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Robert Rhee's Article, *The Irrelevance of Delaware Corporate Law*,[1] poses provocative questions about why Delaware dominates the market for corporate law given the apparent irrelevance of state incorporation choice for companies' market valuations. He shows, first, that publicly traded companies incorporated in Delaware have similar valuations to companies incorporated in other states over time, and second, that market actors do not exhibit a preference to reincorporate existing firms in Delaware.

Rhee analyzes exclusively the realm of publicly traded corporations, which is understandable given that his analysis is necessarily limited to publicly available data. Publicly traded corporations are undeniably economically significant, yet they constitute only one method of carrying out economic activity that, arguably, is shrinking in importance over time.[2] When one considers the space of non-publicly traded corporations, a different picture emerges. This response considers that space below and then offers some thoughts on how these competing pictures might be reconciled.

I. ALTERNATIVE ENTITIES

The alternative entity space—LLCs and different types of partnerships—has exploded in importance in recent years. In Delaware, the prominent player in this space, the number of alternative entities now stands at over three times the number of corporations.[3] As with corporations, alternative entities can organize under the laws of whichever state they choose, thereby adopting that state's laws for matters involving the internal governance of those entities. Is Delaware law irrelevant for these entities as Rhee claims it is for publicly traded corporations? There are reasons to think not, as a matter of both theory and empirics.

First, as a matter of theory, state law governing alternative entities is neither as old nor as well-settled as corporate law. Alternative entities did not achieve practical economic

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1. Robert J. Rhee, *The Irrelevance of Delaware Corporate Law*, 48 J. CORP. L. 295 (2023).

2. *See, e.g.*, Peter Molk & D. Daniel Sokol, *The Challenges of Nonprofit Governance*, 62 B.C. L. REV. 1497, 1498–99 (2021) (discussing the large-scale impact and recent developments of nonprofits); Elisabeth de Fontenay, *The Deregulation of Private Capital and the Decline of the Public Company*, 68 HASTINGS L.J. 445, 452–61 (2017) (discussing declines in the public equity markets); Peter Molk, *How Do LLC Owners Contract Around Default Statutory Protections?*, 42 J. CORP. L. 503, 504–05 (2017) (addressing LLCs' rising popularity).

3. Peter Molk, *Uncorporate Insider Trading*, 104 MINN. L. REV. 1693, 1710 (2020).

significance until the last few decades; corporations achieved this practical significance well over a century ago. Consequently, state alternative entity law has had neither the number of years nor cases to develop an optimal, standardized approach for dealing with legal issues as has corporate law. Of course, some areas of alternative entity law mimic analogous provisions of corporate law, effectively leveraging the well-settled attributes of those provisions. Others, however, are new, giving rise to meaningful differences in states' approaches.

Perhaps nowhere is this newness as important as with the foundational question of whether alternative entity governance provisions apply merely by default to investors or are instead mandatory protections. Delaware is comparatively unique in its strong statutory commitment to default-only protections; most protections can be, and are, waived by these alternative entities.[4] Traditional mandatory protections from corporate law, such as management's fiduciary duties, the right to seek judicial dissolution, and owner inspection rights, can all be reduced or eliminated under Delaware alternative entity law, dramatically affecting the mix of owner protections and companies' cost of capital.[5] Although some states imitate Delaware's contractual freedom approach, there remains a meaningful amount of heterogeneity that may, as a matter of theory, render Delaware law important and meaningfully different from other states' approaches to alternative entities.[6]

State law may theoretically be relevant for alternative entities, but how about as a matter of empirics? Here, too, there is evidence that Delaware law matters. In a recent work,[7] I have examined the impact of the Delaware Supreme Court's *Gatz Properties v. Auriga Capital Corp.*[8] case, which upended the accepted state of Delaware statutory alternative entity law by questioning whether fiduciary duty protections apply, even by default, or whether those protections must be affirmatively adopted by alternative entities.[9] The legal community broadly construed this decision as a meaningful decrease in the relative attractiveness of Delaware law.[10]

4. *See* Mohsen Manesh, *Creatures of Contract: A Half-Truth About LLCs*, 42 DEL. J. CORP. L. 391, 403 (2018) (discussing freedom of contract principles found in Delaware LLC law); Peter Molk, *Protecting LLC Owners While Preserving LLC Flexibility*, 51 U.C. DAVIS L. REV. 2129, 2138 (2018) (describing Delaware as "the leader for out-of-state LLC formations" in part because of its commitment to contractual freedom); Mohsen Manesh, *Contractual Freedom under Delaware Alternative Entity Law: Evidence from Publicly Traded LPs and LLCs*, 37 J. CORP. L. 555, 560–62 (2012) (identifying default protections); Peter Molk & Verity Winship, *LLCs and the Private Ordering of Dispute Resolution*, 41 J. CORP. L. 795, 800–11 (2016) (studying several default protections in Delaware LLC agreements); Suren Gomtsian, *The Governance of Publicly Traded Limited Liability Companies*, 40 DEL. J. CORP. L. 207, 209 (2015) ("LLC members are free to choose a governance that best fits their needs. This is in stark contrast to listed corporations that have to comply with mandatory governance structures offered by the law.").

5. Peter Molk, *How Do LLC Owners Contract Around Statutory Protections?*, 42 J. CORP. L. 503, 510–11 (2017).

6. *See, e.g.*, 2 LARRY E. RIBSTEIN, ROBERT R. KEATINGE & THOMAS E. RUTLEDGE, RIBSTEIN AND KEATINGE ON LIMITED LIABILITY COMPANIES 129–46 (2d ed. 2022) (tabulating states' varying approaches to fiduciary duty waivers).

7. *See generally* Peter Molk, *Delaware's Dominance and the Future of Organizational Law*, 55 GA. L. REV. 1111 (2021) (speaking to the idea that Delaware law is meaningfully different from other approaches and has a significant impact on this area of law).

8. Gatz Props. v. Auriga Cap. Corp., 59 A.3d 1206 (Del. 2012).

9. *Id.* at 1212–22.

10. Molk, *supra* note 7, at 1143.

I found two notable impacts from *Gatz*. First, the decision was immediately associated with a decrease in the value of the handful of publicly traded, Delaware-organized alternative entities that exist relative to Delaware corporations whose law was unaffected by the decision. This decrease was significant and persistent—on the order of 2.5% to 5%—suggesting that the decision had a negative effect on the value of existing Delaware-organized, publicly traded alternative entities.[11] Second, the decision was associated with a long-term decrease in the formation rate of new privately-held alternative entities in Delaware relative to other states, suggesting the decision reduced the attractiveness of Delaware as a place to form new alternative entities.[12]

These decreases in value and formation rate could have been due to a variety of factors such as a change in Delaware law, a change in the value of Delaware's judiciary, or a change in the perceived degree that Delaware commits to producing responsive organizational law. Any of these factors would suggest that the state of organization matters for alternative entity law. How could this be true for alternative entities, but not publicly traded corporations? My response returns to possible explanations later, after first considering, in Part II, additional evidence for how the state of incorporation may matter for nonprofits.

II. NONPROFITS

I next turn to nonprofit corporations. Nonprofits are organizations that are statutorily barred from distributing accrued profits to private individuals.[13] Like other types of organizational forms, nonprofits can incorporate under the laws of any state they wish, and the incorporation state will supply the laws that govern internal disputes. Nonprofits are fundamentally different from the publicly traded corporations that Rhee analyzes. Is there reason to think Delaware law matters for nonprofits?

Although the statutory bar on profit distribution means nonprofits lack the investor class that other organizations have, state law regarding internal governance still theoretically matters to their operations. State nonprofit law determines the scope of management's fiduciary duties, whether nonprofit members and other parties have standing to sue derivatively on the nonprofit's behalf, who has inspection rights, and other related matters of internal governance. These factors in turn can affect the nonprofit's organizational performance. Nonprofits with robust fiduciary duties and other legal protections may be able to attract donor funding more easily since they can credibly promise those donors that funds will be spent wisely. These nonprofits may also have a competitive market advantage in industries with asymmetric information where nonprofits historically perform well, like healthcare services, because they may more credibly signal to customers that there is no adverse interest for the nonprofit to prioritize over customers.[14]

In principle, then, state law could theoretically matter for nonprofits just as it seems to matter for alternative entities. But what do actors' revealed preferences demonstrate?

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11. *Id*. at 1151.
12. *Id.* at 1155–59.
13. *See* Henry B. Hansmann, *The Role of Nonprofit Enterprise*, 89 YALE L.J. 835, 838 (1980) (discussing this prohibition).
14. *Id*. at 889 (developing this theory of nonprofits' comparative market advantage).

Some empirical evidence suggests that, at least for many nonprofits, the incorporation state may be largely irrelevant. In an examination of nonprofit incorporation decisions, I found that the vast majority (95%) of nonprofits incorporate in their headquarters state.[15] One explanation for this home-state preference is that the choice of state law does not matter for these nonprofits, so they might as well incorporate in their headquarters state to economize on filing fees and regulatory burdens.

However, when examining the 5% of nonprofits that incorporate elsewhere, state law seems to matter a good deal. On average,[16] these nonprofits appear to choose their state of incorporation to facilitate exacerbation of managerial agency costs.[17] Nonprofits with indicators of problematic managerial agency costs more often incorporate out-of-state, and changing one's state of incorporation is associated with an increase in agency cost indicators post-reincorporation. Moreover, after New York strengthened its nonprofit laws in 2014, it experienced lower rates of new nonprofit formations relative to other states. Additionally, nonprofits that left New York after the law change were more likely to have indicators of higher agency costs than before they reincorporated.[18] For this appreciable subset of nonprofits, then, state law seems very important, so much so that it may even drive companies to reincorporate in search of their preferred set of state statutory rules.

III. RECONCILING THE DIFFERENCES

How can it be that organizational law is irrelevant for publicly traded corporations, as Rhee argues, yet remains relevant for other entity types? One answer may be that corporate law actually still matters for publicly traded corporations, just like other types of entities, despite the empirical findings that Rhee uncovers. Rhee finds that firms incorporated in Delaware have no valuation premium relative to firms incorporated in other states, and that market participants do not agitate firms incorporated elsewhere to reincorporate in Delaware.[19] One explanation consistent with these findings, which Rhee advances, is that Delaware law is irrelevant.

However, perhaps it is the case that Delaware law is relevant, but only for some publicly traded corporations, with most of those companies already having sorted themselves into Delaware. More concretely, suppose there are two types of firms: those that are capable of self-policing—perhaps because of stock ownership by activist investors, widespread analyst coverage, an attentive board of directors, or being in the public eye—and those that are not. Firms capable of self-policing would benefit from Delaware's comparatively hands-off approach to internal governance, while firms less capable of self-policing would benefit from incorporating elsewhere in a jurisdiction with robust judicial or regulatory oversight. If firms optimally sorted themselves into each jurisdiction, then we would not expect to see an arbitrage opportunity of incorporating non-Delaware firms in Delaware as Rhee observes; in fact, reincorporating firms into Delaware would be value-

15. Peter Molk, *Where Nonprofits Incorporate and Why It Matters*, 108 IOWA L. REV. (forthcoming 2023).

16. This will certainly not be true for every nonprofit; no doubt some incorporate in a jurisdiction with "strong" law to commit to minimizing these costs.

17. *See generally* Molk, *supra* note 15 (finding that nonprofits incorporate out-of-state to exacerbate managerial costs).

18. *Id.*

19. Rhee, *supra* note 1, at 351.

reducing for those firms. We likewise would not expect to see cross-sectional differences between Delaware-incorporated firms and firms incorporated elsewhere; firms' optimal sorting into efficient jurisdictions would obscure any differences.

In that case, I would agree with Rhee that Delaware corporate law is largely irrelevant, but only for the subset of firms that have sorted themselves to a different state whose law is superior for their situation. This story may be analogous to what is observed among nonprofits, where the low rate of out-of-state incorporations may arise because, for most nonprofits, state law is comparatively irrelevant. This is not to say nonprofit law as a whole is irrelevant since, as discussed above, an appreciable minority of nonprofits incorporate out-of-state and are apparently responsive to changes in state law. Rather, just like Delaware corporate law, state nonprofit law is relevant only for a subset of nonprofits—the subset that can benefit from out-of-state incorporations.

This hypothesis could be tested in a variety of ways. Ideally, we could randomly reassign existing publicly traded firms to different incorporation states and see the effect on firm valuations. Rhee's conclusion would suggest that market valuations would be unaffected by whichever state to which firms were randomly assigned; proponents of the relevance of state incorporation choices would expect to see a difference in firm valuations.[20] Of course, those studies are not feasible in the real world, but a reasonable alternative would be to extend Rhee's empirical work over a longer time period, analyzing how changes to state law impact firm valuations.[21] Rhee's conclusion would suppose these changes, if not regarding fundamental rules, would have little effect on firm values;[22] proponents of the relevance of incorporation choice would expect otherwise.

It may also be that core differences between publicly traded corporations and other organizational forms mean that state law is irrelevant for publicly traded corporations, as Rhee argues, but not for other forms. There are several fundamental differences that may contribute to this explanation.

One is that publicly traded corporations, with their freely transferrable shares, give investors an easy right of exit while privately held organizations generally do not. Investors in any type of firm are commonly thought to have three tools available to hold management accountable: exit, voice, and liability.[23] Owners can exit by selling their shares in a company; they can exercise voice by electing different management; or they can pursue liability, holding management liable for violations of state fiduciary duty law. If these tools are substitutes, as is commonly assumed, then owners that possess a strong version of one of these rights may be less likely to exercise the others.[24] Ease of exit, therefore, would make it less likely that investors would exercise a liability right, making the choice of

20. *See id.* at 334–35 (discussing scholarly support for Delaware's relevance).

21. *See, e.g.*, Sarath Sanga, *Network Effects in Corporate Governance*, 63 J.L. & ECON. 1, 4–5 (2020) (studying the effects of Delaware's adoption of its 102(b)(7) liability waiver).

22. Rhee, *supra* note 1, at 313 ("If the efficiency of law has reached a steady state for the moment, absent changes in the mix of fundamental rules, the law would be irrelevant to firm value.").

23. ALBERT O. HIRSCHMAN, EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES 2–5 (1970) (discussing exit and voice); Henry Hansmann & Reinier Kraakman, Exit, Voice and Liability: The Dimensions of Organizational Structure 6 (June 2008) (unpublished manuscript) (on file with author) (discussing exit, voice, and liability).

24. *See, e.g.*, HIRSCHMAN, *supra* note 23, at 34 (arguing that a lack of an exit option implies a greater willingness to exercise voice).

liability-defining state law less important for publicly traded corporations (with their ease of exit) than for privately held ones (with their exit restrictions).

This is a question that could be examined empirically. Closely held companies vary in their ease of exit. Most privately held corporations and LLCs, for instance, significantly restrict owners' exit rights.[25] Cooperatives, on the other hand, generally grant owners fairly strong exit rights, giving them the flexibility to leave at any time and, upon leaving, returning those owners' capital contributions and proportionate share of accumulated earnings.[26] If this theory had explanatory power, then we might expect closely held LLCs and corporations to be more affected by differences across state law (as I discussed above), while cooperatives may be less so.

A second explanation lies in the market for organizational control that exists for publicly traded corporations but is rare, or nonexistent, for other types of firms. Because publicly traded corporations combine freely transferable shares with voting proportional to the number of shares owned, wayward management can be replaced by an activist investor who assembles a significant enough ownership stake. Just as with exit, then, investors in publicly traded corporations have a viable alternative to liability to hold management accountable, perhaps rendering liability-defining legal rules of lesser importance. Privately held firms, however, typically do not have freely transferable shares,[27] making it impossible for an investor to accumulate sizable voting stakes to replace management. Cooperatives and mutuals often exacerbate this problem by giving owners equal votes irrespective of their ownership stakes, and nonprofits generally give members, at best, equal votes and often no votes.[28]

For these alternative organizational structures, there is no meaningful market for corporate control, meaning substitute protections provided by legal rules may be more meaningful and, therefore, differences in state law may be more consequential for these firms' valuations. Again, this question could be empirically examined by comparing state organization choices of alternative entities with no market for organizational control with otherwise similar alternative entities that, because of share transferability or proportional voting, have at least some potential organizational control market.

Finally, perhaps it is the case that there is minimal interstate variation in statutory rules for corporate law but more meaningful variation for statutory law of alternative entity types. If the rules of the game are the same regardless of one's state of incorporation, then the incorporation state will have little effect on firm value.[29] Whether for pride, budgetary,

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25. Susan S. Kuo & Benjamin Means, *The Political Economy of Corporate Exit*, 71 VAND. L. REV. 1293, 1300–01 (2018).

26. Peter Molk, *The Puzzling Lack of Cooperatives*, 88 TUL. L. REV. 899, 926 n.118 (2014) ("Nevertheless, cooperative member-owners are largely free to terminate their relationship with the cooperative, making the threat of exit a constraint on management activity.").

27. Kuo & Means, *supra* note 25, at 1300 n.40.

28. Henry Hansmann, The Ownership and Governance of Mutual Insurance Companies 8, 29 (Aug. 9, 2022) (unpublished paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4186367 [https://perma.cc/C3SD-6Y5P].

29. It would also have to be the case that the judicial body interpreting those rules would not vary meaningfully by state (or that the likelihood of litigation is nonexistent) and that the rules of one state would not deteriorate significantly in the future (or that, if they did deteriorate, corporations could fairly easily reincorporate elsewhere). As Rhee notes, it is commonly thought that there is meaningful divergence across both these dimensions. Rhee, *supra* note 1, at 338.

or other reasons, states have continually fought to retain domestic incorporations and attract new ones even as Delaware has long held its advantage in the market for publicly traded firm incorporations.[30] Attempts to attract publicly traded corporations may give rise to more homogenous law that matches corporations' preferences, potentially leading to little variation in statutory corporation law across state lines. This competition has likely pushed these states to emulate Delaware's approach to corporate law, leading to a fairly homogenous set of rules among publicly traded corporations.

It is unclear, however, whether this state chartering competition extends to other entity types. Most states charge token franchise fees for these other forms, which largely mitigates states' financial incentive to attract them with the intensity that exists with publicly traded corporations. If there is little incentive to attract these other forms, then there is also little incentive for state legislatures to tailor state law to match the preferences of those alternative forms, potentially leading to more divergence among states in statutory organizational law. In that case, we might expect state law to be more relevant—and more impactful on market valuations—for these alternatives than for publicly traded corporations. We might begin to explore this hypothesis empirically by assessing the similarities and differences across state statutory laws for different organizational forms. We could also examine how organizations—both publicly traded corporations and otherwise—respond to meaningful changes in those state laws.

IV. CONCLUSION

These explanations should not be taken to form an exhaustive list of possibilities. No doubt there are other potential explanations as well. Rhee's valuable contribution helps justify the value in exploring these questions as we seek a full understanding of organizational jurisdiction choices across the complete suite of organizational forms.

30. *See, e.g.*, *CT Seeks to Challenge Delaware's Business-Friendly Legal Environment*, HARTFORD BUS. J. (June 9, 2014), https://www.hartfordbusiness.com/article/ct-seeks-to-challenge-delawares-business-friendly-legal-environment [https://perma.cc/UR8Q-M5NP] (describing Connecticut's effort "to create a 10-year plan to challenge and eventually overtake Delaware as the leading state in the country for businesses and corporations to locate, incorporate and do business").