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# THE ECONOMIC EFFICIENCY OF CLOSE CORPORATION LAW: A COMMENT

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Ian Ayres' excellent paper, *Judging Close Corporations in the Age of Statutes*,[1] identifies an interesting tension in the law and economics of corporate law by contrasting the views of Judge Richard Posner and his disciples, who see the common law process as being efficient,[2] with those of Judge Easterbrook, Judge Winter, and their followers, who see legislation—at least, state corporate legislation—as being a "race to the top"—i.e., efficient.[3] Ayres extends somewhat the trajectory of the Winter-Easterbrook view because their main concern has been to contrast state statutes with federal regulation, not with state common law. Winter and Easterbrook do not claim that state corporate law is necessarily efficient in any absolute sense, only that it is more efficient than the probable alternative of federal statutory regulation. But Ayres' characterization seems at least a plausible extension of the Winter-Easterbrook approach. Subject to this caveat, I will refer to Ayres' characterization as the "Winter-Easterbrook" view.

Ayres observes that we have one Pangloss too many here. We have two theories, each of them saying that "everything is for the best in the best of all possible worlds"—yet the theories are mutually inconsistent: one focuses on legislation, the other on adjudication. What happens when legislation and adjudication yield different outcomes—when a court essentially nullifies a statute through interpretation, or when a legislature enacts a statute overruling a judicial decision? If they are inconsistent, how can both be efficient? Ayres poses this question in such a provocative fashion that he revitalizes a long-standing debate in corporate law.

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1. Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365 (1992).

2. *See generally* RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW (3d ed. 1986). For other work on the efficiency of the common law, see, e.g., Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977); George L. Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977).

3. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J. L. & ECON. 23 (1983).

Another strength of Ayres' article is its focus on close corporations. Ayres is right that the great debate over the efficiency of corporate law has been played out largely with the large, public corporation in mind. Not nearly as much attention has been given to the problem of close corporations—despite the outstanding work of O'Neal and Thompson, which, as Ayres rightly observes, is the starting point in any analysis of this area.[4]

As Ayres convincingly shows,[5] the dynamics of the close corporation area are quite different from the case of large, publicly traded firms. Following Thompson and O'Neal, Ayres observes that the costs of incorporating in other jurisdictions are almost always prohibitive for close corporations. Such corporations stay in the state where they have their principal operations. This means, as Ayres points out, that there is essentially no market for charters of close corporations. Even if a market could exist, the revenues a state could earn in franchise fees by bidding for close corporation charters would be minimal. Hence there is a significantly different political dynamic in the close corporation area. Ayres deserves credit for illustrating this feature and exploring some of its consequences.

In these comments, I focus on two specific aspects of Ayres' paper: his treatment of the historical evolution of the law of shareholders' agreements in the close corporation context, and his general theory of the efficiency characteristics of the law of close corporations.

## I. EVOLUTION OF THE LAW OF SHAREHOLDERS' AGREEMENTS

The principal case study that Ayres uses to explore the political dynamics of close corporation law concerns the traditional requirement of corporate law that managers, not shareholders, have the power and responsibility to manage a corporation's affairs. Ayres points to a quite remarkable shift in close corporation law, the evolution from what Ayres terms a principle of "immutable separation," under which shareholder agreements that intrude on management functions will be struck down as inconsistent with state corporation codes, to the modern rule, which Ay-

4. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS (3d ed. 1987). The leading article on close corporations from a law-and-economics perspective is Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986).

5. Ayres, *supra* note 1.

res characterizes as a regime of "nullification."[6] Under this modern regime, courts are much more willing to give effect to shareholders' agreements in close corporations even when the effect of the agreements gives shareholders a role in management in apparent disregard of the statutory injunction that managers manage and shareholders do not.[7]

The theory Ayres proposes is somewhat subtle, but its main outlines appear to be four propositions:

1. Because of the lack of competition for close corporation charters, legislatures have less incentive to adopt efficient provisions for close corporations in the first place, or subsequently to correct errors in original legislation, than they do in the case of large, publicly held corporations for which the chartering market is active and vigorous.

2. In the absence of legislative leadership, courts have played an active role in close corporation law, especially in the issue of shareholder agreements, in which the early cases tended to nullify legislative restrictions on shareholder management in the close corporation context.

Stop here, and it sounds as if Ayres is in the Posner camp—legislatures adopted bad rules for close corporations and the courts nullified them, substituting better rules in their stead. In other words, the common law is efficient, the legislative process is not.

But Ayres does not stop here, because he traces the history out two more steps:

3. After an initial period of judicial nullification, many states adopted special statutory rules for close corporations that legislatively approved the common law developments and allowed greater shareholder management through shareholders' agreements.

4. But now at least one court again nullifies a general corporation code, this time by enforcing a shareholders' agreement, even though the corporation in question has failed to avail itself of the special rules available under the close corporation law.[8]

Stop here, and Ayres sounds more like Easterbrook and Winter than Posner. The legislature adopts an efficiency-enhancing rule—the special shareholders' agreement provisions of close corporation statutes—and

6. *Id.* at 378-88.

7. *Id.*

8. Zion v. Kurtz, 405 N.E.2d 681 (N.Y. 1980). Ayres criticizes this decision with the argument that, regardless of its efficiency as applied to the particular close corporation at issue in the case, it undermines the stock of precedents under Delaware law that apply to large, public firms.

here the court mucks everything up. Legislation is efficient, the common law inefficient.

While Ayres' observations on these developments are astute, I find them somewhat unsatisfactory because they are not supported by a developed theory for the dynamic tensions that drive legal history. Without such a theory, we are left in the position of seeing the common law as efficient in some cases, legislation as efficient in others, without any persuasive criterion for explaining the oscillation.

It is possible to conjecture why the immutable rule of separation might have given way to a more flexible rule that allows shareholders a role in the management of close corporations as agreed by contract, without positing an oscillation between efficient adjudication and efficient legislation.[9]

The early state corporate codes were not enacted to govern small businesses, but rather to control the activities of emerging larger firms in the rapidly industrializing years of the late nineteenth century. Most small businesses that today would be incorporated were not incorporated at the end of the century, but instead operated as sole proprietorships or partnerships. Larger corporations were not characterized by the wide dispersal of share ownership that is typical of mature industrial firms today. Instead, insiders—promoters, managers, or other large shareholders—usually held large blocks of stocks. The "public" shareholders were relatively powerless in the face of these powerful blocks. Accordingly, there was a serious danger that the holders of the majority or control block would abuse the minority shareholders.

The early corporation codes responded to this danger by stressing the role of the board of directors, backed by the legal sanction of fiduciary duties. The board of directors was to represent the interests of all shareholders, not just the majority or control block; if it did not do so, it was potentially subject to sanction for breach of duty. Although the board might well be responsive to the interests of the control block, the separate function of the board and its stringent fiduciary duty of loyalty provided some assurance that minority shareholders would be protected.

It is, I believe, this stress on the role of the board of directors as the bulwark against oppression of minority shareholders that explains the "immutable" rule of separation of ownership and control under the early

9. Whether this conjecture holds in fact would require a detailed historical investigation that I have not attempted for purposes of this Comment.

corporation codes. If the controlling shareholders could insert themselves into a management role, the danger of minority abuse—at least according to the theory of the early state corporate codes—would increase to unacceptable levels. Hence the immutable rule.

Of course, the "immutable" rule of separation of ownership and control proved anything but immutable, as courts and later legislatures began to dismantle its hard-and-fast prohibitions. The reason for the development, I believe, may well be found in changed circumstances in the underlying legal and market environments, circumstances that made the immutable rule inappropriate both for very large corporations and for very small corporations.

In the case of very large corporations, the rule that managers should enjoy exclusive management powers came to be seen as relatively unimportant. As industrial corporations expanded during the early decades of the twentieth century, large shareholder blocks became increasingly uncommon. By 1932, Berle and Means had crystallized the concept of large industrial corporations' new ownership structure with the thesis of separation of ownership and control.[10] They observed that as a practical matter, ownership and control had been radically separated in the large industrial corporation. The widespread dispersal of share ownership largely freed managers from accountability to the ostensible owners of the corporation.

The immutable rule of separation of ownership and control made little sense for the Berle and Means corporation. First, it was unnecessary, as a practical matter, to mandate the separation of ownership and control, since the separation was there in any event. The danger of majority shareholders' oppressing minority shareholders was increasingly attenuated as majority or controlling shareholder blocks became less and less common in the case of large industrial corporations. The legal rule of immutable separation, accordingly, became largely superfluous as a means of protecting minority shareholders against majority oppression.

Equally significant, the premise of the immutable rule—that the board could serve as a useful bulwark against oppression of minority shareholders by majority investors—became problematic under the Berle and Means model. In the Berle and Means corporation, the main problem came to be seen not as majority shareholder oppression of minority

10. ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

shareholders but managerial abuse of shareholders generally. To this extent, the value of letting managers manage came to be seen as more troubling. In the case of large firms, which had been the principal users of state corporation statutes, the danger came to be seen, not as one of improperly *denying* managers the power to manage, but rather one of improperly giving managers *too much* power to manage. This undermined part of the foundations of what Ayres calls the rule of "immutable separation."

At about the same time as share ownership was becoming widely dispersed among the public in the case of the largest corporations, a new class of business enterprise—*very small* firms, or firms with only a very small number of shareholders—began to make increasing use of the corporate form. It turned out that the immutable rule of separation of ownership and control made even less sense for these very small corporations than it did for the very large ones. In the case of very small corporations, the small number of shareholders greatly reduced the transactions costs of obtaining shareholders' agreements that permitted management by means other than the board of directors. The rule that only managers could manage impeded the very small firms in their flexibility of operations. At the same time, if everyone involved in a corporation could agree that a shareholder agreement be given efficacy, it was hard to see the harm in enforcing such a rule.

Cases such as *Clark v. Dodge*[11] can be explained on this ground. The corporations involved in that case were small (each had only two shareholders).[12] The shareholders' agreement was freely assented to by both parties, and was supported by a good business purpose.[13] Moreover, the agreement in question was one that *protected*, rather than oppressed, the minority shareholder: the minority shareholder received assurances that he would be allowed to continue as a director and general manager of one of the corporations, that he would receive one-fourth of the net income either by way of salary or dividends, and that unreasonable salaries would not be paid to other officers or agents so as to unfairly reduce the

11. 199 N.E. 641 (N.Y. 1936).

12. *Id.* at 641-42.

13. Clark, the minority shareholder, was in sole possession of trade secrets essential to the operation of the corporations and did not want to divulge the secrets to the majority shareholder without assurance that his management and ownership interests would be protected; Dodge, the other shareholder, wanted to ensure that his son would be able to continue the business after the death of Clark. *Id.*

minority shareholder's share.[14] Accordingly, the rationale of protecting minority shareholders was not present here.

The same is true of *Zion v. Kurtz*,[15] a case strongly criticized in Ayres' article. The New York Court of Appeals enforced an agreement giving the minority shareholder of a Delaware corporation veto power over the conduct of corporate business. Here again, as in *Clark*, the agreement enjoyed the unanimous assent of all the shareholders.[16] And, again as in *Clark*, the purpose and effect of the agreement was to protect the minority shareholder against oppression by the majority. Thus the goal of minority shareholder protection was again not present. The rationale for applying an immutable rule of separation of ownership and control hardly seems compelling in such a case.

Thus, the immutable rule of separation of ownership and control came, over time, to make little sense both in the case of very large corporations, in which ownership and control was separated in any event and in which the problem of management abuse suggested caution about vesting too much confidence in the board of directors as the safeguard of shareholder interests, and in the case of very small corporations, or corporations with only a very small number of shareholders, in which low transactions costs permitted the negotiation of value-enhancing arrangements that enjoyed the assent of all shareholders ex ante. The immutable rule, however, continues to fulfill a valuable function in the case of medium-sized corporations in which large ownership blocks continue to present a threat of minority oppression. Not surprisingly, the rule does not appear to have broken down in this context.

## II. Efficiency of Close Corporation Law

It may already be evident that I tend to be more optimistic than is Ayres about the efficiency implications of this history. To be sure, Ayres does not see the history as all bad by any means. He is, however, critical of parts, such as legislatures' initial adoption of broad immutable rules that did not take account of the special needs of close corporations, and the more recent phenomenon of the *Zion* decision that Ayres believes goes too far in the direction of abandoning the immutable rule against

14. *Id.* at 642.
15. 405 N.E.2d 681 (N.Y. 1980).
16. *Id.* at 682.

shareholder management in an area in which the legislature has recently spoken.

Ayres' model implicitly sets up a four-cell matrix for judging the efficiency of legal principles in the close corporation context:

TABLE 1: EFFICIENCY MATRIX FOR CLOSE CORPORATION LAW

| | Statute Efficient | Statute Inefficient |
|---|---|---|
| Common Law Efficient | I | II |
| Common Law Inefficient | IV | III |

Ayres' view, I believe, is that the Posner school falls essentially in Cell II: the common law is efficient; statutory law is inefficient. Easterbrook and Winter, in this scheme, fall in Cell IV: the common law is inefficient; statutory law is efficient. In Cell III is William Cary and the traditional "race-to-the-bottom" theory, which sees both the statute law and the common law of states such as Delaware, which compete in the corporate chartering market, as reflecting a competition in laxity in which the interests of shareholders are sacrificed in order to serve those of corporate managers.[17] Ayres' own view seems to be that, over time, the situation has fluctuated between Cells II and IV: sometimes, as in *Clark v. Dodge*, the common law is efficient and the statute is inefficient; other times, as in *Zion*, the statute is efficient, or at least entitled to a presumption of efficiency, and the common law is inefficient.

My own view is that the case of close corporations falls mostly in Cell I: both the common law and statutes are efficient. Ayres' article suggests that, at least in the area of shareholders' agreements, Cell I should be empty since the statute and the common law are in conflict and both cannot be efficient at the same time. Ayres, however, fails to show any real conflict between statute and common law in this area. Even when the common-law judges nullified statutes, there was no real conflict because, as Ayres himself acknowledges, this was a judicial response to changed circumstances.[18] Far from resenting the judicial intermeddling, the legislatures subsequently revised the laws to codify the common-law changes.[19] The *Zion* case, which Ayres views as essentially in conflict

17. *See* William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

18. Ayres cites Dean Guido Calabresi's influential book, *A Common Law for the Age of Statutes* (1982), which encourages judges to update statutes that have become obsolete.

19. *See* Ayres, *supra* note 1.

with recent legislation, was arguably not so because, as I have noted,[20] the shareholder agreement in that case protected, not harmed, the minority shareholder interests that are served by the rule that only managers can manage. There was no real conflict here with the purpose of the statute. The corporation's failure to avail itself of the special protections of the close corporation statute can be easily characterized as a technical flaw that can be judicially corrected, without undermining the purposes of the statute, when doing so enforces the ex ante agreement of the parties and prevents opportunistic and oppressive behavior by the majority shareholder. Thus there is little convincing evidence in the historical record that judges and legislatures have operated at cross purposes in this area.

There are good reasons to conclude, at least as a matter of theory, that both statutes and the common law should be relatively efficient in the close corporation context. Jonathan Macey and I have addressed this general topic in earlier work,[21] following the seminal contributions of Roberta Romano.[22] With respect to large, publicly traded business corporations, the picture appears to sort between Cells I and III depending on the nature of the issue. When agency costs are not an issue and externalities are not present, the Delaware Corporation Code and its body of judicial interpretation seems to fall in Cell I—both are efficient. When, however, agency costs are high and capable of being imposed on persons residing out of state, Cell III is more likely to describe the situation for the large, public corporation: both the common law and the statute law are inefficient. The *locus classicus* for this situation is the hostile takeover, in which both Delaware statutory and judge-made law appear efficiency reducing.[23]

Although theory predicts that both statutory and judge-made law are likely to be inefficient in some cases as applied to large, publicly traded firms, the same is not true for close corporations. In the case of close corporations, unlike large public corporations, externalities are few and agency costs are low. All parties to the close corporation usually live and

20. *See supra* text accompanying notes 15-16.

21. *See* Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

22. *See* Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985).

23. See Mark J. Roe, *Takeover Politics*, *in* BROOKINGS INSTITUTION DISCUSSION PAPER IN ECONOMICS NO. 91-4 (1991); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457 (1988).

vote in the state of incorporation, so the opportunity to impose costs selectively on out-of-state interests is not present.[24] None of the interests associated with a close corporation has a systematic incentive to seek inefficient rules, either by way of legislative lobbying or by way of litigation. In particular, there is no distinct class of "managers" of close corporations who want to exploit shareholders, since the managers typically are the shareholders.[25]

The upshot of all this is that the political economy of close corporation statutes should tend towards efficient outcomes, whether generated by judges or by legislatures. The process should establish good rules over time, not because the rulemakers are particularly brilliant or altruistic, but simply because it is in nearly everyone's interests that good rules be adopted. Indeed, this appears to be what we observe in the close corporation case, at least with respect to the rules respecting shareholder agreements that Ayres discusses in this excellent and extraordinarily interesting article.

24. This may be one reason why franchise fees for close corporations appear to be so low. *See* Ayres, *supra* note 1. Close corporations often have political clout in the state of their incorporation because everyone associated with a close corporation tends to be from the state. One would expect fees to be higher for larger corporations because the costs can be imposed on out-of-state shareholders.

25. Ayres suggests towards the end of his article that majority shareholders form a political interest group in the close corporation, and that this group has a systematic interest in oppressing minority interests. *Id.* But the evidence Ayres cites for this proposition is impressionistic at best.