

# JURISDICTIONAL COMPETITION FOR LIMITED LIABILITY COMPANIES\*

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## Abstract

Most of the work on jurisdictional competition for business associations has focused on publicly held corporations and the factors that have led to Delaware's dominant position in attracting out of state firms. Is there an analogous jurisdictional competition to attract formations by closely held firms? Limited liability companies (LLCs) offer a good opportunity to examine this question. Most LLC statutes have been adopted and changed rapidly during the past 20 years. Unlike general and limited partnerships, which have been shaped by uniform laws, LLC statutes vary significantly, and states have devoted a lot of effort to drafting their individual statutes. This variation provides an opportunity to test the statutory provisions and other factors that influence LLC's choice of where to organize. We find little evidence that firms choose to form outside their home state in order to take advantage of variations in statutory provisions. Instead, we find evidence that large LLCs, like large corporations, tend to form in Delaware, and that they do so for the many of the same reasons – that is, for the quality of Delaware's legal system.

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## I. INTRODUCTION

Much of the work on jurisdictional competition for business associations has dealt with publicly held corporations. The debate has focused on whether this competition has been a race to the top or to the bottom, and on why Delaware has managed to maintain a dominant share of incorporations of firms that incorporate outside their home states. However, there has been relatively little written on jurisdictional competition to attract formations of closely held firms.

The closely and publicly held firm contexts differ in theory.<sup>1</sup> States typically charge initial and annual fees both for being the state of organization and for qualifying firms organized elsewhere to do business locally. For large public firms, this cost of foreign incorporation is trivial compared to the size of the firm, so that incorporating outside the home state is a viable alternative. However, for smaller firms, the costs of organizing outside their home state may outweigh the benefits. Some jurisdictional competition may, however, operate for at least relatively large closely held firms. Moreover, apart from attracting formations of out-of-state firms, states may benefit from efficient business association statutes that attract firms to set up shop locally.

Limited liability companies (LLCs) offer a good opportunity to test for jurisdictional choice. Most LLC statutes have been adopted and undergone significant change over the last 20 years. There is evidence that LLC statutes have evolved toward efficient terms, as by eliminating undesirable mandatory rules,<sup>2</sup> and that they have spontaneously moved toward efficient uniformity.<sup>3</sup> This evidence raises questions whether the evolution of LLC law has been spurred by competition, and whether statutory variations affect LLCs' choice of where to organize. States have devoted a lot of effort to drafting LLC statutes. Is this effort paying off in terms of attracting LLCs from or avoiding loss to other states?

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<sup>1</sup> See *infra* text accompanying note 13.

<sup>2</sup> See Larry E. Ribstein, *Statutory Forms for Closely Held Firms: Theories and Evidence from LLCs*, 73 WASH. U. L. Q. 369 (1995).

<sup>3</sup> For discussions of uniform lawmaking and LLCs, see Bruce H. Kobayashi & Larry E. Ribstein, *Evolution and Spontaneous Uniformity: Evidence from the Evolution of the Limited Liability Company*, 34 ECON. INQ. 464 (July, 1996), reprinted in UNCERTAINTY AND ECONOMIC EVOLUTION (John Lott, ed. 1997) (*Kobayashi & Ribstein, Evolution and Uniformity*); Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws and ULLCA*, 66 COLO. L. REV. 947 (1995); Bruce H. Kobayashi & Larry E. Ribstein, *The Non-Uniformity of Uniform Laws*, (July 5, 2007), U Illinois Law & Economics Research Paper No. LE07-030, available at <http://ssrn.com/abstract=998281> (*Kobayashi & Ribstein, Non-Uniformity*).

This paper empirically examines factors that influence LLCs' choice of formation state. We find that large LLCs are more likely to organize outside their home state, and that Delaware is their dominant destination. However, there is little evidence that firms choose to form outside their home state in order to take advantage of variations in statutory provisions. Rather, our evidence suggests that LLCs choose Delaware for many of the same reasons that public corporations do – that is, the quality of Delaware's legal system. In other words, the significant variation among LLC statutes appears to be disconnected from LLCs' formation decisions. This leaves questions concerning what other motives may be driving the significant investments of lawyer time into LLC statutory reform.

The paper is organized as follows. Section II discusses general considerations underlying jurisdictional competition for closely held firms. Section III discusses our hypotheses regarding the specific factors that drive LLCs' jurisdictional choice. Section IV describes the data and discusses our regression results. Section V concludes.

## II. JURISDICTIONAL COMPETITION FOR CLOSELY HELD FIRMS

The literature examining jurisdictional competition for business associations focuses on public corporations. This Part discusses why, in theory, jurisdictional competition should differ for closely held firms, which are the focus of this paper.

The literature on state competition for business association law first discussed whether state competition for revenue from incorporations would lead to a race to the bottom<sup>4</sup> or to the top.<sup>5</sup> Early data favored the latter hypothesis, as event studies showed significant and positive abnormal returns to firms' decisions to reincorporate in Delaware.<sup>6</sup> Both models assumed that the demand for state chartering business would cause state statutes to evolve toward terms that successfully attracted incorporation business. This suggested that statutes would become uniform, as states

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<sup>4</sup> See e.g., Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435 (1992); Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*, 99 COLUMB. L. REV. 1168 (1999); William Cary, *Federalism and Corporate Law: Reflections upon Delaware*, 83 YALE L. J. 663 (1974); Ralph Nader, Mark Green, & Joel Seligman, TAMING THE GIANT CORPORATION (1976).

<sup>5</sup> See, Roberta Romano, THE GENIUS OF AMERICAN CORPORATE LAW (1993); Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967); Ralph Winter, *State Law, Shareholder Protection, and The Theory of Competition*, J. LEG. STUD. 251 (1977).

<sup>6</sup> See Peter Dodd & Richard Leftwich, *The Market for Corporate Charters: 'Unhealthy Competition' versus Federal Regulation*, 53 J BUS. 259 (1980); Robert Daines, *Does Delaware Law Improve Firm Value?* 40 J. FIN. ECON. 525 (2001); Romano, *supra* note 5. For a critique of this evidence, see Lucian Arye Bebchuk, Alma Cohen, & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?* 90 CAL. L. REV. 1775 (2002).

losing business to innovating states would imitate the latter's statutes in order to prevent further losses.<sup>7</sup> Thus, in equilibrium, firms would have little reason to incorporate out of state.

This perfect competition result did not explain the actual pattern of incorporations in which Delaware acquired and maintained a dominant share of out of state incorporations.<sup>8</sup> Subsequent papers focused on explaining this pattern. Some authors have suggested a product differentiation model, where states tailored their corporation statutes to attract certain types of firms.<sup>9</sup> However, there is little evidence of such product differentiation.<sup>10</sup> As discussed below, there are theoretical reasons why publicly held firms would demand uniform rules.

If large firms do not demand significant variation in corporate laws, how does Delaware maintain its large market share? One answer is that Delaware's superior legal infrastructure, including its courts and well-developed corporate bar, gives Delaware a strong competitive advantage that other states cannot easily replicate.<sup>11</sup> Also, state laws may be fairly uniform while differing in an important respect. Bebchuk & Cohen found evidence of a managerial agency cost theory of competition – that firms' incorporation choices were significantly influenced by differences between antitakeover provisions in their home states and Delaware.<sup>12</sup>

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<sup>7</sup> See Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225, 229 (1985) (noting the literature's emphasis on "survivorship" and that as "a corollary of the process's efficient (optimal) outcome, uniform statutes are predicted).

<sup>8</sup> See Lucian Bebchuk & Alma Cohen, *Firms' Decisions Where to Incorporate*, 46 J. L. & ECON. 383 (2003); Robert Daines, *The Incorporation Choices of IPO Firms*, 77 N.Y. U. L. REV. 1559 (2002).

<sup>9</sup> See, e.g. Richard A. Posner & Kenneth E. Scott, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* (1980) at 111. See also Barry D. Baysinger & Henry N. Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985) (suggesting a self selection mechanism resulting in state specialization).

<sup>10</sup> See, e.g., Romano, *supra* note 5 at 45-48..

<sup>11</sup> See Lucian Arye Bebchuk & Assaf Hamdani, *Vigorous Race or Leisurely Walk: Reconsidering the Competition over Corporate Charters*, 112 YALE. L. J. 553 (2002); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990); Jill E. Fisch, *The Peculiar Role of the Delaware Courts in the Competition for Corporate Charters*, 68 U. CIN. L. REV. 1061 (2000); Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002); Romano, *supra* note 7. Delaware's advantage has been attributed to "network" effects that are inherently difficult to replicate. See Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757 (1995); Lucian Arye Bebchuk & Mark J. Roe, *A Theory of Path Dependence in Corporate Ownership and Governance*, 52 STAN. L. REV. 127 (1999).

<sup>12</sup> See Bebchuk & Cohen, *supra* note 8.

As already noted, there has been relatively little discussion of whether there is a jurisdictional competition to attract formations by closely held and unincorporated firms that is equivalent to the competition for publicly held firms. The following subparts discuss why the two contexts may differ, and the general considerations that may drive the competition for closely held firms.

#### **A. THE ROLE OF FIRM SIZE**

Firm size is likely to be an important factor in jurisdictional competition for business association formations.<sup>13</sup> States typically charge initial and annual fees both for being the state of organization and for qualifying firms organized elsewhere to do business locally. While these costs are likely to be trivial for large corporations,<sup>14</sup> they could be significant for small firms per dollar of capitalization. Small firms might avoid paying any qualifying fee if they do business in a single state. And small firms likely do not get as much advantage out of shopping for law because they are involved in less litigation than larger firms.

These considerations suggest that jurisdictional competition might operate for relatively large closely held firms or for firms that conduct business in more than one state. The larger the firm, the smaller the per-capitalization cost of organizing outside the home state. States other than Delaware do not charge organization fees that scale significantly to size,<sup>15</sup> and no states scale fees for qualifying foreign closely held firms. At the same time, the benefits of choosing the law may increase with size because larger firms are likely to have more litigation.

Although there is reason to expect state competition to apply mainly to larger firms, there are also reasons why there may be competition even for the smallest firms. These firms may choose to locate their entire business in states with attractive laws rather than just choosing the state's governance law while remaining based in another state.<sup>16</sup> Small firms might be attracted not only by standard form rules suited to their needs, but also by laws that would minimize owners' liability to third parties. States have an incentive to attract business activity whether it is carried on by large or small firms.

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<sup>13</sup> See Ian Ayres, *Judging Close Corporation in the Age of Statutes*, 70 WASH. U. L. Q. 365 (1992); Roberta Romano, *State Competition for Close Corporation Charters: A Commentary*, 70 WASH. U. L. Q. 409 (1992).

<sup>14</sup> Bebchuk & Cohen, *supra* note 12.

<sup>15</sup> See Marcel Kahan & Ehud Kamar, *Price Discrimination in the Market for Corporate Law*, 86 CORNELL L. REV. 1205 (2001).

<sup>16</sup> For example, Florida has the second highest number of LLC formations, trailing only Delaware. However, unlike Delaware, a high percentage of these formations are by firms that also locate in the state. See *infra* Table 2.

## **B. DO STATUTORY TERMS MATTER FOR CLOSELY HELD FIRMS?**

Assuming that some closely held firms may choose to organize outside their home state, the further question is what factors drive this choice. One possible hypothesis is that firms choose to organize in states that have the best substantive rules. In order to weigh this hypothesis against the competing hypotheses discussed below – specifically, infrastructure and uniformity – it is helpful to understand why substantive statutory rules might matter, at least in theory.

Firms obviously have an incentive to shop for business association law in order to avoid unwanted mandatory rules. But why should a statute's default rules matter, when firms by definition can achieve the same results simply by contracting? The answer is that the right mix of default rules can reduce litigation, information and other transactions costs by providing a well defined and coherent set of terms. Well defined terms increase the predictability of court rulings interpreting these terms and reduce third parties' information costs of contracting with the firm. A coherent set of terms can avoid tax and regulatory surprises, encourage contracts that efficiently match terms to firms' needs. The set can also include mandatory terms that help the parties credibly commit to efficient long-term contract terms that would otherwise be subject to ex-post opportunism.

While both large and small firms benefit from coherent terms, the two types of firms may differ in how much they benefit from statutory variation. Large, publicly traded firms may benefit from significant standardization across the states to minimize investors' information costs, and therefore their cost of capital. Also, these firms rely on legislatures to revise their terms because of high shareholder collective action costs in making governance rules.<sup>17</sup> Although large firms may readily bear the costs of drafting initial terms when going public, the benefits of standardization, firms' difficulty of opting out of statutory provisions and the application of federal and stock exchange rules all induce firms to demand substantial uniformity.

By contrast, closely held firms that are large enough to justify some customized drafting may easily adopt and change their contracts throughout their existence, do not need to offer their investors standardized terms, and are not subject to federal and stock exchange rules. It follows that these firms may have less need for particular statutory default and mandatory terms. States accordingly can offer different coherent sets of default rules to suit different types of firms. Some states may choose to cater to larger and more sophisticated firms by, for example, offering rules designed for centrally managed firms and that accommodate contracting, while other statutes may be designed for smaller and less formal firms that may need or want direct member management and statutory protection of unsophisticated members.

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<sup>17</sup> See Henry Hansmann, *Corporations and Contracts*, 8 AM L. ECON. REV. 1 (2006).

### C. DO STATES COMPETE FOR CLOSELY HELD FIRMS?

Although closely held firms may choose to form outside their home states, they are likely to generate lower potential franchise fees than publicly held firms. This suggests that there is likely to be less competition for closely held than for publicly held firms. However, with less standardization, any competition in this context may matter more to the substance of the statutes than the competition for publicly held firms. Moreover, even if states are not motivated by substantial franchise fees to attract formations of closely held firms, they at least may have significant incentives to prevent firms domiciled in their state from choosing to form in states like Delaware. Thus, even if only a few firms organize outside their home states, this can be consistent with robust jurisdictional competition for formations of locally-based firms.

Any theory of competition has to explain what motivates state lawmakers to engage in the competition. Lawmakers may want to encourage firms to form under their state's statute in order to charge franchise fees and thereby reduce their tax burden on their constituents. However, as already noted, closely held firms are unlikely to produce a big franchise fee payoff. More likely, the competition has been driven by lawyers. Lawyers can earn fees by serving as local counsel for foreign firms. They can also attract potential clients to locate in the state by having efficient business association statutes. Lawyers may compete for market share within their states by using their participation in drafting business association statutes to develop their reputations.<sup>18</sup> And lawyers may simply derive consumption value from the intellectual challenge and satisfaction of crafting statutes.

There initially was little competition for closely held firms. States adopted special close corporation provisions, but only a small percentage of total corporations adopted these provisions.<sup>19</sup> These small percentages are particularly striking in light

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<sup>18</sup> See *infra* note 70 and accompanying text.

<sup>19</sup> See F. Hodge O'Neal and Robert B. Thompson, *O'Neal and Thompson's Close Corporations and LLCs: Law and Practice*, §1.20 (2008); Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 Berk. Bus. L. J. 2008), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1119280](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1119280). O'Neal & Thompson, *supra*, compiles data on close corporation filings in states with special close corporation provisions. The following are the 1992 ratios of close corporations to total corporations: Alabama, 5,324/155,198; Wisconsin 5,101/98,602; Pennsylvania 24,000/580,000; Kansas "a lot less" than 5% of total corporations; Missouri 863/82,694; Montana 828/ 97,009; Nevada 742/63,172; and Wyoming 753/12,422. Delaware had no close corporation data in 1992, but reported 16,684 close corporations in 1985 and 202,115 total corporations in 1992. Texas reported that of all corporate filings, 3.71% were statutory close corporations in 1978 and 5.59% in 1979. Two 1985 Texas studies based on different data showed 5.91% and 6.09% electing close corporation status. Only California showed significant percentages of close corporations – 28% in 1978 and 19% in 1985 – but the attorney conducting the study thought those numbers "misleading" because most filings were by nonlawyers who did not understand the consequences of close corporation status.

of the fact that the vast majority of all corporations are closely held.<sup>20</sup> This was likely attributable to the fact that these provisions were mainly enabling, existed within general corporation statutes and did not offer complete coherent sets of default rules. Thus, adopting firms were exposed to ill-fitting corporate default rules to the extent they left terms out of their customized agreements.

By contrast, there is evidence consistent with state competition regarding LLC statutes. Unlike corporation statutes, LLC statutes were designed from the ground up for closely held firms. This helps explain why, after the IRS classified LLCs as partnerships for tax purposes in 1988, LLC statutes were quickly adopted by all 50 states and the District of Columbia. Moreover, states have amended these statutes frequently, and there is evidence that these statutes evolved toward substantive efficiency over time. While early LLC statutes contained undesirable mandatory rules and rules designed for centralized management, later statutes eliminated these features, replacing them with default partnership rules appropriate for firms using decentralized management.<sup>21</sup>

Given the striking contrast between the indications of an active state competition for LLCs and the very small percentages of corporations forming under special close corporation statutes, LLCs and close corporations appear to be distinct phenomena from the standpoint of jurisdictional competition for business formations. Accordingly, we focus on the competition for LLCs rather than looking more broadly at all closely held firms.

#### **D. UNIFORMITY**

As discussed above, there is theoretically less need for statutory standardization for closely held than for publicly held firms. However, this difference does not necessarily apply across all provisions of the statute. Provisions affecting third parties present the strongest case for uniformity because the smaller transaction amounts associated with infrequent third-party dealings are unlikely to support customized drafting or extensive information search. Firms therefore may economize on transaction costs by adopting uniform statutory provisions as to terms mainly affecting third parties. By contrast, provisions affecting the members involve frequent and repeated interaction where the net benefits from variation and innovation are likely to be high and the net benefits of uniform rules are likely to be the lowest.

There is evidence that LLC statutes have spontaneously evolved toward efficient uniformity. Because the Uniform Limited Liability Company Act (ULLCA) was not promulgated until after the vast majority of states had passed their LLC

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<sup>20</sup> O'Neal & Thompson, *supra* note 19, estimate the total at 90%.

<sup>21</sup> See Ribstein, *supra* note \_\_.

statutes, uniform LLC statutes had little effect on the early evolution of LLC law.<sup>22</sup> LLC statutes nevertheless achieved significant uniformity as to third-party provisions for which uniformity is efficient under the above analysis.<sup>23</sup> This evidence is consistent with the existence of beneficial jurisdictional competition as to the level of uniformity.

On the other hand, the uniform LLC acts have undermined efficient spontaneous uniformity. The promulgation of the Uniform Limited Liability Company Act (ULLCA) decreased rather increased both efficiency and uniformity by including many idiosyncratic provisions that have not been widely adopted by the states in their existing statutes.<sup>24</sup> The recently enacted revised ULLCA continued this trend.<sup>25</sup>

## E. LEGAL INFRASTRUCTURE

An additional factor in state competition for business associations generally, including closely held firms, is the courts, lawyers and legislature of the enacting state. As discussed above,<sup>26</sup> commentators have theorized that this is an important source of Delaware's strength in corporate law. Firms may choose to organize under a state's law not because of (and perhaps even despite), the specific terms of the statute but because the state's legal infrastructure can be expected to provide sophisticated advice and adjudication and to keep the legislation current with business practices. Although the parties might be able to unbundle adjudication and lawmaking by choosing a forum other than the enacting state, the state of organization is likely to have the most experience interpreting its law.<sup>27</sup> Indeed, courts in non-enacting states may decline to hear a case under another state's law. They may do so in order to conserve judicial resources, or perhaps as a way of inducing parties to organize and pay fees under the adjudicating state's law.<sup>28</sup>

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<sup>22</sup> See Ribstein & Kobayashi, *supra* note 3.

<sup>23</sup> See Kobayashi & Ribstein, *Evolution and Uniformity*, *supra* note 3.

<sup>24</sup> See Ribstein & Kobayashi, *supra* note 3.

<sup>25</sup> See Kobayashi & Ribstein, *Non-Uniformity*, *supra* note 3.

<sup>26</sup> See *supra* text accompanying note 11.

<sup>27</sup> A state such as Delaware may have a specific expertise regarding organization law. Accordingly, parties may choose that state's law and courts for organization law issues but not for general contract interpretation. This may explain data showing that a substantial number of Delaware corporations chose New York law and New York as the litigation forum in a sample of merger agreements. See Theodore Eisenberg & Geoffrey Miller, *Ex Ante Choices Of Law And Forum: An Empirical Analysis Of Corporate Merger Agreements*, 59 Vand. L. Rev. 1975 (2006).

<sup>28</sup> See *infra* note 69 and accompanying text.

## F. IMPLICATIONS

The above analysis has four main implications for the nature of competition for closely held firms. First, size matters. Larger firms are more likely to organize outside their home states, and therefore to be the object of any interstate competition. On the other hand, size is not necessarily determinative. Because states compete for business assets as well as business formations, they have an incentive to offer laws that will attract even very small firms that will organize in their home states.

Second, because uniformity may be attractive as to some terms, and given the evidence of spontaneous uniformity, any competition over substantive terms may be limited to the terms as to which uniformity is not efficient – that is, the terms that matter mainly in transactions among the members.

Third, even as to the largest closely held firms and terms that do not need to be uniform, the competition actually may focus on the legal infrastructure rather than the substance of the statutes.

Fourth, competition for closely held firms is likely to focus on non-corporate statutes. Even if corporate statutes include terms designed for closely held firms, these terms are embedded within general default rules that are unsuited to closely held firms. Thus, it is appropriate to focus on the competition among LLC statutes.

## G. EVIDENCE

The evidence of variation in LLC statutes and the competing theories of competition for closely held firms raise the question whether the variation has significantly influenced LLCs' choice of where to organize. This is obviously an important issue, since states have devoted a lot of effort to drafting their statutes. Is this effort paying off in terms of attracting LLCs from other states, or avoiding loss to other states, particularly including Delaware? If not, it suggests that such efforts may be profitably curtailed.

This question was addressed in a recent study of formation state choices by LLCs by Dammann & Schundeln (D & S).<sup>29</sup> Like Bebchuk & Cohen's analysis of corporations, D & S model a firm's choice as one of formation in the same state where the firm is located or forming out of state.<sup>30</sup> D & S conduct a regression analysis that examines factors affecting LLCs choice to exit or stay in the home state. Their dependent variable, as in the B & C study, is a dummy that equals 1 if the LLC forms in its home state.

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<sup>29</sup> *Where are Limited Liability Companies Formed? An Empirical Analysis* (April 28, 2008), U of Texas Law, Law and Econ Research Paper No. 126, <http://ssrn.com/abstract=1126257>.

<sup>30</sup> Bebchuk & Cohen, *supra* note 12.

D & S find that larger firms (based on the number of employees and total revenues) are more likely to be formed outside their home state (4% total), particularly Delaware (42% of firms formed outside their home state). Also following the B & C study, D & S focus on the attributes of the home state when examining factors that affect the choice to exit or stay home. Their major findings are that firms tend to move away from states that offer less protection for minority investors, as indicated by the state's relatively low manager duty of care (gross negligence or waivable or both), or that allow companies to be dissolved by sub-unanimous vote, which can enable opportunism by dominant owners. D & S characterize their findings regarding the flight from low-duty-of-care jurisdictions as showing a flight from laxity. D & S find that the passage of ULLCA and court quality in the home state do not affect whether firms form in their home states. Overall, the D & S study suggests that variation in LLC statutes is critical in determining where LLCs form.

In general, the D & S data suggest a somewhat different competitive outcome for LLCs than for public corporations. The literature to date on public corporations suggests that both state legal infrastructure and variation in state laws may matter in determining incorporation choices. More specifically, the B & C study suggests that public corporations may be influenced by pro-management takeover statutes to stay at home rather than incorporating in Delaware. By contrast, D & S suggest a flight *from* laxity. In the next part we present data and analysis that supports different conclusions from those reached by D & S.

### III. FACTORS IN THE COMPETITION FOR LLCs

In order to adduce evidence on whether statutory variation is driving LLC competition, it is necessary to develop a theory of what variations are likely to affect firms' choices. This Part develops such a theory, and applies the theory in identifying the specific statutory variations that are most likely to induce LLCs to form under particular laws. Based on this analysis, we design specific tests to determine the role of statutory provisions in LLCs' decisions where to organize.

#### A. QUALITY OF LEGAL ENVIRONMENT

As discussed in the literature on jurisdictional competition for public incorporation revenues, a significant theoretical factor in attracting firms is the quality of litigation outcomes in the state. The same factor also may attract large LLCs. As a proxy for this, we include a court quality variable from the 2007 Chamber of Commerce State Liability Systems Rankings Study.<sup>31</sup>

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<sup>31</sup> See 2007 U.S. CHAMBER OF COMMERCE STATE LIABILITY SYSTEMS RANKING STUDY, Final, Conducted for: U.S. Chamber Institute for Legal Reform, (April 16, 2007), available at [http://www.instituteforlegalreform.com/lawsuitclimate2007/pdf/Liability\\_System\\_Ranking\\_Study.pdf](http://www.instituteforlegalreform.com/lawsuitclimate2007/pdf/Liability_System_Ranking_Study.pdf). The study surveyed practicing lawyers in each state and created a total ranking based upon multiple factors, including treatment of tort and contract litigation, enforcement of meaningful venue

## **B. MANDATORY VS. FLEXIBLE RULES.**

The most obviously important factor relating to substantive law is whether the rules are mandatory or can be varied by agreement. Although some mandatory rules may not matter because there is little practical difference among feasible rules the firm might choose – for example, where the rule specifies the form of the firm’s name. On the other hand, some rules, such as those constraining opting out of fiduciary duties, may have a significant effect on private ordering.

Although firms may care about the flexibility of some types of rules, as with the quality of law it is unlikely that a firm will choose to organize in a state solely on account of the flexibility of a particular rule. Other considerations, such as court quality or the quality of the default rules, are likely to cumulatively matter more. However, states may tend to have either mandatory or flexible rules, and firms may react to these tendencies rather than to specific rules. Accordingly, in testing for the role of flexibility, it may be appropriate to examine a group of rules as to which flexibility matters.

Flexibility is not solely a matter of default vs. mandatory rules. Some default rules may offer more flexibility than others. An example is “lock-in” terms – that is, terms that bar members from dissociating from the firm and getting paid the value of their interest. All LLC statutes let members contract around the statutory default. However, a rule providing against dissociation-at-will may be beneficial because of estate and gift tax rules that provide for a lower valuation of the outgoing interest for estate tax purposes if the statutory default rule does not provide for dissociation at will. This statute is flexible in the sense that it makes feasible tax planning that the parties could not accomplish under the alternative default rule. Also, given the norm in partnership type firms of easy exit, contracts locking in members may not be as clearly enforceable as contracts providing for exit against a statutory default lock-in provision.

To test the flexibility of LLC statutes, we used three specific factors in the regression analysis:

(1) Whether the statute allows the firm to waive fiduciary duties. This differs from the D & S care 2 and care 3 variables, which as explained above relate solely to the ability to waive the duty of due care, and should in theory have little effect on firms’ choice of law decisions. By contrast, our waiver variable refers to statutes that

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requirements, treatment of class action suits, treatment of punitive damages, timeliness of summary judgment and dismissal, discovery, scientific and technical evidence, non-economic damages, judges’ impartiality, judges’ competence, judges’ predictability, and juries’ predictability and fairness. The by state total ranking is listed in the appendix. Delaware leads the rankings with a ranking of 75.6, while West Virginia (38) and Louisiana (47.3) have the lowest indices. The average index is 61.7. The District of Columbia is not ranked in the study.

give firms complete freedom to waive fiduciary duties. This enables firms to waive not only the duty of care, but also the duty of loyalty and the attendant substantive duty of good faith.<sup>32</sup>

(2) Whether the statute enables firms to merge or otherwise combine with all types of firms, or whether it restricts the types of permitted combinations. The additional flexibility of these statutes could be expected to matter especially to firms contemplating a transaction that is prohibited under the statute of either their home state or that of the entity they are considering combining with. This type of provision also may signal the relevant jurisdiction's general flexibility.

(3) Whether the statute allows the firm to admit members who do not make a contribution, or who otherwise lack an economic interest in the firm. Like inter-entity mergers, this could be a significant factor in ensuring the validity of particular types of contemplated transactions

We test these variables both individually and bundled. We expect that bundling flexibility variables would have a greater effect, since firms are more likely to incur the expense of organizing outside their home state if the target jurisdiction is generally flexible than if it includes only a single element of flexibility. In bundling the variables we test the number of flexible provisions.

### **C. INNOVATION.**

Hansmann shows why at least publicly held firms need statutory law – to adjust the parties' contract over time as circumstances demand.<sup>33</sup> These adjustments may be particularly needed where new business practices come into use whose treatment by the courts is uncertain. In this situation, firms might prefer explicit statutory authorization to the uncertainty of case by case adjudication, particularly if the firm operates in several different jurisdictions.

One potentially significant type of innovative statutory provision concerns "series" LLCs. These firms have a single business with discrete assets or sets of assets that they want to separate into distinct entities, especially for liability purposes. An example would be a real estate firm that operates several different properties. A potential advantage of the series option is that the statute prescribes rules that, if followed, presumably will separate the assets and the liabilities. If the firm attempts to separate the assets and liabilities into firms without using the series provision, a court may be more likely to hold that the firm is actually a single entity because it operates

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<sup>32</sup> The only remaining duty would be the implied contractual covenant of good faith and fair dealing, which exists in all contracts and cannot be waived. For a comparison of the two duties, see Larry E. Ribstein, *The Uncorporation and Corporate Indeterminacy*, \_\_ U. ILL. REV. \_\_ (2009).

<sup>33</sup> *Id.* at 9.

similar or related businesses. The series LLC may be considered a type of flexible provision because it facilitates a transaction that would be more difficult or costly in the absence of the provision. The series LLC is also significant as a statutory innovation that enables a new type of business entity not available in states lacking a similar provision.

The salience of series provisions as an innovation was enhanced by the hotly debated decision of the National Conference of Commissioners on Uniform State Laws to omit such provisions from the recently promulgated Revised Uniform Limited Liability Company Act. A state's willingness to adopt a series provision is arguably significant not only regarding the series issue itself, but also as signaling the legislature's general receptivity to innovation. As of the time of our test, only six states had adopted series provisions: Delaware; Illinois; Iowa, Oklahoma, Tennessee, Utah. However, many more states may join this group now that the tax status of a series LLC has been somewhat clarified by a private letter ruling.<sup>34</sup>

The fact that such provisions are relatively new is of significance when one considers the dynamic nature of jurisdictional competition. As Romano notes, statutory innovation in corporate statutes follow a diffusion pattern that resembles an S-curve.<sup>35</sup> Thus, there may be significant effects of innovative provisions soon after their initial adoption. However, as the innovations diffuse among the states, the effect in drawing out-of-state formations would be expected to diminish.

#### **D. DEBTOR PROTECTION.**

Small firms may locate in particular states in order to get better protection from creditors. LLC statutes may play some role in this through their charging order provisions. These sections set forth rules governing how creditors can reach LLC members' economic interests in their firms. The charging order provisions generally clarify that creditors are limited to receiving the distributions that would otherwise be paid to the members, and that the creditors cannot exercise management rights, particularly including dissolving or seeking a court order to dissolve the firm. Management or dissolution rights might enable a charging creditor to not only reach ongoing distributions, but also take out the entire value of the member's interest and perhaps disrupt the firm's operations.

Debtors might take advantage of charging creditors' lack of management or dissolution rights to use the statutes to establish virtual asset protection trusts that hold members' personal assets away from creditors' reach.<sup>36</sup> Our asset protection variable

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<sup>34</sup> Private Letter Ruling 200803004 (classifying a series under the check-the-box regulations).

<sup>35</sup> See Romano, *supra* note 5.

<sup>36</sup> See generally, Larry E. Ribstein, *Reverse Limited Liability and the Design of Business*

denotes statutes that make the charging order the exclusive remedy and provide that the creditor shall have no right to interfere with the management or force dissolution of an LLC.

The virtual asset protection trust may not be a reliable shield. Among other things, creditors may pierce the veil of the asset protection LLC,<sup>37</sup> challenge the use of a charging order to protect the assets of a single-member LLC,<sup>38</sup> or challenge the conveyance to the LLC as fraudulent.<sup>39</sup> Debtors seeking protection therefore might want backup protection from creditors. Accordingly, we include as an additional variable whether the state limits the home exemption in bankruptcy. A large exemption may induce parties to locate their assets or small businesses in the state, and then to locally form LLCs that provide additional asset protection.

Debtor protection also is theoretically a relevant factor regarding piercing the LLC veil to reach members' individual assets. Veil-piercing is a common law doctrine determined on a case-by-case basis where it is difficult or impossible to discern state-by-state differences. D & S test a variable (for which they do not get significant results) that turns on whether the statute includes a provision that the veil cannot be pierced for mere failure to follow formalities. However, it is unlikely that this provision would make a difference to firms' formation decisions, since even without such a statutory provision courts are unlikely to pierce the LLC veil merely for failure to follow formalities, and since courts that want to pierce the veil usually can find some other ground.

## **E. D & S VARIABLES**

As noted above, the main finding of D & S's empirical study of LLCs choices of formation states is that LLCs appear to be fleeing lax states, as indicated by the state's relatively low manager duty of care (gross negligence or waivable or both), or if it allows companies to be dissolved by sub-unanimous vote. As discussed below, it is not clear why these results support D & S's conclusions. Nor is it clear why the results for LLCs should be different from what the authors found for close corporations based on the same database<sup>40</sup> – i.e., that large closely held corporations (based on number of employees) tend to incorporate outside their home state if that state has low-quality courts, a high level of minority shareholder protection, or

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*Associations*, 30 DEL. J. CORP. L. 199 (2005).

<sup>37</sup> See *Litchfield Asset Management v. Howell*, 70 Conn. App. 133, 799 A.2d 298 (2002).

<sup>38</sup> See *In re Albright*, 291 B.R. 538, 541 (Bankr. D.Colo. 2003).

<sup>39</sup> *Cendant Corp. v. Shelton*, 473 F.Supp.2d 307 (D.Conn., 2007).

<sup>40</sup> Jens Dammann & Matthias Schündeln, *The Incorporation Choices of Privately Held Corporations*, The University of Texas School of Law, Law and Economics Research Paper No. 119, December 2, 2007.

relatively high risk of veil-piercing. Finally, there is some doubt regarding whether the correlations are robust to correction of potential errors in the data. Despite these doubts, the fact that D & S is the only current study of LLC competition warrants the inclusion of the authors' variables in our analysis.

There is no theoretical reason to believe that the D & S laxity variables would significantly affect an LLC's decision where to form. To begin with, it is not clear why closely held firms would exit statutes that have default rules providing for low levels of minority protection. Firms would not demand high levels of minority protection unless they were looking for outside investors, which is unlikely for most of these very closely held firms. Even if the firms want minority protection, they can draft for the protection at lower cost than choosing to organize in a state that offers high-protection provisions as default or mandatory rules. And if the firms were seeking minority protection outside their principal place of business, it is not clear why they would tend to choose Delaware, as the data indicates they do. Delaware has two of the main low-protection provisions identified in the study – ability to opt out of the duty of care, and ability to dissolve the firm by less than unanimous vote.

Moreover, even if their general theory worked, D & S's independent variables are inconsistent with the theory for several reasons. First, the authors connect the duty of care to minority protection by arguing that “any norm that reduces the duty of care for managers has the potential to benefit controllers at the expense of minority investors.”<sup>41</sup> But this does not follow, since deviations from the standard of care would tend to hurt the value of the firm as a whole, and thereby injure both majority and minority holders, rather than transfer value from the minority to the majority.

Second, even if the duty of care mattered to minority protection, the authors have not identified relevant differences among statutes regarding the default statutory duty. They distinguish between lax and strict standards by differentiating between statutes that require proof of gross negligence to show a breach of the duty and those that do not provide for this standard. However, these standards do not materially differ.<sup>42</sup> About a third of the statutes appear to require something like ordinary care – that is, acting as a “prudent person in similar circumstances,” but qualify this standard by permitting the managers to rely on reports or the agreement. A substantial minority of statutes do not specify the duty of care. Although the “prudent person” standard sounds like negligence, it leaves significant discretion to the courts, particularly in light of the reasonable-reliance qualification. Under all of these statutes the courts are

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<sup>41</sup> See Dammann & Schundeln, *supra* note 29 at \_\_\_.

<sup>42</sup> For analyses of the duty of care in LLC statutes, see Larry E. Ribstein & Robert Keatinge, RIBSTEIN & KEATINGE ON LLCs, App. 9-4 (tabulating duty of care standards); Elizabeth S. Miller & Thomas E. Rutledge, *The Duty of Finest Loyalty and Reasonable Decisions: The Business Judgment Rule in Unincorporated Business Organizations*, 30 DEL. J. CORP. L. 343, 366-368 (2005).

likely to resolve ambiguities by applying the more well-developed standards under either partnership or corporate law. Partnership law traditionally applies something like a gross negligence standard,<sup>43</sup> and this was the standard explicitly adopted in the Revised Uniform Partnership Act.<sup>44</sup> Corporate law generally applies the business judgment rule, which accords substantial deference to directors unless they have been disloyal or acted with gross negligence. The Uniform Limited Liability Company Act recognized the general rule by adopting the gross negligence standard.<sup>45</sup> The Revised Uniform Limited Liability Company Act attempts to compromise between the ordinary care and gross negligence standards by providing for an ordinary care standard, but then qualifies this by making it subject to the business judgment rule.<sup>46</sup> A committee of lawyers reviewing RULLCA concluded that the “language as written appears circular, in that the prefatory language appears to restate what most believe to be the business judgment rule.”<sup>47</sup>

Third, even if *default* standards of care differ, that difference is meaningless to the extent that the statute lets parties contract around the duty of care. In fact, the vast majority of statutes do explicitly permit the parties to contract around the duty of care, no statutes prohibit such contracts, and there is no case law support for prohibitions on such waivers. D & S take waiver into account both as an independent variable and as part of a joint variable combining the default duty of care and the ability to opt out. But if the statute permits waiver of the duty of ordinary care, it is not clear why the default standard should affect a firm’s decision where to organize. In any event, there would be very little difference in effect between statutes that did, and did not, allow waiver of due care liability. Even if the statute does not explicitly allow waiver of due care liability, courts are very likely to apply something like the business judgment rule, given the inherent problem of judicial second-guessing of management decisions.<sup>48</sup> Conversely, if the statute allows waiver of due care liability, courts can still impose liability for breach of the duty of loyalty, and therefore for its close

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<sup>43</sup> See Alan R. Bromberg & Larry E. Ribstein, BROMBERG & RIBSTEIN ON PARTNERSHIP, §6.07(f).

<sup>44</sup> See R.U.P.A. §404(c) (providing that a partner’s duty of care is limited to refraining from engaging in “grossly negligent or reckless conduct, intentional misconduct, or a knowing violation of law”).

<sup>45</sup> See ULLCA §409(c) (1996).

<sup>46</sup> See RULLCA §409(c) (2006).

<sup>47</sup> See *Partnerships and Unincorporated Business Organizations Committee of the Section of Business Law*, REPORT OF THE RULLCA TASK FORCE (2007). For an analysis of the compromise nature of the provision, see Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA L. & BUS. REV. \_\_ (2008).

<sup>48</sup> See Ribstein & Keatinge, *supra* note 42 at §9:3, n.3.

cousin, the duty of good faith.<sup>49</sup> And courts in any event can still hold that highly unreasonable conduct is at least circumstantial evidence of a loyalty breach. In short, there is little theoretical reason to believe that the D & S care variables would have a significant effect on firms' decisions where to organize.

Fourth, with respect to the other law variable that is significant in D & S's regression – the right to dissolve at will – the authors again provide no coherent theory as to why this should affect firms' decisions where to organize. They argue that a majority can use the power to dissolve opportunistically, so that the existence of a majority power to dissolve indicates lax minority protection. However, an alternative way to apply these statutes is that dissolution by dissociation becomes a mechanism for protecting rather than oppressing minority members. This could change the theory of why the statute matters from a “flight to laxity” to a “flight from laxity.” Moreover, as with the duty of care, it is not clear why the majority would use this as a reason for forming under another state's law when, as under all statutes, the majority can simply draft for a power to dissolve. Moreover, the authors have not identified the relevant variable. The question is not simply whether the majority can dissolve, but whether a single member can trigger dissolution by dissociating from the firm. This traditional partnership power of unilateral dissolution is certainly a form of sub-unanimous dissolution. Thus, in sum, we predict that the D & S laxity variables would not be significant predictors of an LLC's choice of formation state.

D & S also have a variable that indicates whether a state has adopted ULLCA. Prior studies that examined public firms' choice of its state of incorporation have used the adoption of the MBCA as a proxy for the effect of uniformity on choice of incorporation state.<sup>50</sup> D & S used the same variable in their study of private corporations.<sup>51</sup> D & S use a state's adoption of ULLCA as a proxy for adoption of a uniform statute in their study of LLCs. However, there is strong reason to question this use of ULLCA to approximate the MBCA's effect in the corporate context. As we have shown in our prior work, ULLCA was promulgated after most of the states had already passed LLC statutes,<sup>52</sup> and states achieved significant uniformity in the absence of a uniform law, especially in third party and tax provisions areas where a uniform approach is consistent with economic efficiency.<sup>53</sup> More importantly, we found that both ULLCA and RULLCA in many cases promoted *non-uniformity* by eschewing widely adopted leading forms in favor of rarely adopted idiosyncratic

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<sup>49</sup> See *Stone v. Ritter*, 911 A.2d 362 (Del. 2006) (analyzing connection between corporate good faith and loyalty duties).

<sup>50</sup> See *Bebchuk & Cohen*, *supra* note 29.

<sup>51</sup> *Dammann & Schündeln*, *supra* note 40

<sup>52</sup> *Ribstein & Kobayashi*, *supra* note 3.

<sup>53</sup> *Kobayashi & Ribstein*, *supra* note 3.

provisions.<sup>54</sup> We showed that this non-uniformity effect was likely produced by the specific public choice characteristics of the National Conference of Commissioners of Uniform State Laws which drafted both versions of ULLCA. By contrast, the MBCA is a model law produced under different conditions and constraints. Thus, in contrast to the MBCA in the corporate context, a state's passage of ULLCA is not a reliable indicator of uniformity and, if anything, indicates the opposite. Accordingly, we are not surprised that D & S did not find this variable to be a significant predictor, and do not expect it to be in our analysis.

#### IV. DATA AND RESULTS

The previous section provides guidance as to the types of statutory terms that might correlate with firms' decisions to organize outside the home state. We focus on the four factors listed in Part III – quality of law, flexibility, innovation and debtor protection. We also examine the statutory factors contained in the D & S analysis.

To examine the question of choice of formation state, we used data from the ICARUS database. This is the same source used by D & S, and contains firm level information on over 14 million companies.<sup>55</sup> The ICARUS database contains electronic records of data collected by Dun & Bradstreet.<sup>56</sup> Our results are based on a later update of the data set used by D & S.<sup>57</sup> We searched the company name field for

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<sup>54</sup> Ribstein & Kobayashi, *supra* note 3; Kobayashi & Ribstein, *supra* note 3.

<sup>55</sup> For an in-depth description of the ICARUS database, see <http://www.bvdep.com/en/ICARUS.html>.

<sup>56</sup> For a description of the data collection procedures of Dun & Bradstreet (D&B), see Douglas P. Handler, *Business Demographics – Tabulation and Analysis of Dun & Bradstreet's Database Compared to Other Business Data*, available at [http://findarticles.com/p/articles/mi\\_m1094/is\\_n2\\_v25/ai\\_8884857?tag=artBody:coll](http://findarticles.com/p/articles/mi_m1094/is_n2_v25/ai_8884857?tag=artBody:coll). A firm can request listing in D&B. A firm can also get listed if a third party request credit information, or if a third party identifies a firm in its accounts receivable. D&B also searches public records to identify firms not otherwise identified.

<sup>57</sup> Following D & S, we collected data on firms contained in the ICARUS database whose listed name identifies them as a limited liability company and had reported data for employment, and total revenue. D & S used firms that reported data on employment for 2006. Our dataset used all firms that reported employment and revenue numbers. We also constructed a dataset of LLCs that reported data on employment and revenue for 2006 and had 5 or more employees in an attempt to replicate D & S's results. This search yielded 118,874 firms, of which 48,137 listed their state of formation. We were not able to replicate the D & S dataset, which found over 64,000 firms listing the state of formation using the same criteria. One reason for this discrepancy is the fact that our data is based on the August 2008 update of the ICARUS database (Update Number 57), while D & S used data from the March 2008 update (Update Number 52). ICARUS updates its database monthly, and between updates 52 and 57 added over 1.75 million companies and deleted 845,000 non-marketable or inactive companies. Thus, in contrast to D & S, our dataset is likely to have added new LLCs that did not report 2006 data and to have deleted LLCs that had data reported for 2006.

firms that included the term “limited liability company” or abbreviations of this term. We only selected company headquarters and single locations, and did not include branch locations. We also limited our dataset to private firms. Using these criteria, our search yielded 805,414 LLCs that reported employment and revenue data, of which 282,383 listed their state of formation. The data is listed by state in Table 1 for all LLCs culled from the ICARUS database, and for LLCs with 5 or more and 50 or more employees. For comparison, we also list the number of active LLCs reported by the International Association of Commercial Administrators (IACA) in its 2007 annual report.<sup>58</sup> This latter number includes both domestic and foreign LLCs.

[INSERT TABLE 1 HERE]

Table 2 lists the formation state for out-of-state LLCs. The table shows that Delaware is the clear leader, with a 25% percent share of all out of state formations. Florida is second, with just over 9% of the out-of-state formations, and Nevada third with 7.6% of the out-of-state formations. No other state has much as a 5% share of out of state formations. Delaware’s dominance is magnified when we look at large firms. Table 2 also lists the destination states for firms with 5 or more and 50 or more employees. For the largest firm category, Delaware has a 61.7% share of out of state formations. In contrast, Florida and Nevada’s share drops to 2.34% and 2.09% respectively.

[INSERT TABLE 2 HERE]

In order to systematically examine the factors that affect LLCs’ decisions to form out of state, we performed a cross-sectional regression analysis of the ICARUS data. Following D & S, we used a probit estimation procedure with robust standard errors clustered by state.<sup>59</sup> The dependent variable HOME takes the value 1 if the LLC forms in the home state, 0 if it forms in a state other than the home state. All of the regressions contained one digit SIC industry fixed effects. As explanatory

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<sup>58</sup> See THE INTERNATIONAL ASSOCIATION OF COMMERCIAL ADMINISTRATORS, 2007 ANNUAL REPORT OF THE JURISDICTIONS, available at [http://www.iaca.org/downloads/AnnualReports/2007\\_IACA\\_AR.pdf](http://www.iaca.org/downloads/AnnualReports/2007_IACA_AR.pdf).

<sup>59</sup> D & S, *supra* note 29. We attempted to replicate D & S’s results reported in their Table 3. As discussed above, we were not able to replicate the dataset used by D & S because of ICARUS’s monthly updates. Despite the differences in the datasets, our regressions are largely consistent with the basic D & S regressions. When we used a dataset with 2006 data and LLCs with 5 or more employees, both the care 1 variable (denoting states whose statutes contain an explicit gross negligence standard) and the care 2 variable (denoting states that explicitly allow waiver of the duty of care) are negative and statistically significant. The D & S care 3 variable (denoting states that have a gross negligence standard or allow waiver) is negative, but it is not significant at standard levels. One notable difference between our regressions and D & S is the effect of the dissolution variable. This variable denotes states that allow a sub unanimous vote to dissolve. In D & S’s basic regressions, this variable is negative and significant. However, the variable is positive in our regressions but not significant. We found, as did D & S, that the court quality variable was not significant in any of their regressions.

variables, we include firm size, measured by both the log of the number of employees and the log of total revenues. We also control for state population, the number of establishments in a state, and the state's gross domestic product. There are also region fixed effects, as well as a variable that controls for the LLC statute's age. Following D & S, we limited the baseline regression analysis to firms having 5 or more employees.

Based on our discussion in subpart B, we include several groups of state level independent variables, including the court quality variable used by D & S and statutory variables related to innovation, protection for debtors, and statutory flexibility. We also report a specification that includes the D & S variables, including their measures of laxity variables, and a variable that denotes whether a state had adopted ULLCA.

Note that our analysis relates to firms' decisions both to remain in their home state and to organize elsewhere. One major difference between our analysis and that of D & S is that we control for the attributes of the statutes and legal environment in the *formation* state. A firm's decision to organize outside the home state obviously would depend on *both* the home state's law *and* the law of the state of formation. Thus, D & S's approach, which only examines the attributes of the home state statute and legal environment, omits an important set of variables relating to the statute and legal environment in the formation state.<sup>60</sup>

[INSERT TABLE 3 HERE]

The importance of looking at the attributes of both the home and formation state can be illustrated by looking at the univariate statistics of the court quality variable. D & S find that the court quality variable in the home state is not a significant predictor of whether an LLC forms in its home state.<sup>61</sup> Table 3 shows that the mean home court quality for firms that chose to form in the home state is slightly higher than for firms that chose to form out of state (61.5 to 60.8 respectively), based upon LLCs reporting 2006 data.<sup>62</sup> This difference is statistically significant but has a small magnitude. Table 3 also shows the difference between court quality in the formation state for home and out of state firms. For firms that formed out of state, the average court quality of the formation state (67.9) is much higher than that of the states they left (60.8). The court quality of the formation state of firms that stayed

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<sup>60</sup> The Bebchuk & Cohen regression analysis of public corporations' choice of incorporation state also only considers the attribute of the home state statute. See Bebchuk & Cohen, *supra* note 12. They, however, provide univariate statistics showing that firms choosing to incorporate out of state are moving toward incorporation states with stronger antitakeover provisions.

<sup>61</sup> See D&S, *supra* note 29, Table 3.

<sup>62</sup> As noted above, D & S used a dataset containing LLCs that report 2006 data.

home is 61.5. In other words, the D & S approach only considers the small difference in home state court quality between firms that left and firms that stayed, and fails to capture the much larger differential between formation and home states for firms that formed out of state.<sup>63</sup> High court quality in formation states attracts foreign LLC formations, and high court quality in home states allows them to retain their LLCs. This result is consistent with the “Delaware” effect found in the literature on jurisdictional competition for public corporations, where it is the legal institutions rather than the statute that serves to attract firms.<sup>64</sup> The importance of this court quality effect is evident from the fact that the D & S laxity variables are statistically significant when the court quality variables are omitted, but disappear when the court quality variables are included.<sup>65</sup>

The results of our regression analysis are presented in Table 4, which reports the marginal effects of the independent variables on the probability of formation in the home state. Columns (1) through (3) of Table 4 report regressions using the individual statutory provisions set out in Section III, and for firms having 5 or more employees. Column (4) reports the regression using the bundled flexibility variables. The two variables that are consistently significant in the regression analysis are the series variables and the court quality variables. Based on the regression results, allowing series LLCs and having a high court quality keeps LLCs at home and attracts foreign LLCs to the state. Thus, the regression analysis suggests that LLCs are drawn to

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<sup>63</sup> Indeed, contrary to the results in D & S, there is strong evidence that that court quality is a statistically significant factor in explaining the LLC’s choice to form in a state other than the home state when we added the formation state variables to D & S’s regressions. We found that controlling for court quality in *both* the home and formation state we found that both the home state and formation state court quality variables are statistically significant at the .01 level. The home state court quality variable is positive and significant, while the formation state court quality variable is negative and significant. The magnitude of the court quality results is also economically significant. For example, the marginal effect reported in column 4 of Table 6 implies a 18.1 percent decrease in the probability when an LLC switches from an state with an average court quality (with an index equal to 61.7) to Delaware (with a court quality index of 75.16)

<sup>64</sup> See Romano, *supra* note 7; Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

<sup>65</sup> The effects of the court quality variables are also important when examining D & S’s care variables. When the court quality variables are not included in the regressions, we find that D & S’s “care” variables seemingly provide some support for the laxity hypothesis. Both the care 1 variable (which denotes that the state’s statute has a gross negligence standard) and the care 2 variable (which denotes that the state’s statute does not prevent opting out of fiduciary duties) have negative coefficients for the home state variable, and positive coefficients for the formation state variable. The home state and formation state care 1 variables are significant at the .05 and .10 level. When the court quality variables are added, however, the care 1 variables are no longer significant. Thus, the D & S result for the care 1 variable appears to have been driven mainly by court quality. This is not surprising considering the point made above that firms are unlikely to be concerned about the default rule in any event as long as they can contract around it.

states, especially Delaware, in which they can anticipate high quality litigation outcomes. The magnitude of the court quality results is also economically significant. For example, the marginal effect reported in column 4 of Table 4 implies a 5.6 percent decrease in the probability of formation in the home state when an LLC switches from a state with an average court quality (with an index equal to 61.7) to Delaware (with a court quality index of 75.6).

The explanation for out-of-state LLC formations resembles the story for why corporations are attracted to Delaware. The coefficients on the series variable suggest that these new and sparsely adopted provisions attract formation to states that have passed these innovative statutory provisions. It is not clear whether this reflects an overall measure of these states' overall propensity to innovate, or whether this is transitory effect that will evaporate as more states pass legislation that enables the use of series LLCs.

To further examine the Delaware effect, the regressions reported in Table 4 were re-run with variables denoting whether the LLC was located or formed, or both, in Delaware. When these Delaware variables were added, both the home and formation state Delaware variables were of the expected sign and significant at the .05 level for all specifications. Moreover, both the court quality and series variables are not statistically significant at standard levels when the Delaware variables are added. The coefficients and statistical significance on the remaining variables were not substantively affected. Column (5) of Table 4 reports the coefficients for the bundled variable regressions that include the Delaware variables.

Both the log of employment and the log of revenue remain significant factors, both suggesting that larger firms are more likely to form out of state. To isolate factors that matter to these large firms, we re-ran the regression in Columns (4) and (5) of Table 4, limiting the data to firms with over 50 employees. The results of this regression are reported in Columns (6) and (7) of Table 4. The substantive results are similar, with the specification in Column (6) suggesting that court quality and the ability to form series LLCs are important factors in retaining and attracting LLCs. In addition, both the magnitude and the statistical significance of these results increase when the sample consists only of large firms. For example, the effect of moving from a state with average court quality to Delaware is 18.1 percent for the large firm sample. Column (7) adds the Delaware variables, which again are significant and of the expected sign. Moreover, the addition of the Delaware variable again makes both the court quality and series variables statistically insignificant.

None of the flexibility variables is statistically significant, either individually or bundled. Neither debtor protection variable is statistically significant. This may reflect that the regressions reported in Table 4 eliminate the smallest firms (with less than 5 employees). Our regressions confirm D & S's finding of no correlation

between formation outside the home state and that state's veil-piercing rules. This is not surprising because, as the authors note, it is very difficult to isolate differences among the rules, which are subject to application in myriad court cases that tend to apply similar rules.<sup>66</sup> The authors focus on the presence of statutory provisions precluding veil-piercing for mere failure to follow formalities. However, the effect of these provisions is unclear, particularly since the courts rarely if ever pierce on these grounds whether or not there is such a statute.<sup>67</sup>

We also include D & S's variables in specifications (2) and (3). The regressions in columns (2) and (3) use revised coding of several of the LLC statutory variables used by D & S. The revised codes are listed in the appendix. We found several cases in which the D & S coding of duty of care and dissolution variables differed from our reading of the statute. Some of the differences regarding the dissolution variables resulted from the authors' failure to take into account that dissolution by member dissociation has the same (or even more significant) effect as the ability to dissolve by a less than unanimous vote. Also, the member dissociation variable does not take account of the fact that default provisions permitting members to dissociate from the LLC but not get paid are functionally equivalent to not permitting dissociation.

Like D & S, our regressions find no correlation with organization outside the home state and the adoption of ULLCA. For the reasons stated in Part III, this is not surprising, given ULLCA's non-effect on uniformity. Thus, the lack of significance should not be taken as evidence against the importance of uniformity in LLC statutes, but as no more than confirmation of the non-uniformity of ULLCA. D & S also find that the number of years since adoption of the LLC statute is not significant. However, in our regressions, the home state variable is positive and significant at the .10 level in specification (2).

As our theory predicts, the D & S variables do not generally show a flight from laxity in our analysis.<sup>68</sup> The "care 1" and "care 2" variables are not statistically

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<sup>66</sup> See Ribstein & Keatinge, *supra* note 42, at §12.03.

<sup>67</sup> *Id.*

<sup>68</sup> In addition to the coding corrections, we also examined regressions where we assumed that LLCs that did not report a state of formation were formed in the home state. Examining the data in Table 1, the rate at which the formation state is reported varies widely by state, with several states, including Rhode Island, West Virginia and Colorado, all with reporting rates of 5 percent or less. These three states also have the three highest percentage of out of state formations, and are also states that are coded as lax states. Moreover, of the seven states that report out of state formation rates of greater than ten percent, all but one (DC) have the lowest reporting rates. Furthermore, all seven of these states are coded by D & S as lax states. This data suggests the possibility that the propensity of firms in the low reporting states to organize out of state may be an artifact of the low reporting rate. The higher out-of-state formation rate in these states may reflect a higher probability an out of state firm reports its state of

significant. Turning to the “care 3” variable, the home state coefficient is negative and significant at the .05 level, and the formation state variable is positive and significant at the .10 level. The coefficient on the home state care 3 variable implies a 2.9% marginal decrease in the probability an LLC in a lax state forms in its home state. The formation state variable implies a 16.1 percent increase in the same probability.

[INSERT TABLE 5 HERE]

A closer look at the raw data, however, shows that this latter result does not support the flight from laxity theory, and further illustrates the importance of taking into account the attributes of the formation state’s statute. Table 5 shows that based on 2006 data, 1,909 firms chose to form outside of their home state. The vast majority of these firms (1,699, or 89%) come from lax states (firms with care 3 = 1). Note, however, that most firms that leave “lax” states (1457, or 86%) go to other lax states. Thus, while the data show that LLCs often *come from* lax states, the most common outcome is a *move to* another lax state. Thus, the fact that the vast majority of firms move from lax jurisdictions does not suggest an overall flight from laxity.

The only support for a flight from laxity comes from the fact that, *when* firms move from one level of laxity to another, they tend to move to less laxity. In other words, a move from a lax state to a non-lax state occurs more frequently (242) than a move from a non-lax state to a lax state (164). To put this another way, the D & S claim that firms are fleeing laxity rests on only a subset of 406 of the total number of 1909 firms that are moving. But it is the overall movement that needs to be explained, *not* the particular change-in-laxity movement that occurs in a subset of the cases. The fact that most of the movement has nothing to do with laxity undermines rather than supports the flight-from-laxity claim.

In short, neither the substance of the LLC statutes in general, nor a flight from laxity in particular, can explain most LLC’s formation choices after controlling for court quality and the state of origin. The relevant factors that emerge from the study are that larger firms have a greater tendency to organize outside their home state and that court quality of both the home and formation state matter. With respect to the latter factor, Delaware dominates both regarding court quality and as a destination state. In other words, the evidence suggests that larger LLCs seek better courts, or at least Delaware. As noted above, the data indicates that firms are choosing Delaware *law* because disputes under the Delaware statutes are more likely to be heard in Delaware courts than disputes not involving Delaware law,<sup>69</sup> and Delaware rates very

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formation rather than some inherent difference in these states. When D & S’s regressions are run with the assumption that a missing formation state means the firm formed in the home state, the coefficients on the D & S care variables are no longer statistically significant.

<sup>69</sup> Although any court may hear an issue involving any state’s law, courts may decline to hear a case involving another state’s law on forum non conveniens grounds. To the extent that Delaware

high in court quality. Except for the relatively new series provisions, there is little evidence that any statutory provisions have significance independent of court quality.

## V. CONCLUDING REMARKS

The work so far on jurisdictional competition for business associations has focused on publicly traded corporations. But there are equally interesting questions concerning jurisdictional competition for non-corporate and non-publicly traded entities. The D & S article is a start in this direction. However, before running empirical tests on these firms, it is necessary to develop a theory of the factors that drive jurisdictional competition in this context. We provide that theory, and test it using data similar to that used by D & S. We identify several factors that, under our theory, would seem to matter in driving jurisdictional for limited liability companies: firm size; court quality; statutory flexibility; statutory innovation; and debtor protection. Our empirical results suggest that court quality is the most significant factor in allowing states to retain and attract LLCs.

At least as interesting as the factors we find to be important is the factors we find are *not* important – those relating to the substance of the LLC statutes. We have attempted to identify all of the statutory provisions that might influence firms' choice of formation state, and find that none are important apart from the exceptional case of series LLC provisions. This suggests that the significant effort invested by state bars and legislatures in drafting LLC statutes may have little payoff in terms of attracting LLCs to the legislating states.<sup>70</sup> Rather, LLC statutory provisions may matter little in state competition either because they are uniform across the states (as with provisions affecting third parties) or are more easily modified by contract than by forming outside a firm's home jurisdiction.

This paper is only a first step toward a broader analysis and empirical tests of the forces driving jurisdictional competition beyond publicly traded firms. There are other potential factors that researchers should test. On the demand side, lawyers may influence firms' jurisdictional choice. For example, large firms are more likely to have lawyers in major commercial jurisdictions, such as New York, Illinois and California, and these lawyers may advise use of local law. Also, general legal and economic environment matters may play a role in closely held firms' jurisdictional choice. Firms may choose to form in their home state for a combination of reasons relating both to the applicable law and to the legal and economic environment. The choice of physical location therefore may reflect choice of law.

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seeks to, in effect, use formation fees as the price of entry into its courts, they can be expected to decline to hear internal governance disputes for non-Delaware business associations.

<sup>70</sup> The more important payoff may be reputational for the lawyers involved in the drafting projects. With respect to lawyers' incentives to participate in state law reform, see Larry E. Ribstein, *Lawyers as Lawmakers: A Theory of Lawyer Licensing*, 69 Mo. L. Rev. 299 (2004).

On the supply side, it is still not clear what drives states to compete for LLCs, or even whether they are doing so. LLCs produce much less in franchise or similar fees for states than do large corporations. Closely held firms also are not a major source of business for litigators. It may be that the supply side of LLC competition is driven by transactional lawyers, which suggests that the law governing these firms may be more conducive to efficient contracting than corporations.

In general, these research topics will become more important as unincorporated firms come to occupy a larger part of the business association universe.

TABLE 1 – DATA ON LLCs BY STATE

STATE	ALL COMPANIES						LLCs WITH 5 OR MORE EMPLOYEES						LLCs WITH 50 OR MORE EMPLOYEES					
	TOTAL FOR. AND DOM. LLCs (IACA)	LLCs LOCATED IN STATE (ICARUS)	LLCs REPORTING FORMATION STATE	LLCs FORMING OUT OF STATE	% REPORTING	% OUT OF STATE	LLCs LOCATED IN STATE (ICARUS)	LLCs REPORTING FORMATION STATE	LLCs FORMING OUT OF STATE	% REPORTING	% OUT OF STATE	LLCs LOCATED IN STATE (ICARUS)	LLCs REPORTING FORMATION STATE	LLCs FORMING OUT OF STATE	% REPORTING	% OUT OF STATE		
AK	12,394	2,035	887	7	43.59%	0.79%	701	324	6	46.22%	1.85%	77	40	2	51.95%	5.00%		
AL		13,044	5,092	74	39.04%	1.45%	3,471	1,688	37	48.63%	2.19%	342	159	12	46.49%	7.55%		
AR	36,761	5,889	1,781	39	30.24%	2.19%	1,458	545	24	37.38%	4.40%	181	69	11	38.12%	15.94%		
AZ	259,628	25,253	15,491	156	61.34%	1.01%	6,736	4,240	78	62.95%	1.84%	695	427	20	61.44%	4.68%		
CA	384,473	42,881	17,189	575	40.09%	3.35%	14,544	6,381	303	43.87%	4.75%	2,248	923	84	41.06%	9.10%		
CO	175,006	31,183	538	126	1.73%	23.42%	6,214	264	66	4.25%	25.00%	618	64	25	10.36%	39.06%		
CT	168,643	33,194	18,063	111	54.42%	0.61%	6,632	3,426	64	51.66%	1.87%	503	210	26	41.75%	12.38%		
DC		3,437	909	145	26.45%	15.95%	1,041	301	76	28.91%	25.25%	120	32	12	26.67%	37.50%		
DE	391,820	2,365	130	13	5.50%	10.00%	604	74	6	12.25%	8.11%	59	15	1	25.42%	6.67%		
FL	379,175	54,692	23,312	329	42.62%	1.41%	11,439	5,420	165	47.38%	3.04%	1,413	599	46	42.39%	7.68%		
GA		29,135	10,358	226	35.55%	2.18%	7,762	3,496	111	45.04%	3.18%	912	460	54	50.44%	11.74%		
HI	31,998	4,022	1,941	9	48.26%	0.46%	973	499	4	51.28%	0.80%	116	57	3	49.14%	5.26%		
IA		6,928	4,265	37	61.56%	0.87%	1,655	897	19	54.20%	2.12%	198	102	9	51.52%	8.82%		
ID	41,584	6,603	3,208	34	48.58%	1.06%	1,411	661	11	46.85%	1.66%	123	53	1	43.09%	1.89%		
IL	114,830	16,081	5,816	338	36.17%	5.81%	5,796	2,258	204	38.96%	9.03%	1,113	421	103	37.83%	24.47%		
IN	108,957	14,430	5,697	93	39.48%	1.63%	3,783	1,550	52	40.97%	3.35%	572	242	20	42.31%	8.26%		
KS	44,355	7,473	3,277	61	43.85%	1.86%	2,303	1,120	36	48.63%	3.21%	242	121	13	50.00%	10.74%		
KY	68,174	13,210	6,419	85	48.59%	1.32%	3,331	1,738	57	52.18%	3.28%	436	232	22	53.21%	9.48%		
LA	153,867	18,588	646	65	3.48%	10.06%	5,522	393	45	7.12%	11.45%	682	79	17	11.58%	21.52%		
MA	83,916	10,008	4,890	170	48.86%	3.48%	3,095	1,474	103	47.63%	6.99%	507	211	43	41.62%	20.38%		
MD	134,978	21,573	9,673	186	44.84%	1.92%	5,233	2,446	88	46.74%	3.60%	571	250	32	43.78%	12.80%		
ME	20,361	2,200	632	21	28.73%	3.32%	712	270	7	37.92%	2.59%	98	43	2	43.88%	4.65%		
MI	319,492	32,603	1,328	120	4.07%	9.04%	7,375	735	55	9.97%	7.48%	827	121	21	14.63%	17.36%		
MN	69,951	11,469	3,397	66	29.62%	1.94%	2,821	1,030	40	36.51%	3.88%	424	154	22	36.32%	14.29%		
MO	177,565	17,422	7,552	99	43.35%	1.31%	4,701	2,095	38	44.56%	1.81%	487	211	13	43.33%	6.16%		
MS	61,085	6,672	3,210	38	48.11%	1.18%	1,910	983	28	51.47%	2.85%	194	113	11	58.25%	9.73%		

MT	38,056	3,624	2,664	16	73.51%	0.60%	766	535	7	69.84%	1.31%	53	27	3	50.94%	11.11%
NC	128,680	25,940	13,654	173	52.64%	1.27%	6,004	3,210	89	53.46%	2.77%	784	382	38	48.72%	9.95%
ND	7,952	945	497	8	52.59%	1.61%	292	154	4	52.74%	2.60%	41	11	0	26.83%	0.00%
NE	28,957	3,880	1,749	34	45.08%	1.94%	964	390	16	40.46%	4.10%	125	57	4	45.60%	7.02%
NH	40,703	6,009	1,624	34	27.03%	2.09%	1,471	528	19	35.89%	3.60%	120	43	7	35.83%	16.28%
NJ	259,837	37,237	1,198	232	3.22%	19.37%	8,327	703	138	8.44%	19.63%	835	152	62	18.20%	40.79%
NM		5,073	2,964	20	58.43%	0.67%	1,304	740	5	56.75%	0.68%	125	52	1	41.60%	1.92%
NV	114,668	8,065	2,248	38	27.87%	1.69%	2,438	836	12	34.29%	1.44%	303	112	4	36.96%	3.57%
NY	323,282	39,500	1,978	441	5.01%	22.30%	11,766	1,179	245	10.02%	20.78%	1,799	310	104	17.23%	33.55%
OH	258,395	26,602	8,569	152	32.21%	1.77%	6,680	2,839	102	42.50%	3.59%	880	395	52	44.89%	13.16%
OK	99,782	9,558	3,656	38	38.25%	1.04%	2,730	1,098	22	40.22%	2.00%	342	144	9	42.11%	6.25%
OR	87,491	12,380	5,416	47	43.75%	0.87%	3,147	1,473	23	46.81%	1.56%	299	152	11	50.84%	7.24%
PA	137,688	16,620	7,785	168	46.84%	2.16%	4,716	2,257	96	47.86%	4.25%	722	300	52	41.55%	17.33%
RI	17,740	2,534	54	28	2.13%	51.85%	569	27	13	4.75%	48.15%	73	7	5	9.59%	71.43%
SC		15,774	6,977	91	44.23%	1.30%	3,611	1,585	48	43.89%	3.03%	400	166	21	41.50%	12.65%
SD	11,022	1,633	498	14	30.50%	2.81%	420	193	9	45.95%	4.66%	46	27	3	58.70%	11.11%
TN	54,751	16,459	7,371	129	44.78%	1.75%	5,824	3,075	62	52.80%	2.02%	682	350	14	51.32%	4.00%
TX	254,834	46,145	15,387	314	33.34%	2.04%	12,246	4,970	178	40.58%	3.58%	1,343	502	69	37.38%	13.75%
UT	95,677	14,322	7,070	66	49.36%	0.93%	3,199	1,538	27	48.08%	1.76%	287	140	11	48.78%	7.86%
VA	149,331	27,228	13,083	208	48.05%	1.59%	6,419	3,090	103	48.14%	3.33%	665	321	40	48.27%	12.46%
VT	11,343	1,466	553	6	37.72%	1.08%	360	106	3	29.44%	2.83%	33	6	1	18.18%	16.67%
WA	130,318	19,747	7,532	120	38.14%	1.59%	5,135	2,244	50	43.70%	2.23%	552	228	19	41.30%	8.33%
WI		25,561	12,854	61	50.29%	0.47%	5,242	2,562	41	48.87%	1.60%	561	269	26	47.95%	9.67%
WV	21,945	4,281	64	18	1.49%	28.13%	1,124	44	11	3.91%	25.00%	100	6	4	6.00%	66.67%
WY	36,665	2,441	1,237	9	50.68%	0.73%	632	346	5	54.75%	1.45%	41	21	4	51.22%	19.05%
TOTAL		805,414	282,383	5,688			206,609	80,030	3,051			24,969	9,588	1,189		

TABLE 2 – DESTINATION STATE OF OUT OF STATE LLC FORMATIONS

STATE	ALL LLCs		LLCs WITH 5 OR MORE EMPLOYEES		LLCs WITH 50 OR MORE EMPLOYEES	
	NUMBER OF FLLCs	% OF TOTAL FLLCs	NUMBER OF FLLCs	% OF TOTAL FLLCs	NUMBER OF FLLCs	% OF TOTAL FLLCs
AK	36	0.63%	19	0.62%	4	0.33%
AL	34	0.60%	18	0.59%	5	0.42%
AR	19	0.33%	9	0.29%	5	0.42%
AZ	138	2.42%	44	1.44%	4	0.33%
CA	200	3.51%	91	2.98%	22	1.84%
CO	16	0.28%	11	0.36%	5	0.42%
CT	158	2.77%	41	1.34%	10	0.84%
DC	30	0.53%	15	0.49%	0	0.00%
DE	1,461	25.65%	1,210	39.58%	737	61.67%
FL	514	9.02%	148	4.84%	28	2.34%
GA	180	3.16%	81	2.65%	25	2.09%
HI	22	0.39%	9	0.29%	1	0.08%
IA	67	1.18%	23	0.75%	4	0.33%
ID	55	0.97%	22	0.72%	5	0.42%
IL	97	1.70%	48	1.57%	15	1.26%
IN	83	1.46%	41	1.34%	20	1.67%
KS	77	1.35%	29	0.95%	4	0.33%
KY	63	1.11%	25	0.82%	6	0.50%
LA	18	0.32%	9	0.29%	2	0.17%
MA	64	1.12%	29	0.95%	4	0.33%
MD	182	3.19%	77	2.52%	19	1.59%
ME	13	0.23%	6	0.20%	3	0.25%
MI	36	0.63%	24	0.79%	7	0.59%
MN	41	0.72%	33	1.08%	12	1.00%
MO	82	1.44%	37	1.21%	11	0.92%
MS	37	0.65%	16	0.52%	2	0.17%

MT	21	0.37%	7	0.23%	1	0.08%
NC	150	2.63%	60	1.96%	24	2.01%
ND	7	0.12%	3	0.10%	1	0.08%
NE	16	0.28%	9	0.29%	2	0.17%
NH	25	0.44%	4	0.13%	0	0.00%
NJ	45	0.79%	31	1.01%	8	0.67%
NM	47	0.82%	17	0.56%	1	0.08%
NV	434	7.62%	195	6.38%	25	2.09%
NY	89	1.56%	63	2.06%	18	1.51%
OH	133	2.33%	66	2.16%	25	2.09%
OK	31	0.54%	12	0.39%	3	0.25%
OR	58	1.02%	25	0.82%	7	0.59%
PA	89	1.56%	49	1.60%	16	1.34%
RI	3	0.05%	3	0.10%	1	0.08%
SC	34	0.60%	16	0.52%	3	0.25%
SD	13	0.23%	9	0.29%	4	0.33%
TN	95	1.67%	60	1.96%	17	1.42%
TX	132	2.32%	75	2.45%	24	2.01%
UT	38	0.67%	17	0.56%	4	0.33%
VA	244	4.28%	107	3.50%	30	2.51%
VT	4	0.07%	0	0.00%	0	0.00%
WA	41	0.72%	24	0.79%	6	0.50%
WI	87	1.53%	28	0.92%	6	0.50%
WV	5	0.09%	4	0.13%	0	0.00%
WY	133	2.33%	58	1.90%	9	0.75%
TOTAL	5697		3057		1195	

TABLE 3 – AVERAGE COURT QUALITY

	Obs.	Mean.	S.E.
A. Average Court Quality, Formation State = Home State (Home = 1)	46110	61.46	0.027
B. Average Home State Court Quality, Out of State Formation (Home = 0)	1868	60.80	0.14
C. Average Formation State Court Quality, Out of State Formation (Home = 0)	1902	67.86	0.180792
Difference B. - A. (t = -4.60)		-.666	.145
Difference C. - A. (t = 35.00)		6.4	.183

TABLE 4 – REGRESSION ANALYSIS

Dependent Variable = 1 if LLC forms in home state	Firms with 5 or more employees	Firms with 5 or more employees	Firms with 5 or more employees	Firms with 5 or more employees	Firms with 5 or more employees	Large Firms (50 or more employees)	Large Firms (50 or more employees)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Log(Revenue)	-0.006*** (0.001)	-0.005*** (0.001)	-0.005*** (0.001)	-0.006*** (0.001)	-0.006*** (0.001)	-0.013** (0.004)	-0.013*** (0.005)
Log(Employees)	-0.004*** (0.001)	-0.004*** (0.001)	-0.004*** (0.001)	-0.004** (0.001)	-0.003*** (0.001)	-0.019** (0.006)	-0.020*** (0.006)
Log(Total State Population)	-0.001 (0.004)	0.003 (0.003)	0.001 (0.003)	-0.001 (0.003)	-0.001 (0.003)	-0.011 (0.012)	-0.006 (0.014)
Total State Establishments	-0.001 (0.002)	-0.004* (0.002)	-0.001 (0.002)	-0.001 (0.002)	-0.001 (0.002)	0.008 (0.006)	0.008 (0.007)
State GDP	3.82E-08 (4.3E-07)	-8.4E-09 (3.7E-07)	2.28E-07 (4.0E-07)	1.1E-07 (4.9E-07)	1.3E-07 (4.7E-07)	-2.5E-07 (1.3E-06)	-5.8E-07 (1.5E-06)
Northeast	-0.004 (0.007)	-0.006 (0.005)	-0.008 (0.006)	-0.007 (0.009)	0.004 (0.009)	-0.008 (0.019)	-0.002 (0.020)
South	0.008 (0.005)	0.003 (0.005)	0.006 (0.005)	0.005 (0.005)	0.006 (0.006)	0.026** (0.012)	0.031 (0.016)
West	0.008 (0.005)	0.013** (0.004)	0.010 (0.006)	0.009 (0.005)	0.008 (0.005)	0.021 (0.018)	0.021 (0.022)
LLC Age Home State	0.004 (0.004)	0.007* (0.004)	0.004 (0.003)	0.004 (0.004)	0.004 (0.005)	0.010 (0.009)	0.009 (0.011)
LLC Age Formation State	-0.005 (0.005)	-0.006 (0.005)	-0.005 (0.005)	-0.005 (0.005)	-0.004 (0.005)	-0.013 (0.012)	-0.013 (0.014)

<b>Law Quality Variables:</b>							
Court Quality Home State	0.004** (0.002)	0.003* (0.002)	0.004** (0.002)	0.004** (0.002)	0.002 (0.002)	0.011*** (0.004)	0.005 (0.006)
Court Quality Formation State	-0.004* (0.002)	-0.004* (0.002)	-0.004* (0.002)	-0.004* (0.002)	-0.002 (0.003)	-0.013** (0.005)	-0.005 (0.007)
Delaware Home State					0.022* (0.002)		0.091*** (0.007)
Delaware Formation State					-0.831** (0.293)		-0.931*** (0.057)
<b>Innovation Variables:</b>							
Series Home State	0.030** (0.006)	0.029*** (0.006)	0.029*** (0.006)	0.029** (0.006)	0.024 (0.010)	0.096*** (0.020)	0.063 (0.051)
Series Formation State	-0.232** (0.174)	-0.226*** (0.160)	-0.218** (0.159)	-0.215** (0.164)	-0.089 (0.114)	-0.322** (0.184)	-0.086 (0.148)
<b>Creditor Pro. Variables</b>							
Charging Order Home State	-0.002 (0.036)	0.003 (0.030)	0.001 (0.033)	-0.000 (0.030)	-0.030 (0.062)	0.004 (0.074)	-0.085 (0.138)
Charging Order Formation State	-0.016 (0.059)	-0.018 (0.064)	-0.021 (0.068)	-0.016 (0.057)	0.009 (0.032)	-0.063 (0.148)	0.018 (0.114)

<b>Flexibility Variables:</b>				
Contribution Home State	0.005 (0.027)	0.004 (0.026)	0.007 (0.026)	
Contribution Formation State	-0.005 (0.038)	-0.004 (0.037)	-0.009 (0.042)	
Merger Home State	-0.002 (0.023)	-0.002 (0.023)	-0.006 (0.022)	
Merger Formation State	0.003 (0.032)	0.003 (0.033)	0.004 (0.034)	
Fiduciary Wvr. Home State	0.013 (0.023)	0.021 (0.021)	0.017 (0.022)	
Fiduciary Wvr. Formation State	-0.012 (0.035)	-0.022 (0.040)	-0.017 (0.036)	
Bundled Variable Home State			0.007 (0.010)	0.000 (0.010)
Bundled Variable Formation State			0.022 (0.025)	-0.007 (0.029)
			-0.006 (0.011)	0.009 (0.032)
			-0.030 (0.033)	0.009 (0.035)

<b>D &amp; S Variables:</b>							
Care 1 (revised)		-0.041					
Home State		(0.045)					
Care 1 (revised)		0.020					
Formation State		(0.022)					
Care 2 (revised)		-0.026					
Home State		(0.009)					
Care 2 (revised)		0.112					
Formation State		(0.125)					
Care 3 (revised)						-0.029**	
Home State						(0.008)	
Care 3 (revised)						0.161*	
Formation State						(0.152)	
Withdraw (revised)		0.002				0.008	
Home State		(0.032)				(0.036)	
Withdraw (revised)		-0.007				-0.012	
Formation State		(0.031)				(0.027)	
Dissolution (revised)		0.007				0.014	
Home State		(0.024)				(0.024)	
Dissolution (revised)		-0.008				-0.017	
Formation State		(0.031)				(0.033)	
Pierce LLC		-0.021				-0.034	
Home State		(0.031)				(0.034)	
Pierce LLC		0.017				0.020	
Formation State		(0.020)				(0.019)	
ULLCA		0.019				0.014	
Home State		(0.013)				(0.018)	
ULLCA		-0.050				-0.029	
Formation State		(0.098)				(0.079)	
Number of Observations	79711	79711	79711	79711	79711	9555	9555

(Robust Standard Error in Parentheses)

\* - significant at the .10 level. \*\* - significant at the .05 level. \*\*\* - significant at the .01 level.

TABLE 5 - HOME AND FORMATION STATE CARE 3 VARIABLE  
(FIRMS THAT FORM OUT OF STATE, 2006 DATA)

		Formation State		
		0	1	Total
Home State	0	46	164	210
	1	242	1,457	1,699
	Total	288	1,621	1,909

APPENDIX: STATE LEVEL VARIABLES

STATE	FIDUCIARY WAIVER	MERGER	CONTRIBU- TION	SERIES	UN- LIMITED EX- EMPTION	RESTRICT- ED CREDI- TOR RIGHTS	SP. CHARG- ING ORDER
AL	0	1	0	0	0	0	1
AK	0	0	0	0	0	0	1
AZ	0	1	0	0	0	0	1
AR	1	1	0	0	0	0	0
CA	1	1	0	0	0	0	0
CO	1	0	1	0	0	0	0
CT	1	1	0	0	0	0	0
DE	1	1	1	1	0	1	1
DC	0	1	0	0	0	0	0
FL	0	1	0	0	1	0	0
GA	0	1	0	0	0	0	0
HI	0	1	0	0	0	0	1
ID	0	0	0	0	0	0	1
IL	0	1	0	1	0	0	1
IN	0	0	0	0	0	0	0
IA	0	0	0	1	1	0	0
KS	1	1	0	0	1	0	1
KY	1	1	1	0	0	0	0
LA	0	0	0	0	0	0	0
ME	0	0	0	0	0	0	0
MD	0	0	1	0	0	0	0
MA	1	1	1	0	0	0	0
MI	0	1	0	0	0	0	0
MN	0	0	0	0	0	0	1
MS	0	1	0	0	0	0	0
MO	1	0	0	0	0	0	0
MT	0	1	0	0	0	0	1
NE	0	1	0	0	0	0	0
NV	0	1	0	1	0	0	1

NH	0	1	0	0	0	0	0
NJ	1	1	0	0	0	1	1
NM	1	1	0	0	0	0	0
NY	0	1	0	0	0	1	0
NC	0	1	1	0	0	0	0
ND	0	1	0	0	0	0	1
OH	0	1	0	0	0	0	0
OK	0	1	1	1	0	0	1
OR	0	1	0	0	0	0	0
PA	0	1	0	0	0	0	0
RI	0	0	0	0	0	0	0
SC	0	1	0	0	0	0	1
SD	0	0	0	0	1	0	1
TN	0	1	0	1	0	0	1
TX	1	1	1	0	1	1	1
UT	1	1	0	1	0	0	1
VT	0	1	0	0	0	0	1
VA	0	0	1	0	0	1	1
WA	0	0	0	0	0	0	0
WV	0	1	0	0	0	0	1
WI	1	1	0	0	0	0	0
WY	0	0	0	0	0	0	1

STATE	COURT QUALITY	CARE1 (* revised)	CARE2 (* revised)	CARE3 (* revised)	DISSOLU- TION	WITHDRAW (* revised)	PIERCELLC	LLCAGE	ULLCA
AL	50.7	0*	1	1	0	1	0	14	1
AK	56	0	0	0	0	1	0	13	0
AZ	66.3	0	0	0	1	0*	0	15	0
AR	56.5	1	1	1	0	1	0	14	0
CA	53.5	0*	1*	1	1	1	1	13	0
CO	65.1	1	1	1	0	1	1	17	0
CT	66.3	0	1	1	1	1	0	14	0
DE	75.6	0	1	1	1	1	0	15	0
DC		0	1	1	0	1	0	13	0
FL	58.2	1	1	1	0	1	0	25	0
GA	61.2	0	1	1	0	1	1	14	0
HI	56.3	1	1	1	1*	0	1	11	1
ID	61.3	1	1	1	0	1	0	14	1
IL	50.8	1	1	1	1*	1*	1	15	1
IN	68.2	0*	1	1	0*	1	0	14	0
IA	68.9	0	1	1	0	1	1	15	0
KS	66.7	0	1	1	1	1	0	17	0
KY	60.8	1	1	1	0	1	0	13	0
LA	47.3	1	1	1	1	0	0	15	0
ME	68.9	0	0	0	0	1	1	13	0
MD	61.7	0	0	0	0	1*	0	15	0
MA	65.7	0	1	1	0	0	0	12	0
MI	64.2	0	1	1	0	1	0	14	0
MN	70.6	0	1	1	1	1	0	15	0
MS	46.1	0	1	1	0	1	0	13	0
MO	60	0	1*	1*	0	1*	0	14	1
MT	57.2	1	1	1	1*	0	1	14	0
NE	70	0	0	0	0	1	0	14	0
NV	62	0	0	0	0	1	0	16	0
NH	68.2	1	0	1	1	1	0	14	0
NJ	63.4	1	1	1	0	1*	0	14	0

NM	57.5	1	1*	1	1	0	0	14	0
NY	65.6	0	1	1	1	1	0	13	0
NC	65.9	0	1	1	0	1	0	14	0
ND	65.4	0	1	1	1	0*	0	14	0
OH	63.9	0*	0	0*	0	1	0	13	0
OK	57.7	0	1	1	0	1	0	15	0
OR	65.7	1	1	1	0	1	1	14	0
PA	60.8	0	1	1	0	0	0	13	0
RI	58.5	0	1	1	1	1	0	15	0
SC	58.1	1	1	1	1*	0	1	13	1
SD	67	1	1	1	1*	0	1	14	1
TN	68.2	0	1	1	1	0*	1	13	0
TX	54.3	0	1	1	1	1	0	16	0
UT	67.7	1	1*	1	0	1	1	16	0
VT	62.5	0	1	1	0	0	0	11	1
VA	66.9	0	1	1	0	1	0	16	0
WA	63.7	1	1	1	0	1	1	13	0
WV	38	1	1	1	1*	0	1	15	1
WI	67.5	1	1*	1	0	0	0	14	0
WY	64.7	0	0	0	0	0*	0	30	0