reinstate the original bargain once it has been disturbed by judicial or legislative intervention.

For this reason, firms need to be even more concerned about the prospect of future legislative or judicial change than about the content of the law at the point of entity formation. If entrepreneurs dislike the content of a particular legal regime at the stage when the company is formed, they can simply opt out, incorporate their firm elsewhere, or even choose a different entity type. By contrast, private ordering offers little protection against any *future*

51. *E.g.*, Randall Thomas, *What Is Corporate Law's Place in Promoting Societal Welfare?: An Essay in Honor of Professor William Klein*, 2 BERKELEY BUS. L.J. 135, 135 (2005) (noting that the protection of private bargains provides each party with incentives to bargain for "the best deal possible without the threat of having to renegotiate the outcome in the future").

conduct of lawmakers and courts which will detrimentally affect existing firms.

C. The Importance of the Existing Population of Firms

This leads to the central claim of this article: firm homogeneity reduces the risks inherently posed by future judicial and legislative intervention. The reason is that courts and lawmakers tend to respond to the needs of the *existing* population of firms, and as the population of firms becomes more homogeneous, judicial and legislative interventions become more predictable and more narrowly tailored to firms' needs.

Lawmakers' and courts' responsiveness to the needs of the *existing* population of firms as opposed to, say, potential future users of the relevant legal regime, can be depended upon for several reasons.

1. Regulatory Competition

One important motive is regulatory competition. As Roberta Romano has shown, Delaware's financial dependence on the charter market guarantees that Delaware will remain responsive to the needs of corporations.[52] At first glance, this dependence does not entail that Delaware will be responsive to its *existing* population of corporations; rather, Delaware might adopt changes that are opposed by Delaware firms as long as these changes promise to bring in a sufficient number of new firms.

However, one key attraction of Delaware as a chartering state lies in the market's expectation that Delaware will not turn its back on firms that have incorporated there. If Delaware chose to betray these firms' interests, even for the sake of luring other firms to the state, its reputation could be irreparably damaged. A top priority for Delaware lawmakers and courts is therefore to keep its existing corporate customers satisfied, so as to avoid a New Jersey-style exodus.

An example from the realm of takeover law makes this point clear. In the late eighties, Delaware courts imposed serious constraints on the use of the poison pill as an antitakeover device. More specifically, in *City Capital Associates Ltd. Partnership v. Interco*,[53] the Delaware Chancery Court held that tender offers could not justify a poison pill unless such tender offers were coercive in nature.[54] What followed was Martin Lipton's famous memo,

52. *See supra* text accompanying notes 23–25.
53. City Capital Assocs. Ltd. P'ship v. Interco, 551 A.2d 787 (Del. Ch. 1988).
54. *Id.* at 798.

advising Delaware corporations to reincorporate in other states that gave target boards greater latitude.[55] In the following years, the Delaware Chancery Court promptly adopted a much more generous position towards hostile takeovers,[56] an approach that is often described as allowing target boards to "just say no" to takeovers.[57] This episode struck many observers as a demonstration of Delaware's willingness to bow before the dictates of the charter market.[58] For our purposes, the take-away is that Delaware's change in policy seemed designed to prevent an exodus of firms; in other words, its primary function was to appease Delaware's existing customer base.

2. Interest Groups

Interest groups also play a role in shaping corporate law.[59] This is particularly true in those cases where state lawmakers are not constrained by the need to compete for corporations. Yet, as Jonathan Macey and Geoffrey Miller have shown in their seminal work concerning the influence of lawyers

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55. Letter from Martin Lipton, Partner, Wachtell Lipton Rosen & Katz, to Clients (Nov. 3, 1988) (quoted in Roe, *supra* note 13, at 626).

56. *See, e.g.*, Paramount Commc'ns, Inc. v. Time, Inc., 571 A.2d 1140, 1150–51 (Del. 1989) (applying the generous *Unocal* standard rather than the much harsher *Revlon* standard where the target company's defense to a hostile as an attempt to protect a strategic merger).

57. *E.g.*, Jennifer Arlen & Eric Talley, *Unregulable Defenses and the Perils of Shareholder Choice*, 152 U. PA. L. REV. 577, 606 n.69 (2003); Marcel Kahan, *Paramount or Paradox: The Delaware Supreme Court's Takeover Jurisprudence*, 19 J. CORP. L. 583, 604 (1994); A.C. Pritchard, *Tender Offers by Controlling Shareholders: The Specter of Coercion and Fair Price*, 1 BERKELEY BUS. L.J. 83, 106 (2004); Guhan Subramanian, *Bargaining in the Shadow of Takeover Defenses*, 113 Yale L.J. 621, 626 (2003); *see* Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 COLUM. L. REV. 1931, 1932 (1991) (arguing that the TimeWarner decision "came close to explicitly sanctioning a 'just say no' defense"). *But see* Barzuza, *supra* note 13, at 193 (noting that "it is far from clear that Time and Unitrin have established a 'Just Say No' defense and diminished Unocal proportionality test").

58. *See, e.g.*, Michal Barzuza, *The State of State Antitakeover Law*, 95 VA. L. REV. 1973, 1982 n.15 (2009) (arguing that the more generous stance that Delaware took towards takeover defenses in the late eighties may have been a reaction to the threat of companies leaving Delaware, as suggested by the Lipton memo); Mark J. Roe, *Is Delaware's Corporate Law Too Big to Fail?*, 74 BROOK. L. REV. 75, 91 (2008) (noting that talk of exiting Delaware stopped, once Delaware had made takeovers harder); Rachel A. Fink, Note, *Social Ties in the Boardroom: Changing the Definition of Director Independence to Eliminate "Rubber Stamping" Boards*, 79 S. CAL. L. REV. 455, 487 (2006) (citing the reaction to the Lipton memo as an example of "how easily [Delaware courts] respond to the threat of corporations leaving Delaware for more management-friendly states").

59. For a comprehensive analysis of the role of interest groups in shaping Delaware law, see William J. Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715 (1998).

on Delaware law, even the constraints that regulatory competition imposes on states do not eliminate the influence of interest groups.[60]

Interest group politics constitute a further reason for lawmakers to pay heed to those firms that are already incorporated under a specific legal regime. Because these firms are directly and immediately concerned by any legislative changes, they are much more likely to lobby vigorously than are entrepreneurs who have not yet formed a legal entity, or firms which are currently subject to some other legal regime. Indeed, the power of domestic corporations as an interest group is amply confirmed by the history of state antitakeover legislation. Rather than being supported by broad political coalitions, most of the relevant statutes have been pushed through state legislatures by corporations domiciled in the relevant states.[61]

3. Lawmakers, Courts and the Common Interest

Interest group pressure notwithstanding, some lawmakers and many judges may try to do what is best for society, and for many courts and lawmakers this will mean choosing the most efficient rule.[62] In doing so, they

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60. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 498–523 (1987) (explaining that Delaware lawyers form a powerful interest group with incentives that are not perfectly aligned with either those of corporate managers or those of shareholders).

61. *See* Gordon, *supra* note 57, at 1977 n.171 (noting that most antitakeover legislation appears to have been adopted due to the lobbying of target managers); Jonathan Macey, *State Anti-Takeover Legislation and the National Economy,* 1988 WIS. L. REV. 467, 470 (pointing out that individual companies rather than broader political coalitions were responsible for the lobbying that led to the enactment of state antitakeover statutes); Harvey L. Pitt, *On the Precipice: A Reexamination of Directors' Fiduciary Duties in the Context of Hostile Acquisitions*, 15 DEL. J. CORP. L. 811, 865 (1990) (recounting how an Indiana target company under attack from a hostile acquirer employed a New York law firm to design an antitakeover statute and how that statute was then quickly adopted by the Indiana legislature); Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 122–23 (1987) (noting that the Aetna Life and Casualty insurance was the driving force behind the enactment of Connecticut's 1984 fair price statute); *id.* at 136–38 (noting that, in other states, too, the adoption of antitakeover legislation was typically the result of lobbying efforts by local corporations). Corporations have also lobbied at the federal level to change securities law. *See, e.g.*, Dennis Honabach & Roger Dennis, *The Seventh Circuit and the Market for Corporate Control*, 65 CHI.-KENT L. REV. 681, 718 (1989) (noting that "[b]y the mid-1960s, target companies were busy lobbying Congress for amendments to the Securities Exchange Act of 1934 that would limit hostile takeovers").

62. *E.g.*, Richard A. Posner, *The Law and Economics Movement*, 77 AM. ECON. REV. 1, 5 (1987) ("Common law (i.e., judge-made) rules are often best explained as efforts, whether or not conscious, to bring about . . . efficient outcomes."). *But see* Robert Cooter & Lewis Kornhauser, *Can Litigation Improve the Law Without the Help of Judges*, 9 J. LEGAL STUD. 139, 140 (1980) (finding it "difficult to contend that judges have insights beyond that displayed in their written opinions" and noting that "these opinions reflect a calculus of economic costs and benefits only

will likely focus on the needs of existing users. For example, the prevailing approach to designing default rules suggests choosing the rule that most parties would have agreed upon in the absence of bargaining costs, a method often called the "hypothetical bargain approach."[63] In applying this approach, the obvious solution is to focus on the firms that are already incorporated under a particular statute, since courts and lawmakers can only speculate regarding which firms might use the same statute in the future. Indeed, as any reader of legal opinions can testify, focusing on the existing population of firms is precisely what courts tend to do.[64]

4. The Common Law Process

Finally, the common law process itself ensures that the law will remain responsive to the existing population of firms. This is because litigation under a particular legal regime typically involves firms that are already incorporated under that regime.

The common law process gives litigants substantial influence in shaping the law, not least by deciding which cases go to court and which ones do not.[65] Judges naturally respond to the facts of the case at hand, and precedents

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in a narrow class of cases"). Of course, at least in corporate law, economic analysis has long become a standard feature of judicial reasoning.

63. Charles J. Goetz & Robert E. Scott, *The Mitigation Principle: Toward a General Theory of Contractual Obligation*, 69 VA. L. REV. 967, 971 (1983); Jeffrey M. Lipshaw, *Of Fine Lines, Blunt Instruments, and Half-truths: Business Acquisition Agreements and the Right to Lie*, 32 DEL. J. CORP. L. 431, 445 n.62 (2007); *see* Charles K. Whitehead, *Sandbagging: Default Rules and Acquisition Agreements*, 36 DEL. J. CORP. L. 1081, 1090 n.33 (2011) (pointing out the potential of this approach to lower transaction costs).

64. *See, e.g.*, Spencer v. World Vision, Inc., 633 F.3d 723, 745 (9th Cir. 2011) (supporting its argument by reference to the fact that most closely held corporations "pay out the surplus of revenue over other expenses as salaries instead of as dividends"); Keffer v. Connors Steel Co., 1988 U.S. Dist. LEXIS 17122, at *78 n.31 (S.D. W.Va. Apr. 19, 1988) (pointing out that "most corporations of any considerable size have executive or management committees"); Lamb v. United Sec. Life Co., 1972 U.S. Dist. LEXIS 13648, at *32 (S.D. Iowa May 22, 1972) (noting that "most corporations have large amounts of outstanding stock"); Advanced Mining Sys., Inc. v. Fricke, 623 A.2d 82, 83 (Del. Ch. 1992) (pointing out that "most corporations and virtually all public corporations have by by-law exercised the authority recognized by Section 145 so as to mandate the extension of indemnification rights in circumstances in which indemnification would be permissible under Section 145").

65. *See, e.g.*, George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65, 65 (1977) (arguing that private litigants exert an influence on the selection of rules because inefficient rules are more likely to be relitigated than efficient ones); Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51, 51–52 (1977) (arguing that inefficient rules are more likely to be relitigated); *cf.* Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061, 1089 (2000) (noting, with respect to Delaware, that "judicial lawmaking in the business area . . . is

are a function of the cases that end up in court.[66] For example, a court that is frequently confronted with close corporation cases in which unwitting minority shareholders are exploited by ruthless controllers is likely to develop mechanisms for protecting these minority shareholders. If, by contrast, many of the close corporation cases that reach the court involve minority shareholders who are well-informed and business-savvy, the court is more likely to take a laissez-faire approach.

Furthermore, judgments frequently reflect the interests of parties involved because the litigants are able to influence the outcome of the case through their own skillful persuasion.[67]

These different forms of influence taken into account, it is clear that existing firms are bound to shape the law via litigation. The common law process, then, is yet another factor ensuring that the law will be responsive to the needs of the existing population of firms.

D. The Value of Homogeneity

As established, lawmakers and firms tend to focus on the existing population of firms when fashioning a particular legal regime. Because of this fact, firm homogeneity offers two key benefits: it makes legal change more predictable, and it promises to improve the fit between legal reforms and firms' needs.

1. The Predictability of Legal Change

Responsiveness to corporate interests on the parts of courts and lawmakers renders corporate law more predictable. Corporations can be relatively secure in the knowledge that states will not make drastic changes to their legal regimes overnight.

However, the extent of this predictability depends crucially upon the composition of the existing population of firms: the more homogeneous the existing population, the easier it becomes to predict how courts and lawmakers will react to new challenges. By contrast, heterogeneous firm interests undermine legal predictability by forcing courts and lawmakers to mediate between different interests when responding to firm needs. This problem has several distinguishable elements.

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litigant driven" and that "the business community has control over the lawmaking agenda to a degree that cannot be obtained through efforts at legislative influence.").

66. Priest, *supra* note 65, at 65.

67. John C. Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. LEGAL STUD. 393, 394 (1978).

a. Unpredictable Legal Developments

First, it can be difficult to predict which segment of a heterogeneous corporate population will have the upper hand with courts.

A good example is Delaware's middle-ground approach to antitakeover legislation:[68] Delaware has not entirely abstained from enacting antitakeover legislation; it originally adopted a so-called first generation statute that required the bidder to notify state authorities in advance of hostile bids.[69] After the U.S. Supreme Court had made it clear that first-generation takeover statutes violated the Commerce Clause,[70] Delaware enacted a business combination statute designed to make hostile takeovers less attractive.[71] However, Delaware was relatively slow to adopt this antitakeover legislation[72] and has not gone nearly as far as other states,[73] many of which have amassed a whole array of statutory antitakeover protections.[74]

Delaware's cautious approach may well be partially due to a fear of provoking federal intervention.[75] But it has also been noted that Delaware is relatively unique in being home to both target companies and hostile acquirers, which makes it more difficult for target companies to gain legislative support for radical antitakeover legislation.[76] In the literature, hostile bidders' presence among Delaware's corporate constituency has been viewed as a plus; after all, it may have prevented Delaware from adopting

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68. Fisch, *supra* note 65, at 1062; Martin Lipton, *Pills, Polls, and Professors Redux*, 69 U. CHI. L. REV. 1037, 1046 (2002); Martin Lipton & Paul K. Rowe, *Pills, Polls and Professors: A Reply to Professor Gilson*, 27 DEL. J. CORP. L. 1, 12 (2002).

69. DEL. CODE ANN. tit. 8, § 203 (1986).

70. Edgar v. Mite, 457 U.S. 624, 642 (1982); *cf.* Loral Corp. v. Sanders Assocs., Inc., 639 F. Supp. 639, 641 (D. Del. 1986) (enjoining the enforcement of Delaware's first generation takeover statute on constitutional grounds).

71. *See* DEL. CODE ANN. tit. 8, § 203 (limiting the ability of the acquirer to merge with the target company).

72. Curtis Alva, *Delaware and the Market for Corporate Charters: History and Agency*, 15 DEL. J. CORP. L. 885, 895 n.48 (1990) (noting that "Delaware was uncharacteristically slow in adopting a first generation takeover statute, and it was the twenty-eighth state to adopt a second generation statute").

73. Fisch, *supra* note 65, at 1062 (stressing the "moderate" character of Delaware's antitakeover statute); Gordon, *supra* note 57, at 1965 (noting the moderate nature of Delaware's antitakeover legislation); Roberta Romano, *The State Competition Debate in Corporate Law*, 8 CARDOZO L. REV. 707, 725–31 (showing that Delaware's antitakeover legislation does not go as far as that of other states).

74. For a comprehensive survey of state antitakeover legislation see, for example, Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CALIF. L. REV. 1775, 1813–14 (2002).

75. Kahan & Kamar, *supra* note 32, at 740.

76. ROMANO, GENIUS, *supra* note 23, at 60 (noting that Delaware's constituency "includes both target companies and bidders . . . which makes the legislative process less one-sided" than in other states).

more stringent, and hence less efficient, antitakeover protections.[77] For the purpose of this article however, it is noteworthy that the heterogeneity of Delaware's corporate constituency also made Delaware's stance on antitakeover legislation less predictable *ex ante*. Precisely because Delaware's population included corporate raiders, the outcome of the battle over antitakeover legislation in Delaware was not a foregone conclusion in the way it might have been in more homogeneously populated states.

b. Zigzagging

Firm heterogeneity doesn't just make it more difficult to predict how a given issue will be resolved, but also increases the risk that decisions will prove unstable as lawmakers and courts zigzag between different corporate constituencies.

An illustrative case is the development of Delaware's case law on fiduciary duties in takeover cases. On a number of central legal issues, Delaware's courts have famously oscillated between deference to target managers and attempts to secure the rights of hostile bidders.[78] For traditional corporate law scholarship, this inconsistency is difficult to explain. Everyone agrees that Delaware has strong financial incentives to attract public corporations.[79] That consensus is unsurprising, given that about 23% of Delaware's 2014 projected budget is based on revenues from fees and taxes related to the chartering business.[80] Yet zigzagging unpredictably between different legal positions creates tremendous uncertainty and is hardly the way

77. There is now broad agreement among scholars that antitakeover legislation does not serve the interests of shareholders. *See, e.g.*, Bebchuk, Cohen & Ferrell, *supra* note 74, at 1801 ("The evidence from this research consistently shows that antitakeover statutes virtually never increase firm value and, in fact, often decrease it.").

78. This was true in the eighties. *See, e.g.*, Mark J. Roe, *Takeover Politics*, *in* THE DEAL DECADE: WHAT TAKEOVERS AND LEVERAGED BUYOUTS MEAN FOR CORPORATE GOVERNANCE 321, 340–42 (Margaret M. Blair ed., 1993) (analyzing inconsistencies in Delaware's case law on takeovers and identifying fear of federal intervention as one reason). Cash-out mergers constitute another area where Delaware courts have been modified their case law fairly frequently. *See* Elliot J. Weiss & Lawrence J. White, *Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law*, 75 CALIF. L. REV. 551, 591 (1987) (noting that in the "regulation of cash-out mergers . . . Delaware courts have frequently changed their approach").

79. *E.g.*, Kahan & Kamar, *supra* note 32, at 748 (arguing that among all states, only Delaware has strong financial incentives to compete for corporate charters); Bruce H. Kobayashi & Larry E. Ribstein, *Class Action Lawyers as Lawmakers*, 46 ARIZ. L. REV. 733, 740 n.26 (2004) (pointing out "Delaware's incentive to compete for corporate franchise fees, which comprise a significant portion of this small state's revenues"); Todd J. Zywicki, *Is Forum Shopping Corrupting America's Bankruptcy Courts?*, 94 GEO. L.J. 1141, 1181 (2006) (noting that "Delaware has strong financial incentives to compete for corporate-chartering business").

80. STATE OF DEL., GOVERNOR'S BUDGET FINANCIAL SUMMARY AND CHARTS 1 (2014), *available at* http://budget.delaware.gov/fy2014/operating/vol1/financial_summary.pdf.

to make Delaware law attractive. Accordingly, scholars have struggled to explain the lack of continuity in Delaware law.

Perhaps the best explanation to date comes from Mark Roe. According to him, inconsistencies in Delaware's takeover law are due to the ever-changing threat of federal intervention.[81] Roe observed that Delaware can be seen to have subjected antitakeover defenses to stricter scrutiny whenever the threat of federal intervention seemed real,[82] and to have reverted to a target-friendly approach each time this threat subsided. However, even though much of Roe's reasoning is persuasive, his account may not completely explain the relevant inconsistencies in Delaware's takeover law. Thus, in the last decade or so, the threat of federal intervention has loomed larger than ever, with both the Sarbanes-Oxley Act of 2002 and the Dodd Frank Act of 2010 federalizing important aspects of what has traditionally been state corporate law. So if Delaware is in the habit of preventing federal interventions by adjusting its law, why did it fail to adopt the changes brought by Sarbanes-Oxley or Dodd Frank before the latter were enacted?

For example, one of the most famous innovations brought by Dodd Frank was the say-on-pay rule, which makes executive compensation the subject of a shareholder vote, albeit a non-binding one.[83] The introduction of this rule could be seen coming from a mile away. In particular, the year before Dodd Frank was enacted, the U.S. government had already imposed a say-on-pay requirement for those corporations that benefited from the Troubled Asset Relief Program ("TARP").[84] Moreover, executive compensation had long been regarded as excessive not only in the political arena, but also in large parts of the literature.[85] Hence, the U.S. Congress' intervention hardly came out of the blue. Yet Delaware never bothered to rein in executive compensation, which it could have done, for example, by introducing a stricter standard of review for compensation decisions. This suggests that fear of federal invention may be a less important force in shaping Delaware law than it appears. It is noteworthy, therefore, that firm heterogeneity provides an even simpler explanation for Delaware's occasional zigzagging: where both target boards and hostile acquirers clamor for attention, courts face the difficult task of mediating between both groups, and inconsistencies may result.

81. Roe, *supra* note 13, at 626–27 (2003); Roe, *supra* note 78, at 340–42.

82. Roe, *supra* note 78, at 340–42.

83. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, sec. 951, § 14, 124 Stat. 1376, 1899–1900.

84. 12 U.S.C. § 5221 (2014).

85. *See, e.g.*, LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 15–185 (2006) (arguing that high U.S. salaries for CEOs are often the result of agency problems rather than market forces).

c. *Strategic Ambiguity*

Firm heterogeneity also makes it more likely that future legal issues will simply remain unresolved, creating uncertainty for the users of the affected regime. Faced with a heterogeneous population of firms, lawmakers and courts may be unwilling to fully resolve conflicts for fear of offending one or more segments of their corporate constituency. Instead, courts and lawmakers may resort to strategic ambiguity in the hope of pacifying both sides.

Of course, firm homogeneity does not entirely eliminate the risk of such ambiguity either. Other reasons why lawmakers and courts shy away from a clear answer include the fact that, in some cases, the use of indeterminate standards is simply efficient.[86] As Louis Kaplow has shown in his seminal work on rules and standards, using indeterminate standards rather than bright-line rules can have benefits as well as costs and depending on the circumstances, the former may well outweigh the latter.[87]

Even where the use of indeterminate standards is inefficient, the law's reliance on standards may be due to other factors unrelated to firm heterogeneity. In the case of Delaware, it has been suggested that courts preferred vague standards in part because such indeterminacy allowed them to adopt pro-managerial policies without provoking federal intervention.[88] Others have argued that the use of indeterminate standards may be a way for Delaware to engage in price discrimination,[89] or that such standards may help Delaware preserve its power in the charter market.[90] For purposes of this article, however, all of this is beside the point: even if indeterminacy can be efficient and even if states resort to inefficient ambiguity for a number of different reasons, firm homogeneity at least eliminates *one* source of inefficient ambiguity.[91]

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86. Fisch, *supra* note 65, at 1081 (2000) (asserting that Delaware law is indeterminate and that this indeterminacy is good).

87. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 557 (1992) (undertaking a general analysis of the costs and benefits of rules and standards).

88. Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE L.J. 553, 602–03 (2002).

89. Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205, 1232 (2001).

90. Kamar, *supra* note 5, at 1910–11.

91. In other work, I have argued that regulatory competition probably does not make corporate law less determinate and have pointed to the fact that other legal systems such as the United Kingdom and Germany, which have not traditionally been shaped by regulatory competition, subject public corporations to legal regimes that are at least as indeterminate as Delaware corporate law. Jens C. Dammann, *Indeterminacy in Corporate Law: A Theoretical and Comparative Analysis*, 49 STAN. J. INT'L L. 54, 100 (2013). The present article provides a further potential argument for why this is so. Regulatory competition facilitates sorting: Delaware

2. Fit

In addition to making legal change more predictable, firm homogeneity promises to improve the fit between future legal change and the needs of firms.

Faced with heterogeneous firm interests, lawmakers and courts end up either compromising or putting some firms' interests ahead of those of others. Both strategies can prove burdensome for firms. Where regulators opt for compromise, the resulting law may not be ideal for any firm. Where regulators end up tailoring the law to a particular subset of the corporate population, excluded firms may find the resulting law particularly ill-suited to their needs. In other words, even if lawmakers and courts are, in principle, responsive to corporate needs, that responsiveness may be useless to corporations who find themselves within a diverse population.

This problem will not concern all firms alike. To the extent that one segment of the firm population is more numerous or more influential, firms belonging to that particular segment may be confident that future legal change will be tailored to their needs. However, for firms which are not part of the right segment or which are within a population that has no dominant segment, this problem is very real.

Consider the following example from the area of securities regulation. U.S. securities exchanges have traditionally attracted a considerable number of foreign firms that choose to have their shares listed in the United States. In 2002, however, foreign issuers listed in the United States were in for a surprise when the U.S. Congress adopted the Sarbanes-Oxley Act,[92] one of the effects of which was to impose numerous new governance requirements on publicly traded firms.

While the efficiency implications of Sarbanes-Oxley are still a matter of academic dispute,[93] the act met with considerable criticism from the business

corporations may be more similar to each other than to firms incorporated in other states. Hence, regulatory competition may increase firm homogeneity and thereby legal certainty.

92. Public Company Accounting Reform and Investor Protection Act of 2002, Pub L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 5, 11, 12, 15, 18, 28, 29, and 49 U.S.C.).

93. *See, e.g.*, Erica Beecher-Monas, *Enron, Epistemology, and Accountability: Regulating in a Global Economy*, 37 IND. L. REV. 141, 205 (2003) ("[M]andating corporate compliance programs, such as the system under the Sarbanes-Oxley Act, imposes high costs without any indication of their effectiveness."); Roberta Romano, *The Sarbanes-Oxley Act and the Making of Quack Corporate Governance*, 114 YALE L.J. 1521, 1602 (2005) ("An extensive empirical literature suggests that [the corporate governance mandates of SOX] were seriously misconceived, because they are not likely to improve audit quality or otherwise enhance firm performance and thereby benefit investors as Congress intended.").

community.[94] The outrage was particularly great among foreign issuers whose shares were listed in the United States,[95] as the corporate governance provisions of the act had been tailored to the needs of U.S. firms, and were perceived as ill-suited for many foreign issuers.[96] In particular, conflicts arose because foreign issuers also remained subject to corporate governance requirements imposed by their home countries, which were seen as conflicting with those of the Sarbanes-Oxley Act. The Securities Exchange Commission subsequently eliminated some of the relevant frictions via regulations,[97] but refused to excuse foreign issuers wholesale from fulfilling the requirements of Sarbanes-Oxley.[98]

The anguish expressed by foreign issuers over Sarbanes-Oxley nicely illustrates the importance of homogeneity. By listing in the United States, foreign issuers had subjected themselves to a particular legal regime, namely the U.S. law on securities regulation. That foreign issuers had decided to list in the U.S. in the first place implies that this legal regime must initially have seemed attractive, or at least acceptable. But the problem for foreign issuers turned out to be that they had opted into a legal regime whose most influential users, U.S. corporations, had substantially different governance needs. While even many U.S. firms disliked Sarbanes-Oxley, they at least escaped the dilemma posed by conflicting regulatory requirements. Foreign firms were less lucky, because they constituted a non-dominant segment of a heterogeneous population.

To this day, the number of foreign issuers listed in the United States remains relatively low: in 2000, there were 1,310 foreign issuers listed in the United States.[99] By 2012, the most recent year for which data are available,

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94. Cheryl L. Wade, *Sarbanes-Oxley Five Years Later: Will Criticism of SOX Undermine Its Benefits?*, 39 LOY. U. CHI. L.J. 595, 595 (2008) ("[T]he business community's criticism of SOX is almost virulent.").

95. *See, e.g.*, Bo James Howell, *SEC Rule 144 and the Global Market*, 7 ASPER REV. INT'L BUS. & TRADE L. 199, 224 (2007) ("The international business community reacted in a hostile manner . . . ."); Corinne A. Falencki, Note, *Sarbanes-Oxley: Ignoring the Presumption Against Extraterritoriality*, 36 GEO. WASH. INT'L L. REV. 1211, 1211 (2004) (noting that the provisions of SOX "and subsequent SEC regulations have spawned harsh criticism and angry protest from the international business community.").

96. *See, e.g.*, Kenji Taneda, *Sarbanes-Oxley, Foreign Issuers and United States Securities Regulation*, 2003 COLUM. BUS. L. REV. 715, 715.

97. *See, e.g.*, Clyde Stoltenberg et al., *A Comparative Analysis of Post-Sarbanes-Oxley Corporate Governance Developments in the US and European Union: The Impact of Tensions Created by Extraterritorial Application of Section 404*, 53 AM. J. COMP. L. 472–74 (2005) (listing various accommodations that the SEC made for foreign issuers).

98. Kate Litvak, *Sarbanes-Oxley and the Cross-listing Premium*, 105 MICH. L. REV. 1857, 1858 n.3 (2007).

99. *International Registered and Reporting Companies*, SEC, http://www.sec.gov/divisions/corpfin/internatl/companies.shtml (last visited Dec. 20, 2014).

the number of foreign issuers had fallen to 946.[100] There are, of course, various possible reasons for this decline. Foreign stock exchanges may have become more efficient as developing countries have adopted legislative or administrative reforms.[101] Also, some foreign issuers are perhaps deterred by what they view as excessive regulation in the United States.[102] However, an equally or even more important reason for foreign issuers' present hesitance to list in the United States may lie elsewhere. As a result of Sarbanes-Oxley, foreign issuers are now fully aware that the future may hold further such surprises, and that foreign issuers, which have different needs from U.S. corporations but lack the latter's political and economic influence, are particularly vulnerable. In other words, foreign issuers may be less concerned with the present shape of the law, than with future legal development—a concern that arises precisely because foreign issuers constitute a non-influential segment in a heterogeneous population of firms.

III. ANCILLARY HOMOGENEITY BENEFITS

The benefits of firm homogeneity discussed in the previous parts do not presuppose the existence of a network. Indeed, they arise even in the hypothetical case that only a single firm is incorporated under a particular legal regime. I have therefore referred to them as "independent" homogeneity benefits.

However, firm homogeneity also has the potential to create "ancillary" homogeneity benefits by reinforcing positive network externalities. It is these ancillary benefits to which I turn now. Simply put, homogeneous networks yield greater network benefits than heterogeneous ones. Indeed, an analysis of the various positive network effects recognized in the corporate-law

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100. *Id.*

101. *See, e.g.*, Isabel K. Yan et al., *Is the Chinese Stock Market Really Inefficient?* 1 (MPRA, Working Paper No. 35219), *available at* http://mpra.ub.uni-muenchen.de/35219/1/MPRA_paper_35219.pdf (concluding that recent legislative reforms have made the Chinese stock market more efficient). *But see* Su Yongyang & Lan Zheng, *The Impact of Securities Transaction Taxes on the Chinese Stock Market*, 47 EMERGING MARKETS FIN. & TRADE 32 (2011) (finding that the introduction of the securities transaction tax made the Chinese stock market less efficient).

102. *See, e.g.*, Eric C. Chaffee, *The Internationalization of Securities Regulation: The United States Government's Role in Regulating the Global Capital Markets*, 5 J. BUS. & TECH. L. 187, 190 (2010) (seeing the corporate governance requirements imposed by Sarbanes-Oxley as the reason for why the United States has become less popular with foreign issuers); Roberta S. Karmel, *The Once and Future New York Stock Exchange: The Regulation of Global Exchanges*, 1 BROOK. J. CORP. FIN. & COM. L. 355, 356–57 (2007) (suggesting that the costs of complying with Sarbanes-Oxley is a major reason for why the New York Stock Exchange lost many foreign listings).

literature suggests that all of the relevant benefits tend to be greater where networks are more homogeneous.

A. Legal Services

One potential network benefit offered by popular corporate-law regimes is that legal services for frequently used legal provisions will be cheaper, more abundant, and higher in quality.[103] Part of the reason this is so is that lawyers can provide legal advice with less effort if they have addressed the same question before for a different client.[104] Moreover, legal questions that arise with some frequency can typically be answered faster and more reliably.[105] Finally, the presence of more corporate clients translates into a bigger and more competitive market for legal services.[106]

Firm homogeneity renders all of these mechanisms more effective. Firms that are homogeneous with respect to their size, ownership, location, and governance structure are more likely than heterogeneous firms to be faced with the same legal questions. For example, publicly traded firms with dispersed ownership have to worry about defending against hostile takeover attempts, whereas privately held firms and public firms with a majority shareholder do not. Accordingly, savings that result due to the fact that the same legal questions tend to come up repeatedly are likely to be much greater where the existing population of firms is homogeneous. Furthermore, the question of whether a single market for legal services can develop also depends on the degree of firm heterogeneity. For example, large public Delaware corporations tend to have access to the same set of law firms. By contrast, small businesses cannot usually afford top law firms and tend to use an entirely different segment of the legal market. In sum, firm homogeneity determines the extent to which legal service network benefits can be realized.

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103. Klausner, *supra* note 9, at 782–83. *But see* Lemley & McGowan, *supra* note 13, at 577 (arguing that "one would expect the learning curve of lawyers and bankers . . . to drop fairly rapidly and to become immaterial well short of the extent of such terms in the market as a whole"). For the sake of clarity it is worth noting that, when it comes to legal service externalities, one can distinguish between network externalities and learning externalities. Learning externalities result from the *past* use of a legal regime by other firms. Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or "the Economics of Boilerplate")*, 83 VA. L. REV. 713 (1997). Network externalities result from "contemporaneous use" by other firms. *Id.*

104. Klausner, *supra* note 9, at 783.

105. *Id.*

106. *Id.*

B. Interpretative Network Externalities

The greater the number of firms using a particular legal regime, the greater the chance that the provisions of that regime will be clarified through future litigation,[107] allowing users to reap so-called "interpretative network externalities."[108] As with other network benefits, user homogeneity has the potential to increase these benefits.

A rich and coherent set of precedents is particularly helpful to a firm if it addresses the legal issues that are likely to arise in the relevant firm's course of business. For example, a well-developed set of precedents on hostile takeovers is highly useful to public corporations that contemplate making or receiving hostile offers, whereas it is of much less use to privately held firms that do not anticipate getting involved in hostile takeovers. In other words, as firm homogeneity increases, so does the likelihood that the resulting interpretative network externalities will prove useful to the network's members.

Moreover, as explained in the preceding Part, firm homogeneity tends to increase the predictability of legal change and also promises a better fit between future judicial and legislative interventions and firms' needs. These benefits are quite independent of the existence of a network.[109] Nonetheless, they have the potential to also increase the usefulness of interpretative network externalities. The expected clarification of unclear legal provisions may be beneficial *per se*.[110] However, such precedents will obviously be even more helpful if they are both predictable and tailored to firm's needs. Hence, homogeneity's role in reducing the risks inherent in future legal changes also helps to increase the benefits inherent in interpretative network externalities.

C. Common Practice Externalities

Sometimes, contractual provisions or precedents incorporate references to common practice.[111] In order to determine the content of these references, one

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107. *Id.* at 776.

108. *Id.* at 779.

109. It is telling that Klausner does not mention the predictability of future judicial or legislative interventions, or the fit between such interventions and firms' needs, as a network benefit. Rather, the interpretative network externalities analyzed by Klausner lie in the reduction of uncertainty regarding the possible interpretation of legal terms. *Id.* at 777.

110. Of course, it is not always desirable or efficient to clarify the content of a vague rule. As Louis Kaplow has shown in his seminal work on rules and standards, both types of norms have costs and benefits and it may be that neither is optimal in all situations. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992).

111. Klausner, *supra* note 9, at 780.

has to ascertain what the common practice looks like.[112] The existence of a large number of users can make that determination easier.[113] Accordingly, common-practice network externalities, just like interpretative network externalities, have the potential to reduce legal uncertainty.[114]

Identifying a common practice should become even easier if firms are not only numerous, but also homogeneous. Where the firms incorporated under a particular legal regime vary widely, a common practice may be lacking entirely.[115] By contrast, very similar firms are much more likely to develop common practices. Accordingly, firm homogeneity is bound to increase the uncertainty-reducing effect of common practice externalities.

D. Marketing Network Externalities

Another network benefit identified by Klausner is what he calls marketing network externalities.[116] If a particular legal regime is used by many firms, investors and securities analysts are likely to be familiar with the relevant terms or provisions.[117] For the individual firm incorporated under the relevant regime, this means that investors and security analysts can more easily ascertain the value of the firm's securities, which makes it easier to market the relevant securities.[118]

In this context, too, the value of firm homogeneity should be plain. Where firms are so different that they market their securities to very different groups of investors, the marketing externalities envisioned by Klausner cannot be realized to their full extent. Moreover, the same legal norms may impact different firms differently. The law on poison pills and staggered boards serves as an example. For most public corporations, the ability to combine an effectively staggered board with a poison pill is of tremendous importance. After all, this combination has the potential to greatly reduce the likelihood of successful hostile takeovers.[119] However, for corporations that are already

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112. *Id.*

113. *Id.*

114. *Id.*

115. As Klausner notes, "[t]he more firms that operate under a given contract, the larger, and possibly more varied, the base of common practices will be." *Id.* However, in this context, variety increases rather than reduces uncertainty.

116. *Id.* at 785.

117. *Id.*

118. *Id.*

119. *See* Lucian A. Bebchuk, John C. Coates IV & Guhan Subramanian, *The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy*, 54 STAN. L. REV. 887, 950 (2002) (presenting evidence that the presence of a charter provision classifying the board "substantially increase[s] the likelihood that a target receiving a hostile bid will remain independent.").

controlled by a majority shareholder, the availability of poison pills and staggered boards has no relevance: an acquirer can gain control of such a firm if and only if the incumbent controller is willing to sell his controlling stake. If the incumbent controller is willing to sell, he will simply have the board "pull" any existing poison pill. If he wants to get rid of the effective staggered board, he can use his control of the corporation to amend the certificate of incorporation. By contrast, if he is unwilling to sell, no one can make him.

Given that different legal terms impact different types of firms in different ways, the importance of firm homogeneity to marketing externalities quickly becomes apparent: the more homogeneous the firms in a network are, the easier it becomes for investors and security analysts to understand the impact that the applicable legal norms will have. In other words, greater firm heterogeneity translates into greater marketing benefits.

IV. HOMOGENEITY V. ATTRACTIVE LAW

Before moving on to the practical implications of homogeneity effects, it may be helpful to highlight a theoretical distinction. Homogeneity benefits arise because a firm is subject to the same legal regime as a group of relevantly similar firms. They must be distinguished from those benefits accrued because a legal regime's content is well-suited to a firm's needs at the time of its incorporation.[120] This distinction becomes particularly important in those cases where entrepreneurs choose to form their firm under a specialized statute. Two very different considerations might motivate such a choice.

First, the firm may choose the specialized statute because, at the time the firm is formed, the statute offers a particularly good fit between the law and the firm's needs.[121] For example, a privately held firm may decide that Delaware's rules on statutory close corporations are a better fit than Delaware's general corporation law.[122] The fact that the law at the moment of

120. There is an obvious parallel here to the definition of network effects which include only those situations in which "the value of a product depends on its number of users." Klausner, *supra* note 9, at 764 n.16. Thus, one has to distinguish between benefits that arise because of the number of users (network benefits) and those benefits that exist independently of how many users the product now has (such as an already existing wealth of precedents). *Id.* at 776 n.61.

121. *Cf.* Larry Ribstein, *Making Sense of Entity Rationalization*, 58 BUS. LAW. 1023, 1030 (2003) (noting that "[s]eparate standard forms provide sets of default terms that suit different types of firms").

122. Incidentally, few entrepreneurs seem to think so, since very few firms are formed as statutory close corporations. *See, e.g.*, Carol R. Goforth, *The Series LLC, and a Series of Difficult Questions*, 60 ARK. L. REV. 385, 385 n.2 (2007) (noting that close corporation statutes "appear to have been seldom utilized"); Dale Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881,

the company's formation provides a good fit for the firm's needs does not implicate homogeneity effects.

Alternatively though, the firm may have chosen the specialized statute because it is used by a relatively homogenous population of firms, making future changes to the law predictable, and promising a good fit between future legal change and the firm's needs. Only in this case is the firm's decision motivated by homogeneity benefits.

Of course, firm homogeneity and a close initial fit between the firm's needs and the content of the law will often go hand in hand. The more a statute is tailored to the needs of a particular type of business, the more homogeneous one can expect the resulting population of firms to be. Accordingly, a firm incorporating under a specialized statute can hope to reap both the benefits of specialization and the benefits of homogeneity.

It should be noted, however, that a correlation between initial fit and homogeneity is by no means a matter of necessity, since homogeneity can arise in the absence of specialization. For example, a firm of a particular type may choose a jurisdiction for reasons that are unconnected to the law of business associations, and other firms of the same type may follow, resulting in homogeneity in the absence of visible legal specialization.

On the other hand, apparent legal specialization may fail to result in homogeneity. In such cases a seemingly specialized statute draws a very heterogeneous population. For example, the LLC was envisioned, by some, as ideal for small firms.[123] In practice though, limited liability companies attract firms of all sizes.[124]

In fact, there are good reasons why specialization often fails to result in homogeneity. For one thing, while different types of firms have different governance needs, lawmakers may not always be good at anticipating what those are. It is much easier to respond to the needs of an existing population of firms than to predict, *ex ante*, what certain types of firms will want.

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893 (1995) (noting that there are not a significant number of firms electing to be treated as statutory close corporations); Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 BERKELEY BUS. L.J. 263, 314 (2008) (claiming that "only a very small percentage of corporations ever registered as statutory close corporations").

123. *See, e.g.*, William W. Bratton & Joseph A. McCahery, *An Inquiry into the Efficiency of the Limited Liability Company: Of Theory of the Firm and Regulatory Competition*, 54 WASH. & LEE L. REV. 629, 686 (1997) (expecting LLCs to evolve "so as to provide a cost-effective limited liability shell for small firms"); Larry E. Ribstein, *Close Corporation Remedies and the Evolution of the Closely Held Firm*, 33 W. NEW ENG. L. REV. 531, 534 (2011) (noting that the LLC "proved to be the flexible limited liability form small firms were looking for").

124. *Cf.* Dammann & Schündeln, *supra* note 2, at 86 (presenting data on the size of limited liability companies in a large business database).

Furthermore, there is a specific reason why even successful specialization may not result in homogeneity: to the extent that the firms for which the statute was designed have qualities that are attractive to investors or creditors, other firms may try to mimic these qualities by incorporating under the same statute. For example, many startups continue to be formed as corporations[125] despite the fact that limited liability companies plausibly offer more advantages.[126] One possible reason for the lasting popularity of the corporate form is prestige. Corporate law, with its more exacting formalities and greater emphasis on centralized management, is likely to attract firms that are, on average, bigger and more ambitious than the typical LLC. That, in turn, makes it attractive for smaller firms to form as corporations precisely because it makes them seem bigger and more important. Indeed, so-called incorporation services that specialize in forming legal entities for others often stress the higher prestige inherent in a corporation as opposed to a mere LLC.[127]

V. THE EXPLANATORY POWER OF HOMOGENEITY EFFECTS

Homogeneity effects are of substantial theoretical and practical interest: they can provide efficiency rationales for a number of important phenomena that are otherwise difficult to explain or justify.

A. The Survival of Mandatory Corporate Law

One of these phenomena concerns the survival of mandatory corporate law. Today much of U.S. corporate law is enabling in nature,[128] yet some

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125. *E.g.*, Susan C. Morse, *Startup Ltd.: Tax Planning and Initial Incorporation Location*, 14 FLA. TAX REV. 319, 330 (2013) (describing how the vast majority of startups are formed as U.S. corporations); Gregg D. Polsky & Brant J. Hellwig, *Examining the Tax Advantage of Founders' Stock*, 97 IOWA L. REV. 1085, 1106 (2012) (noting that startup companies are typically formed as U.S. corporations).

126. *See, e.g.*, Morse, *supra* note 125, at 348 (pointing out that there are "known net tax costs" to forming a startup as a corporation rather than as an LLC). *But see* Larry E. Ribstein, *Corporations or Business Associations? The Wisdom and Folly of an Integrated Course*, 34 GA. L. REV. 973, 976 (2000) (arguing that the propensity of startup firms to form corporations might make sense despite the tax disadvantages).

127. *See, e.g.*, *Entity Creation*, BOYD GROUP SERVICES, L.L.C., http://www.boydgroupservices.com/entity-creation.htm (last visited Dec. 20, 2014) (advising on the choice between various entity types and stressing that the corporation "bestows prestige").

128. *E.g.*, Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 888 (2005); Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. CORP. L. 719, 742 (2006); John C. Coffee, Jr., *No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies*, 53

mandatory features stubbornly persist.[129] In particular, many of the norms that govern the distribution of power between shareholders and the board of a public corporation retain their mandatory character.[130]

A prime example is section 141(a) of the Delaware General Corporation Law, which entrusts the board with the task of managing—or supervising management of—the corporation.[131] This provision is of central importance to the structure of Delaware law. Not only does it empower the board, it also imposes on shareholders the constraint that they cannot give binding instructions to the board.[132]

To be sure, shareholders are free to adopt bylaws that are binding on the board, and while the charter typically grants the board the power to amend such bylaws, the charter does not have to empower the board in this way.[133] However, under Delaware law, the power to issue bylaws is limited by section 141(a).[134] In other words, bylaws may not be used to tell the board

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BROOK. L. REV. 919, 939–40 (1988); Curtis J. Milhaupt, *The Market for Innovation in the United States and Japan: Venture Capital and the Comparative Corporate Governance Debate*, 91 NW. U. L. REV. 865, 893 (1997); Roberta Romano, *A Cautionary Note on Drawing Lessons from Comparative Corporate Law*, 102 YALE L.J. 2021, 2023 (1993).

129. Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1553 (1989) ("Nevertheless, many features of corporate law, great and small, are mandatory. Even Delaware provides a striking number of mandatory norms.").

130. *Id.* at 1593. For example, section 211(b), which prescribes that the directors are to be elected by the shareholders, is viewed as mandatory. *E.g.*, *id.* at 1553 n.16. Similarly, the rules on shareholder removal rights in section 141(k) of the Delaware corporation law are deemed mandatory. *Id.*

131. DEL. CODE ANN. tit. 8, § 141 (2012).

132. Carol Goforth, *Proxy Reform as a Means of Increasing Shareholder Participation in Corporate Governance: Too Little, But Not Too Late*, 43 AM. U. L. REV. 379, 457–58 (1994) (noting that state law does not allow shareholders in public corporations to issue binding shareholder resolutions). It is striking that even recent federal legislation on executive compensation ("Say on Pay") does not deviate from this pattern. Federal law gives shareholders the right to adopt non-binding resolutions on executive compensation, but does not allow them to issue binding instructions to the board. Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, sec. 951, § 14, 124 Stat. 1376, 1899–1900 (codified at 15 U.S.C. § 78n-1 (2012)).

133. In fact, the default rule is that the board does not have the power to amend the bylaws or issue new ones. *See* tit. 8, § 109(a) (providing that "any corporation may, in its certificate of incorporation, confer the power to adopt, amend or repeal the bylaws upon the directors").

134. Section 109(b) of the Delaware General Corporation Law explicitly provides that bylaw provisions must not be inconsistent with the law. *Id.* § 109(b). The Delaware Supreme Court has held that section 141(a) also constitutes law within the meaning of section 109(b). CA, Inc. v. AFSCME Employees Pension Plan, 953 A.2d 227, 232n.7 (Del. 2008). Accordingly, bylaw provisions must not infringe upon the board's prerogative to manage the corporation. *Id.* at 232; *cf.* Edward B. Rock, *Shareholder Eugenics in the Public Corporation*, 97 CORNELL L. REV. 849, 894 (2012) (noting that the "scope of permissible bylaws is sharply limited").

how to run the corporation. Section 141(a) therefore establishes a bulwark against shareholder interference with the management of the company.

Moreover, section 141(a) is mandatory: the power to run the corporation cannot be handed over to the shareholders.[135] Admittedly, the first sentence of section 141(a) explicitly notes that the certificate of incorporation can provide otherwise and thereby shows that deviations from section 141(a) are, in principle, permitted.[136] However, the second sentence of section 141(a)[137] makes it clear that such deviations are strictly limited in scope: a corporation can adopt a charter which allocates power otherwise than as described in section 141(a) only inasmuch as the tasks usually entrusted to the board can be given to other persons—so-called substitute directors.[138]

This mandatory constraint is all the more significant since other countries give shareholders a much more substantial voice in running the corporation. In the United Kingdom, for instance, shareholders are free to adopt binding shareholder resolutions and thereby interfere with the management of the corporation.[139] In Germany, managers are even required to seek shareholder

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135. *E.g.*, Frederick H. Alexander, *An Optimal Mix of Clarity and Flexibility*, 26 DEL. LAW., no. 1, Spring 2008, at 31; Lucian Arye Bebchuk, *The Case for Increasing Shareholder Power*, 118 HARV. L. REV. 833, 889–90 (2005); William W. Bratton, *Welfare, Dialectic, and Mediation in Corporate Law*, 2 BERKELEY BUS. L.J. 59, 69 (1995) (arguing that "delegation of power to management is mandatory" and that the exception allowed in section 141(a) is "irrelevant to the governance of large firms"); Gordon, *supra* note 129, at 1592 (citing the managerial role of the board enshrined in section 141(a) as a "classic example" of a mandatory rule governing the distribution of power between shareholders and directors); Daniel M. Häusermann, *The Case Against Statutory Menus in Corporate Law*, 9 HASTINGS BUS. L.J. 45, 74 (2012) (classifying "the board's privilege to manage the affairs of the corporation" as a mandatory norm); Kimberly D. Krawiec, *Fundamental Themes in Business Law Education: Building the Basic Course Around Intra-Firm Relations*, 34 GA. L. REV. 785, 796 n.30 (2000) (interpreting section 141(a) as a "rule of mandatory board direction"). *But see* Lynn A. Stout, *The Shareholder as Ulysses: Some Empirical Evidence on Why Investors in Public Corporations Tolerate Board Governance*, 152 U. PA. L. REV. 667, 669 (2003) (asserting that the board governance is a mere default rule).

136. *See* tit. 8, § 141(a) ("[E]xcept as may be otherwise provided in this chapter or in its certificate of incorporation.").

137. *See id.* ("If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.").

138. Bebchuk et al., *supra* note 119, at 889. The largely mandatory nature of section 141(a) is confirmed by section 351 of the Delaware General Corporation Law. *Id.* That provision governs the charter of so-called statutory close corporations, and for this specific type of corporation explicitly allows a charter provision that calls for the firm to be managed by the shareholders rather than by the board. *See* tit. 8, § 351. Clearly, this provision in section 351 would be unnecessary if such sweeping deviations from section 141(a) were permissible for all corporations, suggesting that the general rule in section 141(a) allows only much more limited deviations from the legal default.

139. Bebchuk, *supra* note 135, at 849.

authorization whenever the board wants to make a decision of essential importance.[140] That, too, contrasts sharply with Delaware law where shareholder approval is necessary only for certain formally defined acts such as long-form mergers[141] or charter amendments.[142]

Given the foundational nature of section 141(a), one would expect a clear economic rationale for its mandatory character. After all, the prevailing contractarian view of the corporation assumes that, as a general rule, the internal structure of the corporation is best left to private ordering.[143] Yet traditional justifications for mandatory corporate law norms do not seem to apply in the case of section 141(a) of the Delaware General Corporation Law.

The literature generally advances three reasons for making corporate law mandatory: the existence of externalities, the imperfect pricing of charters, and the prospect of opportunistic midstream charter amendments. However, as the following sections will demonstrate, none of these considerations motivate the mandatory nature of section 141(a). By contrast, the existence of homogeneity benefits can explain the mandatory nature of this provision quite easily.

1. Inefficient IPO Pricing

Underlying the contractarian approach to corporate law is the assumption that a firm's owners have an incentive to choose value-maximizing governance arrangements. In particular, it assumes that they will optimize the charter before going public so as to be able to sell the corporation's shares at the highest possible price. Of course, this reasoning assumes that investors will indeed pay higher prices for value-maximizing charters. Some scholars, however, believe that IPO markets may be pricing charter terms imperfectly.[144] This means and that investors buying the shares of IPO firms

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140. This principle is known as the *Holzmüller doctrine* after the case in which it was first developed. For a thorough treatment of the Holzmüller doctrine and a review of the more recent case law, see Marc Löbbe, *Corporate Groups: Competences of the Shareholders' Meeting and Minority Protection—the German Federal Court of Justice's Recent Gelatine and Macrotron Cases Redefine the Holzmüller Doctrine*, 5 GERMAN L.J. 1057, 1057–79 (2004).

141. *See* tit. 8, § 251.

142. *Id.* § 243.

143. *See, e.g.*, Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 99 (1989); Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989) (viewing the corporation as "a complex set of explicit and implicit contracts").

144. Lucian Arye Bebchuk, *Why Firms Adopt Antitakeover Arrangements*, 152 U. PA. L. REV. 713, 740–42 (2003); *cf.* Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 571–72 (1990) (discussing various factors that might prevent IPO charter terms from being efficiently priced).

may end up bearing some or all of the costs of inefficient charter terms. Where this is the case, the firm's owners may have an incentive to include inefficient charter terms, knowing that the market will not punish them for doing so. Hence, if IPO markets do not price corporate charters efficiently, mandatory legal norms may be necessary to ensure that corporations are not governed by inefficient charter terms.

Whether IPO markets are in fact imperfect at pricing charter terms is, of course, controversial,[145] and the empirical evidence is mixed.[146] But even assuming, for the sake of the argument, that the markets do not adequately price charter terms at the IPO stage, there is little reason to believe that this particular rationale can justify the mandatory nature of section 141(a).

For one thing, it is rather questionable whether departures from section 141(a) would be inefficient; on the contrary, many commentators believe that an increase in shareholder power would increase efficiency.[147]

More importantly though, it is not at all clear why the owners of a firm would try to make use of imperfect pricing to give excessive power to their shareholders. After all, the entrepreneurs taking an IPO firm public expect to control the board, and, therefore, have no incentive to give shareholders an inefficiently large amount of influence. The empirical evidence confirms this point: the most common governance provision in IPO charters is a so-called staggered board provision, which divides the board into several classes.[148] This type of provision significantly reduces shareholder oversight: once a board has been staggered, shareholders can no long remove directors without cause.[149] In short, the evidence suggests that entrepreneurs taking a firm public tend to limit, rather than increase, the influence of shareholders.

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145. *E.g., cf.*, Gordon, *supra* note 135, at 1562 (referring to the claim that IPO markets price charter terms imperfectly "puzzling").

146. *See, e.g.*, Daniel J. Bradley & Bradford D. Jordan, *Partial Adjustment to Public Information and IPO Underpricing*, 37 J. FIN. & QUANTITATIVE ANALYSIS 595, 612 (2002) ("IPO offer prices only partially adjust to public information."); Tim Loughran & Jay R. Ritter, *Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?*, 15 REV. FIN. STUD. 413, 426 (2002) (showing that "underwriters do not fully adjust the offer price with respect to public information"). *But see* Michelle Lowry & G. William Schwert, *Is the IPO Pricing Process Efficient?*, 71 J. FIN. ECON. 3, 25 (2004) (analyzing the efficiency of IPO pricing and concluding that "'underwriters' treatment of public information appears to be *almost* consistent with an efficient IPO pricing process").

147. This position is most prominently associated with Bebchuk, *Shareholder Power*, *supra* note 13, at 913.

148. Robert Daines & Michael Klausner, *Do IPO Charters Maximize Firm Value? Antitakeover Protections in IPOs*, 17 J.L. ECON. & ORG. 82, 110 (2001) (finding that more than half of all IPO firms have staggered boards); Michael Klausner, *Fact and Fiction in Corporate Law and Governance*, 65 STAN. L. REV. 1325, 1329 (2013) ("The only significant governance provisions that appear in IPO charters are staggered boards.").

149. DEL. CODE ANN. tit. 8, § 141(k) (2012).

2. Opportunistic Midstream Charter Amendments

The second traditional justification for mandatory corporate law points to the risk of opportunistic midstream charter amendments.[150] Once a corporation has gone public, the board of directors or the controlling shareholder may try to amend the charter in their favor, at the expense of the (other) shareholders. Of course, investors can anticipate this type of opportunism and react by adjusting the price they are willing to pay for the shares. To overcome this problem, the owners of the IPO firm need a commitment device that will allow them to credibly signal to investors that there need be no fear of opportunistic charter amendments. Mandatory corporate law can function as such a device because its norms, by definition, cannot be amended. In other words, the existence of mandatory law allows the firm's pre-IPO owners to communicate to investors that they can pay a high price for the firm's shares without fear of being taken advantage of. Since the investor knows that the firm is subject to mandatory law, he likewise knows that the firm cannot amend the relevant provisions of its charter to the investor's detriment after he has bought the shares.

However, the risk of opportunistic charter amendments can hardly explain the mandatory character of section 141(a) of the Delaware General Corporation Law. Section 141(a) prevents the corporation from giving more power to the shareholders. If the corporation lacks a controlling shareholder, the board has little incentive to give more power to the shareholders, and, more importantly, the shareholders certainly do not have to be protected against such a transfer of power.

If the corporation does have a controlling shareholder, there are two different scenarios to be attended to. First, it might be the case that a large shareholder already controls the board. In that case, he has little need to transfer power from the board to the shareholders. Moreover, even if he undertook such a transfer, this would not change anything. Since the controller controls the shareholder meeting as well as the board, it does not matter in this case how power is distributed between the board and the shareholders.

Second, the corporation may have a majority shareholder who does not yet control the board. This might be the case if, for instance, he has only recently acquired his controlling stake through a hostile acquisition and the incumbent board is unwilling to act in accordance with the majority

150. *See, e.g.*, Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1401 (1989) (noting the mandatory rules may be necessary to prevent opportunistic charter amendments); Gordon, *supra* note 135, at 1593 (pointing out that the potential for opportunistic charter amendments may justify mandatory corporate law rules).

shareholder's wishes. In that case, there is little need for the mandatory nature of section 141(a) either, because the incumbent directors—whose participation is needed for changing the charter—have no incentive to agree to a charter amendment anyway: if the directors are unwilling to bow to the controller's wishes, why would they agree to a charter amendment that gives him more power? In sum, the mandatory nature of section 141(a) simply cannot be explained as an attempt to prevent opportunistic charter amendments.

3. Externalities

Finally, mandatory law may be necessary to avoid negative externalities; this is a concern that arises where the interests of third parties are at stake.[151] However, this concern can hardly justify a norm, which, like 141(a), focuses solely on the allocation of power between managers and shareholders.

4. Homogeneity Benefits

To summarize, the traditional justifications for mandatory corporate law do not seem to apply to the case we have been considering. What then justifies the mandatory nature of section 141(a) of Delaware General Corporation Law? It is possible, of course, that there simply is no justification and that we owe section 141(a) entirely to the power exerted by managers as an interest group. Notably, however, homogeneity effects provide a very simple explanation for the mandatory nature of the target provision: section 141(a) can be viewed a mechanism to enhance the homogeneity of public corporations in Delaware.

At the center of the law governing public corporations in the United States is the conflict between managers and shareholders. Indeed, much of Delaware corporate law can be viewed as a response to this conflict. The extent to which shareholders are given power over managers is of central importance in this context. All else equal, the easier it is for shareholders to issue binding instructions to managers, the less one has to worry about managerial opportunism.[152] Accordingly, if shareholders were allowed to give binding

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151. Roberta Romano, *Answering the Wrong Question: The Tenuous Case for Mandatory Corporate Laws*, 89 COLUM. L. REV. 1599, 1617 (1989) (noting that externalities may, under certain conditions, justify the enactment of mandatory corporate law).

152. *Cf.* Bebchuk, *Shareholder Power*, *supra* note 13, at 839 (arguing that a corporate law regime allowing shareholders to intervene "would provide management with incentives not to adopt or maintain arrangements that serve management's interests but not shareholder value").

instructions to managers, this would have a profound impact on the design of other corporate governance rules. For example, much of the existing law on corporate takeovers would become obsolete, if shareholders could force boards to dismantle takeover defenses or even to auction off the company.

Of course, whether greater decision rights for shareholders are likely to increase shareholder wealth is one of the most controversial issues in corporate law and well beyond the scope of this article.[153] For the purposes of this article, the crucial point is a different one. Firms that allow shareholders to give binding instructions to managers need different rules from those that fail to empower shareholders in this way. Uniting both types of firms under one statute thus threatens to increase firm heterogeneity in a significant way. By protecting the independence of boards, section 141(a) of the Delaware General Corporation Law prevents such heterogeneity.[154] This is not to say that it is generally undesirable for firms to grant greater decision rights to their shareholders. However, the theory on homogeneity effects suggest that if it is indeed preferable to increase shareholder power, it might be more efficient for such alternative governance arrangements to be implemented under a separate corporate law regime. That way, the relative homogeneity of public corporations incorporated under the Delaware General Corporation Law could be preserved.[155]

In sum, homogeneity effects may hold the key to understanding why some mandatory corporate governance rules have survived the general trend

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For the sake of clarity, it should be noted that Bebchuk only proposes limited intervention rights. *Id.*

153. Lucian Bebchuk has famously called for greater shareholder power. *See id.* at 914. Others have defended the status quo. *See, e.g.*, Stephen M. Bainbridge, *Director Primacy and Shareholder Disempowerment*, 119 HARV. L. REV. 1735, 1758 (2006).

154. Of course, one can reasonably ask whether such a restriction is still necessary. Arguably, firms are at this point so used to the American model's focus on a strong board that few firms would want to deviate from it. However, this argument bears scrutiny. First, it may be that the current prevalence of the managerial model is a *result* of the fact that section 141(a) and similar provisions in other states are mandatory. If they were not, a nontrivial number of firms might seek to deviate. Second, the fact that U.K. firms follow a very different regime suggests that the U.S. model is by no means the only practically feasible approach. The mandatory nature of section 141(a) may in fact be necessary to preserve the homogeneity of Delaware's corporate landscape.

155. It should also be noted that this account is not at all at odds with the assumption that Delaware competes for corporate charters. By protecting the homogeneity of its corporate constituency, Delaware increases the attractiveness of its corporate law to those firms that wish to adhere to this model. Moreover, firms for whom these homogeneity-protecting restrictions are unsavory are not forced to bypass Delaware altogether. Rather, these other firms can make use of another entity type, such as the Delaware business trust. While this option may not be attractive given that the Delaware business trust does not necessarily offer a comparable body of precedents, it has to be recalled that Delaware's precedents are ill-fitting for shareholder-run firms anyway. Indeed, this may be one of the reasons, why statutory close corporations never gained any popularity in Delaware.

toward enabling corporate law. Such rules may limit contractual flexibility under a given corporate law regime, but, in doing so, they help to preserve firm homogeneity.

B. *The Proliferation of Entity Types*

Homogeneity effects also help to provide an efficiency rationale for the seemingly excessive number of entity types available to entrepreneurs. For those seeking to form a legal entity, the law offers an unprecedented panoply of choices. Those starting a business for profit can choose between a corporation, a statutory close corporation, a limited liability company, a partnership, a limited partnership, a limited liability partnership, a limited liability limited partnership, or a business trust.

It is very difficult to justify this abundance of entity types on the grounds that it is necessary in order to provide different types of firms with rules that fit their particular needs. Existing entity types, such as the limited liability company, are flexible enough to allow business owners to adjust governance rules to fit their particular needs.[156] Even assuming that entrepreneurs are unwilling to draft their own rules, their differing needs can be accommodated via so-called "menus," statutory provisions that list a number of governance provisions to choose from.[157]

Most importantly though, the literature has long recognized that some of the different entity types largely duplicate one another. One prominent commentator has noted that "[i]n some cases, the distinctions among the organizations tend to be subtle to the point of nonexistence."[158] Others have suggested that "[t]he new forms are now enjoyed only by legal hobbyists, who debate their microscopic differences with relish and seriousness."[159] Indeed, the legal differences between different entity types can be minimal.

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156. *See* Robert R. Keatinge, *Universal Business Organization Legislation: Will It Happen? Why and When*, 23 DEL. J. CORP. L. 29, 34 (1998) (noting that "[b]ecause organic statutes are becoming increasingly flexible, it is now possible for an organization organized as one form to have characteristics that more closely resemble the properties of another form.").

157. For a discussion of statutory menus see, for example, Daniel M. Häusermann, *The Case Against Statutory Menus in Corporate Law*, 9 HASTINGS BUS. L.J. 45, 45 (2012).

158. Keatinge, *supra* note 156, at 46; *see also* Daryl B. Robertson et al., *Introduction to Texas Business Organizations Code*, 38 TEX. J. BUS. L. 57, 62 (2002) (describing the situation before the introduction of the Texas Business Organizations Code and noting that "many different types of entities are governed by similar default rules").

159. Dale A. Oesterle & Wayne M. Gazur, *What's in a Name?: An Argument for a Small Business "Limited Liability Entity" Statute (With Three Subsets of Default Rules)*, 32 WAKE FOREST L. REV. 101, 104 (1997).

For example, in many states, the limited liability company has characteristics that are very close to those of the limited liability partnership.[160]

Of course, if two or more forms offer essentially identical provisions, then their existence cannot be justified with the desire to provide tailored rules. Against this background, it is unsurprising that scholars have called for the existing menu of entity types to be simplified and narrowed.[161]

The theory of homogeneity benefits, however, suggests a more nuanced analysis. The existence of multiple entity types is one obvious way of allowing firms to sort into different statutes and thereby increase firm homogeneity. This is true even in those cases where different statutes offer near-identical rules, since extremely similar statutes may still result in very different corporate constituencies. If, for whatever reason, one statute becomes popular with a particular type of firm, other firms of the same type may follow, offering these firms the benefit of greater corporate homogeneity. Indeed, it is often the case that businesses of a specific type will gather under the same entity type. For example, limited partnerships enjoy substantial popularity in oil and gas exploration,[162] whereas limited liability partnerships were widely adopted by professional firms such as law firms and accounting firms.[163] One obvious benefit of this type of sorting is the creation of homogeneity benefits.

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160. Keatinge, *supra* note 156, at 46 n.61.

161. In recent decades, corporate law scholars have become increasingly critical vis-à-vis the large number of organizational forms currently available. *See, e.g.*, Thomas F. Blackwell, *The Revolution Is Here: The Promise of a Unified Business Entity Code*, 24 J. CORP. L. 333, 372 (1999) (arguing that the time has come to simplify, harmonize, and consolidate existing business entity statutes); William H. Clark, Jr., *What the Business World Is Looking for in an Organizational Form: The Pennsylvania Experience*, 32 WAKE FOREST L. REV. 149, 173 (1997) (arguing that a substantial simplification of the "current plethora" of business entity types would be desirable); Harry J. Haynsworth, *The Unified Business Organizations Code: The Next Generation*, 29 DEL. J. CORP. L. 83, 83 (2004) (asserting that the number of organizational forms is "a source of increasing confusion"); Keatinge, *supra* note 156, at 69 (making the case for a universal business entity statute); John H. Matheson & Brent A. Olson, *A Call for a Unified Business Organization Law*, 65 GEO. WASH. L. REV. 1, 3 (1996) (calling the existing system "cumbersome and abstruse"); Oesterle & Gazur, *supra* note 159, at 104 (noting that most people "find the still-developing maze of alternate forms of business organization difficult to navigate and unduly costly"); *cf.* Larry E. Ribstein, *supra* note 121, at 1023 ("Lawyers and legislators have started thinking that it is time to clean up the mess created by the proliferation of forms.").

162. Howard M. Friedman, *The Silent LLC Revolution—the Social Cost of Academic Neglect*, 38 CREIGHTON L. REV. 35, 42 n.25 (2004).

163. *Id.* at 42 n.26; *see* Jonathan Macey & Hillary A. Sale, *Observations on the Role of Commodification, Independence, and Governance in the Accounting Industry*, 48 VILL. L. REV. 1167, 1170 (2003) (noting the move of accounting firms from general partnerships to limited liability partnerships).

C. The Absence of Corporate Mobility in Europe

Homogeneity may also explain differences in corporate mobility between the United States and Europe. In the United States, of course, large corporations have long proven to be quite mobile. Over 60% of all Fortune 500 companies are incorporated in Delaware.[164] Among initial public offering (IPO) firms, the percentage is even higher: in 2013, about 85% of all IPO firms were Delaware entities.[165] Nor is corporate mobility limited to public firms. Large, privately held corporations are also highly mobile, with Delaware once again being the destination of choice.[166]

In the European Union, by contrast, the legal framework long prevented corporate mobility.[167] Under the so-called "real seat" rule, which prevailed in most Member States, corporations were subject to the law of the state where their headquarters was located.[168] Hence, unless they were willing to relocate their headquarters—usually a prohibitively expensive move—they were stuck with the law of their home state.[169] In 1999, however, this situation changed abruptly, when the European Court of Justice, in its *Centros* decision, found the real seat rule to be in violation of the fundamental freedoms.[170] Henceforth, European firms too could freely choose their state of incorporation.

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164. *Why Businesses Choose Delaware*, STATE OF DEL., http://corplaw.delaware.gov/eng/why_delaware.shtml (last visited Dec. 20, 2014).

165. *See* Jeffrey R. Wolters, *Delaware Law Pitfalls in IPOs*, BUS. L. TODAY (Nov. 2013), *available at* http://www.americanbar.org/publications/blt/2013/11/delaware_insider.html (noting that in 2013 about 85% of all IPO firms were incorporated in Delaware); *see also* Dammann & Schündeln, *supra* note 2, at 87 (finding that 88% of all corporations that went public in 2013 were Delaware corporations). This suggests that Delaware's share among IPO firms has increased substantially over time. *See* Daines, *supra* note 2, at 1571 (analyzing 6671 IPOs from 1978 to 2000 and finding that Delaware's market share was about 50%).

166. Dammann & Schündeln, *supra* note 2, at 84 (showing that among privately held corporations with 5000 or more employees, only about 41% are incorporated in the state where their primary place of business is located, whereas almost 50% are incorporated in Delaware). Only smaller firms constitute an exception from the rule of corporate mobility. Among very small firms, the overwhelming majority incorporates locally, *see id.* at 84 (showing that among firms with less than 50 employees, 93% incorporated locally), presumably in large part because these firms are unwilling to shoulder the various transaction costs of incorporating in another state.

167. Jens C. Dammann, *Freedom of Choice in European Corporate Law*, 29 YALE J. INT'L L. 477, 480 (2004) (explaining how the real seat rule prevented corporations from reincorporating).

168. Didier Martin & Forrest Algona, *A Relic of a Rule*, WALL ST. J. (Mar. 29, 2006, 12:01 AM), http://online.wsj.com/articles/SB123802089115841691.

169. Dammann, *supra* note 167, at 480.

170. Case C-212/97, Centros Ltd. v. Erhvervs-og Selskabsstyrelsen, 1999 E.C.R. I-1459. The holding in this decision was further clarified and expanded upon in two further decisions, namely, Case C-208/00, Überseering B.V. v. Nordic Constr. Co. Baumanagement GmbH, 2002 E.C.R. I-

Initially, this freedom was limited to newly formed firms. *Centros* allowed entrepreneurs to form a firm in the state they preferred, but existing corporations could not reincorporate in another Member State without first being dissolved and then being formed anew, a move prompting substantial adverse tax consequences.[171] In 2005, however, even that problem was solved as the European Union adopted the Cross-Border Merger Directive.[172] This directive, together with an older directive on the taxation of mergers,[173] now ensures that European firms can reincorporate without adverse tax consequences by setting up a new corporation in the state of destination and then merging the old corporation into that new corporation, in just the same way that American corporations do.[174]

Despite all of this, U.S.-style corporate mobility has not yet materialized. Admittedly, in the wake of the *Centros* decision very small privately held firms from all over Europe started incorporating in the United Kingdom to avoid the often substantial incorporation costs they faced at home. According to one study, entrepreneurs from other Member States formed more than 67,000 new U.K. companies between 2003 and 2006.[175] Yet the mobility of even privately held firms has decreased substantially in the years since, as is made evident by data from Germany. By 2006, the annual number of German firms newly formed in the United Kingdom had increased to 16,438.[176] In 2008 though, only 4,884 U.K. companies had a registered head office in Germany,[177] and by the year

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9919, and Case C-167/01, Kamer van Koophandel en Fabrieken voor Amsterdam v. Inspire Art Ltd., 2003 E.C.R. I-10.

171. Dammann, *supra* note 167, at 490–91.

172. Council Directive 2005/56/EC, On Cross-Border Mergers of Limited Liability Companies, 2005 O.J. (L 310) 1 [hereinafter Cross-Border Merger Directive]. The directive had to be implemented by 12/31/2007. *Id.* art. 19 (1).

173. *See* Council Directive 90/434/EEC, On the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, 1990 O.J. (L 225) 1, amended by Council Directive 2005/19/EC, 2005 O.J. (L 58) 19, art. 4 (1) (providing that "[a] merger or division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes").

174. Jens C. Dammann, *The Mandatory Law Puzzle: Redefining American Exceptionalism in Corporate Law*, 65 HASTINGS L.J. 441, 467–68 (2014).

175. Marco Becht, Colin Mayer, & Hannes Wagner, *Where Do Firms Incorporate? Deregulation and the Cost of Entry*, 14 J. CORP. FIN. 241, 242 (2008).

176. *Id.*

177. STATISTISCHES BUNDESAMT, UNTERNEHMEN UND ARBEITSSTÄTTEN: GEWERBEANZEIGEN IN DEN LÄNDERN: DEZEMBER UND JAHR 2008, at tbl.5 year 2008 [hereinafter: STATISTISCHES BUNDESAMT 2008].

2010 that number had dropped to 1,978.[178] In contrast, the number of firms formed in 2010 as privately held corporations under German law (GmbHs) was 69,474,[179] demonstrating that the vast majority of German firms preferred to incorporate locally. More importantly, corporate mobility always remained limited to small privately held firms, never extending to public corporations.[180]

Why do public corporations and their privately held counterparts forgo the benefits of corporate mobility? Lack of incentives cannot be the reason. On the contrary, European firms have much more to gain from reincorporation than their U.S. counterparts.[181] In the United States, corporate law is relatively similar across states,[182] and much of U.S. law is enabling,[183] reducing the incentive to avoid local law by incorporating elsewhere. In contrast, European countries have traditionally made heavy use of mandatory corporate law.[184] Moreover, European countries' corporate law systems differ drastically on issues of central importance. For example, some states have codetermination statutes that give

178. STATISTISCHES BUNDESAMT, UNTERNEHMEN UND ARBEITSSTÄTTEN: GEWERBEANZEIGEN IN DEN LÄNDERN: DEZEMBER UND JAHR 2010, at 16 [hereinafter: STATISTISCHES BUNDESAMT 2010]; compare the excellent account by Wolf-Georg Ringe, *Corporate Mobility in the European Union—A Flash in the Pan? An Empirical Study on the Success of Lawmaking and Regulatory Competition*, 10 EUR. COMP. & FIN. L. REV. 230, 248 (2013) (relying on data from the FAME database on U.K. incorporated companies and finding that the number of German-based firms incorporated in the United Kingdom peaked in March 2006 and has been "falling continuously" since then).

179. STATISTISCHES BUNDESAMT 2010, *supra* note 178, at 16.

180. *See* Dammann, *supra* note 91, at 70; Becht et al., *supra* note 175, at 242 (noting that "[b]etween 2003 and 2006, over 67,000 new private limited companies were established in the U.K. from other E.U. Member States," but stressing that the absence of evidence for reincorporation decisions by public corporations, noting instead that "[m]ost of the new foreign limited companies are small entrepreneurial firms"); *see also* William W. Bratton et al., *How Does Corporate Mobility Affect Lawmaking? A Comparative Analysis*, 57 AM. J. COMP. L. 347, 385 (2009) (arguing that corporate mobility extends only to "economically-negligible small entrepreneurs").

181. Ringe, *supra* note 178, at 258–59, noting that German courts still apply German criminal law and insolvency law to pseudo-foreign corporations. However, even in the United States, these areas of the law are not subject to regulatory competition.

182. John C. Coffee, Jr., *The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications*, 93 NW. U. L. REV. 641, 663 (1999) (pointing out that "a high degree of uniformity has emerged in American corporate laws"); Dammann, *supra* note 167, at 525 (describing U.S. corporate law as "relatively uniform across states"); Romano, *supra* note 73, at 709 (pointing out "substantial uniformity across the states").

183. *See supra* Part V.E.

184. Dammann, *supra* note 174, at 443.

employees a powerful voice in corporate governance, while other states impose no such requirements.[185]

So what are the obstacles that prevent public corporations in Europe from shopping around for the most favorable corporate law? Commentators have pointed to language barriers,[186] fear of exposure to litigation in foreign courts,[187] and self-interested advice by corporate lawyers who do not wish to lose their clients.[188] Yet while all of these factors surely play *some* role, neither individually nor in their entirety do they provide a good explanation for the lack of corporate mobility.[189] For example, it is not clear why large French or German corporations would be concerned about having to litigate in U.K. courts. The latter have an excellent reputation and are highly sought after forums for commercial and corporate litigation; in fact, many international contracts specify the

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185. *Cf.* MADS ANDENAS & FRANK WODRIDGE, EUROPEAN COMPARATIVE COMPANY LAW 417–47 (2009) (describing various European codetermination regimes).

186. Dammann, *supra* note 167, at 492.

187. Dammann, *supra* note 167, at 492; Ringe, *supra* note 178 at 258–59

188. Dammann, *supra* note 167, at 505–06.

189. Commentators have also named a few other reasons that may be relevant to small privately held businesses but plainly do not apply to large publicly traded firms. For example, Ringe, *supra* note 178, at 260 notes that privately held U.K companies may have an image problem in Germany due to the fact that many have ceased to do business relatively shortly after their formation. This consideration is likely to be of considerable importance to small privately held firms, but it is unlikely to matter to large German companies with well-established reputations, given that the latter are unlikely to be confused with "fly-by-night" outfits. In his careful and thoughtful analysis, Ringe, *supra* note 178, at 264 also invokes diffusion theory to argue that "social pressure towards conformity" may have played a role in the explaining why German firms have been unwilling to incorporate in the United Kingdom. To what extent social pressure may have influenced the small, privately held firms on which Ringe focuses is not entirely clear. On the one hand, one could argue that any social pressure to incorporate locally should have been greatest in the years immediately after the Centros decision and should have declined over time as more and more firms were formed in the United Kingdom. What happened, though, was exactly the opposite: the number of German firms formed in the U.K. first grew quickly and then started falling again. On the other hand, Ringe may be correct in pointing out that social pressure on German firms to incorporate locally increased as negative reporting about the disadvantages of U.K. firms increased.

In any case, however one views the role of social pressure with respect to privately held corporations, such pressure seems unlikely to explain the general reluctance of public corporations to incorporate in other states. At most, some firms that market directly to consumers might be sensitive to being accused of turning their backs on their home country. However, many German corporations fail to market their products directly to consumers and in fact are largely unknown to the public at large. Hence, these firms do not have to worry about how the general public views choice-of-law questions. Second, it's not clear that the German public even knows, let alone cares, where large firms are incorporated or what their organizational form is. For example, the European subsidiary of Amazon that serves German consumers is incorporated in Luxembourg, yet no one appears to take notice let alone take umbrage.

U.K. as a forum for litigation.[190] Self-interested advice by law firms can also hardly explain the reluctance to consider reincorporation, as Europe is now dominated by transnational law firms. For example, one of Germany's top two corporate law firms is Freshfields Bruckhaus Deringer, the result of a merger between a U.K. and a German firm. There is no question that such firms can offer advice on both German and English law, so if one of Freshfields' German clients were to reincorporate to the United Kingdom, he would in all likelihood stay with the same firm. For the same reason, language barriers seem unlikely to constitute a major obstacle to corporate mobility. Among high end corporate practitioners, an English-language law degree such as an LL.M. is now the norm anyway. It is also worth noting that even managers of the leading German corporations are not always able to speak German fluently, the paradigmatic example being Anshu Jain, CEO of Deutsche Bank, who only started learning German after ascending to the top job.[191] In sum, none of the factors discussed above seem to have all that much weight.

By contrast, homogeneity effects provide a fairly powerful reason to incorporate locally. Many European firms may secretly prefer the more flexible U.K. law, but firm homogeneity makes it safer for firms to stay in their home countries.

Germany is a case in point. German law is notorious for subjecting large firms to mandatory worker codetermination, meaning that employees are given a voice in corporate governance. For example, in firms with two thousand or more employees, the employees elect half of the members of the supervisory board.[192] It is safe to say that most firms would prefer to avoid codetermination,[193] and they could do so by incorporating in another member state such as the U.K.[194] However, reincorporating in the United Kingdom

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190. This is particularly true in the area of maritime law. *See, e.g.*, Dammann & Hansmann, *supra* note 5, at 29 (noting that "London has become the worldwide locus for admiralty disputes"); Fred Konynenburg et al., *Shipping Dispute Resolution Forums: Competition and Cooperation*, H.K. LAW., Nov. 2006, at 78, 78 (pointing out that "London has enjoyed a traditional pre-eminence as an arbitration and court forum [in maritime disputes], due to its imperial roots in the international shipping industry and commodity markets").

191. Jannis Brühl, *Schmusen mit Anshu Jain*, SÜDDEUTSCHE ZEITUNG, May 23, 2013, http://sz.de/1.1678910 (pointing out that Anshu Jain gave his first German-language speech in May 2013).

192. Gesetz über die Mitbestimmung der Arbeitnehmer [Employee's Codetermination Act], May 4, 1976, BGBl. I at 1153, § 1(1)(2) (Ger.).

193. Tellingly, firms do not adopt codetermination voluntarily. ROMANO, , *supra* note 23, at 129–30.

194. *E.g.*, Jens Dammann, *The Future of Codetermination After Centros: Will German Corporate Law Move Closer to the US Model?*, 8 FORDHAM J. CORP. & FIN. L. 607, 621–22 (2003).

would entail the loss of homogeneity benefits. As long as German-based firms remain in Germany with other German firms, they can be sure that future legislative change will be tailored to their interests. In the United Kingdom, by contrast, future legislation will be geared to the needs of U.K.-based firms and may therefore be highly detrimental to the interests of German-based firms formed in the U.K.

VI. CONCLUSION

Entrepreneurs selecting a legal regime for their firms have reason to care about which other firms are using a prospective regime. But should firms care solely about *how many* other firms are using a particular legal regime, or should they be interested in the other firms' qualitative attributes?

Traditionally, scholars have invoked network theory as a reason to focus on quantitative aspects: all else equal, the greater the number of firms using a particular legal regime, the greater the benefits for each individual user.

This article has not questioned the importance of a legal regime's number of users. However, I have argued that qualitative aspects of a regime's user base matter as well. Firms benefit if the users of a particular legal regime form a relatively homogeneous group. As we have seen, some of the benefits of homogeneity arise solely in connection with network effects; simply put, more homogeneous networks yield greater network benefits. However, it is clear that other homogeneity benefits are independent of network effects, as they do not even presuppose the existence of a network. In particular, homogeneity offers two key advantages: it increases the predictability of judicial and legal interventions, and it also improves the fit between such interventions and firm needs.

A naïve understanding of network effects suggests that, given two legal regimes with equal inherent qualities, the one with the greater number of users should yield greater benefits. Moreover, because bigger is better, any newcomer to a network would bestow additional network benefits and should therefore be welcomed with open arms.

However, the existence of homogeneity effects calls for a more nuanced analysis. Among legal regimes with equal inherent benefits, the one with fewer users may be preferable if these users form a more homogenous group. Moreover, a newcomer may at the same time increase the size of the network and reduce its homogeneity. Thus, whether a newcomer's entry into a network bestows net positive or net negative externalities depends on the circumstances.

Homogeneity are of substantial practical and theoretical interest. They help to explain the largely mandatory nature of the allocation of power between managers and shareholders. Furthermore, they make it easier to justify the seemingly excessive number of different entity types available, and they cast light upon the question of why corporate mobility among public corporations is a standard feature of U.S. law, but has not caught on in Europe. In sum, homogeneity effects provide a powerful efficiency rationale for a number of otherwise puzzling phenomena in corporate law.