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# STATE COMPETITION FOR CLOSE CORPORATION CHARTERS: A COMMENTARY

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Ian Ayres' article, *Judging Close Corporations in the Age of Statutes*,[1] raises some interesting questions concerning the relation between courts and legislatures in the production of corporation codes and the degree to which our general understanding of state competition for corporate charters is applicable to close corporations. These issues have not been considered by scholars participating in the debate over the efficacy of state corporation laws. Ayres' article suggests that there is no reason to expect an overlap of concern, because one of his central points is that the processes by which public corporations and close corporations come to be regulated are quite distinct.

I have a few quibbles with some of the characterizations in the article, and while they serve as the focus of my Comment, they really are only quibbles.

## REPHRASING THE QUESTION

My first quibble concerns the article's packaging. Ayres suggests that there is a contradiction or inconsistency between the work of Ralph Winter and Frank Easterbrook on the efficacy of state competition and Richard Posner's work on the common law. He contends that state corporation codes and judicial decisions cannot both be efficient because sometimes the two disagree; courts ignore or overturn statutes, and legislatures override judicial decisions. I think that this packaging is unfortunate, for there is no basis for contending that these scholars' positions are inconsistent.

First, Ayres' principal thesis is, in fact, an effort to demonstrate that there is no cause for disagreement among the three because the states do not compete over close corporation charters. If the states do not compete, there is no necessary reason for Winter and Easterbrook to charac-

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

terize the output of the legislative process as efficient, and they would not then need to disagree with Posner concerning the efficiency of courts.

Second, state competition in corporation codes is not evidence that the common law was "not getting the job done," as Ayres suggests.[2] Rather, it is a function of the need for efficient default rules, which readily identify the standard-form, corporate-law contract for parties in business, and of comparative institutional advantage. It is difficult, and thus costly, for lawyers to examine numerous court cases, instead of a corporation code, to isolate default rules to determine what needs to be explicit in a corporate charter. Indeed, because case holdings are confined to particular facts, they are less useful or less easily interpretable as defaults. My contention is that statutes, which codify an efficient common law, reduce the transaction costs of doing business in the corporate form. Hence, there is a need for states to produce and update corporation codes, even when courts create efficient corporate-law rules or efficiently interpret statutes. Courts are not, in this view, an institutional rival regarding the efficiency of outputs.

Third, and more important, proponents of state competition do not contend that all state corporation laws are efficient. Rather, they maintain that the system *tends* to efficiency, and that it is more efficient than a national corporation law regime would be. I assume that believers in the efficiency of the common law also hold to a similarly more sensible position regarding the relative tendency of opinions; this is, in any case, how Ayres describes Posner's position ("common-law rules tend to be efficient").[3] If this statement of the two positions is correct, then disagreements between courts and legislatures need not be put in opposition, as in Ayres' framing. Rather, they are *complementary* agents and equally efficiency minded; if one branch makes a mistake or is out of touch, the other moves forward to correct it. Disagreement is temporary and temporal, and it is a quite natural occurrence because business conditions and practices change over time, rendering rules derived from older arrangements no longer desirable.

Because specific code provisions and judicial opinions are static while the world of business transactions is dynamic, there is a need for accelerating legal evolution. Evolution is easier and cheaper if courts as well as legislatures can implement changes. A dual role, and hence "disagree-

2. *Id.* at 368.

3. *Id.* at 366.

ment," can occur without leaping to the conclusion that such an arrangement implies that the two branches are not efficiency minded and without having to prove that states do not compete for close corporation charters. I would, at least, want to see evidence of a systematic bias, that one branch was always correcting the other, before I would reject this characterization of the efficiency orientation of both branches in favor of Ayres' either-or-neither choice.

The interesting question for research then, involves determining when a specific branch, judicial or legislative, is more likely than the other to be in touch with the changing needs of investors. More precisely, when will a grievance concerning the efficacy of a particular corporation law be brought to the court, as opposed to the legislature, for redress? In other words, when is litigation cheaper than lobbying?

Ayres' hypothesis is that courts are more efficient law producers for close, as opposed to public, corporations. A conjecture consistent with this thesis is that it may be cheaper for participants in public corporations than for those in close corporations to lobby a legislature. Public-firm issues may be more likely to recur, as their transactions are more numerous than those of close corporations. These characteristics reduce the cost of lobbying and create a demand for greater clarity that comes from a general statute than from a judicial holding that can be limited to the facts. Close corporation issues, however, may be more likely to arise in an end-game setting when there are no gains to be had from the parties' future relations. Hence, obtaining a "private personal ruling," which comes from a court, will be the cheaper course for these firms. In addition, public firms may be better organized politically; they are likely to have a major voice in the policy positions adopted by state chambers of commerce and other business lobbying groups, and to have more intimate relations with local politicians, as they are major local employers and charitable contributors. What we need to know is, for varying corporate contexts, the relative costs of informing courts and legislatures—the costs of learning or updating information concerning what legal rules are efficient for which types of firms—because the relative reaction speed of courts and legislatures in providing relief presumably depends upon information costs.

Another possibility is whether use of the corporate form changed over the period from the enactment of general corporation statutes to the burst of close corporation cases that Ayres discusses, which indicated the need for specialized statutes. For instance, were there tax-code or part-

nership-law changes that made parties in business shift to the corporate form, thereby creating the statutory mismatch? Or did these coincide with technological innovations or other changes in business conditions? The reforms of close corporation statutes appear to have occurred in the same time period in which public corporation statutes were modernized (the 1960s); is there a relation here indicating a renewed charter competition that touched all corporate levels, or is it simply coincidence?

These are the interesting questions, not whether Posner, Winter, and Easterbrook have to battle it out on institutional efficiency, or, to put it in a less flamboyant way, whether there is a strict dichotomy between courts and legislatures as efficiency maximizers.

## THE RELEVANCE OF STATE COMPETITION FOR CLOSE CORPORATIONS

My second quibble concerns the close corporation context and the import of state competition. One factor that Ayres does not mention, but that supports his thesis regarding the absence of competition for close corporation charters, is the lack of a capital market for close corporation shares. Capital markets play a crucial function in ensuring that state competition is efficient for public firms by mitigating the agency problem that managers will seek laws that are detrimental to shareholders. The thinness of the close corporation equity market is therefore another signal that state competition may not work well here. However, I am ambivalent as to whether Ayres has really overlooked something of note that supports his thesis—hence this is just a quibble—because a thick capital market is less relevant for the production of efficiency minded close corporation codes, as there is little or no separation between ownership and control in the close corporation.

The relevant question involves determining whether minority shareholders are less well protected from majority shareholder exploitation through disadvantageous corporation laws, as public corporation shareholders are protected from self-interested managers, because their shares are not marketable: that is, how much does state competition depend on capital-market competition as opposed to low migration costs? To answer this question, we would want to know whether minority shareholders pay too much for their initial investments—do they discount for the posited imbalance in the legal regime? Presumably, the majority shareholder in the close corporation wishes to obtain the maximum payment for minority shares, and thus it will desire corporation codes (or share-

holder voting agreements thereunder) that offer credible commitments against exploitation. The minority shareholders of close corporations may be better informed at the initial issuance of shares about the enterprise than the outside shareholders in public firms: they may be managers or close relatives of managers, or they may be venture capitalist firms, quite well versed in the enterprises in which they invest.[4] There thus may be alternative protections to a thick capital market for close corporation investors. In any event, how this affects competitive behavior for charters should be explored.

Another, perhaps more important, factor is the likelihood of greater diversity in ownership, management, and control arrangements across close corporations than in publicly held firms. If this is the case, closely held firms will be less likely to need and use standard form contracts, which would make courts, rather than legislatures, the important governance institution for their investors. And it would downplay the need for, as well as the possibility of, competition among states. That is, if there is no useful default rule because a close corporation's problems are distinctive, then there is no reason for states to compete by offering standard form contracts, as such provisions will not reduce transaction costs. To ascertain the validity of this claim, we need data comparing the variety and uniformity of close corporation charters or voting arrangements. The institution of significance for promoting efficient arrangements for close corporations would be the courts, whose role is to enforce idiosyncratic agreements, whether or not the states compete for close corporation charters. This view is consistent with Ayres' detailing of the role of courts in close corporation law, but it provides an alternative gloss on the significance of his claim regarding the absence of state competition in this market sector.

While on the issue of corporation codes as standard form contracts, let me make a tangential remark. If the law were so flexible concerning corporate structure as to be completely trivial, as Bernard Black asserts—a position with which Ayres seems to agree[5]—we would not need courts to overturn inefficient statutes because corporation codes would not hinder the parties from contracting as they wished. The efficient role of courts in statutory updating that Ayres praises is superfluous if one buys Black's

4. *See* William A. Sahlman, *The Structure and Governance of Venture-Capital Organizations*, 27 J. FIN. ECON. 473 (1990).

5. Ayres, *supra* note 1, at 375-76 (citing Bernard Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542 (1990)).

thesis, but not if one adopts the story I have offered: that courts and legislatures are complementary institutions, that there will be a lag effect in the efficacy of corporation laws, given the dynamic nature of the business environment, and that there is less standardization in close corporation than in public corporation forms.

## STRATEGIC INTERACTION OF COURTS AND LEGISLATURES

My third quibble relates to strategic considerations. If we consider the structure of the game between courts and legislatures, the legislature has the last move in the sequence. It therefore would be highly unusual for us to find courts making inefficient decisions when they overturned close corporation laws, because the courts must anticipate that such decisions will be overruled by the legislature (if the legislature wishes to adopt efficient rules). This view is consistent with Ayres' thesis, but the characterization that courts are willing to act primarily when the legislature is not actively monitoring them, is, I think, inapposite and not necessary for his thesis. Losing parties in the corporate context can notify the legislature and turn it into a monitor, even if it had no interest in judicial monitoring before the decision. This characterization is analogous to Mathew McCubbins' and Thomas Schwartz's observation of Congress' fire-alarm approach to oversight of agencies: Congress exercises supervision over an agency only after aggrieved constituents notify it of a problem.[6]

In this regard, we should investigate how frequently after a court overturns a statute the legislature reverses itself and carefully codifies the opinion (rather than engaging in continued benign supervisory neglect or judicial reversal). Judicial modification of corporation laws to aid close corporations need not be characterized as pursuit of the public good in derogation of the legislature's will; instead, such a court can be viewed as perfecting the legislature's will by acting, as the legislature would have desired should the issue have been before it, to maximize shareholder wealth. This more plausible characterization is consistent with all of the examples Ayres provides.

I would be less persuaded of a dual-efficiency maximizing explanation if Ayres could provide examples of the legislature's overruling court decisions on close corporations because the state's public corporation business was adversely affected or because interest groups objected. Ayres'

6. Mathew D. McCubbins & Thomas Schwartz, *Congressional Oversight Overlooked: Police Patrols Versus Fire Alarms*, 28 AM. J. POL. SCI. 165 (1984).

example of the North Carolina statutory revision story of interest-group politics is not clearly on point because it does not appear to follow a judicial decision favoring the minority shareholders. It would be interesting, however, to compare the lobbying strategies of the North Carolina majority shareholders to those of public-corporation managers; did they threaten employment losses or that local plants would be closed if the minority position succeeded, as corporate managers typically contend when lobbying for antitakeover statutes?[7] In the public-corporation context, when these non-shareholder constituents are arguably affected, it is more likely that a non-shareholder-value-maximizing corporation law is produced.

There is also another player in the corporation code competition game whose interests should be examined: the corporate bar. Ayres does note the bar's role in the public-corporation context, and there is little reason to think that attorneys are less important in the making of close corporation codes. Because corporate lawyers typically represent the firm, in the close corporation context they may be likely to represent the majority shareholders (the manager-owners). Examining the bar's activity is thus one mechanism by which to operationalize and test Ayres' hypothesis that legislatures are sympathetic to majority and not minority shareholders' interests in the choice of close corporation statutes.

Systematic empirical research into the making of close corporation laws would be quite helpful on this point, as would tracing the evolution of those laws across the states. If close corporation reforms spread as quickly as innovations in public corporation codes, perhaps the world of close corporation charters is more competitive than otherwise meets the eye. The motive may not be to increase close corporation franchise fees. Rather, it could be to maintain public-corporation fees. Namely, a legislature might fear a negative reputational spillover effect on its public-chartering business from its treatment of close corporations: if public firms perceive that a state is not responsive to the concerns of close corporations, they may conclude that it also will not be responsive to their concerns.

I am skeptical, then, whether, as Ayres contends, states desire inefficient judicial holdings on close corporations to enhance their stock of precedents for public corporations. Indeed, a stock of corporate-law

7. *See* Roberta Romano, *The Political Economy of Takeover Statutes,* 73 VA. L. REV. 111 (1987); Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion,* 57 U. CIN. L. REV. 457 (1988).

precedents is of value primarily to Delaware in maintaining its competitive position vis-a-vis other states, and it has so vast a number of public firms that it does not need to misuse close corporation decisions to provide public-firm precedents.[8] A negative spillover effect would constrain perverse incentives.

We might test which conjecture is correct by looking for changes in trends of reincorporations and incorporations after judicial decisions, which reform or do not reform statutes for close corporations, and after the corresponding legislative reactions. Or we might see if there is a correlation between states' responsiveness to close corporations' concerns and their responsiveness to public corporations' concerns. We also might want to know whether close corporation practices have changed as dramatically as public corporations; we might see less statutory action because business practices have not changed as rapidly; this also would be true if private-firm arrangements are less standardized.

## CONCLUSION

All of these points are quibbles that should not detract from the article's valuable contribution. It highlights that the field of close corporations offers interesting insights into our understanding of the forces of state competition and reminds us of the need to focus on the important relation between courts and legislatures when evaluating this process.

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