

Why Incorporating A Company in NY/NJ is Better for Small Businesses Than in Delaware

Kunj Sheth

Principal CPA, Sheth Tax Inc

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Abstract

Delaware incorporation is expensive. Companies pay up to \$180,000 a year for this simple privilege, more than any other state to form. Professors Marcel Kahan and Ehud Kamar's contentious work, *Price Discrimination in the Market for Corporate Law*, indicates that Delaware's yearly franchise tax gives it market strength in corporate charter competition. Professors Kahan and Kamar demonstrate that Delaware generates more money than merely charging a premium, but they also show that it price discriminates depending on how much each firm values incorporating in Delaware. This article applies Professors Kahan and Kamar's research to LLCs. This article examines the LLC tax, which is equivalent to the corporate tax, to determine how powerful Delaware is in the legal struggle for LLC charters. Delaware LLCs pay a \$250 annual tax, not a franchise tax. This article illustrates that Delaware's LLC tax is not greater than its company franchise tax and does not price discriminate. But why? The report suggests that Delaware may have less market strength competing for LLC charters in multiple jurisdictions than for company charters. The essay suggests that LLC law's high contractibility and minimal legal ambiguity reduce Delaware's traditional competitive advantages—its expert judiciary and easy-to-contract laws. Since these two economic gains are gone, Delaware LLC law is not obviously better to company law. Delaware may not be able to charge more because other jurisdictions provide LLC legislation.

Keywords - *Delaware franchise tax; Price discrimination in corporate law; Jurisdictional competition for corporate charters; Market power in state incorporation law; LLC contractibility and legal indeterminacy; Network effects in corporate law.*

1. Introduction

In the eyes of first-time business owners, the optimal structure for their organization may remain a mystery. Since choosing an entity structure isn't straightforward, you should prepare well before making a final decision. An additional degree of intricacy is introduced by the many legal and tax factors.

Delaware is an excellent choice for incorporation for several reasons. Regardless, would you recommend that your business be structured as a Delaware corporation? The simple answer is that you and your employer have total control. It is recommended that you incorporate in the state where your business is headquartered if it is still in its early stages. In spite of this, there are some benefits to incorporating in a foreign state (here meaning a US state other than your home domicile) for your business.

There are substantial and far-reaching effects of the choice of incorporation state. Thorough research should be conducted before making a final choice. Many businesses choose to incorporate in Delaware because of the state's

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business-friendly atmosphere, reasonable taxes, and solid corpus of law. But there are those who think it's ideal for their business to incorporate in New York, where they live.

Advantages of Incorporating in New York

If you start a company in New York, you may expect the majority of your clients and activities to be in the Empire State. In most cases, business owners believe that incorporating in the place where their company is physically located makes the most sense from a logistical standpoint. Also, companies have a lot of leeway to do what they want in New York. Members are permitted by New York LLC statutes to:

- Customize the distribution of their funds
- Set up a limited liability company (LLC) with an endless term
- Keep creditors at arm's length from their private wealth
- Get the most out of New York's business contract laws and courts by using them.

By regularly revising policy measures, state authorities have been attempting to make the state more hospitable to businesses. Incorporating in New York is a cost-effective choice for many companies.

Business Environment and Legal Protections

Businesses in New York are well-protected by the state's advanced legal system. Some of the main benefits include:

- The Business Judgment Rule protects directors from liability for honest business practices
- New York's courts are renowned for their fairness and predictability in commercial disputes, which leads to strong contract enforcement.
- The business laws of New York provide clarity and adaptability in the administration of corporations, as well as in limited liability company formation and operation.
- The Commercial Division of the New York Supreme Court effectively handles complicated commercial disputes, providing access to specialized courts.
- Companies, particularly those in the banking, IT, and real estate sectors, find New York's favorable legal climate appealing.

Tax Benefits and Financial Considerations in New York

There are a number of tax advantages to forming a corporation in New York, and they vary by company structure. There is a corporate franchise tax in the state, although there are tax breaks and credits available to many new and small companies. Factors that are crucial to the budget include:

- **QETC Tax Credits:** These are refundable tax credits that may help startups in the IT industry.
- **Empire State Development Grants:** Financial incentives for companies that work to boost the economy.
- If a company's net income is less than a certain level, it may be eligible for a lower rate of state corporate tax.
- Businesses and industries located in certain economic development zones are eligible for a number of sales and use tax exemptions.

Businesses considering a long-term presence in the Empire State find the state's economic development initiatives to be very appealing.

Disadvantages of Incorporating in Delaware

Some potential drawbacks of forming an LLC in Delaware include:

- Dealing with supplementary duties or paying supplementary costs
- Why Delaware isn't as appealing now that other states provide similar opportunities.
- Why Incorporating in Delaware won't be beneficial for many New York companies.
- You'll have to pay more to get your company registered in New York as a foreign corporation if you choose to incorporate in Delaware.
- You may still pay your company's taxes in New York even if you incorporate in Delaware.
- The expense of hiring a registered agent
- An annual franchise fee
- Companies in Delaware are required to submit yearly reports.
- There may be little to no advantage, if any, for small firms that operate out of only a few of states to incorporate in Delaware.

Hidden Costs of Incorporating in Delaware

There are hidden expenses to think about, despite Delaware's reputation as a business-friendly state:

- New York Foreign Qualification: Operating businesses formed in Delaware are required to pay extra fees and register as foreign entities in order to do business in New York.
- Franchise Tax in Delaware: Costly for bigger firms, businesses are required to pay this tax every year.
- The additional expense of having a registered agent in Delaware is a requirement that businesses must meet.

Delaware incorporation may not be worth the additional expenses for startups that aren't planning to seek funding from other sources.

2. Objective

- i. To evaluate franchise taxes, yearly fees, international registration, and small company administrative hurdles, New York/New Jersey and Delaware incorporation costs and regulatory compliance requirements are compared.
- ii. Determine whether Delaware's legal advantages—specialized courts, established corporate case law, investor appeal—help tiny, locally owned NY/NJ enterprises or predominantly large or venture-backed corporations.

3. Methodology

Finding out if New York (NY) or New Jersey (NJ) is preferable than Delaware for small companies is the main goal of this research. It does this by weighing the pros and cons of various legal systems. The research draws on secondary sources such as statutes, regulations, fee schedules, scholarly articles, and studies on regional competitiveness and business law that have previously been conducted. Companies that are formed in Delaware but primarily do business in New York or New Jersey are compared with respect to the international license requirements, the expenses of incorporation (file fees, franchise taxes, and annual report fees), and the regulations that must be adhered to. Additionally, the research examines the ways in which small, tightly owned businesses might benefit from the legal advantages often associated with Delaware, such as its specialized courts and extensive body of case law. The approach takes into account factors like administrative burden, actual legal advantages, and cost-effectiveness to determine which location is ideal for small enterprises operating in the area.

4. Result And Discussion

i. Delaware in the Competition for Business Entity Charters

A. Delaware's Dominance in the Competition for Corporate Charters

One classic example of regulatory rivalry is the struggle between governments to provide business charters. Every state strives to provide the greatest corporate law "product" to entice corporate charters, as a corporation has the option

to incorporate in any state, regardless of whether it really does any business there. There are three main parts to every state's corporate law "product": the substantive law, which governs how a company is internally run, the judicial system, which handles conflicts involving how a company is internally run, and the administrative services, which handle things like certificate issuance, filing acceptance, and tax collection. According to regulatory competition theory, states enter into corporate charter competitions for two main reasons: first, to collect the taxes and fees involved with incorporation; and second, to bring in clients for the state's attorneys and other service providers. Since the early 1900s, when the contest for company charters first began, Delaware has been unrivaled. Sixty percent of the Fortune 500 and most publicly listed corporations are established in Delaware. When compared to Delaware, no other state comes close to its market share. Companies really only have two options when choosing a state to incorporate in: their home state and Delaware. It is widely believed among academics that the race for corporation charters has ended with Delaware's longstanding supremacy. The high amount of money that the state of Delaware gets from the yearly franchise taxes that businesses based there pay as well as from the initial incorporation fees that the state collects as a consequence of its monopoly on company charters. The following table details the yearly business franchise tax income that Delaware received from 2005 to 2009.

Table 1: Revenue from Delaware Franchise Taxes

Year	Revenue from Corporate Franchise Taxes (in millions)	Percent of State Gross Revenue
2005	\$508.1	16.4%
2006	\$526.4	15.6%
2007	\$540.4	15.3%
2008	\$566.3	15.5%
2009	\$574.2	16.7%
Average	\$543.1	15.9%
State of Delaware Governor's Recommended Budget for Fiscal Years 2007–2011		

Corporate franchise taxes brought in \$574.2 million for Delaware in 2009, accounting for about 17% of the state's overall income (as shown in the table). Considering that Delaware is a little state with a population of just 885,122 can help put this amount into perspective. For every Delaware household in 2009, the business franchise tax brought in \$1648. Income from corporate charters is crucial to the state's budget, more so than any other state.

B. The Corporate Franchise Tax

Can you tell me the fees associated with forming a company in Delaware? First, a chartering company is required to pay a small, one-time cost to the state of Delaware, which is little compared to other states (as low as \$89 in this case). The second and most crucial point is that every company formed in Delaware is subject to an annual franchise tax.

There are two aspects of Delaware's franchise tax that set it apart from the other fifty states. The first is that, compared to franchise taxes in other states, it's a huge premium. Additionally, companies that place a greater value on incorporating in Delaware are subject to a higher franchise tax rate.

One must be familiar with the structure of Delaware's corporate franchise tax in order to grasp its distinctiveness. When calculating the franchise tax, the smaller of the two numbers is used. The "authorized share method" is the first

calculation that relies only on the total number of authorized shares in the company. The authorized share method categorizes corporations in Delaware as follows: those with 5,000 or fewer authorized shares pay \$75 per year in taxes, those with 5,000 to 10,000 authorized shares pay \$150 per year, and those with 10,000 authorized shares or more pay \$150 per year plus \$75 for every 10,000 authorized shares beyond the initial 10,000 shares.⁴⁶ Based on the assumed par value capital of the firm, the second calculation (the "APVC method") is performed. A company's franchise tax, as calculated using the APVC technique, is typically equal to the sum of all of its gross assets multiplied by the ratio of authorized shares to issued shares.

It is necessary to calculate the tax using both the authorized share technique and the APVC approach in order to ascertain the true tax burden of a business, since the real franchise tax is equal to the lesser of the two. The annual franchise tax cannot exceed \$180,000 under any approach. For six made-up Delaware companies, we have the following table that shows the authorized share method, the APVC method, and the real franchise tax that resulted from each.

Table 2: Franchise Tax Charged to Six Hypothetical Firms

	Authorized Shares	Issued Shares	Total Gross Assets (in millions)	Authorized Shares Method	APVC Method	Actual Franchise Tax
Corporation A	15,000	5,000	\$1.0	\$225	\$1,050	\$225
Corporation B	75,000	5,000	\$1.0	\$675	\$5,250	\$675
Corporation C	5,000,000	2,500,000	\$30.0	\$37,575	\$21,000	\$21,000
Corporation D	5,000,000	2,500,000	\$90.0	\$37,575	\$63,000	\$37,575
Corporation E	30,000,000	20,000,000	\$90.0	\$180,000*	\$47,250	\$47,250
Corporation F	30,000,000	20,000,000	\$900.0	\$180,000*	\$180,000*	\$180,000*
The franchise tax computation is capped at the statutory maximum of \$180,000 annually						

As this chart shows, Delaware's franchise tax may be high, especially for bigger, publicly listed companies. Approximately 80% of New York Stock Exchange-listed companies pay the maximum franchise tax. Delaware corporations having more than 24 million approved shares and assets exceeding \$514 million (or less depending on the ratio of authorized to issued shares) must pay the maximum franchise tax of \$180,000.

These instances demonstrate Delaware's corporate franchise tax's uniqueness. First, the franchise tax is far more than any other state's. Delaware is the only state not in one of two groupings. States that charge domestic companies no or a low franchise tax are the first.⁵⁴ Domestic companies pay no or little yearly tax in these states. The second category is states that tax domestic and international firms based on their business in the state. These states have no incorporation fee. Domestic and international firms are taxed equally, thus state incorporation doesn't matter. Delaware is the only state that taxes domestic companies' franchises regardless of their business volume. Thus, Delaware charges domestic companies a high fee to incorporate in the state. Second, Delaware's franchise tax prices discriminate. Delaware's franchise tax costs more to businesses that value incorporation in Delaware more. Only businesses with a high number of authorized shares and a high gross asset value will have a large franchise tax burden since it is based on the lesser of two procedures. Large, publicly traded enterprises are typical. Large, publicly traded

firms value Delaware incorporation more than smaller or private enterprises. No other state has a comparable franchise tax..

C. Delaware in the Competition for LLC Charters

The process of vying for an LLC charter is in its infancy compared to that of a corporation. While the first limited liability company (LLC) laws went into effect in 1977, Delaware did not follow suit until 1992. In spite of this relative youth of the process, Delaware already seems to be head and shoulders above the competition for LLC charters on a national level.

Take into account the yearly ratio of Delaware company formations to LLC formations. The following table details the annual growth rate of Delaware limited liability company formations from 2003 to 2009.

Table 3: New Entity Formations 2003–2009

Year	New Corporations	New LLCs	Ratio of New LLCs to New Corporations
2003	32,664	55,381	1.70
2004	33,636	68,641	2.04
2005	34,377	87,630	2.56
2006	34,733	96,831	2.79
2007	35,700	111,820	3.13
2008	29,501	81,923	2.78
2009	24,955	70,274	2.82
Delaware Department of State, Division of Corporations Annual Reports from 2003–09			

Between 256% and 313% more Delaware limited liability companies were formed over the five years ending in 2009 than corporations. Put these figures in context with the fact that Delaware created an average of 430 limited liability companies (LLCs) every day in 2007. The near-monopoly that Delaware has on the market for big and publicly listed LLCs is perhaps more astonishing than the sheer volume of LLC creations in the state. While Delaware's position in the battle for big and publicly listed LLCs is not as well-documented as its supremacy in attracting the charters of publicly traded companies. According to the Hoover IPO Reports database on LexisNexis, every limited liability company (LLC) that sought or completed an initial public offering (IPO) between March 31, 2004 and March 31, 2010 is included in Appendix A. This allows us to analyze Delaware's standing in relation to other states for big and publicly traded LLCs. Here is a brief overview of the findings.

Table 4: LLC IPOs Between March 31, 2004 and March 31, 2010

LLC Domicile	LLC IPOs
Delaware	15
Other States	0

Total	15
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These outcomes clearly demonstrate that Delaware has been successful in luring big, publicly listed LLCs. No less than fifteen limited liability companies (LLCs) were established in Delaware out of the sixteen that went public between March 31, 2004 and March 31, 2010.

This result is in line with the research of Professors Bruce Kobayashi and Larry Ribstein, who discovered that more than 61% of big limited liability companies (LLCs) with fifty or more workers choose to form under Delaware law when they chose to incorporate outside of their home state. When it comes to big limited liability companies (LLCs) formed outside of their home state, the next closest state, Virginia, has less than 3% of the market share.

One indicator of Delaware's success in luring limited liability companies is the state's budget. Although limited liability companies (LLCs) are usually considered pass-through businesses for federal tax reasons, 76 certain states, like Delaware, impose an entity-level tax on LLCs that are formed or do business inside their borders.⁷⁷ The yearly tax that domestic limited liability companies (LLCs) are required to pay is a growing contributor to Delaware's coffers due to the state's booming LLC creation rate. The following table details the yearly tax income that Delaware received from limited partnerships ("LPs") and limited liability companies ("LLCs") from 2005 to 2009, as well as the anticipated revenue for 2010 and 2011. Although this data combines both LLC and LP tax income, the growth in this revenue is likely due to the expansion of LLCs in Delaware, since the number of LLCs created in recent years has been about 10 times higher than the number of LPs.

Table 5: Revenue from Delaware LLC Taxes*

Year	Revenue Attributable to Annual Taxes from LLCs and LPs (in millions)	Percent of Gross State Revenue
2005	\$63.4	2.0%
2006	\$76.5	2.3%
2007	\$91.9	2.6%
2008	\$107.6	2.9%
2009	\$137.1	4.0%
2010	\$147.8**	4.7%**
2011	\$158.1**	5.0%**
State of Delaware Governor's Recommended Budget for Fiscal Years 2007–2011 Projected		

Based on the data shown above, it is clear that LLC taxes contribute significantly—and increasingly—to Delaware's overall yearly income, much like corporate franchise taxes.

Taken together, these numbers suggest that Delaware is trying to replicate its corporate charter success in the limited liability company (LLC) setting. Delaware seems to have a knack for luring big, publicly listed LLCs, and the state continues to establish LLCs at an amazing pace, so it stands to reason that it would have significant influence in the market. It is logical to assume that Delaware would use its market dominance to demand a premium or even discriminate in pricing among limited liability companies (LLCs) only to organize under Delaware law, much as it has done in the corporate environment. What follows, however, demonstrates that Delaware has done neither.

E. Implications of Pricing on Delaware's Market Power

The preceding discussion has shown that an interesting disparity is seen when the corporation franchise tax of Delaware is compared to its LLC tax. By demanding premium and discriminatory fees, Delaware has historically abused its market strength in the jurisdictional battle for business charters. But when it comes to LLC jurisdictional competitions, Delaware isn't one of them. It is not immediately clear what this discovery means. It should be noted that just because Delaware does not impose any special pricing or premium on its LLC legal product, it does not rule out the likelihood that Delaware has any kind of market dominance when it comes to other jurisdictions offering LLC charters. However, Delaware's LLC rates do not reflect any market strength that Delaware may have. But there can be other, less apparent ways that Delaware's market dominance is used. On the other hand, Delaware may have decided against using its market power in any way. The intriguing questions would arise in any case.

Delaware may not have the same kind of market strength it has always had for corporate charters when it comes to jurisdictional competition for limited liability company (LLC) charters. This would explain why the state does not demand premium, discriminating rates for its LLC legal product. Indeed, it is very unlikely that Delaware lacks market strength given its track record of successfully luring big, publicly listed, out-of-state LLCs. Parts III and IV demonstrate, however, why Delaware could not have the same competitive advantages—and, by extension, the same market power—in the jurisdictional battle for limited liability company (LLC) charters as it has in the fight for corporate law.

ii. Delaware's Traditional Competitive Advantages

The strange pricing disparity between Delaware's LLC and corporate law products might be explained, at least in part, by the fact that Delaware's law product does not provide the same benefits in the market for LLC charters as it does for corporation law. A quick look of the LLC legal product in Delaware, however, reveals that this is not the case, as shown in this Part.

When it comes to corporations, Delaware's dominance in the market is due to the fact that its product is better and has fewer alternatives. In fully competitive marketplaces, as Professors Kahan and Kamar have elucidated, vendors offer their wares for sale at a price that precisely matches their marginal production costs. Any product or service in such a market may be easily replaced, thus prices drop until no one is prepared to make or sell them at a loss. By charging more than their marginal costs, producers that have a lot of sway in the market may boost their earnings. When a manufacturer sells a product with few, if any, suitable alternatives, they have market power. In this kind of market, producers may confidently charge whatever rates they choose without worrying about losing money to competitors.

Although every state has its own corporation laws, the corporate law product from Delaware stands out from the competition because to its unique set of benefits. Scholarly work has long pointed to four distinct advantages that Delaware has over its competitors: (1) the network effects of its substantive law; (2) the competence of its judiciary; (3) the rapidity and effectiveness of its administrative services; and (4) the state's credible promise to satisfy the demands of corporations. These competitive advantages give Delaware's corporate law product market power over its rival states. Companies are prepared to pay a premium to incorporate in Delaware because to the state's ability to leverage its corporate law product's value.

This Part shows that each of these competitive advantages appears to be present in Delaware's LLC law product. If we were to compare the corporate and LLC legal products of Delaware, we'd find that Delaware has about the same amount of sway when it comes to the rivalry for LLC charters. As a result, the four competitive advantages that have long been recognized by discriminatory pricing practices in the past for its LLC legal product are.

5. Conclusion

This article is based on a single observation: that Delaware's fees for corporation and limited liability company (LLC) charters are strangely different. When it comes to the new market for limited liability company charters, Delaware isn't charging companies a premium, discriminatory pricing as it does for corporation charters. Based on this one

finding, the article has investigated the likelihood that Delaware does not have the same level of market dominance when it comes to competition for limited liability company (LLC) charters as it does when it comes to corporation charters. In particular, this article has demonstrated that Delaware's capacity to distinguish itself from its competitors in the early stages of the competition for limited liability company (LLC) charters is hindered by the diminished impact of two of Delaware's conventional competitive advantages—the increased contractibility and decreased legal uncertainty—that are accessible under Delaware law. Delaware LLC law is not exceptional when it comes to the contractibility and decreased legal indeterminacy that may be appealing to enterprises. However, two of Delaware's long-standing competitive advantages—contractibility and decreased indeterminacy—are being eroded, which is a particularly negative development for the state. Delaware may not be able to maintain the same level of market dominance it has historically had for company charters in the market for limited liability company (LLC) law if it does not have its advantageous network effects and knowledgeable judges. Several significant consequences for Delaware, its unclear LLC legislation, the regulatory rivalry between the corporation and LLC forms, and the regulatory rivalry among states for LLC charters would result from this research, if it is accurate. This shows that a seemingly little observation may have far-reaching consequences.

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