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Delaware's Familiarity

Brian J. Broughman

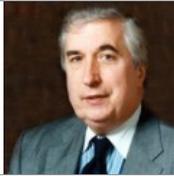
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Delaware's Familiarity



By [Brian J. Broughman](#) and [Darian M. Ibrahim](#) November 6, 2014

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The following post comes to us from Brian J. Broughman, Associate Professor of Law at the Indiana University Maurer School of Law, and Darian M. Ibrahim, Professor of Law at William & Mary Law School. It is based on their recent papers, "Delaware's Familiarity," which is forthcoming in the San Diego Law Review and available [here](#), and "Delaware Law as Lingua Franca: Theory and Evidence," which is forthcoming in the Journal of Law and Economics and available [here](#).

One of the enduring topics of interest in corporate law is why Delaware dominates the market for incorporations. The "internal affairs" rule allows corporations to choose which state's law will govern their corporate affairs. Yet the overwhelming majority of corporations choose to domicile in Delaware, or in lesser numbers, their home states. Delaware is the only state that attracts a significant number of out-of-state incorporations.

The existing literature falls into two camps—"race-to-the-top" and the "race-to-the-bottom"—both of which credit Delaware's success to the quality of its corporate law and the expertise of its judges. Under the "race-to-the-top" view, Delaware has prevailed because it provides a body of law that protects the interests of shareholders. Under the "race-to-the-bottom" view, management chooses to incorporate in Delaware because its law favors managerial interests, possibly at the expense of shareholders.

In a pair of new studies—*Delaware's Familiarity* and *Delaware Law as Lingua Franca* (coauthored with Jesse M. Fried, Professor, Harvard Law School)—we consider an alternative explanation for Delaware's success: familiarity. After decades of dominance, business parties—including investors and legal counsel—have become increasingly *familiar* with Delaware law, causing it to function as a "lingua franca," or common language. A close analogy is the use of English as a common language in international business deals. We believe that Delaware law serves the same lingua-franca function for investors from different U.S. states.

We find that startup firms financed by out-of-state investors are more likely to incorporate in Delaware. We argue that this is due to out-of-state investors' familiarity with Delaware corporate law and relative lack of familiarity with the corporate law of the startup's home state. The more out-of-state investors, the more likely such investors share in common only a familiarity with Delaware corporate law, as opposed to home state law or third state law. In short, Delaware law is needed as a lingua franca that investors from various states all "speak," since they do not all speak home state (or third state) law.

We collected data on 1,850 US startup firms financed by venture capital (VC). VC-backed startups provide a desirable empirical setting, as they exhibit heterogeneity regarding investor location. Some VC-backed startups receive out-of-state financing, while others are funded primarily by in-state investors. Furthermore, because VCs are financed in stages, there is also heterogeneity over time in the mix of in-state and out-of-state investors. This variation allows us to test the importance of investor familiarity as a determinant of incorporation choice in our regression analysis. Indeed, it is difficult to think of another type of firm that exhibits this kind of heterogeneity in investor location necessary to test the familiarity hypothesis.

Our most salient empirical results are as follows. First, we find that the race for VC-backed startup charters is a "bi-modal" race between Delaware and the startup's home state. Only a small percentage of startups in our sample chose to incorporate or reincorporate in a state that was not either Delaware or the startup's home state. Second, in this bi-modal race, Delaware beats the home state handily. Almost sixty eight percent (67.8%) of startups choose Delaware as their initial state of incorporation, versus twenty nine percent (28.7%) choosing their home state. When incorporations and reincorporations are combined we find that 79% of the firms in our study ultimately chose Delaware.

Third, out-of-state investors have more impact on choice of domicile than in-state investors. For example, moving from one out-of-state investor to four or more out-of-state investors after the initial round of financing is associated with an approximate 17% increase in Delaware incorporation. By contrast, the same increase in the number of in-state investors only increases Delaware incorporation by approximately 2%. This basic result holds up to numerous tests for potential endogeneity of out-of-state financing, including reincorporation and a VC fixed effect analysis. Our research suggests that it is not the number of investors that matter, but rather their location. This finding and others like it, detailed in the two articles, are strongly supportive of our investor familiarity hypothesis.

The normative implications of our findings are both positive and negative. On the positive side, familiarity with Delaware law can lower transaction costs for firms seeking financing from out-of-state investors. Familiarity may also make it easier for corporate lawyers to negotiate a complex financing arrangement at low cost to the client, potentially lowering the overall cost of capital. On the other hand, because of familiarity Delaware law may still be chosen even if it is not the "best" law. Familiarity may create a barrier to another state seeking to compete with Delaware, hindering desirable state-level innovation. A competing state would not only need to provide better law, but it must also overcome lack of familiarity that may prevent parties from adopting the alternative law.

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