

PRIVATE GOALS AND COMPETITION AMONG STATE LEGAL SYSTEMS

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In almost twenty continuous years of association with Yale, this has to be the most extraordinary gathering that I have seen, and that includes some Black Panther rallies in the 1970s. I will begin by discussing the history of a very peculiar brand of law in the United States and will then suggest a totally different view of what we can do with the states.

The history of American corporation law has been, by everyone's agreement, a history of the reduction of legal restrictions on the power of management. I think everyone also agrees that this reduction has not been random. It has not been the result of scholars' reading and thinking late into the night and then writing articles suggesting what ought to be the law. It has come about in a very different way. It came about because there was a state sufficiently small that the revenues achieved through corporate chartering substantially reduced the tax burdens on the citizens of that state. That state is Delaware. Solely to make money, Delaware sold law. The way that it sold law was to have the Delaware bar determine what law would bring more corporate charters to the state and then go to the legislature and say, "this language will bring more charters to the state of Delaware." Without the vaguest idea of what it was doing, other than bringing more charters to the state of Delaware, the legislature would pass the legislation.

The law professors, meanwhile, screamed at this system of "law for sale," as they put it. About eight years ago, someone brought to my attention an article by Professor William Cary of the Columbia Law School, who argued that federal law was necessary to end Delaware's entrepreneurial ventures.¹ The piece had met with universal acceptance; everyone was talking about it. One hundred and fifteen law professors, including people like Marvin Chirelstein, who should have known better, were quoting it and demanding a federal corporation law because law was for sale.

Cary's theory is as follows: First, management makes a business

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¹ Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974).

decision where to incorporate. Second, management will choose to incorporate in that state in which management will make the most money. True enough. Third, Delaware, to attract management, will write its law so that it tilts toward profits to management and away from profits to shareholders. Fourth, other states wanting to have a corporate law will have to follow Delaware in a "race for the bottom."

In fact, the opposite of Cary's point is true. As long as we assume that there is real competition to make money through attracting corporate charters, Delaware will not tilt toward management. First, a corporation in a state that writes its law so as to allow management to siphon off money from other factors of production will find that its earnings go down. If the earnings of the corporation go down, it will have more trouble raising capital in a public offering of shares, bonds, debentures, short term paper, and the like. Banks look at earnings. Banks are not going to be happy about the fact that management is raking off all this money. Certainly in times of high interest rates, a corporation that is at a disadvantage vis-a-vis its product market competitors in raising capital will suffer a loss in the product market. Once this happens, the share price of the corporation will decline. Someone could make a tidy bundle by taking it over, reincorporating in a state with a more rigorous law, and reaping the capital gains. Plain common sense belies Cary's point. In a public offering, an underwriter takes the shares. No underwriter is going to get stuck with shares governed by a law that allows management to loot the corporation. That is not going to happen.

Moreover, what persuades people to buy certain stocks? People do not have to buy Delaware stock. They can buy stock in corporations of other states. They can get bonds; they can go into partnerships; they can buy land; there are all kinds of things in which they can invest. It is silly to think that Delaware can somehow monopolize capital.

Indeed, there are now empirical studies showing that shares in Delaware corporations are, if anything, more profitable than shares in other corporations. Now that corporate law has gotten so similar in all the states, it is harder to tell, but all of the empirical studies have borne out this hypothesis.

Corporation law is thus a very peculiar animal; it is different from other kinds of law. With Delaware leading this race, you no longer have to worry about what the right law is. As long as Dela-

ware is competing, there will be a race to the top. There will be a race to establish the optimal corporation code, and that is significant, I put it to you, so far as federalism is concerned. We are accustomed to talking about federalism in the sense of a state being responsible for determining its own laws on the basis of what it thinks is right. The system I am talking about is peculiar because it is the one area of the law in which the contracting parties can choose from among the law of fifty states. That and the fact that Delaware could make significant revenue out of corporate charters have made it a very peculiar area of law, but it is one that is instructive.

There has been a lot said at this conference about how federalism performs the function of permitting states to decide things, and if people do not like the decisions, they vote with their feet; they move. But that entails high transaction costs. It is not so easy to move. For example, in rent-controlled New York City, revenue generators tolerate enormous kinds of damage before they begin to leave. By the time they vote with their feet, people are usually in very bad shape indeed.

Think, however, of the things a system of competitive state laws could accomplish. For example, if states could generate enough revenue by offering a law of security transactions and parties, regardless of where they were located, were free to pick the legal system they wanted to use, the law of secured transactions would automatically move toward optimality without any help from the law schools. At least, it would not be moving in the direction of absolute non-optimality. This system would also prevent certain groups from monopolizing resources, as happens under rent control. The same could be done with sales of goods. Instead of working through a nationwide body sitting around deciding what ought to be in the U.C.C., the same result would be achieved by finding a way for states to make money by writing a law. In no time, there would be a commercial code, in fact, several commercial codes, perfect for everyone. Think what could be accomplished in the landlord/tenant area. The *Yale Law Journal* some years back published a study by some former students of mine who did an empirical analysis of the effect of the New Haven Legal Assistance Association on landlord/tenant disputes.² The effect of the

² Note, *Legal Services and Landlord-Tenant Litigation: A Critical Analysis*, 82 *YALE L.J.* 1495 (1973).

program was to raise rents for poor people, because nonpayers of rent were able to use the local code to stay in apartments for six months to a year. Ultimately, of course, that use of the resource is paid for by other tenants. Examining a cooperative apartment, the study showed that effect directly and calculated right down to the penny what the cost of the landlord/tenant code was.³ Competition among legal systems would produce optimal landlord/tenant codes. It seems to me that instead of thinking about the rights of states to decide things for themselves, maybe we ought to be thinking more about facilitating competition among states.

To think the unthinkable, suppose we said that we would measure the gross state product of every state and that the federal money would go to the top half of states that have the largest increase in gross state product. If that were a substantial amount of money, state legal systems would develop to foster economic growth. Everyone, rich and poor alike, would share in the economic growth. I do not mean to say that this is a politically practical idea. I do not expect that as soon as this idea is reported to the Speaker of the House, he will embrace it. Some of you people writing papers or writing articles ought to think about things like this, however, because this is a new way of looking at the states.

3 *Id.* at 1500 n.22.

Questions and Answers

Question: Is not one of the real reasons some people are opposed to allowing states to compete for corporate charters that they want to use contract law to redistribute wealth and power?

Answer-Judge Winter: Of Course, but my proposal would at least make those people expose what the goals are. There are a lot of laws, particularly in the contract area, that people advance - falsely - as laws optimizing the relationship between the parties. These are either straight out calls for redistribution or, like rent control, ways of monopolizing something for a particular group. It helps just to be able to expose people who claim to be protecting shareholders as really pursuing more selfish goals. If people want to redistribute, they are going to redistribute, but you at least can take away from them the argument that they are not redistributing, that they are just optimizing private relationships.

Question: I can see how this works very well for everything involving contracts—all this paternalistic stuff. I do not see how it works as well with products liability or other cases where third parties are involved.

Answer-Judge Winter: I do not think it works there at all. Anytime you have externalities, you are going to have that problem, and we really do not have a theory for handling externalities.

Question: Land is not a resource that can be easily moved across state borders, as can corporate charters or contracts. How do you handle an area like this, other than landlord/tenant law?

Answer-Judge Winter: I would think the mechanics are easy enough. What happens is that you choose the law you want and you pay a fee to the chosen state; the state not only makes money but is provided with the means to adjudicate these disputes. By another law, the local jurisdiction enforces whatever judgment there is. You have to get rid of the idea that because it's land, the state in which it lies exercises exclusive power over it. For some reason, we are able to get rid of that notion when speaking of a corporation that does all of its business in the state of Connecticut. For practical purposes, the corporate headquarters are here in Connecticut, the factory is here, and so forth, and nobody has any trouble saying it is governed by Delaware law. I am not proposing anything that is practical; that would violate the ethos of Yale

Law School, not to mention tradition. It just seems to me that maybe instead of returning things to the states, we ought to do the opposite, which is to put pressure on them to compete.

Question: Since being on the bench, have you made any change in your perspective on the world?

Answer-Judge Winter: My eyes have gotten worse. Also, everything I ever said was right.

Question: To what degree should competition among the states extend to monetary units?

Answer-Judge Winter: You do not want the states to be able to print money. Indeed, one of the things people ought to be looking at is legal controls on monetary decisions of some kind. But I certainly would not want the states to be able to print money.

Question: But if you are going to have radically different policies from state to state, is it not inconsistent to maintain only one monetary unit?

Answer-Judge Winter: No, not at all. First of all, it is a mirage to say that there are different policies. Law becomes a commodity of the state, which is sold. It ends up governing people far away. It is not as though Idaho would have a different legal system applying only to people in Idaho. Idaho would have a legal system available to anyone who wanted to use it. I bet you would find a greater degree of uniformity than you have now. That has happened in corporation law, surprisingly; for if you say that corporations, the largest economic units in the American economy, will be governed by fifty different laws, the immediate reaction is, "My God, chaos." It is not chaos, however; all the laws are quite similar, because most corporate transactions are part of a class of transactions with certain similarities for which there is an optimal rule at this time and place. Delaware or somebody else finds it, and everybody else adopts it. I do not think that in the sale of goods or security transactions or anything else, you would have a lack of uniformity. I think you would have more uniformity than ever. Moreover, I would expect the law that resulted from competition among legal systems to be quite protective. In areas such as sales of goods, you would find it as protective as it is now with, perhaps,

one exception—there probably would not be a doctrine of unconscionability.

Question: It is a kind of entrepreneurship in justice?

Answer-Judge Winter: You put it in a way that our enemies might use.

Question: Do you see federal securities regulation as one of the kinds of regulation that would be ripe for this kind of whirlwind?

Answer-Judge Winter: I do not know. In the sale of securities, it is kind of hard to see why you need so much federal regulation. I say it is kind of hard because the securities market is highly organized and attracts really high rollers. Why we have this enormously complex system of consumer protection for very wealthy individuals is a bit puzzling, although it certainly has helped the Yale Law School, in that contributions from alumni who make money from no source but this are likely to be substantial.

Question: It seems that the monetary reform that you just dismissed would fit in very neatly with the other federalist policies you are suggesting. Suppose that each of the fifty states could issue its own currency and that contracting parties could choose the currency in which they would transact business, then just as a state that drafted an inefficient commercial code would lose revenues, so would a state that allowed the value of its currency to become eroded.

Answer-Judge Winter: It sounds good. There is nothing that is legal tender, though. You are not talking about legal tender law, I take it. No one has to accept that money; no one has to accept a New York dollar, New York City dollar, unless they have contracted for it.

Questioner's response: There are two ways you could do it. One would be that each state's corporation law would require corporations under the jurisdiction of that state to use that state's currency, or they could separate the two regulations so that an Idaho corporation whose headquarters was in Connecticut could use Hawaii's currencies. You could do it either way.