

UNCORPORATIONS AND THE DELAWARE STRATEGY

*Saul Levmore**

The emergence of limited liability companies and other so-called unincorporate business entities raises a number of interesting questions. This essay argues that federal regulation often follows or competes with state regulation, rather than arising in a vacuum, and that both sources are apt to produce regulation in response to crises. States have enabled unincorporations, but these creations have been followed by state regulation. It is to be expected that federal regulation will follow, so that unincorporate law will be a mix of state and federal law, as is presently the case for corporate law. In turn, this essay predicts that the regulatory gap between corporate and unincorporate law will narrow.

The essay goes on to suggest that Delaware can be thought of as pursuing a distinct strategy with respect to corporations and unincorporations. This strategy is in transition. In order to extend its dominant position from the market for corporate law into that for unincorporate law, Delaware must first welcome unincorporate forms. In time, however, we can expect some revenue extraction at the state level, as well as federal intervention. The critical competition is between Delaware and the federal government.

I. INTRODUCTION

Will jurisdictions that dominate corporate law dominate partnership law, and other “unincorporate” (noncorporate) forms, as well? Should we anticipate federal legislation with respect to partnerships, limited liability companies, and other “unincorporations,” to recapitulate federal involvement in corporate law? These are important questions without obvious answers. These questions are avoided, or perhaps simply not confronted, in the academic literature, which is otherwise rich in its discussion of incorporation and alternatives to it. In this essay, I set out a few claims with respect to these matters, and then a blueprint for future work. The

* Dean & William B. Graham Professor of Law, University of Chicago Law School. I am grateful for suggestions received from Kevin Blackman, John Coates, and Larry Ribstein, and from participants at the University of Illinois Incorporation Symposium in April 2004.

first of these claims is that, contrary to conventional wisdom which depicts federal intervention as arising where there is a regulatory vacuum, national regulation often follows substantial state regulation. The second is that it is useful to think of Delaware as pursuing a distinct strategy with respect to corporations and unincorporations. The nature of this strategy and the thinking behind it is, however, open to interpretation, as the Delaware strategy is consistent with a variety of policies and assumptions about competitive behavior.

This essay draws on two important articles as starting points for these inquiries. One is a paper by Professor Larry Ribstein on the puzzle of the dominance of the corporate form,¹ and the other is one by Professor Mark Roe on the importance of federal-state, as opposed to interstate, competition in the regulation of corporations.² Part II offers a brief review of these contributions, with some critical reactions. Part III incorporates an argument about the role of crises in bringing about federal incursions into business law. This evolutionary explanation makes it possible to weave together the pattern of federal-state competition for corporate law with notions about the competition, if it can be called that, between corporate law and partnership (and other “unincorporate”) law. Part IV brings on the puzzle of Delaware’s own incorporation-unincorporation strategy. Part V concludes with some ideas for future work.

II. THE POPULARITY OF THE CORPORATE FORM AND ITS REGULATION

A. *Why Corporations or Unincorporations?*

Professor Ribstein first asks why corporations remain so popular and then declines to accept conventional—and inadequate—answers.³ The question arises because unincorporations’ income is generally taxed less, which is to say once rather than twice, and because they offer substantial flexibility for co-venturers who want to blaze their own path even as there are default rules for those who want tried and true rules to govern their principal-agent, formation, dissolution, and other arrangements.⁴ A sophisticated observer might insist that businesses prefer the corporate form, and especially Delaware’s version of it, because there is a great deal of experience and settled law for such entities.⁵ The default

1. Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183 (2004).

2. Mark J. Roe, *Delaware’s Competition*, 117 HARV. L. REV. 588 (2003).

3. Ribstein, *supra* note 1, at 196–96.

4. In the spirit of this Symposium, I endeavor to use the terms unincorporations and unincorporate law interchangeably with expressions such as noncorporate forms, or partnership law and limited liability company law, meaning always to refer to the law enabling and regulating noncorporate forms of business activity.

5. Alternatively, attorneys may be continuing to guide clients towards corporate forms because they are familiar with the legal implications of different strategies under corporate law. This trend

rules for corporations may often be more mandatory than default in character, but they provide predictability, or at least a kind of mainstream solidity, that can be attractive to investors. If investors choose nonwaivable, clear rules of engagement over flexible, and even less expensive material, we might simply recognize this preference for experience and certainty. There is much more to be said about Delaware's advantage, but this is hardly the place to tweak conventional wisdom on that subject. I will proceed with the shared and common understanding that, at present, Delaware is simply immensely popular, perhaps because of network effects (with so many corporations arranged there, it is convenient to share in the pool of law and practitioners operating in that stew) or reliability.⁶ Delaware is also said to be beholden to corporations which provide it with substantial tax revenue,⁷ though that claim is a more vulnerable one, and is touched on below.⁸

Twenty years ago it may have been convincing to claim that the prevalence of corporations in the business sector could be explained by the fact that the law surrounding these entities was more certain, and that legal certainty or even network effects explained the dearth of partnerships and other forms. But time has weakened that explanation, for the intervening years and potential profit have not done much to stimulate change.⁹

There is no shortage of attempts to explain the dominance of the corporate form. Thus, one contrarian approach is to argue that the apparent tax disadvantage of two-tier corporate taxation is actually an advantage because it puts all investors on equal footing with respect to an enterprise's disposition decisions.¹⁰ It is thus possible that corporations are popular because tax law, combined with the structure of the corporation, facilitates the pooling of capital.

But these ideas are clever after-the-fact attempts to explain the world that we know, a world in which the corporate form dominates. They are hardly neutral reactions or assessments of the likely impact of

may be due to risk aversion on the part of attorneys, or to the lower transaction costs associated with the use of familiar, corporate law.

6. See Ronald J. Gilson, *Globalizing Corporate Governance: Convergence of Form or Function*, 49 AM. J. COMP. L. 329, 350 (2001) (noting that the aggregation of public companies in Delaware creates a "de facto national corporate law"); Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908, 1910-11 (1998) (discussing Delaware's sources of competitive advantage).

7. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, J.L. ECON. & ORG. 225, 276 (1985).

8. See *infra* note 27 and accompanying text.

9. "If network externalities really did impede efficient evolution, partnership-type firms likely would opt for the LLP rather than the LLC form. In fact, the opposite has occurred . . ." Larry E. Ribstein, *The Evolving Partnership*, 26 J. CORP. L. 819, 833 (2001).

10. Hideki Kanda & Saul Levmore, *Taxes, Agency Costs, and the Price of Incorporation*, 77 VA. L. REV. 211, 234-36 (1991) (arguing that the two-tier tax causes investors in different tax brackets to be single-minded about disposition decisions within the corporation, though differing about distribution decisions out of the corporation).

legal rules. One suspects that if partnership law or limited liability law became as dominant and well settled as corporate law is at present—though it should be noted that corporate law is not that stable when all is said and done¹¹—it would in fact be easier to explain the evolutionary success of those systems. Nor is any perceived advantage or disadvantage to the early-mover sufficient to explain the world of business law that we know.¹² A variety of forms has been tried, and the returns to successful innovation (along with the benefits available to states and law firms that facilitate such success) are so great as to make a first-mover argument implausible. At least where large enterprises with pooled capital are concerned, unincorporations are common only in a small set of industries.¹³ A fair-minded observer must surely find the dominance of the corporate form a bit puzzling. In any event, Professor Ribstein devotes some space to conventional responses to the Why Corporations? question,¹⁴ and I will proceed under the assumption that this is not the place to try out other ideas or counterarguments. Professor Ribstein's readers are, as usual, safe in his hands.

For the purposes of the present essay, I follow most observers in focusing not on the tax bite associated with corporations but rather on the cost of the corporate form in terms of managerial flexibility. Mandatory governance rules may be attractive to many businesses because they provide commonly understood default rules that investors can count on. An enterprise that sought new capital, and disclosed that it would announce at some future time what governance rules apply to it, would surely need to pay more for capital than if it offered the investors some certainty about the rules of the game. On the other hand, there must be many businesses that would prefer to, and would do better if they could, con-

11. Delaware's fluctuating takeover law in the mid-1980s is such a case. The Delaware "court decisions zigzagged" during this period, giving little guidance to future litigants. See *Roe*, *supra* note 2, at 626. Students of corporate law are also familiar with changes, or even unpredictability, in Delaware law with respect to corporate law issues such as special litigation committees and sale-of-control issues.

12. A state that was an early-mover might gain some business either because it signaled its reliability in seeking to accommodate business and its perceived needs, or simply because firms would migrate in response to an innovation and then have no need to migrate away. On the other hand, first-movers can make drafting errors, and second-movers can gain a reputation for reliably imitating good innovations. Somewhat similarly, at the level of the firm rather than the state, first-movers might be disadvantaged by the higher transaction or information costs associated with the use of a new form. The market may trade new unincorporations at a discount because of uncertainty about the qualities of the untested form. Managers may, therefore, have little incentive to choose an unincorporate form before it is well-known and, in turn, it is possible that it will not become well-known. In the long run, with so much money at stake, it is hard to believe that the "best" forms will not emerge and win out. Cf. Daniel S. Goldberg, *Choice of Entity for a Venture Capital Start-up: The Myth of Incorporation*, 55 *TAX LAW*, 923, 950 (2002) (stating that the LLC will be the "best" choice in most start-up situations because of its tremendous flexibility).

13. The location of unincorporations is not well explained. Conventional wisdom is that tax law explains the emergence and even prevalence of public limited liability companies (LLCs) in the real estate and natural resources industries. These businesses are able to identify more than ninety percent of their income as passive income and thus enjoy single-tier, pass-through taxation. See I.R.C. § 7704 (2000).

14. See Ribstein, *supra* note 1, at 187–89.

tract out of or simply avoid much of the corporate law that Delaware, or another state, imposes. Professor Ribstein emphasizes that partnership-like forms are more flexible in this regard,¹⁵ and I will follow his lead and use the word “flexible” to mean capable of contractual design in a way that is inconsistent with, and more liberal than, that required of Delaware corporations by that state’s legislature and courts. The idea is that courts will second-guess corporate managers, even as they allow partnership-like entities to be governed by the firm-specific rules drafted by their clever lawyers, most often in the context of *ex ante* contractual agreements.¹⁶

The overall picture is one in which, setting tax considerations aside, the partnership form (along with other unincorporate forms) is superior for many sophisticated investors. Anything a corporation can do, a partnership can do better. The partners can contract, or select defaults, to be like corporations in terms of governance norms. But when they want something different, perhaps because their own principal-agent relationships will thrive with different rules, they can simply contract for that as well. Viewed this way, corporations are certainly more rigid than partnerships.

Put somewhat differently, or at least in more illustrative terms, corporate law emphasizes, encourages, and to some extent mandates the primacy of the board of directors (though it is apparent that managers can influence and anoint these directors to a large degree) and the power of courts to respond to and encourage shareholder lawsuits interpreting the managers and directors’ fiduciary duties. This regulatory framework may not be optimal for all firms and shareholders, and one solution is to offer an alternative regime or simply to allow shareholders the right to cash out.¹⁷ In some sense this is precisely what partnership law offers. Readers who prefer a nonbusiness analogue might think about the realm of politics, where many of our rules are mandatory.¹⁸ Some citizens might prefer significantly more direct democracy than is permitted in our federal political system, for example. Direct democracy, of a sort, is much more easily integrated into a partnership than it is into a corpora-

15. See Ribstein, *supra* note 1, at 216–23 (emphasizing the flexibility of partnership and other unincorporate law with reference to case law and also to parties’ power to avoid some federal law).

16. Delaware has embraced freedom of contract in partnerships. Ribstein, *supra* note 1, at 213 (“At least in the leading state of Delaware, the [partnership] agreement may modify both loyalty and care duties, not merely the duty of care as in Delaware corporate law.”).

17. Ribstein stresses the utility of giving owners the right to cash out. *Id.* at 216.

18. Citizens might prefer direct election of the President, or the power to introduce and enact federal legislation directly through plebiscite, but such preferences would require constitutional amendments to be effected. Somewhat similarly, shareholders have no simple way of bypassing or avoiding the board of directors of their corporation.

tion, because the latter requires intermediation by the board of directors.¹⁹

Professor Ribstein's own attempt to explain the evolutionary success of the corporate form is rather pessimistic in nature and gives a nod to the importance of tax law (which I, too, have tried to set aside) and center stage to the concept of rent-seeking (by which is meant the fact that while managers profit from being in control, they also service legislators, and waste resources in the process, in order to protect their comfortable positions). The argument is that corporations offer managers insulation from displacement; there is, after all, not much in the way of direct democracy and there is a fair incentive to retain earnings if only to avoid dividend taxation. Law thus works to freeze corporations in place, and managers have no reason to push for changes in these legal rules because their well-compensated positions go along with the insulated character of the firm. The very inflexibility associated with the corporate form begets rent-seeking. The picture is one in which federal and state governments get to regulate corporations, in large part because of the corporations' inflexibility and inability to escape the regulation, and in which corporate managers become further insulated from their shareholders.

B. *State-Federal Competition*

But what exactly is this federal regulation, for it must be obvious that interstate competition for corporations, or at least for their chartering and governance regulation, affects state regulation in ways that it cannot possibly affect federal regulation? It is this federal-state competition that intrigues Professor Mark Roe, who points to the rather considerable volume of federal regulation—in the form of securities laws (including insider trading laws), takeover law, Sarbanes-Oxley's impact on governance law, corrupt practices sanctions, and more—and then also to the idea that states must see that the federal government is at least as important a competitor as is any other state.²⁰

At one level, Professor Roe delivers an important educational message: The most common conception of corporate law, not to mention the way in which we educate new lawyers, is fundamentally misguided. Academic commentary (and virtually every casebook and hornbook) focuses entirely on interstate competition.²¹ Delaware's dominance at the state

19. Another example of flexibility relates to federal law. Partnerships, and their close relatives, may be able to avoid some federal securities law by structuring their contracts around the definition of "security" that triggers federal law.

20. See Roe, *supra* note 2, at 603–34.

21. The only debate, if it is that, is whether there is any remaining competition, or perhaps whether the competition is for law firm and other business. See Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679, 687–700 (2002) (arguing that only Delaware structures its taxes to raise money and gain directly from incorporations).

level may only be weakly understood and explored, but it is the center of activity. I suspect that most students of corporate law would be surprised to learn that Delaware also dominates the market for partnerships;²² this importance undermines, or at least complicates, Professor Roe's excellent argument. Indeed, Delaware's success in the partnership law field weakens much of the conventional wisdom about the nature and cause of its success in corporate law.

At another level, Professor Roe's thesis, that Delaware's real competitor is in Washington D.C., can be understood as an evolutionary argument. It is that Delaware's corporate law is crafted with an eye toward maintaining its position not just with respect to other states, for that is the least of it (or so he holds), but especially with respect to the federal government. A strong form of this argument would be that Delaware—which is to say some combination of its legislature, bar, and judiciary—works anxiously so that the federal government does not offer federal charters for corporations or simply preempt and take over the chartering function, for that would really put Delaware out of business. A more modest form is that Delaware suffers a loss each time the federal government preempts, or takes for itself, part of the regulatory domain. Thus, when the federal government intervened with the 1933 Securities Act, with insider trading regulation, with takeover legislation and, most recently, with Sarbanes-Oxley, Delaware lost some of its market. In each case, some state law was trivialized or supplanted. Its law became less relevant and, presumably, some of the state's law business moved not only to federal courts and agencies but also to out-of-state law firms. In turn, with each bite by the federal government, Delaware's legislators became a bit less important to interest groups. Of course, Professor Roe's argument is that even if there were no federal legislation of the kind just listed, though there is of course plenty of it, the threat of federal corporate law has a strong influence on Delaware law. State law changes

22. "Dominates" is probably not the right word, and there is something of an apples-and-oranges comparison here because of the role of the Uniform Partnership Act and other uniform acts. Still, Delaware's legislature and courts (and law firms) are, undeniably I think, disproportionately important in unincorporate law. "As in corporate law, Delaware has frequently amended its version of R.U.L.P.A. to accommodate newly perceived needs of organizers and managers Thus, Delaware will often be the first choice for a limited partnership that is to be formed somewhere outside its main place of operation." See 3 ALAN R. BROMBERG & LARRY E. RIBSTEIN, BROMBERG AND RIBSTEIN ON PARTNERSHIP § 12.25(c) (1998). Note that Delaware has experienced growth in LLCs from 67,000 in 1998 to 222,000 in 2003. By way of (virtually random) comparison, in 2003, Delaware had seven times the number of corporations, six times the number of LLCs, and two and one-half times the number of LPs as Texas; these ratios have remained roughly stable in the past five years, though the absolute number of LLCs has of course grown. E-mail from Tina Passell, Manager for Public Information and Technology, Corporations Section of the Secretary of State, State of Texas, to Kevin Blackman (July 26, 2004, 15:34:51 CST) (on file with author); E-mail from Nicole Hall, Department of State: Division of Corporations, State of Delaware, to Kevin Blackman (July 22, 2004, 09:00:01 CST) (on file with author). These illustrative data do not differentiate between public and private entities and do not tell us anything about state revenues.

in fear of anticipated federal law, some of which can be avoided by the right moves at the state level in advance of any federal incursion.

It is possible to take issue with this view of state-federal competition. Contrary to Professor Roe, and perhaps to common sense, Delaware might be indifferent to, or even welcoming of, federal intervention, though surely not total preemption of a kind that would take place if there were large-scale federal chartering of corporations. Assuming that Delaware's goal is to dominate the interstate market for corporate law, because it enjoys and protects either the corporate franchise tax revenues that are associated with its market position or the legal business generated by Delaware corporations, or both, then it is plausible that Delaware protects its position best if there is less terrain on which other states can innovate.

The question is empirical because in theory the impact of federal regulation (or the thinking in Delaware) could go either way. Beginning on the smug side, Delaware might reason that the more the federal government takes over, so that fewer issues remain contested among the states, the more the state's dominant position in corporate law is secure. If there is some fear at present that a competitor state will develop new and better default rules at a lower price (either in terms of corporate taxes or the cost of legal services), then this fear must diminish with fewer possible rules or subjects regarding which states could differentiate. Similarly, as the domain of state law shrinks because of federal incursions, there is less need for Delaware to fear that another state will prove superior at appealing to corporations by finding the optimal balance (from the hungry states' point of view) between captivating managers and attracting shareholders. With too much managerial slack, corporations will stay away from the state or allow share prices to drop; excessively anti-managerial rules will reduce flexibility and interfere with profit-making or simply encourage managers, who are not perfectly responsive to their investors, to lead their firms elsewhere. In short, we can go forward thinking about Delaware's strategy in a world in which Delaware seeks to avoid federal incursions, but we can also ponder its strategic thinking in an atmosphere in which it benefits from some federal incursions, especially if these limit the competitive capacity of its state competitors.

III. FEDERAL INCURSIONS AND THE FLEXIBILITY OF UNCORPORATIONS

It should be noted that Professor Roe does not offer a theory as to when we, or state lawmakers, might expect federal intervention, perhaps because he would say that there is always the threat of federal intervention. In any event, there is no reason to expect federal lawmakers to be any more or less public-regarding than state legislators. Indeed, federal lawmakers may be less so because they face less horizontal competition than do their state counterparts. But we might simply think of federal

politicians and regulators as episodically interested in corporate law. They are presumably motivated by organized interest groups, either because there is private gain from responding to interest groups or because these groups bring information and focus to what lawmakers might do.

I would emphasize the role of crises, or even simple newsworthiness, in stimulating federal law. When a market crash or serious corporate scandal dominates the news, opportunistic (or responsive) politicians will be drawn to the matter and inclined to act. Sophisticated citizens might see that a dark event, and even an avoidable one, is not necessarily a sign of underregulation, but the need or perceived need for regulation is less a matter of science than one of politics. Moreover, a major and newsworthy disappointment is often good evidence of the need for change, or it may help overcome barriers to change that were not easily overcome in the past. Much as a space shuttle explosion occasions changes at NASA and new safety rules, so too an Enron or Arthur Anderson collapse will bring about something on the order of Sarbanes-Oxley. A shuttle explosion does not prove that new safety steps were needed, but in a Bayesian manner each striking piece of evidence does change the probability that new safety steps are desirable. It is also plausible that there is a large set of cost-benefit justified regulations that could be enacted, and that a jolt simply causes politicians to reach into this set and draw out a few that can now be installed because of the altered political climate. Politics and change thrive on crisis. An even better analogy is offered by the likely federal response, to what is otherwise a matter for the states, after a major earthquake or flood or terrorist attack. The intervention may bring federal relief (and for this the states are supplicants rather than competitors), but it is also likely to beget regulation in the form of new building codes, insurance requirements, or direct precautionary steps.²³ Corporate scandals are not terribly different, even if the victims are not nearly so successful in gaining federal relief.

Viewed through such a lens, it follows that there may not be much states can do to avoid federal intervention, other than try to prevent salient events, or crises, in the first place. This is difficult, or even hopeless, not only because the best regulatory systems, like the best traffic laws, will not aim to prevent all losses, but also because federal intervention will follow a shocking scandal even if only one state could have saved the day with regulation. A state may have a terrific strategy for preventing blow-ups, and it may even be motivated by the desire to avoid federal regulation, but another state's lax enforcement or regulatory structure may cause a crisis that brings on nationwide federal intervention. Mean-

23. See Saul Levmore, *Coalitions and Quakes: Disaster Relief and Its Prevention*, 34 U. CHI. L. SCH. ROUNDTABLE 1, 32-34 (1996); Saul Levmore & Kyle D. Logue, *Insuring Against Terrorism—and Crime*, 102 MICH. L. REV. 268, 278-79 (2003).

while, the zealous state might lose some corporate law business if managers prefer more flexible states.

One way or the other, we should expect an increasing amount of federal corporate law, precisely as we have experienced over the last seventy years. Crises are simply inevitable even in the face of overregulation (by state or federal power) and, as just argued, it is possible that states see little point in aggressive regulation in which case crises might happen more quickly still.²⁴ In the very long run, it is possible that the cost of overregulation will become apparent—perhaps through a different sort of crisis—and a national politician will benefit by deregulating this sector of the economy. This phase of the regulation cycle seems so far off at present that I will focus here only on the state-federal competition to regulate (rather than deregulate), and leave for another day the longer term view in which deregulation is a federal strategy, as it has been in other law.

If the connection between crises and federal intervention is correctly understood, then it should be noted that it is possible, though I think quite unlikely, that states, in a quest for more corporate law activity in their jurisdictions, underregulate with the idea of allowing crises to develop—and then profiting from the predictable increase in federal regulation. This could be a winning strategy for states other than Delaware if the federal intervention did indeed take away much of Delaware's advantage. In contrast, it could, I suppose, be a strategy for Delaware to follow, if federal intervention removed opportunities for insurgent states to innovate.²⁵

IV. DELAWARE'S STRATEGY

There is much more to be said about all this state-federal competition, especially if we think of it as essentially Delaware-federal competition. But rather than pursuing various lines opened here, I turn to the particular question of Delaware's strategy with respect to the development of partnership, limited liability company, and other unincorporate law. We can think of this development as one part of Delaware's competition strategy with the federal government, not to mention with other states. We normally think of the growth of unincorporate law as something that is generated by private enterprises gravitating toward that business form. We are accustomed to asking why business firms migrate to, or begin with, the corporate form or with an alternative form, and less accustomed to asking when a state will see fit to encourage firms to undertake such migration. The firm is not the only active participant in the

24. I do not mean to imply that we are overregulated but rather that even if states sought simply to discourage federal intervention by regulating matters they thought would, if unchecked, lead to such regulation, there would inevitably be some crises anyway.

25. See *supra* text accompanying note 22.

process. A state can affect results by making new law that investors (or managers) will find relatively attractive, by lowering the franchise and other tax costs associated with unincorporations, and by making the corporate form relatively less attractive—in the expectation that firms will migrate to the unincorporate side of the state, so to speak, rather than to other jurisdictions.

All of this takes on importance when we recognize that Delaware is significant, and perhaps as important, for partnerships and limited liability companies as it is for corporations. Whatever the source of its dominance in corporate law, that atmosphere, reliability, human capital, or political will carries over to unincorporate law. Delaware was not the first state to offer a limited liability company or limited liability partnership statute, but once Wyoming or Texas innovated, Delaware was among those states quickest to follow. Delaware was able not only to imitate and respond, but also to capture more than its share of the new market.²⁶ I will ignore for now the question of whether this market success shows that commentators put too much weight on Delaware's corporate franchise tax revenues when explaining its dominant position in corporate law.²⁷ Delaware's fees for partnerships and the like are extremely low, and yet investors (or their lawyers) seem to feel safe in Delaware's hands.²⁸ For now the point is simply that we must combine our understanding of state-federal competition with that of the choice of corporate form; Professors Ribstein and Roe cast light on different aspects of a single phenomenon, even though that would hardly be apparent on first reading.

If we add to this the notion that federal corporate law follows crises, either because perceived need breeds legal solutions or because politicians go where the news cameras are to be found, then it should also be clear that the distance between corporate and unincorporate law is bound to narrow. Professor Ribstein's case for unincorporations rests largely on the observation that corporate law is much more regulated, with unincorporate law significantly more flexible.²⁹ Principals and agents who seek to profit by delegating more flexibility to the agents than Delaware's

26. See Robert W. Hamilton, *Entity Proliferation*, 37 SUFFOLK U. L. REV. 859, 864, 870–71 (2004); Kahan & Kamar, *supra* note 21, at 742 (noting Delaware's theory incentive to imitate); Larry E. Ribstein & Bruce H. Kobayashi, *Choice of Form and Network Externalities*, 43 WM. & MARY L. REV. 79, 86 (2001).

27. I do not mean to minimize Delaware's revenues or reliance. In 2003, it collected \$448 million, or 18.4% of its total revenue, from the corporate franchise tax, and just \$66 million, or 2.7% of total revenue, from the corporate income tax, which is of course collected on the basis of a multistate formula and not affected by the place of incorporation. DELAWARE DEPARTMENT OF FINANCE, FISCAL NOTEBOOK: STATE GENERAL FUND (2003), available at http://www.state.de.us/finance/publications/fiscal_notebook_03/Section02/sec2page24.pdf (last visited Sept. 28, 2004).

28. Delaware limited liability companies are subject to a flat annual fee of \$200 as compared to its corporations which pay, in what might be described as an old-fashioned or charming manner, based on the number of authorized shares or assumed no-par capital, a minimum of \$35 to a maximum franchise tax of \$165,000. DEL. CODE ANN. tit. 6, § 18-1107, tit. 8, § 503 (2003).

29. Ribstein, *supra* note 1, at 230.

courts have in mind for corporations, can choose to be governed by partnership law, for example. Partnership law is in this way said to be more flexible than corporate law, where default rules are more often mandatory rules.

But as more unincorporations arise, and as (or if) they occupy significant parts of the economy, then it is inevitable that newsworthy crises will draw these entities, and the forms that make them possible, into the political wringer. Federal law will grow to regulate partnerships and other forms, either with the claim that unsophisticated investors and pension funds and the like need protection or with the intent of avoiding the costs of federal bailouts—for there will be pressure for such bailouts when various interest groups lose fortunes in the wake of partnership collapses. If these unincorporate enterprises grow in importance, then the pattern that brought federal lawmaking to corporations will bring federal lawmaking to limited liability companies and their cousins. One conclusion of this essay, therefore, is that the relative flexibility of unincorporations is likely to be a short term state of affairs.

This claim, that both federal regulation of unincorporations and the narrowing of the corporation-unincorporation regulatory gap are to be expected, will seem less surprising if we think of business law as not terribly unlike other law. Federal law followed state regulation in such areas as workplace safety, highway regulation, environmental regulation, and even primary education. If partnerships grow in importance and if their mistakes or misfortunes create groups of disappointed citizens, then there is every reason to expect increased federal regulation. The difference in flexibility between corporate law and unincorporate law may be a function of the increased federal presence in corporate law—and along with it, the steps states have taken to prevent further incursions.

I am describing the growth of federal regulation of unincorporations as inevitable, but I should be more cautious. So long as partnerships and other unincorporations are the projects of relatively sophisticated investors, at least as compared to the large publicly held corporations, a scandal or major loss associated with an unincorporation may not bring on federal regulation the way it would for a corporation. Conventional, unsophisticated investors are the stuff of the evening news, as well as the cause of protective political reactions. On the other hand, pension funds and other intermediaries are better equipped to lobby for protection and for bailouts than are unsophisticated corporate shareholders, so that the case for expecting federal intervention in unincorporate law may gain as much force from interest groups as it loses from the characteristics of the likely investors.

The narrowing of the regulatory gap between corporations and unincorporations may come from state lawmakers rather than federal lawmakers, so long as the threat of federal intervention is on the horizon. It is the states that might bring about the end of unincorporations' ability to

accommodate almost any bargain that investors or promoters advance. After all, if states do dread federal intervention, then we should expect state law in advance of anticipated federal law except, as before, where the state gains little from leading the pack because federal law is inevitable, as when crises are unpreventable or arise in more lax states. One way or the other, if unincorporations continue to grow in significance, then more opportunities for political intervention will arise in association with unincorporations—and increased regulation is sure to follow. The gap between corporations and unincorporations will narrow or disappear.

A very different, but related, conclusion concerns the pattern of Delaware law. Why does Delaware allow unincorporations such relative flexibility? And why does it tax unincorporations modestly? Delaware must fear migration to unincorporate forms because it has no reason to think that it can retain its strong competitive advantage once the boundaries of corporate law are breached.³⁰ Perhaps Delaware hopes to build up human capital and reputation in the partnership area (and with respect to other unincorporate law) before there is a large shift across the nation away from corporate law. If and when such a migration occurs, Delaware will be ready and attractive to the migrants. This view is consistent with the low franchise taxes that Delaware presently associates with unincorporations. With little established advantage in noncorporate business law, Delaware cannot afford to extract the revenues that it attracts from corporations. But as it builds up an advantage in partnership and in other noncorporate law, then we can expect increased franchise taxes for unincorporations, not to mention revenue through legal and other services provided in Delaware to enterprises that are, at least on paper, located in Delaware and subject to its courts and legislature.

Even if Delaware sees that its own light-handed regulation of unincorporations makes federal regulation more likely in the future, it must fear competing with, or obviating, federal intervention now because individual firms will then migrate from Delaware corporate status to unincorporation status in other states. Delaware law can thus be understood as in transition. What we observe is consistent with a dominant player hoping to extend its position to a new market which is, in this case, unincorporate law.

Meanwhile, Delaware has little to fear. The migration to unincorporate status has been slow, somewhat to Professor Ribstein's surprise and in part, perhaps, because (federal) corporate tax rates have declined. At this pace, large-scale, unincorporate scandals that would bring about federal intervention may be some time off and Delaware can in the interim build up an advantage in unincorporate law. And, in the long run, Delaware can do just fine alongside active federal lawmaking, raising tax

30. Delaware, of course, is not a single-minded "it." A state's laws are the product of disparate political forces, legislative and judicial minds, and interest groups. But the singular image is convenient. A state can, after all, have *a* strategy.

revenues and business from partnerships, much as it derives these from corporations today.

V. CONCLUSION AND FUTURE INQUIRIES

This essay has made two claims, one about the inevitable coming of federal (and therefore state) regulation of unincorporations, and the other about Delaware's strategy in this regard. In future work, I plan to explore the question of whether increased federal regulation does indeed diminish Delaware's regulatory dominance or whether perhaps a reduced state domain leaves the leading state better off, or perhaps as well off as before. That question surely bears on the practical question of a state's best lawmaking strategy.

The second question for state lawmakers is what to do in their partnership and other unincorporate codes. Once it is clear that competition, to use an inaccurate word, comes not only from other states and not only from federal regulation, but also from other business forms, this question is an interesting and difficult one. Moreover, the nature of interstate competition must also be reexamined. Small states (in business terms) can attract firms with tax breaks for factories and the like, and the question is how they might attract corporations and unincorporations to make their legal homes in particular jurisdictions or whether the larger point is simply that it is unwise for eager states to go this route because of the threat of federal law. These questions are left for another effort.