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# Judging Close Corporations in the Age of Statutes

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# JUDGING CLOSE CORPORATIONS IN THE AGE OF STATUTES

IAN AYRES\*

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\* Visiting Professor, Yale Law School; Professor, Stanford Law School. My title is a variation on Guido Calabresi's seminal book, *A Common Law for the Age of Statutes* (1982). I would like to thank Roberta Romano and Robert Thompson for their substantial contributions to this article. I would also like to thank Bill Carney, Henry Hansmann, John Hetherington, Leon Lipson, Paul Mahoney, Chuck O'Kelley, Richard Posner, and Frank Wozencraft for helpful comments. Christopher Muñios provided excellent research assistance. I am in substantial agreement with the excellent comments provided by both Geoff Miller and Roberta Romano. While each of these commentators gave me a chance to incorporate their comments into this piece, I believe it is more useful to publish our dialogue as it occurred at the conference.

## INTRODUCTION

This Article examines the interaction between courts and legislatures in developing the law that governs close corporations. Much has been written analyzing whether corporate *statutes* are efficient. Others have examined whether individual areas of corporate common law promote efficiency.<sup>1</sup> I hope to gain a new purchase on these issues by examining the interplay between these two sources of corporate law. A crude goal of this Article is to begin an argument among three of the leading academic judges in the United States, who (listed in alphabetical order) are: the Honorable Frank Easterbrook, Richard Posner, and Ralph Winter.<sup>2</sup>

At this crude level, the idea is fairly straightforward. Judge Posner has suggested that common-law rules will tend to be efficient.<sup>3</sup> While Posner has not directly applied this theory to the common law of corporations, there is nothing in Posner's voluminous writings (that I have been able to find) that would indicate that corporate common law should be an exception to his general rule.

Judges Winter and Easterbrook, on the other hand, have suggested that corporate statutes will tend to announce efficient law.<sup>4</sup> This of

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1. See, e.g., Daniel R. Fischel, *The Business Judgment Rule and the Trans Union Case*, 40 BUS. LAW. 1437 (1985).

2. As opposed to the normal "let's-you-and-me-fight" form of scholarship, this article falls more within the "let's-you-and-her-fight" genre. I recently co-authored a piece that pursues this mode of analysis, suggesting that Judge Posner should argue with President George Bush about what is really wrong with Title VII. Posner has argued that the prospect of firing liability may lead employers not to hire women and minority workers; Bush argues that disparate-impact liability leads employers to hire "quotas" of women and minority workers. An argument (or at least discussion) between the two might clarify how the law should be changed—and might even lead to a recognition that the Civil Rights Act of 1991, Pub. L. No. 102-166, 105 Stat. 1071, is the appropriate modification. See Ian Ayres & Joel Siegelman, *Quotas Are Not the Problem* (Aug. 18, 1991) (unpublished manuscript).

3. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* (3d ed. 1986). While Posner has not proposed a causal explanation for this tendency, other scholars (in a wonderful ongoing dialogue published in the *Journal of Legal Studies*) have suggested that private parties will have more incentives to relitigate inefficient rules—so that inefficient rules will be more likely overturned than efficient rules. See 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); John C. Goodman, *An Economic Theory of the Evolution of the Common Law*, 7 J. LEGAL STUD. 393 (1978); William M. Landes & Richard A. Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979); Robert Cooter & Lewis Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 9 J. LEGAL STUD. 139 (1980).

4. Ralph K. Winter, Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977); RALPH K. WINTER, *GOVERNMENT AND THE CORPORATION* (1978); Frank H. Easterbrook, *Antitrust and the Economics of Federalism*, 26 J. L. & ECON. 23 (1983).

The dichotomy between Judge Posner and Judges Easterbrook and Winter is false, or at least

course is the “race to the top” thesis—that competition among legislatures for charter revenues will promote laws that maximize the shareholders’ value (and hence corporate value, because shareholders hold residual claims on the corporate assets). The “race to the top” theory responded to early theories of Professor William Cary and Justice Brandeis, which suggested that the competition among states engendered a “race to the bottom.”<sup>5</sup> A great deal of academic writing has sought to evaluate whether state legislatures are engaged in a race to the top or bottom.<sup>6</sup> Some articles have analyzed the substantive content of particular rules to assess whether statutory rules are consistent with the efficient rules derived from economic theory.<sup>7</sup> Other articles have empirically tested whether businesses that incorporate in Delaware—the undisputed leader of the race<sup>8</sup>—have higher or lower returns.<sup>9</sup> It is striking that law-and-economics scholars have argued that efficient legal rules can be generated by two powerful theories, yet to date no one has compared the relative efficiency of the two theoretical engines themselves.<sup>10</sup>

This Article begins to provide this comparison. By examining how

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flimsy. Judge Posner is clearly a proponent of both the common-law-efficiency hypothesis and the race-to-the-top hypothesis. Indeed, Posner has a claim to independent if not prior discovery of this insight: page proofs of his *Economic Analysis of Law* (2d ed. 1977) contained a race-to-the-top argument at the time when then-Professor Winter submitted his original article to the *Journal of Legal Studies*.

5. William L. Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); *Liggett Co. v. Lee*, 288 U.S. 517, 558-59 (1933) (Brandeis, J., dissenting) (corporate race not one of diligence but of laxity).

6. See, e.g., Daniel R. Fischel, *The “Race to the Bottom” Revisited: Reflections on Recent Developments in Delaware’s Corporation Law*, 76 NW. U. L. REV. 913 (1982); Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987); Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 585-91 (1990); Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. (forthcoming 1992).

7. See, e.g., Roberta Romano, *The Future of Hostile Takeovers: Legislation and Public Opinion*, 57 U. CIN. L. REV. 457, 461-63 (1988).

8. “Over 40 percent of the companies listed on the New York Stock Exchange are incorporated in Delaware. A majority of the publicly traded Fortune 500 companies are Delaware corporations. More than 80 percent of the companies that have reincorporated during the past quarter century have migrated to Delaware.” R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS*, at F-1 (2d ed. 1990).

9. Professor Roberta Romano has the classic piece in this genre. Roberta Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J. L. ECON. & ORG. 225 (1985).

10. Jack Coffee has written, however, an important work that suggests this comparison by analyzing the role of judges in interpreting statutory rules. John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989).

courts and legislatures react to each other's rules, I hope to gain insights into the efficiency of the law. At a very basic level, the three judges cannot be correct simultaneously if we see courts and legislatures fight with each other. If both the common law and statutory law of corporations are efficient, then we would not expect to observe such institutional tensions. These tensions might take two forms:

- (1) statutes might be drafted to overrule past judicial decisions and, prospectively, to preempt courts' common-lawmaking power; and
- (2) court decisions might explicitly or implicitly nullify statutory intent.<sup>11</sup>

The existence of either type of tension is evidence against the proposition that the two efficiency theories are both correct.

Indeed, the very existence of a statutory race is itself some evidence that the common law was not getting the job done.<sup>12</sup> If, to use Professor Romano's metaphor, the common-law legal product were being efficiently produced, there would be no need for states to legislate. Moreover, if the common law were being efficiently produced in all jurisdictions—as Posner's theory suggests it is in other substantive areas—there would be nothing for individual states to race over, because there would be no legislative opportunity to become more red than the common law rose.<sup>13</sup> Of course, for Posner's common-law efficiency theory to stand, corporate common-law precedents must also *change* at an efficient speed. There must be an efficient rate of product innovation. But this is no more (or less) true in the corporate context than in the other areas of common law in which Posner has waived the efficiency banner.<sup>14</sup>

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11. Beyond the instances of outright nullification, the reluctance of common-law courts to follow legislative intent is captured in the maxim of interpretation that "statutes in derogation of the common law shall be narrowly construed." See *Texas & Pac. Ry. v. Abilene Cotton Oil Co.*, 204 U.S. 426, 437 (1907).

12. Romano has presented quantitative evidence to support a theory that at least some states, such as Delaware, appear to be competing for corporate charters. See Romano, *supra* note 9 and *infra* text accompanying note 19. Carey provides several qualitative pieces of evidence to the same effect. Carey, *supra* note 5, *passim*.

13. This metaphor is taken from the communist argument that it was impossible to be "redder than the rose"—that is, more progressive/revolutionary than the communist party itself. ROBERT FORSYTHE, *REDDER THAN THE ROSE* (1935).

14. See, e.g., WILLIAM LANDES & RICHARD A. POSNER, *THE ECONOMIC STRUCTURE OF TORT LAW* (1987). Judge Posner has appreciated that legal efficiency must comprehend the dynamically efficient rate of change. In a recent article, for example, he argued that Title VII might drive bigots out of the employment market at an inefficiently high rate. Richard A. Posner, *The Efficiency and the Efficacy of Title VII*, 136 U. PA. L. REV. 513 (1987). See also John J. Donohue III, *Is Title VII Efficient?*, 134 U. PA. L. REV. 1411 (1986).

Evidence of judicial and/or legislative nullification, however, cannot—without more—tell who is wrong. Courts and legislatures might disagree for three possible reasons:

- (1) *The common law is inefficient* (i.e., Posner is wrong; Winter and Easterbrook are right). Under this scenario, a “race to the top” would drive legislators to overturn inefficient rules; or
- (2) *Statutory law is inefficient* (i.e., Posner is right; Winter and Easterbrook are wrong). Under this scenario, a “race to the bottom” would drive legislators to overturn efficient common-law rules; or
- (3) *Both sources of law are inefficient* (i.e., all three judges are wrong). Under this scenario, both judge-made and legislature-made law deviate from efficiency, but deviate in different ways—leading legislators to insist (via legislative supremacy) on their brand of inefficiency.

This analysis of “nullification” provides only a single-tailed test of the hypothesis that both the common and statutory law are efficient. Thus, even if courts and legislators never disagreed, it would not prove that both sources of law were efficient. Such evidence could be equally consistent, for example, with the hypothesis that judges join the legislators in racing to the bottom. This indeed was Professor Cary’s original analysis of Delaware (in which he stressed the close identity of interest between judges and members of the Delaware legislature).<sup>15</sup>

While both efficiency theories have provided (and continue to provide) an illuminating benchmark, many scholars believe that the tendency toward efficiency is not strong enough for either to provide a very powerful tool for predicting the contours of any individual legal rule.<sup>16</sup> For these scholars at least, it comes as no surprise that courts and legislatures sometimes disagree. Yet I would argue that an analysis of the judicial and legislative interactions can do more than simply disprove the straw-person theory that both judicial and statutory corporate rules are at all times efficient.

The larger goals of this Article are two-fold. First, I hope to provide a more subtle theory about the situations in which each institution is likely to take the leading role in shaping a particular area of corporate law. Second, I hope to show that the forces that lead to judicial or legislative dominance can also inform our judgement about whether this particular piece of corporate law enhances social welfare. The most important framing force that determines the lawmaking roles of courts and legisla-

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15. See Carey, *supra* note 5, at 688-92.

16. See, e.g., STEVEN SHAVELL, *ECONOMIC ANALYSIS OF ACCIDENT LAW* (1987).

tures is the principle of legislative supremacy: when the institutions disagree, the legislature wins.<sup>17</sup> Yet the ability and desire of legislators to constrain common-law courts—either *ex ante* or *ex post*—will often depend on other structural and contextual features that limit the legislators' efficacy in monitoring their judicial agent. Courts also appreciate these structural limitations and are likely to follow their common-law instincts when there is less effective legislative supervision.

My specific thesis is that states competing for corporate charters do not focus on the laws governing close corporations. Because states' revenues are not particularly sensitive to the rules governing close corporations, state competition for close corporation charters will not be nearly as intense as for publicly held corporations. In passing the "modern" corporation statutes in the early years of this century, state legislatures did not have the needs of close corporations in mind. Courts, for example, were the first to see how the immutable statutory rules—especially those regarding shareholder control agreements—were poorly tailored to fit the governance of the close corporations.<sup>18</sup>

As a result, judges have exerted a much greater influence on the law governing close corporations and, at times, have even shown a willingness to openly nullify inefficient corporate statutes. The nullification of certain Procrustean, immutable provisions by a few individual state courts not only initiated a dialogue with the legislatures of those states, but also conveyed information that motivated action by other state legislatures.

Legislatures reacted to these judicial innovations primarily by codifying the common-law rules. However, even absent competition for charter revenues, legislatures may be motivated to act on behalf of well-organized private groups, and at times close corporation statutes constrain common-law trends to reflect these private interests. In sum, legis-

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17. Unless, of course, the court's disagreement is based upon a constitutional principle that itself is a form of legislative supremacy—because the court is giving primacy to a higher statutory codification.

18. Bebchuk has forcefully argued for federalization of the discrete corporate rules when there is a "race to the bottom." Bebchuk, *supra* note 6. My thesis suggests, however, that race-to-the-bottom stories do not justify federal preemption of close corporation governance for the simple reason that states do not race for these charters. My argument that courts have mitigated the inefficiencies of statutes with regard to close corporations might offer some check on Bebchuk's race-to-the-bottom arguments in other contexts. While not dispositive, we might choose not to bear the inefficiencies of federalization if state courts can do a better job of "nullifying" legislation that is the product of inefficient chartermongering.

lative neglect of close corporations encouraged courts to alter rules that were Pareto inefficient. The individual legislatures—not competing for the close corporations' charters—have not been averse to adopting Pareto superior rules, but in certain instances also have been willing to sacrifice general social welfare for local private interests.

As the title suggests, this Article also can be viewed as an application of the insights that my temporary dean, Guido Calabresi, originally formulated in his seminal work *A Common Law for the Age of Statutes*.<sup>19</sup> Calabresi argued that common-law courts should at times invalidate obsolete statutes that no longer served their initial function.<sup>20</sup> My thesis that state legislatures do not actively compete for close corporation charters suggests that there would be greater legislative inertia to correct flawed close corporation rules and that judges may legitimately scrutinize these statutes more closely. The close corporation context also suggests that the Calabresian method not only may describe judicial behavior regarding desuetude, but also may comprehend aspects of statutory overbreadth when courts have a structural confidence that certain applications were unintended.

Outside of Delaware's Chancery Court, there are no special state courts for corporate issues, much less for close corporation litigation. This Article argues, however, that judges deciding close corporation issues act differently. Judges who normally would respect the strictures of legislative supremacy have been willing to flout constitutional legislation openly by nullifying successive generations of corporate statutes.

The Article is divided into three sections. The first Section details the structural reasons states are not likely to compete for close corporation charters. The remaining sections consider the role of courts and legislatures in shaping two changing areas in the law of close corporations. Section II analyzes the crucial role of courts in changing the immutable requirement that ownership and control be separated. In Section III, I discuss a variety of legislative responses to innovative judicial remedies for deadlock and oppression.

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19. GUIDO CALABRESI, *A COMMON LAW FOR THE AGE OF STATUTES* (1982).

20. *Id.* at 163-66. Legislative supremacy could also affect the contours of this common-law power. It is unclear, for example, in a Calabresian world whether courts should retain a power to update obsolete statutes—regardless of whether the legislature has granted or denied them such a power—or whether courts need an affirmative legislative grant of power for this type of updating.



## I. REVENUE INELASTICITY CONCERNING CLOSE CORPORATION LAW

While “race to the bottom” and “race to the top” adherents disagree on many issues, Roberta Romano saw that both camps do agree that states like Delaware compete to maximize their revenues from corporate charters.<sup>21</sup> Starting with this basic premise, she then went out to look whether a race was actually occurring. She showed, for example, that Delaware’s legislature was particularly responsive to legal innovations in other states.<sup>22</sup> Moreover, she showed that states that earn a high proportion of their state revenues from corporate franchise taxes were more likely to adopt legislative innovations of other states.<sup>23</sup> Romano’s qualitative empiricism confirms the wealth of qualitative data William Cary provided that indicates that Delaware actively seeks charter revenues. This includes the legislature’s explicit pronouncement: “[T]he favorable climate which the state of Delaware had traditionally provided for corporations has been a leading source of revenue for the state. . . . The General Assembly . . . declares [this] to be the public policy of the State. . . .”<sup>24</sup> Thus, there is broad consensus from all sides that a primary objective of states in drafting corporate statutes is to maximize franchise revenues.

This Section argues, however, that this motivation does not govern state provision of close corporation law.<sup>25</sup> A state’s tax revenues are relatively insensitive to the substantive content of the laws governing close corporations. Competitive federalism accordingly will not be a primary determinant of close corporation statutes. Thus, whether one believes that state competition leads to good or bad law, a prime thesis of this Article is that interstate competition will not significantly motivate legislative regulation of close corporations. In this competitive vacuum, I

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21. Romano, *supra* note 9, at 233 (“The most fundamental postulate of both shareholder wealth maximization and managerialist state competition stories is that states compete for incorporations by passing laws that the corporations’ decisionmakers support.”).

22. *Id.* at 240.

23. *Id.* at 239.

24. Act of Dec. 31, 1963, ch. 218, 54 Del. Laws 724 (authorizing the financing of the Delaware Corporation Law Revision Commission of 1967), *quoted in* Carey, *supra* note 5, at 663.

25. This argument is consonant with the suggestion of Richard Posner and Ken Scott that Delaware “has tailored its law to the needs of the large public corporation. . . . In short, the advantages of a Delaware charter may outweigh the additional Delaware taxes only for businesses attaining a certain scale of operations.” RICHARD A. POSNER & KENNETH E. SCOTT, *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION* 111 (1980).

suggest that close corporation statutes will be determined by the same forces that drive many other types of legislative action: a desire to promote the public welfare, tempered by a willingness, at times, to cater to well-organized private interests.

Legislators may also have preferences for leisure; my thesis that there is relatively little (tax revenue) at stake suggests that elected officials may not have large incentives to exert themselves in researching, drafting, and passing the optimal legal rules. Given the likelihood of legislative inaction, it is not surprising that we will find common-law judges taking a greater lead in shaping the content of close corporate governance.

The one caveat to my thesis that state revenues are insensitive to close corporation rules stems from the “perverse” use that states may make of close corporation precedent. Some scholars have argued that Delaware may have an advantage because it has a rich body of court decisions applying its statutes.<sup>26</sup> A state may have a revenue-based incentive to force close corporations to abide by the rules governing publicly held corporations to enhance the richness and depth of its precedent base. Even though the legislatures know that the legal rules are not efficient for closely held businesses, forced pooling of the close corporations under a single statutory law may enhance a state’s ability to compete for large corporate charters.<sup>27</sup> I return to this argument below.<sup>28</sup>

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26. See, e.g., Romano, *supra* note 9, at 280; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1566 n.56 (1989).

27. This argument is consistent with Michael Spence’s generative insight that firms competing for marginal sales may be driven to choose a product quality that the marginal consumer prefers. A. Michael Spence, *Monopoly, Quality, and Regulation*, 6 BELL J. ECON. 417, 418 (1975). This choice of quality may be socially inefficient if the average consumer’s preferred quality diverges from the preferences of the marginal consumer. Competition leads producers to ignore the quality preferences of average (or infra-marginal) consumers, because these consumers are capturing sufficient gains from trade (consumer surplus) such that forcing them to buy inefficient quality will not deter their purchases.

In this context, the close corporations are the infra-marginal consumers of the states’ legal “product.” States intent on maximizing revenue may have incentives to choose a quality (i.e., substantive legal rules) that appeal more to the marginal consumers—the publicly held corporation. The precedent story is similar to Spence’s assumption that producing products with more than one quality is costly. In the corporate context, doing so undermines the value of the precedent base.

28. As an empirical matter, it is also possible that close corporation interpretations of the statute may distort and hence undermine the value of precedent. Later in this Article, I show how judicial nullification of general corporate statutes applied to close corporations may have produced just this result. See *infra* text accompanying notes 95-97.

*A. Dominance of Domestic Domicile: Expenses Disproportionate to Any Advantages Gained*

Strong structural forces tie a small business' incorporation to the state where it conducts most of its business. These forces are acknowledged in no less than the definitive close corporation treatise by F. Hodge O'Neal and Robert Thompson:

Almost invariably, domestic incorporation is preferable for a close corporation, especially for a small enterprise whose operations are to be limited to one state. Incorporating a closely held enterprise in a state other than that in which its principal place of business is to be located ordinarily involves inconvenience and expense disproportionate to any advantages gained.<sup>29</sup>

Following O'Neal and Thompson's lead, this Section argues that there are significant costs and limited advantages in nondomestic incorporation. Moreover, an examination of state tax schemes supports the thesis that total charter revenues are unlikely to be very sensitive to changes in laws governing close corporations.

*1. Additional Costs of Foreign Incorporation*

A business incorporating in a jurisdiction where it does not conduct business still must "qualify" to do business in the state where it actually does conduct its business. Thus a double taxation not only occurs at the time of initial registration, but also takes the form of annual fees that must be paid to both states—one to remain qualified to do business as a foreign corporation,<sup>30</sup> the other to maintain corporate status in the foreign jurisdiction.<sup>31</sup> For many publicly held corporations, qualification fees are not duplicative. When these corporations conduct business in multiple states, they already pay multiple qualification fees in the ordinary course of their business operations.

Foreign corporations also must maintain a registered agent in the state of incorporation. While this expense by itself would not deter foreign incorporation by many closely held firms, the fear that the registered agent might be used to receive process could act as a deterrent. This is

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29. F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 2.11, at 55 (3d ed. 1987).

30. The dividends of foreign corporations are potentially taxed by both the states of commercial and statutory domicile. *See* Romano, *supra* note 9, at 255 n.45; JEROME R. HELLERSTEIN, STATE TAXATION ¶ 9.3 (1983). But as Romano notes, "no jurisdiction apparently exercises this power." Romano, *supra* note 9, at 255 n.45.

31. This discussion is based on the excellent treatment in O'NEAL & THOMPSON, *supra* note 29, § 2.11, at 55.

because a corporation can be sued in the state of incorporation. If the foreign state is geographically distant from the corporation's base of operations, the possibility of more expensive litigation might significantly raise the expected cost of foreign incorporation. This potential expense might not deter a closely held Philadelphia company from incorporating in Delaware, but might substantially chill the similar interest of a small Chicago business.<sup>32</sup>

Finally, foreign incorporation might substantially increase the company's costs of capital. The Securities Act of 1933 exempts issuers from all registration and disclosure obligations under federal law when both the issuer and the offerees are within the same state and when the proceeds are to be used in that state.<sup>33</sup> This exemption is automatically forfeited if the business incorporates in a state where it does not conduct business. Registration and disclosure costs under the federal securities laws can be substantial.<sup>34</sup> Thus, the intrastate-offering exemption might provide a strong deterrent to foreign incorporation for those smaller businesses that would benefit from the exemption.

## 2. *The Limited Advantages of Foreign Incorporation*

Most states permit corporations substantial contractual freedom and thereby obviate the need for foreign incorporation. This argument relates to Bernie Black's "triviality" hypothesis.<sup>35</sup> Black argues that state corporate law is trivial because "it does not prevent companies—managers and investors together—from establishing any set of governance rules they want."<sup>36</sup> Black explicitly argues that state laws granting corporations complete contractual freedom undermine the competition among states for corporate charters: "The chartermongering race, whether to the top, the bottom, or somewhere in between, is essentially over."<sup>37</sup> Whether this accurately describes the recent race to adopt antitakeover amendments for the benefit of publicly traded corporations, the argument has particular force with regard to the specialized governance structures of close corporations. Close corporations no longer have to travel to fulfill their particular needs, because "the laws of most states are

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32. Geographic distance may also increase the expected cost of being placed in receivership because receivers can be appointed for a business in the state of incorporation. *Id.*

33. 15 U.S.C. § 77c(a)(11) (1988).

34. See LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION (2d ed. 1988).

35. Black, *supra* note 6.

36. *Id.* at 544.

37. *Id.* at 586.

sufficiently elastic to permit the setting up of almost any kind of capital and management structures."<sup>38</sup>

Finally, to the extent that a close corporation's domestic law is not trivial, the advantages of incorporating elsewhere are reduced by a "you-can-run-but-you-cannot-hide" effect. The internal affairs doctrine and the dormant commerce clause notwithstanding,<sup>39</sup> some states impose substantive rules of corporate governance on businesses that have substantial domestic contacts even if they are incorporated elsewhere.<sup>40</sup> A California statute, for example, imposes cumulative voting and other substantive laws on foreign corporations with specified ties to the state.<sup>41</sup> New York's corporation statute subjects directors and officers of foreign corporations to the same fiduciary standards as their counterparts in a domestic corporation.<sup>42</sup> A recent New York case underscores the difficulty close corporations might have in contracting for another jurisdiction's statute. In *Application of Dohring*,<sup>43</sup> a New York court held that New York courts could dissolve Delaware corporations under New York statutory and common-law powers when the corporation's sole contact with Delaware was its certificate of incorporation.<sup>44</sup> Especially to the extent that the equitable power of domestic courts can govern a close corporation's internal affairs, the competition for out-of-state charters will be substantially impeded.

### 3. *The Relative Insignificance of Close Corporation Revenues*

From the available evidence, it seems that franchise fees paid by close corporations represent only a small portion of the charter taxes corporate America pays. Thus, while Delaware expects to earn 201 million dollars in 1991 from its franchise tax rolls,<sup>45</sup> only a small portion of this is likely to come from close corporations. Thus, even if states could potentially

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38. O'NEAL & THOMPSON, *supra* note 29, § 2.11, at 56.

39. See generally Deborah A. DeMott, *Perspectives on Choice of Law for Corporate Internal Affairs*, 48 LAW & CONTEMP. PROBS. 161 (1985). See also *Arden-Mayfair, Inc. v. Louart Corp.*, 385 A.2d 3 (Del. Ch. 1978); *Wilson v. Louisiana-Pacific Resources, Inc.*, 187 Cal. Rptr. 852 (Ct. App. 1982) (California cumulative voting statute does not burden interstate commerce when California residents held more than half of Utah corporation's shares).

40. O'NEAL & THOMPSON, *supra* note 29, § 2.11, at 55.

41. CAL. CORP. CODE § 2115 (West 1990).

42. N.Y. BUS. CORP. LAW § 1317 (McKinney 1986).

43. 537 N.Y.S.2d 767 (Sup. Ct. 1989).

44. The implications of this case are discussed more fully *infra* at text accompanying note 101.

45. BNA Daily Report for Executives, State Developments DER No. 82, April 27, 1990, at H-2.

compete for close corporation charters, their efforts to reap these low-revenue incorporations are likely to be less than those to lure the publicly held corporations that produce the bulk of a state's charter revenues.<sup>46</sup>

It is difficult to assess directly what proportion of corporate charters come from close corporations, because states do not keep separate information on the source of franchise funds. Yet some information can be gleaned from a direct analysis of Delaware's franchise tax rates themselves. For example, a corporation with six thousand shares and fifteen million dollars in total assets would pay fewer than fifty dollars a year as franchise tax to Delaware,<sup>47</sup> while most publicly listed corporations would pay the maximum \$130,000/year tax, or close to it.<sup>48</sup>

Although few businesses opt for statutory close corporation status,<sup>49</sup> the large number of potentially qualifying close corporations probably still does not represent a substantial source of state charter revenue. If the sixteen thousand closely held corporations in Delaware paid the fifty dollar annual franchise fee, the resulting eight hundred thousand dollars in revenue would represent less than one third of one percent of Delaware corporate tax receipts.

We can also gauge the insignificance of close corporation revenues by imagining the potential revenues if all small businesses incorporated in Delaware. There were approximately three million corporations in the

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46. The market for corporate charters—like the market for cars—might generate highly concentrated profits when a small percentage of buyers produce a large proportion of a firm's (or state's) profits. See Ian Ayres, *Fair Driving: Gender and Race Discrimination in Retail Car Negotiations*, 104 HARV. L. REV. 817, 854 (1991) (noting that car dealership profits tend to be concentrated in a few sales).

47. This example is taken from BALOTTI & FINKELSTEIN, *supra* note 8, at 20-13 to 20-15. The disparity between the size of the franchise tax for small and large corporations might work against the previous analysis of the structural forces that tie the incorporation to the state in which the firm primarily conducts business. If small corporations face significant switching costs, states might be expected to exercise their effective market power by increasing the size of the franchise tax. The response that the option of alternative forms of business organization (such as a limited partnership) constrains states is only partially persuasive, since states could tax these alternative forms as well. Political forces may keep a state from trying to exploit its own small businesspeople, and perhaps discourage small business formation, by imposing heavy franchise fees on close corporations, most of the shareholders of which will be residents of the state.

48. Corporations with more than 40 million authorized shares or assets worth a billion dollars will pay the maximum tax of \$130,000. Many publicly traded companies have substantially more shares, for example (in millions of shares): Dow Chemical, 500; Kellogg Co., 165; Black and Decker, 150; Warner Lambert, 300. See MOODY'S INDUSTRIAL MANUAL (1991).

49. In 1985 only six-tenths of one percent of corporate franchises were statutory close corporations. Delaware and Maryland reported a total of 16,684 and 1100 statutory close corporations respectively in recent years. O'NEAL & THOMPSON, *supra* note 29, § 1.18.

United States in 1983, and ninety-eight percent of these corporations had total assets worth fewer than ten million dollars.<sup>50</sup> If Delaware could overcome the structural forces outlined above and monopolize the small business charter market, it would not even double its revenues.<sup>51</sup> In sum, the structural forces that tie corporations to their state of primary business<sup>52</sup> and the relative insignificance of close corporation charter revenues both support the notion that a state's franchise revenues are unlikely to depend on changes in the rules governing close corporations.

Because states do not compete (or do not compete strenuously) for close corporation charters, common-law courts have more freedom to pursue their conception of the good. In the Sections that follow, I argue that courts, true to Posner's efficiency hypothesis, have improved the law of close corporations. Without the disciplining effect of competitive federalism, the legislative attitude toward close corporations has been passive. Legislatures have largely approved of common-law innovations as long as the court decisions (1) do not adversely affect the states' quest for publicly traded corporations, and (2) do not conflict with the legislative demands of well-organized private interest groups.

## II. UNDERMINING THE IMMUTABLE REQUIREMENT THAT OWNERSHIP AND CONTROL BE SEPARATED: JUDICIAL ENFORCEMENT OF SHAREHOLDER CONTROL AGREEMENTS

### *A. The Immutable Separation: Herein McQuade v. Stoneham*

The separation of ownership from control often has been characterized as one of the fundamental attributes of the modern corporation.<sup>53</sup> This separation was caused not only by structural forces,<sup>54</sup> but also by immutable statutory provisions mandating that "[t]he business of a corporation shall be managed by its board of directors."<sup>55</sup> Shareholder control

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50. UNITED STATES DEPARTMENT OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1987, at 512-13 (1987).

51. At \$50 per corporation, *see supra* text accompanying note 45, Delaware would increase its revenues by less than \$150 million. Its projected current franchise revenues are \$201 million.

52. There are of course exceptions to this tendency. *See, e.g.,* *Zion v. Kurtz*, 405 N.E.2d 681 (N.Y. 1980); *Application of Dohring*, 537 N.Y.S.2d 767 (Sup. Ct. 1989).

53. ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1991); ROBERT C. CLARK, *CORPORATE LAW* § 1.2, at 22 (1986).

54. *But see* Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10 (1991); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 (1990).

55. N.Y. Gen. Corp. Law § 27, *cited in* *Clark v. Dodge*, 199 N.E. 641, 642 (N.Y. 1936). Over

agreements that attempted to limit the discretion of the board of directors ran afoul of this and other statutory provisions<sup>56</sup> and were routinely voided by courts as being unenforceable in the early part of this century.<sup>57</sup> One of the best-known final statements of this rule came in *McQuade v. Stoneham*.<sup>58</sup> In *McQuade*, the New York Court of Appeals in 1934 refused to enforce a shareholder control agreement in which the shareholders agreed, *inter alia*, to “use their best endeavors” to have themselves elected as officers of the corporation (and to pay certain salaries). The court, even in reaffirming the traditional rule, signalled its discomfort:

It is urged that we should pay heed to the morals and manners of the marketplace to sustain this agreement. . . . We do not close our eyes to the fact that such agreements, tacitly or openly arrived at, are not uncommon, especially in close corporations. . . . Nor are we unmindful that *McQuade* has, so the court has found, been shabbily treated as a purchaser of stock from *Stoneham*. . . . [But] we are constrained by authority to hold that a contract is illegal and void so far as it precludes the board of directors, at risk of

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40 states required management “by” a board of directors. O’NEAL & THOMPSON, *supra* note 29, § 5.06, at 24 n.2. See MODEL BUSINESS CORP. ACT ANN. 759-61 (Committee on Corporate Laws ed., 2d ed. 1971).

It is unclear whether this immutable rule was a codification of prior common law. See generally Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593 (1988); Christopher Grandy, *New Jersey Corporate Chartermongering, 1875-1929*, 49 J. ECON. HIST. 677 (1989). An important question this Article does not address concerns the causes of this prior common-law rule and whether the common law prior to statute adequately met the governance needs of closely held corporations.

It is likely that the rise of close corporations in the 20th century might be caused by changes in the tax system that caused closely held partnerships to incorporate. Thus, the early common law of corporations—prior to the “modern” corporation statutes of the early 20th century—might not have had to accommodate the governance demands of both large and small organizations.

56. According to O’Neal and Thompson:

Other statutes on which attacks on shareholders’ agreements may be grounded include those with provisions generally to the following effect: the directors shall be elected by a plurality of votes cast by the shareholders; specified kinds of shareholder action (e.g., that required for charter amendment or dissolution) shall be passed by stated percentages of the stock vote; the shareholders shall be entitled to one vote for each share of stock held, except to the extent otherwise provided in the corporation’s charter; the shareholders shall meet annually at a time and place fixed in the bylaws; the election of directors shall be by ballot at a shareholders’ meeting; directors shall be elected by cumulative voting; a director shall be deemed qualified when he has filed a written acceptance and not before; a director shall hold office until his successor is elected and qualified; and the officers shall be elected by the directors.

O’NEAL & THOMPSON, *supra* note 29, § 5.06, at 19 (footnotes omitted).

57. See, e.g., *Nickolopoulos v. Sarantis*, 141 A. 792 (N.J. 1928) (voiding shareholders’ agreement that violated statute mandating equal voting strength for each share).

58. 189 N.E. 234 (N.Y. 1934).



incurring legal liability, from changing officers, salaries, or policies or retaining individuals in office, except by consent of the contracting parties.<sup>59</sup>

Even against strong pragmatic and equitable pressures, the *Stoneham* court followed the mandate of the New York statute requiring that directors manage the business of the corporation.

Other courts did not find these statutory provisions as restrictive. As one would expect,<sup>60</sup> when a statutory requirement seems anachronistic both to business needs and to equity, courts will find interpretations that allow relief. Thus, in the same year as *Stoneham*, the New York Court of Appeals enforced a unanimous shareholder agreement providing for cumulative voting, even though an amendment of the certificate of incorporation had not been filed (as required by statute).<sup>61</sup> Other state courts enforced shareholders' control agreements by ruling that conflicting statutes were merely directory.<sup>62</sup>

*B. Limited Nullification and the Statutory Response: Herein  
Clark v. Dodge*

In 1936, just two short years after *McQuade*, the New York Court of Appeals took the lead in relaxing the immutable separation of ownership and control. In *Clark v. Dodge*,<sup>63</sup> Judge Crouch (who along with Judge Lehman had concurred in *McQuade*'s result, but who had rejected the court's analysis of the statute) upheld the legality of a shareholder agreement under which a minority shareholder was to continue as general manager and director and was to receive one-fourth of the "net income" of two corporations at issue.

The opinion is remarkable because it upholds the shareholder control and compensation agreement, while at the same time openly admitting that the agreement violates section 27 of the state's General Corporation Law, which, as in other states, mandated "the business of a corporation shall be managed by its board of directors."<sup>64</sup>

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59. *Id.* at 236-37.

60. *See* CALABRESI, *supra* note 19, at 2.

61. *In re* American Fibre Chair Seat Corp., 193 N.E. 253 (N.Y. 1934).

62. *Clark v. Foster*, 167 P. 908, 911 (Wash. 1917) (enforcing voting trust). *See* O'NEAL & THOMPSON, *supra* note 29, § 5.06, at 22.

63. 199 N.E. 641 (N.Y. 1936).

64. *Id.* at 642. The Court applied the New York statute, even though the two corporations were incorporated in New Jersey. *Id.* at 641. In its 1936 opinion, the Court did not address explicitly the choice-of-law issue. However, when Clark sought an order for specific performance of the agreement in subsequent proceedings, the Dodge faction pleaded illegality under New Jersey law.

Are we committed by the *McQuade* Case to the doctrine that there may be no variation, however slight or innocuous, from the norm, where salaries or policies or the retention of individuals in office are concerned? . . . Public policy, the intention of the Legislature, detriment to the corporation, are phrases which in this connection mean little. Possible harm to bona fide purchasers of stock or to creditors or to stockholding minorities have more substance; but such harms are absent in many instances. *If the enforcement of a particular contract damages nobody—not even, in any perceptible degree, the public—one sees no reason for holding it illegal, even though it impinges slightly upon the broad provision of section 27.*<sup>65</sup>

*Clark* openly flouts legislative supremacy. The court “sees no reason” for upholding an agreement prohibited by statute—as if the statute were not reason enough. Perhaps sensing the “lawless” basis for its holding, the opinion attempts to cabin the reach of this common-law exception in two ways. First, economists will have noted that it adopts a Pareto criterion for statutory nullification. If ignoring a statute can make some people better off without hurting anyone, the case for nullification is strongest.<sup>66</sup> Second, the *Clark* court seemed to limit enforcement to shareholder agreements when the “invasion of the powers of the directorate . . . is so slight as to be negligible.”<sup>67</sup>

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The official referee, observing that the Court of Appeals had noted the fact of New Jersey incorporation, applied New York law on the theory that the shareholders' agreement: (1) was a contract made and delivered in New York by New York residents, and (2) was to be performed in New York by corporations whose sole manufacturing plant and place of business was in New York. *See supra* note 41 and accompanying text (discussing application of substantive law to internal affairs of foreign corporation).

65. 199 N.E. at 642 (emphasis added).

66. The use of the phrase “not even . . . the public” in the italicized quotation is interesting—as it suggests that consideration of the public good is an unusual judicial concern. Calabresi has recently argued that this criterion would define a null set for nullification. Guido Calabresi, *The Pointlessness of Pareto: Carrying Coase Further*, 100 YALE L.J. 1211 (1991). If enforcing the contract would not harm anyone in the least, there would not be two adversaries in this case, and the legislature would have already repealed the rule.

67. 199 N.E. at 643. Distinguishing *McQuade*, the court found:

There was no attempt to sterilize the board of directors, as in the *Manson* and *McQuade* Cases. The only restrictions on Dodge were (a) that as a stockholder he should vote for Clark as a director—a perfectly legal contract; (b) that as director he should continue Clark as a general manager . . . ; (c) that Clark should always receive as salary or dividends one-fourth of the “net income” . . . ; (d) that no salaries to other officers should be paid unreasonable in amount or incommensurate with services rendered—a beneficial and not a harmful agreement.

*Id.* It is difficult to see how these provisions distinguish *Clark* from *McQuade*. It may be true that the agreement was “beneficial” but it does seem to be a significant “invasion of the powers of the directorate.” Indeed, Clark would not have entered the agreement if he had not believed that it would significantly restrict the board's powers.

The immutable rule of *McQuade* did not disappear immediately thereafter. New York opinions in the 1940s and early 1950s continued to strike down shareholder agreements that impinged too significantly on board discretion.<sup>68</sup> *Clark*, however, sent an important signal to courts and legislatures across the country.<sup>69</sup> Most importantly, the New York Legislature did not respond with hostility to the court's arguably lawless action. Instead, it incorporated *Clark*'s common-law rule. The 1961 revision of the New York Business Corporation Statute contained a provision expressly allowing shareholder restriction of boards of directors.<sup>70</sup> The Revisers' comment made explicit that "Paragraph (b) expands the ruling in *Clark v. Dodge* and, to the extent therein provided, overrules . . . *McQuade v. Stoneham*."<sup>71</sup>

After *Clark*, increasing numbers of state courts and legislatures moved to liberalize enforcement of shareholders' control agreements. The Kansas Supreme Court held in 1953 that shareholders of close corporations

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68. *Long Park, Inc. v. Trenton-New Brunswick Theatres Co.*, 77 N.E.2d 633 (N.Y. 1948); *Frieda Popkov Corp. v. Stack*, 103 N.Y.S.2d 507, 509 (Sup. Ct. 1950) ("It is a fundamental principle of the laws of this State governing corporations that the management and affairs of each corporation are to be guided by the officers provided for or authorized in its charter. This management must be separate and exclusive, and any arrangement by which control of the affairs of a corporation may be taken from its stockholders and authorized officers and agents would be hostile and in opposition to the established policy of our general corporation statutes. . . .").

69. Professor Manne, however, has argued:

Legislative approval of small corporate norms developed long before the courts began to reflect a more sympathetic approach. As early as 1901, for instance, state legislatures approved voting trusts which had earlier been declared illegal by courts because of the separation of the vote from the underlying share interests.

Henry G. Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259, 283 (1967) (citing General Corporation Act of 1901, ch. 167, § 18, 22 Del. Laws 286, 293). Manne's argument shows only how the legislature allowed shareholders to contract for the election of directors. Prior to *Clark*, no legislation allowed shareholders to control the identity of officers or their salaries—core separation issues.

70. Act of Apr. 24, 1961, ch. 855, § 620 (b), 1961 N.Y. Laws 2356, 2394-95. That provision allows:

A provision in the certificate of incorporation otherwise prohibited by law as improperly restrictive of the discretion of powers of the directors in their management of corporate affairs . . . shall nevertheless be valid: (1) If all the incorporators or holders of record . . . have authorized such provision . . . ; and (2) If . . . shares are transferred or . . . issued to one who did not have knowledge thereof, and such person consents in writing to such provision.

A 1948 amendment authorized charter provisions fixing higher votes and quorums for shareholder and director actions in a response to the close corporation needs. Act of Apr. 6, 1948, ch. 862, Sec. 1, § 9, 1948 N.Y. Laws 1704. This statutory section has been superseded. See N.Y. BUS. CORP. LAW §§ 616 & 709 (McKinney 1986 & Supp. 1991).

71. *Zion v. Kurtz*, 405 N.E.2d 681, 686 (N.Y. 1980).

could waive statutory rights by contract.<sup>72</sup> In 1955 the Delaware Chancery Court struck down a “sterilizing” shareholders’ agreement but intimated that less intrusive agreements with unanimous shareholder approval might be enforced.<sup>73</sup> In the late 1950s and early 1960s, three other states (South Carolina, Connecticut, and North Carolina) joined New York in expanding the rights of shareholders in close corporations to contract for control. While both covert and explicit judicial nullification initiated the process, by the mid-1960s there appeared to be a legislative recognition that the shareholders of close corporations needed a broader freedom of contract.<sup>74</sup>

### C. *Expanded Nullification in Galler and Zion*

Even in the midst of the statutory reform movement, courts continued to play a crucial role in moving the law. In 1964, the Illinois Supreme Court in *Galler v. Galler*<sup>75</sup> granted specific performance of a shareholders’ agreement providing for salary and dividend payments to the shareholders as well as their families. The court’s enforcement again contradicted an Illinois statutory requirement that “[t]he business and affairs of a corporation shall be managed by a board of directors.”<sup>76</sup> The *Galler* opinion quoted *Clark*’s Pareto standard for nullification, but seemed to go beyond *Clark* to find that shareholder control agreements in close corporations would be upheld without regard to the degree of board sterilization.<sup>77</sup> Like *Clark*, the opinion is remarkable for the open-

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72. *Peck v. Horst*, 264 P.2d 888 (Kan. 1953), *decision adhered to on reh’g*, 272 P.2d 1061 (Kan. 1954). Dean (now Judge) James Logan, in parsing the opinion, concluded that the decision “would seem to establish that in Kansas the owners can do as they wish on any or all management questions.” James K. Logan, *Methods to Control the Closely Held Kansas Corporation*, 7 KAN. L. REV. 405, 431 (1959).

73. *Abercrombie v. Davies*, 123 A.2d 893 (Del. Ch.) (“our corporation law does not permit actions or agreements by stockholders which would take all power from the board to handle matters of substantial management policy. This is particularly true absent 100% stockholder approval. . . . Even unanimous stockholder actions in this field has its limitations.”), *modified*, 125 A.2d 588 (Del. Ch. 1956), *rev’d on other grounds*, 130 A.2d 338 (Del. 1957).

74. See Ernest L. Folk III, *Corporation Statutes: 1959-1966*, 1966 DUKE L.J. 875, 946-57.

75. 203 N.E.2d 577 (Ill. 1964).

76. Business Corporation Act of 1933, § 157.33, 1933 Ill. Laws 308 § 33 (current version at ILL. REV. STAT. ch. 32, para. 8.05 (1985)).

77. Eight years later, in *Somers v. AAA Temporary Services, Inc.*, 284 N.E.2d 462 (Ill App. Ct. 1972), an appellate court rejected an argument that *Galler* permitted a shareholders’ agreement to amend the by-laws to be enforced despite contrary statutory language—and in doing so seemed to return to a *Clark*-like standard: “Slight deviations from corporate norms may be permitted. However, action by the shareholders which is in direct contravention of the statute cannot be allowed.” *Id.* at 465.

ness with which it discusses common-law nullification:

[T]here has been a definite, albeit inarticulate, trend toward eventual judicial treatment of the close corporation as *sui generis*. Several shareholder-director agreements that have technically "violated" the letter of the Business Corporation Act have nevertheless been upheld in the light of the existing practical circumstances, i.e. no apparent public injury, the absence of a complaining minority interest, and no apparent prejudice to creditors.<sup>78</sup>

*Galler* is an opinion that Guido Calabresi must love. This common-law court sensed the clear failure of the statute and spoke candidly about the covert judicial trend. Citing a growing consensus among scholars<sup>79</sup> and explicitly recognizing the statutory trend toward enforcement in other states,<sup>80</sup> the court casts itself as initiating a dialogue—very much in Calabresian terms:

Perhaps, as has been vociferously advanced, a separate comprehensive statutory scheme governing the close corporation would best serve here. . . . At any rate, however, the courts can no longer fail to expressly distinguish between the close and public-issue corporation when confronted with problems relating to either. *What we do here is to illuminate this problem*—before the bench, corporate bar, and the legislature, in the context of a particular fact situation. To do less would be to shirk our responsibility, to do more would perhaps be to invade the province of the legislative branch.<sup>81</sup>

More than just the Illinois Legislature heard this signal. In 1966, the Model Business Corporation Act was revised to allow certain contractual options for enhanced shareholder control.<sup>82</sup> More importantly, it was not until 1967 that Delaware—the quintessential charter competitor—finally was motivated to add special statutory provisions for close corporations.<sup>83</sup>

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78. 203 N.E.2d at 584.

79. See, e.g., George D. Hornstein, *Stockholders' Agreements in the Closely Held Corporation*, 59 YALE L.J. 1040 (1950); Note, *A Plea for Separate Statutory Treatment of the Close Corporation*, 33 N.Y.U. L. REV. 700 (1958), cited in *Galler*, 203 N.E.2d at 585.

In making a structural argument about the force of the law, I should not be heard to have said that individuals do not make a difference. Corporate scholars also played key roles in affecting the content of legislation. Professor Latty seems to have played a key role in the 1955 North Carolina statute; Professor Folk is responsible for the South Carolina statute; more recently Professor Carney has influenced the content of the Georgia corporate statute. William J. Carney, *Changes in Corporate Practice Under Georgia's New Business Corporation Code*, 40 MERCER L. REV. 655 (1989).

80. 203 N.E.2d at 585.

81. *Id.* (emphasis added).

82. Folk, *supra* note 74, at 946 n.408.

83. General Corporation Law, ch. 50, 56 Del. Laws 151 (1967) (redrafting tit. 8, ch. 1 of the Delaware Code, to add, *inter alia*, subch. 14—Close Corporations; Special Provisions to the Code). See DEL. CODE ANN. tit. 8, §§ 341-56 (1983).

It is surprising, however, that Judge Easterbrook and Dan Fischel have praised this opinion. In an important analysis of close corporation law published in the *Stanford Law Review*,<sup>84</sup> these strong advocates of the race-to-the-top theory<sup>85</sup> heap scorn on *McQuade*, calling it “a fossil” and praising the judicial nullification of corporate statutes in both *Clark* and *Galler*.<sup>86</sup> Yet from the race-to-the-top perspective, if the legislatures are getting it right, how can nullifying judicial opinions be praiseworthy?

This modest conundrum is resolved, I hope, by my thesis that the states were not racing for close corporation charters. As previously suggested by O’Neal and Thompson,

[T]he norms in the corporation statutes were designed largely to protect shareholders and investors in publicly held corporations where there is a separation of management from ownership and a very real danger to the investing public. In all probability, the legislatures in enacting these norms did not think of close corporations at all.<sup>87</sup>

The preoccupation of state legislatures with “domesticating” publicly held corporations undermines judicial confidence that the breadth of the statutory language had been adequately considered. Moreover, it was likely that there would be greater legislative inertia toward correcting provisions that had unforeseen and wrongheaded consequences for close corporations. Under these circumstances, it is not surprising that legislatures might get it wrong (and leave it wrong)<sup>88</sup> and that courts might feel more comfortable taking a more activist common-law stance. Yet given the *Galler* court’s recognition that other state legislatures had overcome their inertia and recently adopted expansive close corporation provisions, the result in *Galler* is normatively harder to accept. In contrast to *Clark*, the *Galler* court might have been able to send a message to the Illinois Legislature that its corporations act was out of date without abrogating the terms of a constitutional statute.

Judicial nullification, moreover, has not been limited to *Galler*’s pur-

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84. Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986). This article is included in a wonderful collection of the authors’ writings. The book provides a definitive statement of the nexus-of-contracts view of corporations. See Ian Ayres, Book Review, 59 U. CHI. L. REV. (forthcoming 1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991)).

85. See, e.g., Easterbrook, *supra* note 4; Fischel, *supra* note 6.

86. Easterbrook & Fischel, *supra* note 84, at 281-82.

87. O’NEAL & THOMPSON, *supra* note 29, § 5.06, at 20.

88. Yet even here it is possible, as I suggested earlier, *supra* text accompanying note 24, that legislatures intentionally sought to enslave close corporations to inefficient corporate rules to generate a richer precedent base.

ported signalling function. In *Zion v. Kurtz*,<sup>89</sup> Delaware statutory requirements for close corporation governance were nullified, even though the Delaware Legislature had passed an enabling close corporation statute.<sup>90</sup> Although the general Delaware statute still vested the board of directors with authority to direct the affairs of the corporation,<sup>91</sup> a 1967 amendment allowed shareholders in a close corporation to agree to restrict directors' powers if they recorded these restrictions in the articles of incorporation.<sup>92</sup> *Zion* held that an agreement prohibiting the conduct of corporate business without the consent of the minority shareholder was enforceable even though the agreement had not been incorporated in the corporation's charter.<sup>93</sup>

I would argue that the nullification in *Zion* is normatively even less reasonable. When a legislature has recently updated an outmoded statute and has specifically addressed itself to the context at issue, the Calabresian rationale for common-law "updating" is much weaker.<sup>94</sup> More important, I would like to propose a descriptive theory of why the legislature imposed the procedural requirement that corporations explicitly opt for close corporation status and for its accompanying judicial treatment.

As I argued above, the legislature might have been motivated to apply an immutable separation of ownership and control rule to produce a larger base of precedents and hence to gain an advantage in chartermongering. The benefits of this forced pooling, however, would have been significantly impaired by the increasing tendency of common-law courts to bend if not break the statutory rules. This common-law tendency and the resultant deleterious effect on publicly traded corporations are discussed once again with great candor in the *Galler* decision. After cataloging the "definite, albeit inarticulate, trend" toward *sui generis* treatment of close corporations, the decision concluded:

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89. 405 N.E.2d 681 (N.Y. 1980).

90. It may be significant that a New York court nullified the Delaware statute. *Cf.* *Clark v. Dodge*, 199 N.E. 641 (N.Y. 1936) (New York court improperly applies New York law to New Jersey corporation).

91. *See* DEL. CODE ANN. tit. 8, § 141(a) (1983).

92. General Corporation Law, ch. 50, § 350, 56 Del. Laws 151, 247 (1967).

93. 405 N.E.2d at 685.

94. O'Neal and Thompson's normative assertion that "[c]ourts and legislatures which have not already done so should hasten to repudiate [*McQuade*-type] decisions," O'NEAL & THOMPSON, *supra* note 29, § 5.06, at 20, is similarly overbroad. While there are strong reasons for statutory rescission of the immutable prohibition of shareholder management, the appropriateness of court repudiation—even within the Calabresian framework—turns in part on the degree of legislative inertia.

[W]e have thus far not attempted to limit these decisions as applicable only to close corporations and have seemingly implied that general considerations regarding judicial supervision of all corporate behavior apply.

The practical result of this series of cases, while liberally giving legal efficacy to particular agreements in special circumstances notwithstanding literal "violations" of statutory corporate law, has been to inject much doubt and uncertainty into the thinking of the bench and corporate bar of Illinois concerning shareholder agreements.<sup>95</sup>

The uncertainty described in this quotation gives rise to a less altruistic motive on the part of legislators who moved to pass special close corporation provisions. Even without competitive federalism, legislatures often promulgate public-regarding rules<sup>96</sup>—especially when the rule change (as the *Clark* opinion suggested) could pass the Pareto criterion. Yet the *Galler* opinion, while citing *Clark*, also suggests a reason judicial nullification in both cases might not have wrought a Pareto improvement.

Simply stated, judicial nullification of a general corporate statute for the benefit of closely held corporations might have spillover effects that reduce a statute's certainty and therefore its value for publicly traded corporations. Legislatures might have decided it would be easier to channel close corporations into a different classification and treatment scheme so that judicial nullification would not reduce the desirability of a state's statute for publicly traded corporations. This theory suggests that, although states may not compete for close corporation charters, states will have competitive concerns about the close corporation rules to the extent to which these rules have spillover effects for publicly traded charters. The theory also predicts that *Zion*-type nullifications are more likely to be overturned by legislation reiterating the procedural requirements.

In sum, the judicial opinions in *Clark*, *Galler*, and *Zion* played leading roles in changing the immutable rule prohibiting shareholder management to a mere default for close corporations.<sup>97</sup> Because legislatures do

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95. 203 N.E.2d at 584.

96. LANDES & POSNER, *supra* note 14.

97. Under *Clark*'s Pareto criterion, it is difficult to understand why publicly held corporations are not given the option of contracting for restrictions of management power. See DEL. CODE ANN. tit. 8, § 141(a) (1983). While powerful structural forces may eliminate the demand for these provisions, unanimous assent to such a restriction under *Clark*'s rationale would not seem to injure anyone. O'Neal and Thompson have suggested that "investors in a publicly held corporation . . . play no part in preparing the charter or bylaws which set up the organization or structure of the corporation and . . . therefore may need the protection afforded by statutory norms." O'NEAL & THOMP-



not compete for close corporation charters, courts exercised greater discretion in interpreting and at times nullifying or updating unnecessary restrictions on the freedom of contract for close corporation shareholders. By now, legislatures have largely codified these early nullifications, both to improve the law for locally domiciled close corporations and to reduce the deleterious spillover effects that judicial nullifications might have had on the competition for the charters of publicly held corporations.

### III. LEGISLATIVE OVERSIGHT OF EQUITABLE REMEDIES FOR OPPRESSION

This Section considers a legal question that has no obvious answer based on principles of efficiency: What legal rights to exit a close corporation should a minority shareholder have in the absence of a specific contract? In contrast to the strong Pareto argument that close corporation shareholders should be able to contract for control, it is much more difficult to divine what default contractual rights courts should give minority shareholders in cases of deadlock or oppression. Because it is a close issue, it is not surprising that courts and legislatures have evolved a variety of different standards, which at varying times lead courts to be more or less willing than legislators to protect minority shareholders' rights. My thesis is that, as before, looking at the interaction between these institutions—especially the tensions or divergent views—can yield insights about how efficient law might be structured.

The corporate statutes of most states give minority shareholders only limited opportunities to exit. As Easterbrook and Fischel have summarized:

Statutes typically require either a deadlock that makes operation of the business impossible or some form of serious misconduct by those in control. The Model Act, for example, authorizes involuntary dissolution if deadlock causes "irreparable injury" or if those in control "have or will have acted in a manner that is illegal, oppressive, fraudulent or unfairly prejudicial" to the complaining shareholder.<sup>98</sup>

It is significant that Delaware's statute does not address the issue. In

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SON, *supra* note 29, § 5.06, at 21. If this explanation is only compelling, it suggests that the corporate contract may not further shareholders' interests—leading legislatures to the race-to-the-bottom theory.

98. Easterbrook & Fischel, *supra* note 84, at 286.

Delaware there is thus no statutory guarantee of involuntary dissolution even under the extreme Model Act conditions.

The courts' reaction to these limiting statutes has been quite diverse—including not only various forms of judicial gap filling, but arguably both liberalizing and constraining forms of statutory nullification. Easterbrook and Fischel, for example, have noted:

Even where the relevant statutory criteria [for oppression] arguably have been met, courts have been reluctant to grant involuntary dissolution. In *In re Radom & Neidorff, Inc.*, [119 N.E.2d 563 (N.Y. 1964)] to take one well known example, the court declined to dissolve a profitable firm at the request of one of two equal shareholders, even though the other refused to sign salary checks and did not to [sic] contribute to the running of the business.<sup>99</sup>

These authors then go on to provide an efficiency explanation for these judicial opinions. But as an initial matter, it is surprising to see strong proponents of statutory efficiency going out of their way to praise judicial nullification. Why are they not compelled by their own process arguments to accept that the statute is more likely to be “right” than the judges? Again, this seeming inconsistency is explained by the authors' implicit acceptance that the race-to-the-top theory does not necessarily apply here.<sup>100</sup> We just do not have the same procedural confidence that corporate statutes concerning close corporation governance are going to be efficient.

Easterbrook and Fischel's substantive rationalization for what I am calling a form of judicial nullification is also illuminating:

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99. *Id.* (footnote omitted). For other cases similarly “nullifying” statutory conditions for involuntary dissolution, see *Kruger v. Gerth*, 210 N.E.2d 355 (N.Y. 1965); *Polikoff v. Dole & Clark Bldg. Corp.*, 184 N.E.2d 792 (Ill. App. Ct. 1962); *Baker v. Commercial Body Builders, Inc.*, 507 P.2d 387 (Or. 1973).

100. Writing for the majority, Judge Desmond refused dissolution at least in part because the firm was prosperous. The New York legislature shortly thereafter amended its corporate statute to overrule this part of the *Radom* holding. N.Y. BUS. CORP. LAW § 1111(b)(3) (McKinney 1986) (“[D]issolution is not to be denied merely because it is found that the corporate business has been or could be conducted at a profit.”).

The New York legislature similarly overruled Judge Desmond's holding that bylaws requiring unanimity for shareholder and director action in a close corporation were invalid because of a public policy requiring majority rule. *Benintendi v. Kenton Hotel*, 60 N.E.2d 829 (N.Y. 1945). See N.Y. BUS. CORP. LAW § 613 (McKinney 1986). Easterbrook and Fischel do not address whether these exercises of legislative supremacy in nullifying the common-law holdings enhance efficiency. Presumably they would argue that the legislature erred in overruling *Radom* but not in overruling *Benintendi*. But it is hard to make out a causal theory for the institutional behavior. I am indebted to John Hetherington for bringing this point to my attention.

The right to call on a judge may undermine the specificity of the property right because the parties must predict how a judge will decide. The more trouble they have predicting, the less likely they are to resolve their differences short of litigation, even when there are only two parties. In short, the parties may want to make deadlock costly (so there will be less of it) and to keep the courts out when deadlock occurs (so they can settle their own disputes).<sup>101</sup>

In a sense, the legal issue concerns the appropriate protection for the majority's entitlement to the minority's continued participation in the corporation. Denying minorities an opportunity for judicial exit (through involuntary dissolution or a buyout) protects the majority's entitlement with a property rule; allowing minorities to petition for exit under various conditions protects the majority's entitlement with something more akin to what Calabresi and Melamed have termed a liability rule.<sup>102</sup> But to see the issue in terms of a choice between a property rule and a liability rule is only to emphasize the difficulty in identifying the optimal amount of entitlement protection. As Calabresi and Melamed elegantly argued, property-rule protections induce higher bargaining costs, while liability-rule protections induce higher litigation costs. Especially in contractual settings, there often will be a close "horse race" to determine the least-cost form of protection.<sup>103</sup> As Easterbrook and Fischel indicate, the parties *ex ante* "may . . . want to keep the courts out when deadlock occurs"—but, then again, they may not.<sup>104</sup> The decision

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101. Easterbrook & Fischel, *supra* note 83, at 287. Judge Posner published a similar analysis of *Radom* in 1986. POSNER, *supra* note 3, at 399-400.

102. See Guido Calabresi & A. Douglas Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 HARV. L. REV. 1089 (1972). I realize that by citing the signer of my paycheck repeatedly in the same article, I am likely to subject myself to sustained conflict-of-interest criticism. I confess that I have recently gone even further by titling an entire policy section after yet another one of his books. See IAN AYRES ET AL., *UNEQUAL RACIAL ACCESS TO KIDNEY TRANSPLANTATION* (Stanford Law & Economics Working Paper No. 85, 1991) (citing repeatedly GUIDO CALABRESI & PHILIP BOBBITT, *TRAGIC CHOICES* (1978)).

103. The corporate opportunities doctrine also reflects a choice between property and liability rules. For example, if courts say that officers must not seize opportunities even when the corporation is not capable of exploiting them, then a property rule protects the corporation's entitlement. If the officers do not need to bargain to exploit this opportunity, then the corporation's entitlement has at best a liability protection. *Cf.* *Miller v. Miller*, 222 N.W.2d 71 (Minn. 1974); *Klinicki v. Lundgren*, 695 P.2d 906 (Or. 1985) (en banc).

104. That property-rule protections encourage additional explicit bargaining suggests that property rules may at times be a species of "penalty defaults" or information-forcing rules that, by encouraging parties to contract around the original entitlements, reveal information to the courts or to the parties to the contract. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989). See also Easterbrook & Fischel,

whether and under what conditions to allow minority exit, unlike the immutable prohibition of shareholder agreements, is not a choice between a Pareto inferior and Pareto superior rule.

Given the difficulty of identifying *the* efficient rule, it is not surprising that there have been other judicial and legislative responses to the problem. In some jurisdictions, courts, instead of refusing to grant dissolution in the case of oppression, have increasingly fashioned alternative forms of relief for minority shareholders based on the courts' inherent equitable power.<sup>105</sup> In contrast to *Neidorff*'s nullification against the minority interest, the judicial desire to allow minority exit has increasingly led judges to "nullify" statutes to benefit minority interests. For example, in *Application of Dohring*,<sup>106</sup> a New York court "lawlessly" violated the internal affairs doctrine by applying New York statutory and common law to a Delaware corporation to allow dissolution.<sup>107</sup>

As an alternative to involuntary dissolution, several state statutes (and the Revised Model Business Corporation Act)<sup>108</sup> give the corporation and/or the majority shareholders a "majority call" option to buyout the minority shareholders upon a showing of oppression. These new judicially crafted remedies, however, grant minority shareholders an option to sell their shares back to the corporation (a "minority put" option).<sup>109</sup> The equitable remedy of a judicial put has been seen "as a less harsh remedy" than involuntary dissolution because it is less likely to sacrifice the corporation's value as an ongoing business.<sup>110</sup> Courts accordingly are more likely to find majority oppression and grant relief when the

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*supra* note 83, at 287 ("Restrictive legal rules concerning involuntary dissolution also create incentives for the parties to establish less expensive methods of adjusting conflicting interests.").

105. See, e.g., *Belcher v. Birmingham Trust Nat'l Bank*, 348 F. Supp. 61 (N.D. Ala. 1968) (Alabama law); *Orchard v. Covelli*, 590 F. Supp. 1548 (W.D. Pa. 1984) (Pennsylvania law), *aff'd*, 802 F.2d 448 (3d Cir. 1986); *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270 (Alaska 1980).

106. 537 N.Y.S.2d 767 (Sup. Ct. 1989).

107. The court suggested that under its broad equitable powers it could dissolve a foreign corporation when the corporation's sole contact with the foreign state was its corporate registration and when most of the corporation's assets, employees, offices, operations, and two of its five directors were in New York. *Id.*

108. REV. MODEL BUSINESS CORP. ACT § 14.30(2) (1991).

109. See, e.g., *In re Wiedy's Furniture Clearance Ctr. Co.*, 487 N.Y.S.2d 901 (App. Div. 1985); *McCauley v. Tom McCauley & Son, Inc.*, 724 P.2d 232 (N.M. Ct. App. 1986); *Davis v. Sheerin*, 754 S.W.2d 375, 380 (Tex. Ct. App. 1988). But see *Corlett, Killian, Hardeman, McIntosh & Levi, P.A. v. Merritt*, 478 So. 2d 828 (Fla. Dist. Ct. App. 1985).

110. F. HODGE O'NEAL & ROBERT B. THOMPSON, *O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS* § 7.20 (2d ed. 1985, 1991 revision).

remedy is socially less costly.<sup>111</sup>

Yet even in this equitable setting, the corporate statute often provides an important frame. In several instances, courts use the statutory grounds for involuntary dissolution as the basis for granting the minority put.<sup>112</sup> Conversely, some courts have shown reluctance to exercise their inherent equitable powers to grant relief (including minority puts) without a statute establishing some minority cause of action.<sup>113</sup> Finally, Virginia decisions have held that the presence of a statutory dissolution remedy is exclusive and preempts the courts' exercise of any general equitable power.<sup>114</sup>

While some state legislatures have joined the judicial trend toward granting minorities exit alternatives other than involuntary dissolution,<sup>115</sup> the majority of statutes—including Delaware's—still do not authorize alternative forms of exit such as the minority put. Moreover, North Carolina, which since 1955 had statutory authorization for a minority put and for other forms of equitable relief, has recently revised its statute to limit courts' power to grant these exit options.<sup>116</sup>

I would like to contrast two alternative explanations for these diverse, but still divergent, institutional reactions—i.e., in instances of majority oppression, courts are more likely than legislatures to authorize minority puts. The first explanation suggests that the courts' concern with ex post equity might make the judiciary the less efficient creator of legal rules. The courts' increasing willingness to find oppression and grant minority puts might grow out of their ex post concerns both for equities and for the seeming inefficiency of wasting assets. As Easterbrook and Fischel argued, however, it is possible that dynamic efficiency is better founded on ex ante incentives for ex ante contracting. If the North Carolina Leg-

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111. *Id.* ("The recognition of the possibility of buyout as a less drastic remedy undoubtedly has contributed to the breakdown in the traditional judicial and legislative resistance to granting relief where there is dissension among shareholders.").

112. *Maddox v. Norman*, 669 P.2d 230 (Mont. 1983); *Delaney v. Georgia-Pacific Corp.*, 564 P.2d 277 (Or. 1977).

113. See O'NEAL & THOMPSON, *supra* note 110, § 7.11.

114. See *Giannotti v. Hamway*, 387 S.E.2d 725 (Va. 1990); *White v. Perkins*, 189 S.E.2d 315 (Va. 1972).

115. See, e.g., ARIZ. REV. STAT. ANN. § 10-216 (1990); ILL. REV. STAT. ch. 32, para. 12.55 (1991); ME. REV. STAT. ANN. tit. 13A, § 1123 (West 1981); MICH. COMP. LAWS § 450.1489 (1990).

116. N.C. GEN. STAT. §§ 55-14-30 & 55-14-31 (1990) (replaced N.C. GEN. STAT. § 55-125.1, which authorized minority put). For an excellent discussion of the revision, see Robert S. McLean, Note, *Minority Shareholders' Rights in the Close Corporation Under the New North Carolina Business Corporation Act*, 68 N.C. L. REV. 1109 (1990).

islature believed that the courts were granting minority shareholders puts too often or for inappropriate valuations, concerns with ex ante efficiency might lead it to limit courts to the former all-or-nothing choice of dissolution.

An alternative explanation, however, turns on the relative inefficiency of legislatures in crafting rules of close corporation governance. I should stress that this alternative hypothesis is extremely tentative—and is proposed primarily to provoke further empiricism. This alternative grows out of the foregoing procedural argument that states will have weak incentives to compete for close corporation charters. In the absence of competitive federalism, the legislative process is likely to be influenced by a variety of factors—but in particular by concentrated private interest groups that can lobby for self-interested legislation.<sup>117</sup>

In the close corporation setting, the majority shareholders are likely to be residents of the incorporating state and are likely to have particular lobbying power. As a result, an additional influence on close corporation statutes will be the lobbying pressure for “pro-majority” rules.<sup>118</sup> The premise that majority shareholders are likely to be residents of the incorporating state flows directly from the widely accepted observation that majority shareholders often contract to control the management of the assets. The minority interests are more likely to be passive and hence can be more geographically dispersed. The North Carolina experience itself might provide some support for this alternative “public choice” explanation. Robert Thompson tells me that the legislature, in revising the statute, was explicitly lobbied by both majority and minority shareholders of the closely held corporation that owns the Belk department stores.<sup>119</sup> Although the minority shareholders were also in-state residents and were sufficiently organized to do some lobbying, the majority interest not surprisingly prevailed in restricting the statutory remedies available to “oppressed” minorities. Thus, an alternative explanation for North

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117. For an important analysis of corporate statutes in this vein, see Macey & Miller, *supra* note 6.

118. I should stress that this very tentative hypothesis is only one of a variety of public-choice influences that will determine the content of legislation in the absence of state competition. Local creditors, for example also might exert concentrated lobbying efforts on issues of corporate governance. Paul Mahoney has pointed out to me that creditors' interests might be aligned with majority shareholders in this area. The creditors' primary interest is that equity capital invested in the venture will be illiquid (at least until creditors have been paid) and thus creditors might prefer rules that make it hard for minorities to exit.

119. Telephone conversation with Robert Thompson, Professor of Law, Washington University (Nov. 1, 1991).

Carolina's revision—and for the continued refusal of most states to provide for minority puts—might be the successful self-interested lobbying of concentrated, in-state majority shareholders.<sup>120</sup>

An interesting corollary to this hypothesis applies to publicly held corporations, but here the analysis is inverted. In publicly held corporations, well-organized minority blocks of shares are likely to be held by domestic residents, and an additional influence on corporate statutes governing publicly held corporations will come through lobbying for “prominority” rules. This influence will be especially felt in states that have not joined the race for public charters. Thus in Texas, for example, well-organized minority groups succeeded until 1967 in retaining legislative support for a de facto merger provision that mandated an eighty percent shareholder approval for “the sale of all or substantially all the corporation's property and assets.”<sup>121</sup> Under this provision, in-state minority shareholders (holding at least twenty-one percent of the stock) could successfully block out-of-state majorities from changing the corporate structure.<sup>122</sup> Either theory might explain the divergent treatment by courts and legislatures of exit issues in the close corporation context. These majority-minority hypotheses are crude public-choice theories put forward here to suggest. In specific contexts other well-organized interest groups, including debt holders of a close corporation and the corporate bar, undoubtedly influence the legislation as well.<sup>123</sup> This Article's larger theory suggests that the failure of states to compete for close corporations' charters will lead, *ceteris paribus*, to greater legislative inertia. To the extent that these two law-making institutions are maximizing inconsistent objectives, there will be a tendency for the courts to take advantage of their greater rulemaking power. It may be that in equilibrium we

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120. This theory does not explain, however, why other state statutes have not gone further and explicitly stripped courts of any equitable power to grant minority puts.

121. TEX. BUS. CORP. ACT ANN. art. 5.10, at 400 (Comments of Bar Committee—1957 to 1979) (West 1980). The current statute mandates that two-thirds of shareholders approve the sale. *Id.*

122. I would like to thank Frank Wozencraft for bringing this to my attention. Further “tests” of the hypothesis are clearly required. Bill Carney has told me of an experience he had with the revision of the Georgia corporation statute in which an Augusta legislator successfully lobbied to limit the access of minority shareholders (with less than two percent of outstanding shares) to corporate information. See GA. CODE ANN. § 14-2-1602(e) (Michie 1991); see generally Carney, *supra* note 78, at 670-71. Shareholders with less than two percent might be in-state, but not politically well organized.

123. The leading public-choice analysis of the determinants of state corporate statutes has been authored by Jon Macey and Geoffrey Miller. See Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws*, 70 TEX. L. REV. 347 (1991).

see just as many instances of legislative reaction to court nullification of close corporation statutes as in other contexts in which there is more rigorous charter competition. Courts knowing the approximate demarcation between silent acceptance and legislative veto may have equal incentives to push the envelope of their common-law domain—even if the size of the common-law envelope is much smaller with regard to rules governing publicly held businesses.

### CONCLUSION

In this Article, I have suggested that it is unlikely that state legislatures will compete for close corporation charters. Structural forces tend to tie the incorporation process to the company's principal place of business, and the potential revenue from close corporations is relatively small compared to that from large, publicly held corporations. The legislatures' focus on attracting large corporate charters leaves the law governing close corporations as more of a backwater, in which common-law courts are able to exercise a freer hand in shaping the law.

In the absence of direct competition for close corporation charters, legislative action will be prompted by a number of factors. Legislative behavior might be influenced by spillover effects—that is, by the extent to which close corporation laws affect the ability of the state to compete for publicly held charters. Legislators might want either to force close corporations to abide by public-corporation law to feed a larger (and more valuable) precedent pool, or to force close corporations to clearly opt for separate legal treatment to avoid the application of confusing (and therefore less valuable) close corporation precedents to publicly held incorporations.

I have argued that the evolution of rules governing shareholder agreements is consistent with (i.e., does not falsify) these positive theories. Legislatures began by forcing close corporations to adopt inefficient governance structures (and thus to pool with public corporations). Judges then took the lead in nullifying the inefficient statutes. Legislatures responded by allowing shareholders to contract for control, but conditioned this right on the corporations' clearly opting for separate precedential treatment (thus reducing a possible negative spillover).<sup>124</sup>

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124. The strong form of this spillover theory would predict that states would force close corporations to opt for a separate form of law. Most general corporate statutes, however, allow shareholders of close corporations to contract for control. This contractual flexibility undermines the strong form of the spillover theory because the statutes do not require small corporations to opt for separate



To the extent that spillover effects are small, legislators are likely to be governed by the public-choice variables—such as the lobbying of concentrated interest groups—that lead theories for legislative behavior in other contexts in which the disciplining force of competitive federalism is absent. I suggested that majority blocks of shareholders are more likely to lobby effectively in the close corporation context and that minority blocks of shareholders (including managers) are more likely to lobby effectively in the public-corporation setting. There is highly tentative support for this theory in North Carolina's recent repeal of the minority put remedy for showings of oppression. Again, it is not surprising that courts, in the absence of competitive federalism, have exercised discretion in supplementing and at times supplanting statutory rules in this area. In contrast to the matter of shareholder agreements, however, it is more difficult to assess which institution is more often right.

A larger purpose of this Article is to suggest that an enlightened examination of the interplay between courts and legislatures can yield a wealth of testable hypotheses. For example, the public-choice explanations of legislative behavior are likely to have greater power with regard to the large number of nonracing jurisdictions—for example those that have pooled together by adopting similar versions of the Model Business Corporations Act. If these states are not primarily motivated by charter revenue, then we might expect to see larger effects from private-interest lobbying—even with respect to the law governing publicly traded corporations.

In their excellent analysis of close corporation law and economics, Easterbrook and Fischel praise the statute-nullifying decisions in *Clark, Galler* and *Radom*<sup>125</sup>—yet say nothing about the race-to-the-top or competitive federalism that they have extolled at length and with great elegance elsewhere.<sup>126</sup> Given the absence of any significant charter competition, their lack of deference for statutory efficiency is completely appropriate. While Calabresi's central thesis is normative, his insights suggest several falsifiable explanations for the interactions between the judicial and legislative makers of corporate law. I suggest that focusing

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statutory treatment—and indeed, few businesses opt for statutory close corporation law. *See supra* text accompanying note 47. However, merely giving small corporations this option may reduce the likelihood of judicial nullification and hence be consistent with a weaker spillover theory.

125. Easterbrook & Fischel, *supra* note 84, at 281, 286.

126. *See* Easterbrook, *supra* note 4; Fischel, *supra* note 6.

on the institutional tensions provides an especially powerful lens through which to view the efficiency of the substantive rules.

