NEVADA AND THE MARKET FOR CORPORATE LAW

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Abstract

Berle & Means' view that managers rather than shareholders control our largest corporations finds important expression in William Cary's famous article arguing that managers have led shareholders on a "race to the bottom" whose finish line is Delaware. These views, in turn, support supplanting state corporation law with federal regulation of corporate governance. Concerns about a race to the bottom lately focus on Nevada, which seeks to be Delaware's first real competitor for out-of-state firms in the national incorporation market. Evidence suggests that Nevada's strategy is to raise tax revenues by offering a significantly laxer corporate law than Delaware.

We examine Nevada's strategy and evidence concerning Nevada incorporation and show that there is an alternative explanation of Nevada law which poses much less cause for concern. Specifically, we argue that Nevada corporation law may actually reduce some firms' total agency costs by reducing the costs of judicial monitoring. This analysis has implications as to the need for federal regulation of corporate governance.

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Contents

NEVADA AND THE MARKET FOR CORPORATE LAW 1

I. RACE TO LAXITY 6

II. EFFICIENT MARKET SEGMENTATION 9
   A. AGENCY COSTS AND STATE CORPORATE LAW 9
   B. NEVADA'S STRATEGY 11
   C. CHOICE OF FORM 13

III. DID NEVADA ATTRACT MISCREANTS? EVIDENCE FROM RESTATEMENTS 15

IV. EFFECT OF NEVADA INCORPORATION ON FIRM VALUE 18

V. CONCLUSION AND IMPLICATIONS 19
Berle & Means altered the direction of debate on corporate governance by presenting evidence suggesting that corporations were not controlled by their owners. In Berle & Means' view, the shareholders were too dispersed and uncoordinated to effectively exercise control, so that power devolved to the non-owner agents charged with managing the firm.

An important implication of Berle & Means' book is that the states could not be trusted to continue to regulate corporate governance. If managers control their corporations then they also effectively choose the law that regulates corporate governance since the law of the state where the firm chooses to incorporate governs the relationship between the managers, the shareholders, and the corporation. It is not surprising that the influence of Berle & Means book was almost immediately reflected in the adoption of the federal securities laws, the first federal laws regulating corporate governance. The link between Berle & Means and the distrust of state law is evident in Justice Louis Brandeis's famous 1933 dissent in Louis K. Liggett Co. v. Lee:

The typical business corporation of the last century, owned by a small group of individuals, managed by their owners, and limited in size by their personal wealth, is being supplanted by huge concerns in which the lives of tens or hundreds of thousands of employees and the property of tens or hundreds of thousands of investors are subjected, through the corporate mechanism, to the control of a few men. Ownership has been separated from control; and this separation has removed many of the checks which formerly operated to curb the misuse of wealth and power. * * * Such is the Frankenstein monster which states have created by their corporation laws.

These ideas have retained a powerful hold on the popular and scholarly imagination. More than forty years after Berle & Means William Cary denounced U.S. corporate law as a "race to the bottom," with Delaware as the "bottom," where managers could use their power over the demand side of the market to effectively determine the nature of the law supplied by the leading incorporation jurisdiction. Cary's assertion that Delaware could win incorporation business by attracting selfish managers and ignoring shareholders has provided a powerful basis for federalization of corporate law.

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1 See Adolf A. Berle, Jr., and Gardiner C. Means, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).
2 See Restatement (Second) of Conflict of Laws, §§ 304 and 307.
3 288 U.S. 517, 564-67 (1933) (footnotes omitted).
In the eighty years since the publication of Berle & Means' book, other ideas have risen to challenge its assumption. Although the logic that the dispersed many are weaker than the concentrated few may seem compelling, in fact the logic breaks down when one considers the market forces that discipline corporate governance. Corporate executives have nothing to manage unless their firms can attract investments in highly competitive capital markets. Investors who are at the mercy of corporate managers will demand a discount to reflect potential cheating. It follows that the firms that can best protect their owners from cheating can raise money at the lowest cost. In other words, managers must pay investors for permission to cheat them. Investors can determine the likelihood of cheating from firms' disclosures about their managers and business. If investors cannot trust firms' disclosures, they will charge an additional discount to reflect the risks imposed by poor information. In short, efficient securities markets discipline managers.

This logic extends to state law. Even if managers can choose the governing state, they will pay a price for choosing a law that ignores shareholders' interests. Contrary to the assumption that Delaware is the "bottom" in the competition for corporate law, evidence developed in connection with the competing corporate finance thesis shows that investors actually pay more for firms that are incorporated in Delaware.

Many scholars continue to share Cary's skepticism that Delaware's dominance of the national market for corporate law indicates the existence of a healthy competition for corporate law. A leading explanation is that the market for incorporations is least effective as a discipline regarding law protecting managers from threats to their control. This theory suggests that Delaware wins the state competition by providing takeover protection. Another leading theory suggests that Delaware caters to lawyers who are the

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7 The market for corporate law is now generally understood to consist of a "local" market in which about half of publicly held firms choose their home state over Delaware and a national market for out-of-state corporations which Delaware dominates. See Lucian Arye Bebchuk, et. al, Does the Evidence Favor State Competition in Corporate Law?, 90 CAL. L. REV. 1775 (2002) (Delaware has a 58% overall share of publicly traded non-financial firms); Robert Daines, The Incorporation Choices of IPO Firms, 77 N.Y.U. L. REV. 1559 (2002) (about half of IPO firms choose Delaware).


main interest group in Delaware responsible for crafting corporate law. There is also concern that the competitive edge Delaware gets from its sophisticated legal infrastructure of courts and lawyers precludes effective competition. However, even if the state competition for corporate law does not produce optimal corporate law, there remains the question whether a monolithic and cumbersome federal system could provide a sufficient improvement to justify displacing the current system.

This brief overview of the corporate federalism debate provides the backdrop for analyzing recent papers on Nevada corporation law as the first viable alternative to Delaware in the national market for out-of-state incorporations. These papers argue that Nevada's recent moves to become a low-liability haven for managers offer a competitive threat to Delaware to which the latter state may not be able to respond effectively. Evidence that Nevada-incorporated firms have a significantly higher likelihood of issuing accounting restatements seems to support the conclusion that Nevada is attracting firms with lax governance. This theory and evidence could renew concern about a potential race to the bottom.

We suggest an alternative version of what is happening in Nevada. Instead of managers racing their firms to Nevada to make it easier for them to cheat, firms may be going to Nevada to reduce their costs of controlling cheating. Nevada law therefore actually may reduce rather than increase firms' overall costs of delegating power to agents. Evidence concerning the firms that incorporate in Nevada does not refute this alternative story. This theory and evidence highlights the need to exercise caution before concluding that there is a need for legal intervention in the market for corporate law.


11 See Roberta Romano, Law as Product: Some Pieces of the Incorporation Puzzle, 1 J.L. ECON. & ORG. 225 (1985). This explanation appears to be robust as to business form in light of evidence of Delaware's ability to dominate the competition for large limited liability companies. See Bruce H Kobayashi & Larry E. Ribstein, Delaware for Small Fry: Jurisdictional Competition for Limited Liability Companies, 2010 ILLINOIS LAW REVIEW 53.


13 Note that our analysis is focused on corporate fiduciary duties. News stories also have alleged that Nevada is a haven for corporate shells promoted by purveyors of tax avoidance and asset protection devices. See Brian Grow & Kelly Carr, Special report: Nevada's big bet on secrecy, Reuters.com, September 26, 2011, available at http://www.reuters.com/article/2011/09/26/us-shell-games-nevada-idUSTRE78P1Y0201110926. While these devices are indirectly relevant to our paper insofar as they relate to Nevada's general reputation and market niche, they are legally distinct from fiduciary duty provisions of corporate law.
This paper also suggests a broader response to continued assertions of the Berle- Means hypothesis that strong federal law is necessary to deal with the separation of ownership and control. The general lesson is that before prescribing this harsh medicine, it is important to consider carefully the reasons for choices firms make and market mechanisms for disciplining bad choices.

Apart from the implications of Nevada for federalization of corporate law, the appearance of a significant competitor to Delaware triggers re-evaluation of the state competition for corporate law and consideration of whether some legal reform might be warranted. In particular, given the appearance of Nevada it is worth asking why only Nevada and not other competition elsewhere on the spectrum of potential corporate governance law. The answer to this question may lie outside the "box" of state corporation law in alternative business forms and private lawmaking.

I. RACE TO LAXITY

The debate over Nevada essentially reduces to two accounts of Nevada's role in the market for corporate law. One view is that Nevada law is racing to the bottom by enabling corporate managers to escape the discipline of fiduciary duties. Nevada thus can earn incorporation fees for its taxpayers by disregarding the interests of out-of-state shareholders. This view of Nevada competition, which is presented in this Part, provides some support for federalizing corporate law. Part II discusses an alternative view of Nevada's role which raises doubts about using Nevada as a basis for federalization.

Nevada's participation in the national market for corporate law began in 2001 when Nevada changed its statutory rules defining the fiduciary liability of Nevada corporation directors as part of a plan to significantly raise franchise taxes for Nevada corporations and to encourage corporations to pay the higher taxes. Under the 2001 law, Nevada directors and officers have mandatory liability only for intentional misconduct and no other default or mandatory liability. Nevada corporation law provides in relevant part that "[d]irectors and officers shall exercise their powers in good faith and with a view to the interests of the corporation." However, except as otherwise provided in the articles of incorporation or certain provisions of the corporation law "a director or officer is not individually liable to the corporation or its stockholders or creditors for any damages as a result of any act or failure to act in his capacity as a director or officer unless it is proven that: (a) His act or failure to act constituted a breach of his fiduciary duties as a director or officer; and (b) His breach of those duties involved intentional misconduct, fraud or a knowing violation of law." In 2003 Nevada followed through on

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14 See Barzuza, supra note 12.
the revenue part of its plan by raising its maximum annual franchise tax from $85 to $11,100. These changes combine with Nevada's 1999 clarification of the business judgment rule's application to takeover defenses that do not restrict shareholders' voting rights.\textsuperscript{16}

In order to assess Nevada's role in the national market for corporate law it is necessary to compare Nevada with the leading competitor in that market. Delaware provides by default for the standard run of director fiduciary duties of care and loyalty.\textsuperscript{17} However, most Delaware publicly held corporations have taken advantage of a provision of Delaware's law which provides that a corporation may include in its articles of incorporation

(7) A provision eliminating or limiting the personal liability of a director to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, provided that such provision shall not eliminate or limit the liability of a director: (i) For any breach of the director's duty of loyalty to the corporation or its stockholders; (ii) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law; (iii) under § 174 of this title; or (iv) for any transaction from which the director derived an improper personal benefit. * * *\textsuperscript{18}

On the revenue side, Delaware provides for taxes of $75 to $180,000.\textsuperscript{19}

It is important to emphasize that the difference between Nevada and Delaware law is not as stark as might first appear. As noted above, the Nevada statute does impose a default fiduciary duty to act in good faith. The Nevada Supreme Court explicitly recognized this duty in 2006 in a case involving demand excuse in a shareholder derivative suit.\textsuperscript{20} The Court cited Delaware law throughout the opinion.

The key difference between Delaware and Nevada law lies in the standard for imposing liability for breach of the standard fiduciary duty. Under Nevada law, directors are liable only for a breach of fiduciary duty that involves "intentional misconduct, fraud or a knowing violation of law." A conflict of interest transaction would breach Nevada's default fiduciary standard. It arguably follows that a deliberate breach of this duty would

\textsuperscript{16} NEV. REV. STAT. § 78.139.
\textsuperscript{17} See Del. G. Corp. L. §144.
\textsuperscript{18} Del. G. Corp. L. §102(b)(7).
\textsuperscript{19} State of Delaware, Department of State, Division of Corporations, "How to calculate franchise taxes," available at http://corp.delaware.gov/frtaxcalc.shtml.
\textsuperscript{20} Shoen v. SAC Holding Corp., 122 Nev. 621, 137 P.3d 1171 (Nev. 2006).
constitute "intentional misconduct" or an act not in "good faith" and therefore would be outside of Nevada's exculpatory provision. Under Delaware law, corporations that use the §102(b)(7) opt-out are liable not only for "intentional misconduct," "knowing violation of law," or improper personal benefit, all of which are arguably actionable in Nevada, but also for breach of the duty of loyalty or acts or omissions that are not in good faith. These categories may involve conduct that is neither selfish nor intentionally wrongful, and that therefore may border on conduct protected by the business judgment rule.

This difference between Nevada and Delaware is highlighted by the Delaware Supreme Court's opinion in Stone v. Ritter,21 where the court upheld a claim for a board's conscious failure to adopt a compliance program. It is unlikely that such a claim would survive dismissal in Nevada. Assuming that Nevada law does not mandate a compliance program, managers' failure to adopt one may not be intentional misconduct. Nor is there any open-ended bad faith exception in Nevada that could catch this conduct as there is in Delaware. In other words, the key difference between Nevada and Delaware is not that Nevada managers have no liability for wrongdoing, but that they are liable only when they know they are engaging in wrongdoing.

Apart from the precise standard of liability in Nevada, the question concerning whether Nevada is facilitating a race to the bottom is whether firms' opportunity to incorporate under Nevada law injures shareholders. This is a more complex question than might first appear. It is not enough that Nevada offers its managers a greater opportunity to cheat than other states' laws. As discussed below in Part II, shareholders might reasonably trade higher cheating costs for lower costs of controlling cheating. Nor is Nevada law clearly a problem if raises the cost of capital for Nevada firms compared to that of comparable firms incorporated under other states' laws. Even in that case post-incorporation shareholders are not harmed because they are paying a lower price for their shares to reflect the possibility of managerial cheating.

The main concern here is for existing shareholders who are harmed by their managers' decision to reincorporate in Nevada, perhaps because they were misled by faulty proxy disclosures. At that point the shareholders may be stuck with the choice of living with higher agency cost, selling out for the lower price caused by the reincorporation, or incurring the substantial expense of removing the managers or otherwise forcing a move out of Nevada. Nevada's corporate law can contribute to the risk of poor governance by offering managers an opportunity to escape monitoring that would not exist in the absence of the law.

It is difficult to definitively determine whether a particular state corporate law provision reduces shareholder welfare in the context of a generally competitive market.

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21 911 A.2d 362, 370 (Del. 2006).
for corporate law. If shareholders generally are getting what they pay for, offering
investors an additional governance choice may be worth the risk to shareholders who are
injured by transition to the new law. However, there may be a point at which a state
corporation law offers so little potential benefit to the overall market that it is not worth
the risk of injury to some shareholders. The next Part addresses this concern by
considering Nevada's potential contribution to the overall market for corporate law. This
analysis is important in determining whether the Nevada statute supports imposing
federal minimum standards or other regulation.

II. EFFICIENT MARKET SEGMENTATION

Part I presents the worst case for Nevada, that it provides a refuge for lax
governance. This Part discusses an alternative or additional perspective on Nevada law,
that it provides a mechanism for reducing agency costs by tailoring managers' fiduciary
duties to the type of firm and to Nevada courts' capacity for judging corporate agents.
Policymakers must evaluate both perspectives on Nevada in deciding its implications for
the appropriateness of federalizing corporate law.

A. AGENCY COSTS AND STATE CORPORATE LAW

An important objective of corporate law is to assist firms to enter into contractual
provisions that minimize agency costs. This is not the same as reducing the amount of
cheating by agents. Rather, agency costs are better understood as the total costs of
owners' delegating control over the management of property to agents, thereby separating
control from ownership of the property. These include not only losses from agent
cheating, but also principals' and agents' monitoring and bonding costs of reducing the
risk of loss. For example, a principal could reduce agent cheating by watching
everything the agent does or reducing the agent's discretion. However, this approach
could increase total agency costs because the costs of watching the agent or reducing the
value of the agent's exercise of discretion exceed the benefits of reduced cheating.
Agency costs, defined as the costs of hiring an agent, are never zero because the incentive
problem inherent in separating ownership and control requires either incurring the costs
of controlling cheating or leaving the agent free to cheat. At the same time, there may be
significant benefits associated with delegating to agents, particularly in situations where
agency costs are highest -- that is, where numerous and dispersed principals must
delegate control to a central authority because of the impossibility of effectively
coordinating decision-making.

22 See Michael Jensen & William Meckling, Theory of the Firm: Managerial Behavior, Agency
Costs and Ownership Structure, 3 J. FIN. ECON. 305 (1976).
In evaluating the efficiency of state corporate law it is important to keep in mind that law is just one of many potential ways principals have of reducing agent cheating. State-imposed fiduciary duties involve ex post judicial review of fiduciary conduct and judicially enforced damages and equitable relief for misconduct. Principals could supplement or substitute for these duties, among other things, shareholder approval of agents' acts, incentive compensation to align agents' incentives with the firm's interests, shareholder transfer or exit rights, and review of agent conduct by independent directors, auditors, or lawyers. Principals also could rely on market mechanisms such as price signals in product and securities markets, markets for corporate control and managerial services, and reputational incentives. Some of these terms could be provided by judicially enforced contract provisions rather than default or mandatory rules in state corporate law. The federal securities laws provide additional mandatory penalties for fraud, non-disclosure and other misconduct. This helps ensure that shareholders have the facts regarding how well their firms are governed. Federal law also provides some minimum governance standards for publicly held firms. In short, the efficiency of state corporate law depends on its marginal costs and benefits in controlling agent cheating given other constraints on agency costs.

An additional consideration in assessing state corporate law is that firms have differing governance needs. Firms with concentrated shareholdings or majority or controlling shareholders may have very different agency cost control problems from firms with widely dispersed shareholders. Firms may select the rules that fit their needs not only by entering into customized contracts, but also by choosing a suitable organizational form or state law. It follows that state competition may be efficient even if it does not produce a single superior "winner" but rather a mix of laws that is suitable for different types of firms.

Nevada law also can be analyzed in terms of error costs. Even if fiduciary duties might seem to add a necessary constraint on cheating, these duties still may not be efficient in the real world in which human judges must decide fiduciary duty cases. Lax fiduciary standards may lead to "Type II" errors, meaning that these standards allow more cheating than the shareholders would prefer. On the other hand, Nevada law also may reduce "Type I" errors by reducing liability that might motivate managers to engage in acts that do not benefit shareholders such as non-cost-justified monitoring or avoiding risky but positive net present value business decisions.

The risk of Type I error is compounded by agency costs in litigating fiduciary breaches. Courts must determine in hindsight whether business judgments that turn out bad were reasonable under the circumstances in which they were made. The risk of error may be compounded by another set of agents -- plaintiffs' lawyers -- who can earn fees for bringing marginal cases that survive dismissal even if these cases cause net harm to
shareholders. Thus, it may be efficient to restrict fiduciary duties in order to reduce error costs even if fiduciary duties would provide efficient discipline in an ideal world.

B. NEVADA'S STRATEGY

This subpart discusses Nevada law's approach to agency costs in light of the above analysis. As emphasized in Part I, the key difference between Nevada and Delaware law is that Nevada imposes liability for breach only where the defendant knows she is breaching a legal duty. Nevada law thus ensures that Nevada courts will keep in mind their limited ability to second-guess business decisions. Nevada's intentional misconduct standard alleviates the indeterminacy problem that plagues Delaware judges' attempts to draw fine lines between business decisions that do and do not warrant special judicial attention.\(^23\) This reflects a tradeoff between the benefits of strict discipline of fiduciary misconduct and the potential costs of excessive monitoring judicial error.\(^24\)

Analysis of Nevada's competitive strategy must explain not only how Nevada's supposed laxity attracts out-of-state incorporations, but how it can maintain its competitive advantage despite charging more for incorporation than any state in the country other than Delaware, and although it lacks Delaware's substantial infrastructure and long-standing reputation. The problem for Nevada is that any state could pass the same law and charge a lower price. Nevada has no copyright in its law which could protect it from this price-cutting competition.\(^25\) It would seem that another state could take over Nevada's leadership as a Delaware alternative just as swiftly as Delaware took over New Jersey's spot in the early days of the corporate competition in the U.S.\(^26\)

One explanation for Nevada's strategy is that it not only offers firms a law that some may find attractive, but Nevada also bonds its promise not to materially change this


\(^{24}\) The point here is not that Nevada law reduces the risk of "frivolous" lawsuits that have a low likelihood of liability. See Barzuza, *supra* note 12 at 37. Rather, it guards against Type I error by narrowing the situations in which liability can be imposed to those that can be avoided at a relatively low cost. For a similar explanation of the *mens rea* requirement in criminal law, see Jeffrey S. Parker, *The Economics of Mens Rea*, 79 VA. L. REV. 741 (1993).


law after corporations have incurred the costs of incorporating in the state. Nevada's dependence on the substantial revenues its unique law attracts makes it politically difficult for the legislature to change the standard ex post and thereby in effect forfeit its bond.27

There is an additional question why Nevada chooses to compete with Delaware on the low end of monitoring rather than by offering a stricter law. One explanation is that Nevada's bright-line approach to liability meshes well with Nevada's legal infrastructure of judges and lawyers. Delaware corporate judges are adept at writing extensive opinions, sometimes on a tight schedule, which analyze corporate transactions carefully and expertly. These decisions must distinguish between acceptable business judgment viewed as of the time of the decision, and a violation of the applicable legal standards in the particular case. They also must prescribe governance practices that are both realistic and effective and fit the case into the complex network of existing Delaware law. In order to do their job even the most expert judges must rely on comparably expert attorneys. Indeed, Delaware judges are drawn from the ranks of the Delaware bar. By contrast, Nevada, like other non-Delaware states, lacks a comparable legal infrastructure and has no hope of acquiring one without either first attracting the high-end incorporation business or making a substantial investment in infrastructure on the gamble that the business will come.

Delaware faces the converse problem from Nevada. Because Delaware already has invested in a high-level infrastructure it can maintain its competitive advantage only by applying legal rules that can utilize this infrastructure. If Delaware were to imitate Nevada's bright-line approach, it would effectively devalue its costly infrastructure and sacrifice its main competitive advantage. In other words, Nevada and Delaware are essentially in two distinct businesses -- low-infrastructure/bright line rules versus a high-infrastructure/flexible standards form of corporate law.

To be sure, there are many other states that lack Delaware's infrastructure and that could offer not only the same law as Delaware but also similar assurances against change. However, Nevada has two characteristics that particularly lend themselves to its low-monitoring strategy and thereby enable it to out-compete against other states. First, Nevada's relatively sparse population makes it more dependent on incorporation fees than more populous states. Second, Nevada can successfully compete against other smallish states because its reputation based on a large and successful substantial gambling industry reduces the likelihood of a political backlash based on public concern that lax corporate law will cast the state in a bad light.

Nevada's strategy also has implications for the types of firms Nevada could be expected to compete for. In general, firms could be expected to choose Delaware law if they want to offer investors strong assurances that they are making substantial investments in monitoring. Consistent with our agency cost analysis above, firms would want to do so when the benefits of such monitoring exceed the cost. Two characteristics of Nevada firms are consistent with a demand for lower levels of monitoring. First, Nevada public firms are smaller than those in Delaware. This alone increases the per capitalization cost of establishing setting up controls that could catch accounting errors. Indeed, small size is one of the factors associated with weaker controls.28 Second, Nevada has a relatively high percentage of family firms.29 Such firms are generally directly controlled by their shareholders and therefore need not rely on auditors and disclosure to discipline managers. Indeed, Coffee attributes the presence of fewer accounting scandals in Europe than in the U.S. following the 2001 stock market crash to basic difference between European and U.S. firms regarding shareholder concentration.30 U.S.-style dispersed shareholder firms are more likely to rely on option compensation and which increases the risk of revenue-recognition problems.31 The relatively high percentage of family firms in Nevada suggests that Nevada firms are more like those in Europe than those incorporated in Delaware.

C. CHOICE OF FORM

Subpart B discusses reasons why Nevada is able to secure a position as a key competitor to Delaware in the market for corporate law. However, an alternative scenario is competition in the market for non-corporate business forms. Indeed, Delaware is already competing successfully by offering non-corporate (limited partnership and LLC) law that is laxer than Nevada corporate law plus access to its superior infrastructure32 all at a significantly lower price than both Nevada and Delaware corporate law.33 The uncorporate alternative provides additional support for this article's proposition that the Nevada phenomenon is not simply a competition over laxity, but rather a more nuanced competition over the nature of agency cost control and the role of legal infrastructure.


29 See Barzuza, supra note 12 at __.


31 See id.


Delaware's limited partnership and LLC statutes provide for near-complete opt-out from all fiduciary duties, comparable to the freedom under the Nevada corporate statute. For example, Delaware's limited partnership statute provides:

(d) To the extent that, at law or in equity, a partner or other person has duties (including fiduciary duties) to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement, the partner’s or other person’s duties may be expanded or restricted or eliminated by provisions in the partnership agreement; provided that the partnership agreement may not eliminate the implied contractual covenant of good faith and fair dealing.

(e) Unless otherwise provided in a partnership agreement, a partner or other person shall not be liable to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement for breach of fiduciary duty for the partner’s or other person’s good faith reliance on the provisions of the partnership agreement.

(f) A partnership agreement may provide for the limitation or elimination of any and all liabilities for breach of contract and breach of duties (including fiduciary duties) of a partner or other person to a limited partnership or to another partner or to an other person that is a party to or is otherwise bound by a partnership agreement; provided that a partnership agreement may not limit or eliminate liability for any act or omission that constitutes a bad faith violation of the implied contractual covenant of good faith and fair dealing.34

Notably, the Delaware uncorporate statutes, unlike both Nevada and Delaware corporate law, provide for complete waiver of fiduciary duties, leaving only "the implied contractual covenant of good faith and fair dealing." Delaware’s courts have confirmed that these statutes do, indeed, allow complete waiver of default fiduciary duties, leaving only a contractual duty that is defined with reference to the parties’ contracts.35 These features of Delaware uncorporations come at a much lower price than either Nevada or Delaware incorporation.36

Delaware uncorporate law provides additional insights into state competition for business association law in general, and Nevada corporation law in particular. As noted above, a key difference between Delaware and other states with regard to both corporate


35 See Ribstein, supra note 32.

36 See Manesh, supra note 33.
and uncorporate law is legal infrastructure. Delaware uncorporate law demands a substantial infrastructure for interpreting agreements that dispense with the rich background of fiduciary duties.\textsuperscript{37} The Delaware uncorporate alternative also raises the question why firms need to go to Nevada to opt out of liability for unintentional breach of fiduciary duty when they can completely avoid fiduciary duties through Delaware uncorporate law.\textsuperscript{38} This supports the above explanation of Nevada law based on error costs rather than laxity.\textsuperscript{39}

III. DID NEVADA ATTRACT MISCREANTS? EVIDENCE FROM RESTATEMENTS

Part I shows that the Nevada statute can be explained as a way to reasonably economize on agency costs rather than more simplistically as a platform for managers to cheat shareholders. But this benign explanation for Nevada law does not eliminate the possibility that, whatever its strategy, Nevada is in fact a haven for cheaters, and therefore contributes to a race-to-the-bottom in the market for corporate law. This Part addresses this argument by analyzing the evidence on the types of firms that are incorporating in Nevada.

Barzuza and Smith approach this determination by using firms' accounting restatements as a proxy for bad governance.\textsuperscript{40} They find that firms incorporated in Nevada between 2000 and 2008, mostly after Nevada changed its law, have a 40% higher likelihood of issuing a restatement than those incorporated in Delaware and other states during this period after controlling for various firm-level characteristics. They note that accounting restatements involve an admission by the firm that its previous accounting was materially inaccurate, as shown by data showing a strong negative market reaction to

\textsuperscript{37} For an analysis of these cases see Ribstein, \textit{supra} note 32. Indeed, this indeterminacy could be as much a problem for uncorporations as for corporations. \textit{See id} at 165-166. This has prompted Delaware's Chief Justice Steele to suggest that Delaware should dispense with \textit{default} fiduciary duties, a change that would move Delaware uncorporate law even beyond Nevada corporate law in "laxity." \textit{See} Myron Steele, \textit{Freedom of Contract and Default Contractual Duties in the Delaware Limited Partnerships and Limited Liability Companies,} 46 AM. BUS. L.J. 221 (2009); Larry E. Ribstein, "Should there be default fiduciary duties in Delaware LLCs and LPs?" \textit{Truth on the Market} (December 9, 2011), http://truthonthemarket.com/2011/12/09/should-there-be-default-fiduciary-duties-in-delaware-llcs-and-lps/.

\textsuperscript{38} In fact, shedding fiduciary duties makes more sense for uncorporations, which trade these duties for other agency cost control mechanisms, particularly including exit and high-powered managerial incentives. \textit{See generally,} Larry E. Ribstein, \textit{THE RISE OF THE UNCORPORATION} (2010).

\textsuperscript{39} Delaware's embrace of open-ended contracting for fiduciary duties raises doubts about Barzuza's argument that Delaware would hesitate to compete with Nevada for laxity in corporate law for fear of diluting its brand or increasing the possibility of federal regulation. \textit{See Barzuza, supra} note 12.

\textsuperscript{40} \textit{See} Barzuza & Smith, \textit{supra} note 12.
Barzuza and Barzuza and Smith also cite data that they argue support the link between restatements and lax governance.\footnote{Barzuza & Smith, supra note 12 at 18-19 (discussing regressions that include firm level fixed effects).}

Note that Barzuza does not claim that Nevada law causes or even permits more accounting restatements. Indeed, Barzuza and Smith found no evidence of increased restatements following reincorporation under Nevada's lax provisions.\footnote{See Barzuza & Smith, supra note 12 at 18-19 (discussing regressions that include firm level fixed effects).} This is not surprising, since accounting fraud is disciplined primarily by federal law. Nevada corporations' higher likelihood of restatements may indicate that Nevada's lax law attracts poorly governed firms. On the other hand, as emphasized throughout this paper, a higher probability of an accounting restatement may simply reflect a rational corporate decision to reduce overall agency costs by investing less in monitoring.\footnote{Indeed, the find that Nevada firms are much less likely to use Big 4 audit firms at the time of the restatement, and generally relay on smaller, regional accounting firms. Id., Table 3, Panel B, and Table 4.} The question, then, is whether Nevada firms' high level of restatements indicates that they are poorly governed not simply because they invest less in monitoring than other firms, but because they choose a level of monitoring that decreases firm value. This depends on the type of restatements prevalent among Nevada firms and the connection between these restatements and firm governance.

For several reasons, the Nevada restatements noted by Barzuza & Smith do not necessarily indicate a high prevalence of fraud, as distinguished from mistakes that could result from a decision not to invest in stringent monitoring. First, the raw data indicate that while Nevada firms are about 60% more likely than other states to require restatements, they are only marginally more likely than Delaware firms to involve fraud allegations or an investigation by regulators (1.3% vs. 1.2%).\footnote{Id., Table 3, Panel A. Note, however, that that there is a positive and significant Nevada effect on fraud allegations in the regressions. See id., Table 5, Panel C.}

\begin{itemize}
\item \footnote{See Kristen L. Anderson & Teri Lombardi Yohn, The Effect of 10K Restatements on Firm Value, Information Asymmetries, and Investors’ Reliance on Earnings (2002), available at \url{http://ssrn.com/abstract=332380}; Coffee, supra note 30.}
\item \footnote{See Barzuza & Smith, supra note 12 at 18-19 (discussing regressions that include firm level fixed effects).}
\end{itemize}
Second, even the restatements accompanied by fraud allegations may not indicate excessively low monitoring that would result in reductions in firm value. Alleging accounting restatements has become a significant way to escape dismissal in the wake of the higher pleading standards under the Private Securities Litigation Reform Act (PSLRA). Because such cases are much more likely to be filed, some of the filed cases will be type I errors. The PSLRA’s heightened pleading requirement therefore may tend to exaggerate restatements’ association with fraud allegations in the post PSLRA data used by Barzuza and Smith.

Third, the data do not indicate that Nevada restatements are the types particularly associated with fraud. Nevada firms lost less income as a result of restatements than firms in other states or than Delaware firms. This suggests that Nevada firms with bad accounting are less prone to inflating income than firms with bad accounting in other states. Revenue recognition in particular has been most directly associated with poor controls. Barzuza & Smith's random sample of restatements indicate a variety of problems that do not point to a particular propensity to fraud. Indeed, Barzuza notes that "[w]e found that no one type of restatements dominates Nevada companies in a way that could explain the frequencies of such restatements." The summary reveals accounting errors that, for example, "do not reflect a net gain or benefit from certain embedded derivative securities; “change [that] * * * did not affect the Company’s earnings or net worth.”; “an adjustment of $79,750 which had been erroneously included in paid-up capital rather than shareholder loans”; and “Company inadvertently failed to record the appropriate expense for such Options in accordance with FAS 123(R).”

Fourth, the association between Nevada incorporation and restatements may be consistent with firms' selecting Nevada because they incur high costs or derive lower benefits from monitoring. For example, Nevada firms may be more volatile than other types of firms. Volatility has been found to be a stronger predictor than size of internal controls weakness. Volatile firms are inherently subject to more influences on earnings variation and therefore may have to invest more in monitoring and accounting controls to

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47 See Barzuza & Smith, supra note 12, Table 3, Panel B.
48 See Anderson & Yohn, supra note 41; Coffee, supra note 30.
49 See Barzuza & Smith, supra note 12, Table A3.
50 Barzuza, supra note 12, n. 150.
avoid restatements. A high propensity for restatements in these firms therefore may reflect economizing on monitoring rather than a likelihood of fraud.

Fifth, Barzuza's emphasis on accounting restatements assumes a link between restatements and weak governance. This assumption arguably supports the inference that managers of weakly governed firms use their power to incorporate in Nevada in order to take advantage of weak ex post judicial scrutiny of their conduct. Indeed, stronger external governance, such as takeover discipline, has been associated with fewer accounting restatements. However, Barzuza and Smith find that Nevada firms actually do not have worse governance than firms incorporated in other states as shown by the "G" and "E" governance indices. This non-correlation in Nevada between governance indices and restatements is consistent with other data showing that governance is no more than weakly related to accounting restatements. This, in turn, would counter the suggestion that the prevalence of restatements in Nevada indicates that poorly governed firms are flocking to that state.

IV. EFFECT OF NEVADA INCORPORATION ON FIRM VALUE

The price investors are willing to pay for Nevada corporations is the ultimate test of whether there is a problem with Nevada law. The value of Nevada firms compared to comparable firms incorporated elsewhere could indicate the market's evaluation of Nevada law's tradeoff between costs and benefits of monitoring.

Barzuza and Smith show that Nevada corporations do not have a lower Tobin's Q than those incorporated in other states, although Nevada incorporation has a less favorable effect on Tobin's Q than Delaware incorporation, which is associated with increased value. However, Barzuza recognizes that Tobin's Q may be an unreliable reflection of shareholder value, particularly in small firms. Moreover, Nevada firms' Tobin's Q may reflect characteristics not controlled for in the regressions rather than the effect of Nevada incorporation.

The most direct evidence of what Nevada law adds or subtracts from the value of firms incorporated there would be an event study showing shareholders' reactions to a publicly held firm's reincorporation to Nevada from some other state. But data that

52 See Baber, et al, supra note 42.
53 See Barzuza & Smith, supra note 12.
54 See David F. Larcker, Scott A. Richardson & Irem Tuna, Corporate Governance, Accounting Outcomes, and Organizational Performance (working paper, 2007).
55 See Barzuza & Smith, supra note 12.
56 See Barzuza, supra note 12 [at 45].
would allow one to examine the stock price effects of Nevada reincorporations is sparse. Our research has disclosed only one publicly held corporation, Dynacq Healthcare, which reincorporated from another state to Nevada for which there was sufficient event and stock price data to enable such an event study. This firm offers a potential opportunity to do a single firm event study based on the firm's stock price reaction to its decisions to reincorporate. Dynacq was initially incorporated in Nevada, reincorporated to Delaware in 2003 and reincorporated back to Nevada in 2006. Two alternative hypotheses might be tested using this single firm: that reincorporation from Nevada to Delaware is a positive event and that reincorporation from Delaware to Nevada is a negative event. We could not reject the null hypothesis that shareholders were unaffected by the decision to reincorporate, as there is no evidence of significant positive abnormal returns generated by the decision to reincorporate to Delaware or of significant negative abnormal returns generated by the decision to reincorporate to Nevada.

Thus, the only corporation that might have offered an opportunity to test shareholder reaction to Nevada vs. Delaware incorporation provides no evidence that would clarify this issue. The most that we can say at this time is that there is a general absence of direct stock price evidence regarding the validity of a Nevada race-to-the-bottom theory.

V. CONCLUSION AND IMPLICATIONS

The 2001 Nevada corporate law amendments reignited the specter of a race to the bottom in corporate law raised by Cary, and suggested a need for federal corporation law advocated by Cary and Berle & Means. However, we have provided a benign explanation for Nevada law that emphasizes firms' decision to reduce agency costs by choosing cost-effective mechanisms for monitoring agents. Rather than supporting federalization, Nevada corporation law indicates the depth and complexity of the state law market for monitoring and therefore an important cost of one-size-fits-all devices for controlling agency costs.

57 During the period we studied, the company was subject to two class action lawsuits. The first occurred during its first incorporation in Nevada, and the lawsuit was dismissed. The company subsequently reincorporated to Delaware. Soon after, the company was forced to delay the filing of its quarterly and annual reports, which lead to an earnings restatement, delisting, and a second round of class action suits. These suits are summarized at http://securities.stanford.edu/1023/DYII02-01/ and http://securities.stanford.edu/1029/DYIIIE03-01/.

58 We used a one tailed non-parametric SQ test to test the null hypothesis. For a discussion of this tests and its use in single firm event studies, see Jonah B Gelbach, Eric Helland, and Jonathan Klick, Valid Inference in Single-Firm, Single-Event Studies, (January 6, 2011), available at http://ssrn.com/abstract=1442222. In the case of the firm’s decision to reincorporate back to Nevada, there is a single negative and significant abnormal return on the date of board meeting where the reincorporation decision was made. However, this date precedes the public disclosure date, and there is no evidence of any insider selling on or around the date of the board meeting.
Data on the causes and effects of Nevada incorporation could change this conclusion. However, the data so far are inconclusive. This raises the question of the appropriate burden of proof of problems with state law that could warrant federal override. Even if some evidence were to indicate that Nevada was providing a refuge for inefficiently governed firms, it is not clear that this would justify outlawing experimentation in the market for state law. Problems with a first-mover state like Nevada are likely to be sufficiently salient that shareholders in Nevada corporations know what they are getting. As long as the market applies an appropriate discount, there is room for Nevada-type experimentation.

All of this is not to say that the market for corporate law functions perfectly. In particular, it is still not clear why there are only two competitors in the market for law, why one of these competitors is dominant, and why there is not more diversity in state corporate law. We have elsewhere suggested that the problem may lie in government legislators' weak incentives to innovate and the limited and skewed incentives for private parties' participation in the market for business association standard forms. If private actors had stronger property rights in law, they might have an incentive to create a variety of different standard forms which states could adopt. There might then be more alternative standard forms and more variations on each standard form.

In general, the market is still learning about what does and does not work in corporate governance. Just as Berle & Means' warning of the dangers of separating ownership and control have given rise to a large literature on offsetting benefits of this separation and how the dangers can be addressed, so Cary's warning about Delaware's race-to-the-bottom spawned theories and evidence concerning the benefits of the market for corporate law. We should now be skeptical about substituting Nevada for Delaware as the new "bottom" and should wait for more evidence that Nevada represents a system problem before attempting to regulate it.

59 See Kobayashi & Ribstein, supra note 25.