

2000

Freezing the Company Charter

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Repository Citation

Kades, Eric, "Freezing the Company Charter" (2000). *Faculty Publications*. 197.
<https://scholarship.law.wm.edu/facpubs/197>

FREEZING THE COMPANY CHARTER

ERIC KADES*

When legislatures alter corporate, partnership, and other business entity statutes, they simultaneously amend the governing document of all entities of that type formed within the jurisdiction. In many circumstances these business entities may wish to retain existing rules for internal governance. This Article offers a novel tool for firms wishing to so manage their own legal transitions: the "charter freeze." A freeze provision in the company charter declares that future (non-mandatory) changes in relevant statutes have no effect on the firm. Owners may affirmatively adopt the new rules, but choose to exercise complete control over their adoption vel non of legal innovation. This Article argues that current law permits a firm to adopt charter freezes and demonstrates situations in which freezes are socially desirable.

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* Associate Professor, Wayne State University Law School, Detroit, Michigan. I thank Peter Henning and participants at a Florida State University Law School faculty workshop for helpful comments and suggestions. I dedicate this Article to the memory of Steve Schulman. He ate more of my Milky Way bars than everyone else combined, but in return gave me invaluable lessons on both corporate law and other matters of true importance.

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INTRODUCTION

Whenever a legislature amends a state's corporation, partnership, or other business entity¹ statute, it simultaneously amends the charter² of each and every such firm in the jurisdiction. While this state of affairs often surprises and disturbs those observers uninitiated to corporate law, it follows from the primary justification for devoting state resources to business entity law. Modern company law theory views most provisions of corporate, partnership, and other entity laws merely as off-the-rack enabling rules for internal governance, which most firms would adopt if they considered each issue.³ Enabling rules are default rules that apply to companies that choose not to adopt alternative provisions.⁴ Public promulgation of

1. This Article uses "company" as shorthand for "business entity"; thus, company denotes a corporation, a partnership, a limited partnership, a limited liability partnership, a limited liability company, a business trust, or any other business entity.

2. This Article uses "charter" to denote the foundational document of all types of business organizations. In common parlance, there are distinct names for each—e.g., partnership agreements for partnerships, articles of organization for limited liability companies. The assertion that statutory amendments alter existing charters is not merely a characterization of effect; the leading corporate code states that "[t]his [statute] and all amendments thereof shall be a part of the charter or certificate of incorporation of every corporation." DEL. CODE ANN. tit. 8, § 394 (1991 & Supp. 1998); *see also* REVISED UNIF. P'SHIP ACT § 103, 6 U.L.A. 16 (1995 & Supp. 2000) ("To the extent the partnership agreement does not otherwise provide, this [Act] governs relations among the partners . . ."); UNIF. LTD. LIAB. CO. ACT § 103, 6A U.L.A. 435 (1995 & Supp. 2000) (using language virtually identical to the Revised Uniform Partnership Act § 103).

3. *See infra* note 40 and accompanying text; *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 34 (1991) ("[C]orporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting.").

4. The exceptional areas are those in which company laws include mandatory rules—rules from which companies cannot opt out. *See infra* Parts III.B, III.C (discussing rules designed to protect third parties and to facilitate contracting within the firm). Focusing mainly on intra-firm enabling rules comports with the modern view that company law principally addresses contractual issues *within* the business entity. Thus, the law of public

widely-preferred default rules saves business entities the time and cost of re-inventing desirable internal business governance rules. As long as the legislature does its job, most firms will invite the continual stream of statutory amendments that alter their charters.

Even if the legislature always properly selects default (enabling) rules, firms with uncommon preferences will opt out of some of the statutory defaults. Voting, however, is an imperfect device for owners desiring to opt out of statutory changes. It is expensive and poses significant collective action problems.⁵ Further, amending the firm's charter may require a supermajority vote, giving a minority the benefit of new statutory rules for which they never could have mustered sufficient votes.

This Article suggests a novel device for firms wary of legislative innovation—a freeze provision declaring that non-mandatory amendments to the company's statute have no effect on the firm's internal rules of governance until adopted by an affirmative vote. Freeze provisions enable firms to reject all legislative innovation in enabling rules *ex ante*. If legislatures regularly select suboptimal default rules, a freeze provision may become attractive to firms beyond those with unusual preferences. Entities worried about amendments to specific statutory enabling provisions might adopt limited versions, freezing out only the relevant code sections.⁶

Given the current flux in many areas of business entity law, the potential for freeze provisions is particularly relevant. Over the last twenty-five years, corporate law has changed significantly on a number of important issues.⁷ In the near future, many states may

corporations deals with those rules "that primarily govern the relationship between a company's managers and investors." Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 547 (1990). Analogously, most other business entity law (e.g., close corporations, partnerships, and limited liability companies), where owners are managers, primarily deals with relations among the owners.

5. For a cogent summary of these problems with shareholder democracy, see ROBERT CHARLES CLARK, *CORPORATE LAW* § 9.5, at 389–400 (1986); see also JESSE H. CHOPER ET AL., *CASES AND MATERIALS ON CORPORATIONS* 521–28 (4th ed. 1995) (discussing, *inter alia*, "rational apathy" and "free rider" problems in corporate democracy); EASTERBROOK & FISCHER, *supra* note 3, at 171–72 (discussing problems with shareholder monitoring); Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520 *passim* (1990) (same).

6. Limited freezes may fail to prevent change effectively because creative scriveners can usually find ways to sidestep the restriction. See *infra* text accompanying notes 140–42 (describing the difficulty of making a partial freeze effective against creative draftsmanship).

7. Delaware and many other states have made directors' and managers' duty of care waiveable in the charter. E.g., CAL. CORP. CODE § 204(a)(10) (West 1990); DEL. CODE ANN. tit. 8, § 102(b)(7) (1991 & Supp. 1999). Similarly, both statutes and case law on

replace the Uniform Partnership Act (UPA) with a recently promulgated revised statute, the Revised Uniform Partnership Act (RUPA).⁸ Limited liability company (LLC) statutes, providing default rules for an entity that did not exist twenty-five years ago, continue to evolve rapidly.⁹ Part I begins this Article's analysis by discussing why transitions in business entity law's enabling rules differ from transitions in other mandatory areas of law. Part II argues that, although debatable, existing law likely does not prohibit charter freezes. Part III assesses the policy arguments for and against the freeze. Finally, after explaining why conventional normative analysis of transitions does not apply to enabling bodies of law,¹⁰ this Article demonstrates that none of the reasons for mandatory rules of business entity law justify a mandatory rule against charter freezes.¹¹

The desirability of the freeze for public companies¹² depends on whether their state of incorporation is engaged in a "race to the top"

permissible defensive measures in the face of a hostile takeover offer has changed significantly. See, e.g., *Paramount Communications v. Time Inc.*, 571 A.2d 1140, 1151-55 (Del. 1990) (refining the *Unocal* standard); *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 955-56 (Del. 1985) (permitting defensive measures only if proportional to some threat to the corporation or its shareholders). In the wake of the Supreme Court's approval of some anti-takeover statutes, *C.T.S. Corp. v. Dynamics Corp. of Am.*, 481 U.S. 69, 70-71 (1987) (finding Indiana's control share acquisition statute constitutional), most states now have comprehensive anti-takeover legislation. E.g., DEL. CODE ANN. tit. 8, § 203 (1991 & Supp. 1998); N.Y. BUS. CORP. LAW § 912 (McKinney 1986 & Supp. 2000). The standard for reviewing decisions on derivative suits by special litigation committees continues to evolve. Compare *Zapata Corp. v. Maldonado*, 430 A.2d 779, 788-89 (Del. 1981) (requiring the court to apply its own independent business judgment, in addition to examining independence and good faith of a special litigation committee, in deciding whether or not to uphold committee decisions), with *Hirsch v. Jones Intercable, Inc.*, 984 P.2d 629, 638 (Colo. 1999) (requiring the trial court to give deference to the special committee if it finds that the committee was disinterested, independent, and employed reasonable procedures in its analysis).

8. See UNIF. P'SHIP ACT, 6 U.L.A. 1-124 (1995 & Supp. 2000). The Revised Act was promulgated in 1993. As of 2000, twenty-six of the fifty states had adopted it. 6 *id.* at 1 tbl.

9. See Larry E. Ribstein & Bruce H. Kobayashi, *Uniform Laws, Model Laws & Limited Liability Companies*, 66 U. COLO. L. REV. 947, 951-52 (1995) (tracing significant changes in limited liability company (LLC) law throughout the country between 1991 and 1995).

10. See *infra* Part III.A.

11. See *infra* Part III.B, III.C.

12. In addition to corporations with widespread (public) ownership, some limited partnerships and other business entities qualify as public companies. Limited partnerships "may have up to several hundred limited partners . . . who . . . do not expect to participate actively in management." CHOPER ET AL., *supra* note 5, at 690. Joint stock associations and business trusts are other business entities that may possess the key attribute of a public corporation—a relatively large number of owners uninvolved in the operation of the business. See HARRY G. HENN & JOHN R. ALEXANDER, *LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES* 109-25 (3d ed. 1983).

favoring shareholders, or a “race to the bottom” favoring management. In a race to the top world, a charter freeze protects management from amendments likely to favor shareholders, and hence is undesirable. Conversely, in a race to the bottom world, the freeze performs the desirable task of preventing management from obtaining rules that they cannot obtain by shareholder vote.¹³ Public companies and privately-held businesses alike may find the freeze useful if the legal profession possesses enough influence to pass business entity rules that generate excessive planning and litigation fees. To the extent general corporate law focuses on public corporations, close corporations will find the freeze useful in keeping irrelevant or positively harmful statutory innovations out of their charters.

Widespread use of the freeze would result in a much more heterogeneous company-law landscape—contemporaneous entity statutes would not apply to firms that had “frozen in” superceded laws. Recent work on network and learning externalities strongly suggests that it is efficient to offer firms a wider choice of law for internal governance, and, thus, that worries about this possible fragmentation of company law are misplaced.¹⁴ Although many of the grounds for permitting the freeze also weigh in favor of making it the default rule for company legal transitions, there is a paradox—the more desirable the freeze, the less likely lawmakers will be to choose it as the default transition rule.¹⁵

I. THE SPECIAL NATURE OF ENABLING TRANSITIONS & IMPLICATIONS FOR FREEZING

In almost every other area of law, legal transitions are mandatory. The legislatures and courts dictate whether a new rule will be fully retroactive or whether to provide some form of transition relief (such as grandfathering pre-existing activity at odds with the new rule or providing actors a window of time to comply with the new rule). People can, of course, try to anticipate and plan for legal change—expected taxes depress the price of targeted assets and expected zoning changes alter the price of affected parcels.¹⁶ Private

13. See *infra* Part III.D.

14. See *infra* Part III.E.

15. See *infra* Part III.F.

16. The technical word for such planning is “capitalization”: actors factor all conceivable risks and rewards into the prices they pay for assets. For an accessible but penetrating discussion of capitalization in the context of tax shelters, see Boris I. Bittker, *Tax Shelters and Tax Capitalization or Does the Early Bird Get a Free Lunch?*, in

parties, however, can do nothing to alter the transition rules chosen by lawmakers. Indeed, permitting private parties prospectively to opt out of changes in tax, zoning, and most other types of laws would defeat the purpose of legal change and lock in the status quo forever.

This is not so for company law transitions. There is no question that a company can effectively freeze its charter on a specific (non-mandatory) issue simply by including a charter provision on point. For example, consider Acme Corporation's requirement of an eighty percent vote to consummate a merger in a state where the default rule is a two-thirds vote. If the legislature amends the statutory default to a simple majority, the internal rules of firms without a charter provision on point change. Acme, however, is unaffected: its eighty percent requirement trumps future as well as present statutory defaults. Generally, firms adopting specific charter provisions varying from statutory defaults effectively freeze out all future legal transitions on that particular issue.¹⁷

Freezing the entire charter, then, is redundant protection from legal change for those matters controlled by specific charter provisions. It is not by any means, however, a fruitless transition tool. Including a specific charter provision on every issue is expensive and undermines the entire purpose of business entity statutes—saving firms the cost of re-inventing sound rules for internal governance. For the multitude of issues on which a company's charter is silent, a general freeze prevents legislative action from changing the company's rules. For example, assume that Acme had no specific charter provision on merger votes, but did have a provision freezing its charter against all legal change. After the legislature changed the default required merger vote from two-thirds to a simple majority, Acme would retain the old two-thirds rule.¹⁸

COLLECTED LEGAL ESSAYS 547, 547–52 (Boris I. Bittker ed., 1989).

17. Under a provision in Pennsylvania's corporate code, however, firms wishing to freeze out statutory changes cannot simply include a cite to an existing code section. Pennsylvania mandates adoption of newly enacted rules by firms whose charters cite specific statutory provisions: "A reference in the articles or bylaws or other organic documents of an association to any provision of law supplied or repealed by this title shall be deemed to be a reference to the superceding provision of this title." 15 PA. CONS. STAT. ANN. § 101(c) (West 1995 & Supp. 2000). This rule is likely suboptimal. Incorporators who take the time and effort to cite *explicitly* a default rule that would govern them if their charter remained silent on the issue likely find the cited rule of particular importance. This is strong evidence that the incorporators would reject any change to the statutory default rule.

18. A more subtle case arises if lawmakers amend the company statute from *silence* on a particular issue to some default rule. Specific provisions in company charters will trump whatever new default is enacted. If the charter of a company with a general freeze

Without discussing positive legality or normative merits, it is important to note that freezing entire company charters does not frustrate the purpose of company law—choosing default rules desired by most firms.¹⁹ As long as lawmakers do their job effectively, the plurality of companies will not want to freeze their charters. Further, freezes adopted by other firms have no obvious impact on the plurality.²⁰ Thus, private choices of transition rules do not undermine the purpose of company law.

Although the majority of company laws are enabling, there are a few mandatory company laws. These include taxation and rules governing relationships with third parties. Just as in the non-company law context, allowing firms to plan around or opt out of transitions to mandatory rules may undermine the policy behind the law.²¹ No problem arises, however, for transitions from mandatory to enabling laws.²² Such transitions do raise some interesting issues and surprising results.

If a charter contains a general freeze when the legislature replaces a mandatory rule with an enabling rule (or simply erases the mandatory rule), strict construction of the freeze dictates that the firm will retain the pre-existing mandatory rule. For example, imagine that Beta Corporation had a charter freeze and was governed by a state statute mandating that two-thirds of all shareholders approve mergers. If the legislature subsequently abolished the supermajority

has no relevant provision, however, the effect of the new statutory default is unclear. While the firm's freeze evidences an intent to reject all legal change, the firm had no pre-existing rule on point since there was originally no statutory default. Because there is no old rule to retain, arguably the only possible choice is the new statutory default.

19. See *infra* notes 39–44 and accompanying text (describing the enabling nature of company law).

20. Part III.E *infra* considers in greater detail whether freezes by some companies can have a negative effect on other companies and concludes that such effects are minimal or nonexistent.

21. It is also possible that the new mandatory rule may disrupt existing company arrangements; in such cases "it may be appropriate to make the new provision binding only on firms that affirmatively elect to be governed by it." Larry E. Ribstein, *Changing Statutory Forms*, 1 J. SMALL & EMERGING BUS. L. 11, 29 (1997) [hereinafter Ribstein, *Statutory Forms*]. Although the very policy reasons supporting the freeze, see *infra* Part III, buttress this view, reserved power clauses included in most business entity statutes give states virtually plenary power to alter existing company charters by statutory amendment. See, e.g., DEL. CODE ANN. tit. 8, § 394 (1991 & Supp. 1998) ("This chapter may be amended or repealed, at the pleasure of the legislature . . . all amendments thereof shall be a part of the charter or certificate of incorporation of every corporation . . .").

22. Third parties may object to the elimination of mandatory rules designed for their protection, and the very possibility of repeal may undermine the value of mandatory rules as a means for firms to *bond*—i.e., commit to perform some acts and forego others. Ribstein, *Statutory Forms*, *supra* note 21, at 26–27.

requirement, Beta arguably would retain the two-thirds requirement. This result may seem surprising and counterintuitive. To the extent, however, that a given mandatory rule imposes costs without benefits on firms, there may be grounds to infer that a company did not intend to freeze the mandatory rule into its charter. In any event, companies can make their preferences explicit by including a clause in their freeze provision declaring the desire to free themselves of any (or some) repealed mandatory rules.

The repeal of a mandatory company law may revive charter provisions that existed at the time when lawmakers first enacted the mandatory rule.²³ For example, imagine that Beta, like Acme, had a charter provision requiring an eighty percent shareholder vote to approve of a merger when the legislature mandated a two-thirds vote. When the legislature repeals its two-thirds rule, is Beta's eighty percent rule revived?

This situation is closely analogous to the question of whether a judicial decision overruling a previous decision holding a statute unconstitutional revives the statute. Almost without exception, courts have held that the repealing decision does indeed restore the statute.²⁴ The logic behind these decisions is highly formal—while courts can bar application of a statute, they cannot erase the pages of the statute books.²⁵ In the words of one court, statutes are “dormant[,] but not dead” when declared unconstitutional.²⁶

Whether the formal justification for reviving statutes once held unconstitutional applies to company charters is unclear. Legislatures usually retain the power to amend business charters²⁷ and thus may have the power to render privately-drafted provisions not just

23. The possibility of revival also touches on the possibility that company charter provisions, like laws, perhaps should not be enforced after long periods of desuetude.

24. See William Michael Treanor & Gene B. Sperling, *Prospective Overruling and the Revival of “Unconstitutional” Statutes*, 93 COLUM. L. REV. 1902, 1908–15 (1993) (collecting cases).

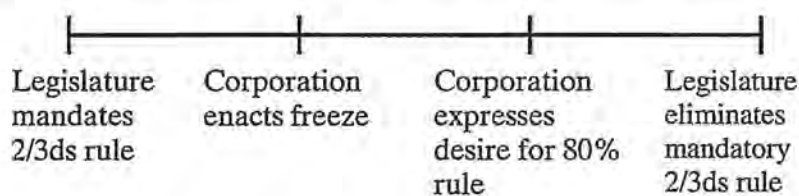
25. See *id.* at 1913–14 (“Almost all . . . courts that have addressed the issue of whether a statute that has been found unconstitutional can be revived have . . . us[ed] . . . formalistic analysis.”).

26. *Jawish v. Morlet*, 86 A.2d 96, 97 (D.C. 1952) (emphasis added). Treanor and Sperling criticize this formal approach because it ignores how rational parties will behave in light of the initial decision striking down a statute as unconstitutional. As long as reversals are rare, opponents of such statutes have little reason to devote valuable time, effort, and political capital to the seemingly redundant task of obtaining a legislative repeal of the voided statute. Treanor & Sperling, *supra* note 24, at 1917–41. Treanor and Sperling would apply a version of prospective overruling and would not resuscitate the statute unless the legislature re-enacted it after the court reversed itself. *Id.* at 1907.

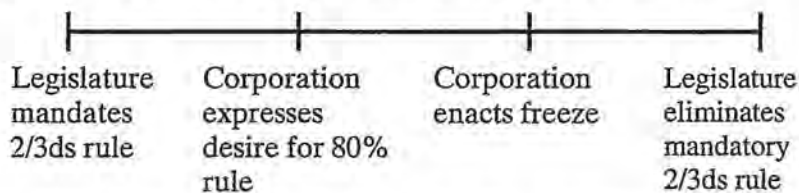
27. See *infra* Part II.A.2.

dormant, but dead. Moreover, the formal rule may fly in the face of the likely intent of most parties. Given the cost of company elections, shareholders may not bother repealing a provision voided by statutory mandate, just as political voters may not pursue legislative solutions where they have obtained a judicial victory.²⁸

If owners anticipate such a legislative termination of a mandatory rule, they may plan ahead by enacting an anticipatory charter provision declaring their desire to deviate from the mandatory rule if and when repealed. When companies employ this declaratory device in combination with general freezes, however, there may be difficult issues of construction. For example, assume that Beta has no specific charter provision on the vote required to effectuate a merger and the legislature mandates a two-thirds vote. If Beta enacts a freeze followed by a declaration that it wishes to require an eighty percent vote for mergers, its intent is clear:



The later specific measure in favor of an eighty percent rule trumps the earlier freeze that facially endorsed the existing two-thirds rule. If, however, the corporation enacts the freeze after expressing its desire for an eighty percent rule, its intent is less clear:



The later-enacted freeze, facially, embraces the existing mandatory rule that is inconsistent with the specific charter provision to the contrary, even though the firm enacted the specific provision after the legislature adopted the mandatory rule. The counter-argument is that the corporation never repealed the specific charter provision and likely simply overlooked the effect of a general freeze on this specific issue.

28. Treanor & Sperling, *supra* note 24, at 1918-24.

The determinative factor in these complex transition scenarios is the company owner's intent. This is the touchstone of transition analysis in company law. The issues presented in the remainder of the paper, for the most part, are quite different than those just examined because they involve enabling (as opposed to mandatory) rules. Yet, the intent of company owners retains center stage.

II. POSITIVE LAW: ARE FREEZES LEGAL?

Although specific charter provisions in effect freeze out changes in statutory default rules,²⁹ the legality of a general freeze is less certain. Neither legislatures, courts, nor academic commentators have addressed this Article's novel freeze mechanism. The mandatory language of transition provisions in state company codes and statutory provisions reserving the power to amend company charters provide grounds to argue that the general freeze is invalid. These terms seem to mandate that, where company charters are silent, the new rule *shall* apply. Arguably, a freeze frustrates this practice and hence should be illegal.

After fleshing out this case against the legality of the freeze, the remainder of this Part provides two grounds to reject this interpretation of company law transition and reserved power provisions. First and foremost, the enabling nature of company law provides strong grounds to reject a constrictive reading of transition rules. A limited version of the dormant (but not dead) vested rights doctrine supports this argument. Second, the traditional presumption that legislation applies only prospectively is invariably followed for legal transitions involving enabling (as opposed to mandatory) legal rules.

A. *The Case Against the Legality of the Freeze*

1. Mandatory Transition Provisions

The Model Business Corporations Act (MBCA) contains a typical transition provision: "This Act applies to all domestic corporations in existence on its effective date"³⁰ Formally, then,

29. See discussion *supra* text accompanying note 17.

30. MODEL BUS. CORP. ACT § 17.01 (1999). The Revised Uniform Partnership Act (RUPA) and the Uniform Limited Liability Company Act (ULLCA) are similar but delay their application to existing entities, see REVISED UNIFORM P'SHIP ACT § 1006, 6 U.L.A. 122 (1995); UNIF. LTD. LIAB. CO. ACT. § 1205, 6A U.L.A. 429 (1995), presumably to provide owners with time to enact specific charter provisions preserving old default rules.

for those issues on which a corporation's charter is silent, the default rules in the new act displace those in the original act. This transition rule does not directly declare the invalidity of a general freeze clause, but the official comments provide additional grounds for such a determination. One MBCA comment provides: "It is undesirable to 'grandfather' existing corporations under earlier statutes since that results in the permanent coexistence of two different and overlapping systems of corporate law, with resulting confusion."³¹ This commentary does not facially invalidate freeze clauses. Wide adoption of freezes, however, would result in the potentially "permanent existence" of two or more "different and overlapping systems of corporate law." The MBCA comment considers the "resulting confusion" grounds to move all corporations to the same set of default rules,³² a result unachievable if any firm can adopt a general freeze.

2. Reserved Power Provisions

In addition to mandatory transition provisions, every state corporate code and virtually all other contemporary company statutes contain a section reserving the legislature's power to amend the statute.³³ The MBCA contains a typically broad reserved power clause: "The [name of state legislature] has power to amend or repeal all or part of this Act at any time and all domestic and foreign corporations subject to this Act are governed by the amendment or repeal."³⁴ States began using reserved power clauses in the wake of

31. MODEL BUS. CORP. ACT § 17.01, official cmt. (1999). The same comment also justifies retroactive application based on the separate rationale that the revised MBCA "contains few major substantive changes." *Id.* The Uniform Commercial Code (U.C.C.), discussed *infra* Part III.B.2, relies on this factor in crafting its transition rules.

32. The extent of any confusion is questioned *infra* text accompanying notes 125-26.

33. *E.g.*, DEL. CODE ANN. tit. 8, § 394 (1991 & Supp. 1999). The RUPA, promulgated in 1993, contains a reserved power clause modeled after those appearing in corporation statutes: "A partnership governed by this [Act] is subject to any amendment to or repeal of this [Act]." REVISED UNIF. P'SHIP ACT § 1006, 6 U.L.A. 26 (1995).

The RUPA's precursor, the Uniform Partnership Act (UPA) contained no reserved power clause. Hence, entities formed under the UPA arguably can use the Contract Clause to resist alteration of enabling and even mandatory rules in the statute.

Most LLC statutes contain reserved power clauses. *E.g.*, DEL. CODE ANN. tit. 6, § 18-1106 (1993 & Supp. 1999). There are, however, some prominent exceptions: the California and New York statutes, and the ULLCA do not reserve legislative power to amend existing charters via statutory amendments.

34. MODEL BUS. CORP. ACT § 1.02 (1999). Delaware's reserved power clause carves out a small exception for liabilities incurred under the previous act, stating that amendments or repeals "shall not take away or impair any remedy under this [statute] against any corporation or its officers for any liability which shall have been previously

the Supreme Court's application of the Constitution's Contract Clause³⁵ to strike down a state's attempt to modify unilaterally the corporate charter of Dartmouth College.³⁶ Reserving the power to amend *ex ante* means that state legislatures have effectively destroyed the basis for any Contract Clause objections to changes in their company statutes. Reserved power clauses are not limited to mandatory provisions; as written, they appear to apply to enabling rules as well. Thus, their direct and mandatory language seems to trump attempts by companies to block statutory changes from affecting their charter by implementing charter freezes.

Not all commentators agree that reserved power clauses give state legislatures unlimited power to amend existing company charters. Nelson Ferebee Taylor, for example, argues that reserved power clauses authorize amendments only to those charter provisions touching on relations between the state and the company. Attempts to alter purely private bargains struck in the charter, Taylor maintains, violate either the remnants of the vested rights doctrine or the Constitution's prohibition on the impairment of contracts.³⁷ If Taylor is correct, then reserved power clauses provide no basis for rejecting the legality of a charter freeze. Indeed, under his reading of the Contract Clause, the freeze is not merely legal, it is constitutionally mandated.³⁸

incurred." DEL. CODE ANN. tit. 8, § 394 (1993 & Supp. 1999).

35. "No state shall . . . pass any . . . Law impairing the Obligation of Contracts . . .," U.S. CONST. art. I, § 10.

36. *Trs. of Dartmouth Coll. v. Woodward*, 17 U.S. (4 Wheat.) 518, 650 (1819). Justice Story's dissent suggested that states wishing to amend corporate charters should reserve such rights by statute. *Id.* at 708 (Story, J., dissenting). For a more detailed discussion of the application of the Contract Clause to corporate statutes, see Henry N. Butler & Larry E. Ribstein, *The Contract Clause and the Corporation*, 55 BROOK. L. REV. 767 *passim* (1989) [hereinafter Butler & Ribstein, *Contract Clause and the Corporation*]; Henry N. Butler & Larry E. Ribstein, *State Anti-Takeover Statutes and the Contract Clause*, 57 U. CIN. L. REV. 611, 631-34 (1988).

37. Nelson Ferebee Taylor, *Evolution of the Corporate Combination Law: Policy Issues and Constitutional Questions*, 76 N.C. L. REV. 687, 996-1010 (1998).

38. For a similar view, see Butler & Ribstein, *Contract Clause and the Corporation*, *supra* note 36, at 782-93.

B. The Case Supporting the Legality of the Freeze

1. The Enabling Nature of Corporate Law

Modern company law is, for the most part, enabling rather than mandatory.³⁹ Roberta Romano offers the following definition of, and justification for, enabling corporate statutes.

Modern corporation codes tend to be enabling rather than mandatory statutes: they are standard form contracts specifying the rights and obligations of managers and shareholders, which can often be altered by private agreement to suit the circumstances of particular firms. The enabling approach is a function of the contractual nature of the corporation. Participation in a firm is voluntary; common stock is one of a vast array of available investment vehicles.⁴⁰

The same principles apply to partnerships and other types of firms.

This is not merely an academic gloss; the enabling principle appears in virtually all company codes. Delaware's corporations statute, in a provision over thirty years old, states that a firm's articles of incorporation (charter) may contain "any provision for the management of the business and for the conduct of the affairs of the corporation."⁴¹ The California and New York corporate statutes contain similar provisions.⁴² More recently drafted corporate statutes contain even clearer declarations of the enabling nature of corporate law. In addition to a provision similar to those just cited,⁴³ Michigan's corporate statute, as substantially amended in 1989, declares:

39. See *supra* note 4 and accompanying text.

40. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 85 (1993). Other business entity statutes are similarly enabling, rather than mandatory, sets of rules. See Ribstein, *Statutory Forms*, *supra* note 21, at 22 ("Business association statutes are standard form contracts that the parties can either accept or reject.").

41. DEL. CODE ANN. tit. 8, § 102(b)(1) (1993 & Supp. 1999).

42. CAL. CORP. CODE § 204(d) (West 1990 & Supp. 2000) (stating that articles of incorporation may contain "[a]ny other provision, not in conflict with law, for the management of the business and for the conduct of the affairs of the corporations."); *id.* § 212(b) (containing a virtually identical provision for bylaw provisions); N.Y. BUS. CORP. LAW § 402(b) (McKinney 1986 & Supp. 2000) ("The certificate of incorporation may set forth any provision, not inconsistent with this chapter or any other statute of this state, relating to the business of the corporation, its affairs, its rights or powers or the rights or powers of its shareholders, directors, or officers.").

43. See MICH. COMP. LAWS ANN. § 450.1209 (West 1990 & Supp. 2000) ("The articles of incorporation may contain any provision not inconsistent with this act or another statute of this state . . .").

This act shall be liberally construed and applied to promote its underlying purposes and policies which include all of the following:

...

(b) To provide a general corporate form for the conduct or promotion of a lawful business or purpose with variations and modifications from the form as interested parties in any corporation may agree upon, subject only to overriding interests of this state and of third parties.⁴⁴

Partnership and limited liability statutes contain similar statements of their enabling, as opposed to mandatory, nature.⁴⁵ The essence of these enabling statutes is that owners of companies may arrange their internal affairs any way they desire; anything not positively barred is permitted. Because no company statute bars general freezes, the enabling nature of these laws provides strong grounds for their legality. The seemingly mandatory transition rules discussed in Part II.A should apply only where a firm has adopted neither a specific provision at odds with the statutory default *nor a general freeze rejecting all statutory innovation*.

Similarly, company law can harmonize reserved power clauses with its pervasively enabling nature. There is no doubt that the legislature can enact all sorts of mandatory rules that apply to existing companies (e.g., taxes and fees, filing requirements, and tort liability). These are peripheral matters; company law in the main involves rules

44. *Id.* § 450.1103(b).

45. "[R]elations among the partners and between the partners and the partnership are governed by the partnership agreement." REVISED UNIF. P'SHIP ACT § 103(a), 6 U.L.A. 16 (1995). Section 103(b) of the RUPA, contains a short list of immutable rules governing relations among partners. *Id.* § 103(b), 6 U.L.A. 16 (1995). Even these relatively modest deviations from the enabling ideal have been the subject of substantial controversy, and some have attributed the relatively slow adoption of the RUPA to these restraints on partners' freedom of contract. See Larry E. Ribstein, *The Revised Uniform Partnership Act: Not Ready for Prime Time*, 49 BUS. LAW. 45 *passim* (1993) [hereinafter Ribstein, *Revised Uniform Partnership Act*].

The ULLCA contains a similar provision allowing complete freedom for owners in drafting an LLC's charter ("operating agreement") save for a short list of immutable terms. UNIF. LTD. LIAB. CO. ACT § 103, 6A U.L.A. 434-35 (1995). The official comments state that, save for the exceptions, "[e]very section of this Act is simply a default rule, regardless of whether the language of the section appears to be otherwise mandatory. This approach eliminates the necessity of repeating the phrase 'unless otherwise agreed' in each section." *Id.* at 435. The Delaware Limited Liability Company Act explicitly states that "[i]t is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements." DEL. CODE ANN. tit. 6, § 18-1101(b) (1993 & Supp. 1999).

and procedures for intra-firm governance.⁴⁶ When an amendment changes one of the numerous statutory default rules, and a charter has neither a specific provision on point nor a freeze, the firm is at the mercy of the legislature. Given a reserved power clause, the firm cannot object that the legislature rewrote its charter.

When the firm has a specific charter provision that differs from the new statutory default, there is no question that the specific rule remains valid despite the legislature's reserved power to amend. A general freeze provision has a similar but wider effect. It does not frustrate the legislature's undoubted power to adopt new mandatory rules, and it does not frustrate the legislature's desire to adopt new default rules *for those firms without provisions overriding statutory defaults*. The freeze simply operates on a broader scale than specific charter provisions—it announces that the firm wishes to exert maximal control over transitions involving enabling (voluntary) rules.

Although reserved power clauses are read quite broadly today, they were once subject to significant limitations.⁴⁷ The “vested rights” doctrine⁴⁸ conceptually separated a company into two contracts. For relations between the state and the company, the reserved power clause preserved the state's power to amend unilaterally the company's charter.⁴⁹ For relations between the owners and managers of the firm, however, the vested rights doctrine carved out an arena of contractual freedom immune to legislative innovation:

[T]his reserved power of the State to alter or amend charters of incorporation, although wide, is not unlimited, and that it can properly be exercised only to amend a charter so far as it represents a contract between the corporation and the State, and not in respects as to which it constitutes a contract between the corporation and the shareholders or between the shareholders themselves. That is the view presently taken of the extent of the reserved power by many, if not most, of the courts which have considered the question.⁵⁰

Although the vested rights doctrine has fallen into disfavor as an illegitimate constraint on the power of the legislature to amend company laws,⁵¹ it contains a core insight that remains valid: for rules that have no effect outside of a company, the enabling nature of

46. See *supra* note 4.

47. See HENN & ALEXANDER, *supra* note 12, at 951–79.

48. See *id.* at 953–54.

49. See *id.*

50. *Schaad v. Hotel Easton Co.*, 87 A.2d 227, 232 (Pa. 1952) (footnote omitted).

51. See MODEL BUS. CORP. ACT § 10.01(a) (1999); *id.* § 10.01 official cmt.

corporate law provides compelling grounds to permit firms to manage their own transitions to new statutory defaults.

Further, a prohibition against freezes imposes unnecessary costs on firms that wish to use the device. A general freeze merely accomplishes in one fell swoop what firms may accomplish by a series of specific charter provisions, an expensive endeavor. A rule invalidating general freezes, then, would do no more than force firms wishing to freeze their charters to restate explicitly all statutory default rules in their charter—defeating in large part the economizing rationale for company law in the first place.⁵²

The state, in its role as promulgator of company laws, is analogous to private firms that prepare forms for various legal transactions (e.g., land sales contracts, mortgages, leases, and secured credit agreements). In some contexts, private parties using forms prepared by third parties may wish to emulate the company law model and incorporate all innovations into their ongoing relationship. For example, bond indenture agreements invariably declare explicitly that the parties will use Generally Accepted Accounting Principles (GAAP) rules as they evolve, not as they existed at the time of issuance.⁵³

In general, however, private parties using forms have no intention to incorporate future changes made by the third-party producer of the form. Mortgages, leases, and other contractual arrangements, without any mention of the matter, are universally assumed to be governed by the language within the four corners of each document, unaffected by later alterations by the form's promulgator.

There are two lessons to draw from these examples. First, it goes without saying that contractual parties using a third-party form have complete freedom to follow or reject future alterations to the form and to make this decision *ex ante*. Second, and more importantly, if the parties wish to incorporate future changes, they must explicitly so indicate in the contract. The default rule is that future changes do not affect executed deals using a particular form. Thus, for almost all form consumers, the freeze is not only legal, it is the default rule. To the extent company law is no more than a form contract, this default supports the permissibility of the freeze.⁵⁴

52. See *supra* notes 39–45.

53. See Richard Leftwich, *Accounting Information in Private Markets: Evidence from Private Lending Agreements*, 58 ACCT. REV. 23, 36 (1983).

54. Whether the freeze should be and can be the default transition rule for company law is discussed *infra* Part III.F.

2. The Presumption of Legislative Prospectivity & Enabling Rules

If other enabling areas of law permitted the freeze or similar privately-adopted advance specification of transition rules, it would be easier to make the case for freezing company charters. The device, however, appears to be entirely novel. This Section, using the Uniform Commercial Code (U.C.C.) as an example, demonstrates that combining the fact that (a) statutes presumptively operate only prospectively, with (b) the very nature of enabling rules (like the U.C.C. or company statutes), implies that the freeze is legal.

The basic idea is simple: prospective legislation that parties may opt into is functionally equivalent to a freeze. Prospectivity ensures that legislative action does not rewrite existing agreements; the ability to opt in means that contractual parties may, by consent, select the new rule.⁵⁵ This is the very state of affairs produced by freeze clauses in corporate charters. While company law is largely statutory, judicial decisions also play an important role. The last portion of this Part considers the efficacy of attempting to freeze out judicially-generated changes in the law.

A well established principle is “‘that statutes operate only prospectively, while judicial decisions operate retrospectively.’”⁵⁶ In at least one prominent mandatory statutory regime, this presumption may be honored more in the breach: revisions to the tax code often operate retroactively by their language, and virtually always in their effect.⁵⁷

In enabling areas of the law, however, “[t]he principle that statutes operate only prospectively” does indeed govern transitions. The U.C.C., perhaps the most widely used body of enabling rules, has included transition rules excluding virtually all retroactive effects when it introduces major changes in the law. The first version of the

55. It is true that parties to a company contract may, per their charter, opt into new statutory rules with only a majority or supermajority vote, which is short of the unanimity required to rewrite standard contracts. Parties forming a company or buying an interest, however, are at least on constructive notice that a majority or perhaps a supermajority has the power to amend the charter.

56. *Rivers v. Roadway Express, Inc.*, 511 U.S. 298, 311–12 (1994) (quoting *United States v. Sec. Indus. Bank*, 459 U.S. 70, 79 (1982)). It is unclear whether there are constitutional limits on the extent of legislative retroactivity. In *United States v. Carlton*, 512 U.S. 26 (1994), the Court permitted retroactive elimination of a tax deduction, noting that Congress has a long history of adopting tax rules with relatively short retroactive periods. *Id.* at 35. Justice O'Connor, concurring, warned that government interests in retroactivity at some point become outweighed by taxpayers' interest in “finality and repose.” *Id.* at 37–38 (O'Connor, J., concurring). Justice Scalia, concurring, described the outcome of the case as “harsh and oppressive.” *Id.* at 39 (Scalia, J., concurring).

57. See, e.g., *Carlton*, 511 U.S. at 30–33.

U.C.C., promulgated in 1962, unambiguously declared that its extensive legal innovations “[a]ppled to transactions entered into and events occurring after [enactment].”⁵⁸ It specifically stated that acts displaced by the U.C.C. (such as the Uniform Sales Act⁵⁹ and the Uniform Negotiable Instruments Act⁶⁰) would continue to govern transactions predating the U.C.C.⁶¹ The key moment was the time of contract formation, not performance: “The conclusion that the Code does not apply to transactions occurring before its effective date is not altered by the circumstances that a further fact or transaction relating to the pre-Code transaction takes place after the effective date of the Code.”⁶² Given this uniform prospectivity, there would have been no reason to look askance at a private freeze clause in a contract governed by the statutes displaced by the U.C.C. Such a privately-chosen provision would have been consistent with (indeed, functionally redundant with) the transition rules included in the publicly-enacted U.C.C.

The transition rules for the 1972 amendments to the U.C.C. seem to fly in the face of the original 1962 prospective approach: with a few exceptions, the 1972 amendments applied retroactively.⁶³ The drafters, however, did not believe that the amendments contained many truly new rules of law; “[u]nless a change in law has clearly been made, the provision of [the amended U.C.C.] shall be deemed declaratory of the meaning of the [original U.C.C.].”⁶⁴ By describing the amendments as “declaratory,” the drafters in effect analogized

58. U.C.C. § 10-101 (1962) (amended 2000).

59. UNIF. SALES ACT (1906) (amended 1922).

60. UNIF. NEGOTIABLE INSTRUMENTS ACT (1896).

61. U.C.C. § 10-102 (2000). Thirty years after promulgation of the U.C.C., these otherwise repealed acts continue to govern continuing transactions predating enactment of the U.C.C. See *County of Macon v. Edgcomb*, 654 N.E.2d 598, 600 (Ill. Ct. App. 1995); *Braden Corp. v. Citizens Nat'l Bank*, 661 N.E.2d 838, 840 (Ind. Ct. App. 1996); *Organ v. Value Bus. Ctr., Inc.*, 609 So. 2d 998, 1001-02 (La. Ct. App. 1992).

62. 9A RONALD A. ANDERSON, ANDERSON ON THE UNIFORM COMMERCIAL CODE § 10-101:5, at 763 (3d ed., rev. vol. 1994).

63. The 1972 transition rules are somewhat opaque: “The [1962 Code transition rules] shall continue to apply to the [Code as amended in 1972] and for this purpose the [old and new Codes] shall be considered one continuous statute.” U.C.C. § 11-102 (1972) (amended 2000). The drafters included this provision for those states that had not adopted, or had only recently adopted, the U.C.C. 9A ANDERSON, *supra* note 62, § 11-102:1, at 791 (quoting Editorial Board Comment). They did not want states adopting the major changes embodied in the transition to the original 1962 U.C.C. to apply its rules retroactively. Section 11-102 contemplates that the 1972 amendments apply retroactively, but makes an exception for transactions predating enactment of the 1962 Code. *Id.*

Some of the more substantive 1972 amendments did not apply retroactively, or applied only after a transition period. U.C.C. §§ 11-104 to -107 (1972) (amended 2000).

64. *Id.* § 11-103.

most of the amendments to judicial clarification of statutory meaning.⁶⁵ Thus, the retroactive nature of the 1972 amendments led to little substantive change.

Statutes like the U.C.C. have no monopoly on change—case law evolves too. Judicial decisions, of course, usually claim to declare what the law has always been and thus presumably apply retroactively. It is difficult to imagine how a company could freeze out such run-of-the-mill case law. Suits pitting owners against other owners or managers over the meaning of an explicit charter term or a default statutory rule require courts to decide the “correct” or “true” *pre-existing* meaning of the disputed term. Such rulings do not create new rules in any meaningful sense and the motivation for the freeze—barring *ex ante* future charter amendments affected by third party lawmakers—does not apply. Furthermore, the courts’ interpretive rather than rulemaking role makes the general freeze undesirable:

Even shareholders in corporations formed subsequent to the statute’s passage or its first judicial construction were on notice that the term’s meaning could evolve over time, because the legislature had delegated to the courts the task of solving the problem. Problem solving is a dynamic process, and hence one should not expect the law to remain static.⁶⁶

Similarly, decisions involving other firms that construe statutory defaults (or similar charter language) declare existing law, and do not create new law. Hence, they also seem beyond the reach of a charter freeze.

Courts do on occasion make new law,⁶⁷ and the motivation for the freeze applies just as much for these judicial innovations as for legislative innovations in company law. Specific charter provisions, as in the statutory case, would of course trump judicial innovation in non-mandatory rules. To guard against all possible changes, however, drafters could include freeze provisions to prevent all such court

65. Despite the drafters’ justification for retroactive application of the 1972 amendments as merely declaratory of the meaning of the U.C.C., many courts have refused to apply even modest alterations retroactively. *E.g.*, *Am. State Bank v. White*, 535 P.2d 424, 431–32 (Kan. 1975); *Third Nat’l Bank v. Continental Ins. Co.*, 446 N.E.2d 380, 382 (Mass. 1983). Thus, it seems likely that courts would have upheld freeze provisions locking out the effect of the 1972 amendments despite the drafters’ concerted attempt merely to “declare” existing law as opposed to making new law.

66. John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on Judicial Role*, 89 COLUM. L. REV. 1618, 1689 (1989).

67. See, *e.g.*, *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712–13 (Del. 1983) (replacing dated “block” method of valuing corporations with “any techniques or methods which are generally considered acceptable in the financial community”).

decisions from amending their charters. Some cases are easy, such as when courts explicitly reverse precedents or openly declare that they are crafting a rule from whole cloth. But between such obvious cases of lawmaking and the opinions discussed in the previous paragraph that merely interpret existing law, there will be many gray cases. Reasonable minds will often differ on whether or not a court has generated new law to which a freeze clause would apply.⁶⁸ The freeze provision itself could specify that some trusted third party, such as a respected corporate lawyer, would decide whether or not a new decision was pregnant in pre-existing law or really struck out in a new direction. This party would not be obligated to defer to the court's view in deciding whether or not the freeze should bar the application of a judicial opinion to the company's charter. The enabling nature of company law, combined with a properly limited reading of transition and reserved power clauses, indicates that company charter freezes are likely legal as a matter of positive law.

III. NORMATIVE ANALYSIS: THE INTERACTION OF TRANSITION POLICY & ENABLING RULES

This Part considers the public policy arguments for and against freeze provisions. It begins with three observations on the proper methods for assessing the desirability of freeze provisions. First, it demonstrates that conventional normative analyses of transition rules, designed with mandatory legal regimes in mind, are inappropriate for weighing the wisdom of enabling regime transition rules.⁶⁹ Second, it shows that justifications for mandatory company law rules (which might support a mandatory rule against charter freezes) are irrelevant to the desirability of freeze provisions.⁷⁰ Third, a major justification for mandatory rules is to deter acts adversely affecting third parties—so-called *negative* external effects. This

68. Consider, for example, the "discovery" of the frustration of purpose doctrine in contract law. For instance, *Krell v. Henry*, 2 K.B. 740, 745-49 (Eng. C.A. 1903), along with similar "Coronation Cases" involving contractual disputes in the aftermath of England's King Edward VII canceled coronation celebrations, is widely cited for creating the frustration of purpose doctrine. See, e.g., FRIEDRICH KESSLER ET AL., *CONTRACTS: CASES AND MATERIALS* 930 (3d ed. 1986) ("The term 'frustration' seems to have come into general use, both in England and in this country, following *Krell v. Henry* and the other so-called Coronation cases . . ."). Yet *Krell* neither explicitly nor implicitly admits to creating new rules to govern contracts. Rather, the court sounds as if clauses permitting rescission for frustration of purpose have long been implicit in all contracts and cites an earlier case, *Taylor v. Caldwell*, 122 Eng. Rep. 309 (Q.B. 1863), to support its holding.

69. See *infra* Part III.A.

70. See *infra* Part III.B.

Article shows that permitting charter freezes does not undermine any *positive* external effects that arise when many firms use the same governance rules.⁷¹

The implications of the freeze differ significantly for public companies versus privately-held firms. For public corporations and other firms with widely-dispersed ownership (e.g., some limited partnerships), the desirability of the freeze depends on whether state competition leads to efficient (race to the top) or inefficient (race to the bottom) statutes. If states are racing to the top, freeze provisions stand in the way of efficient corporate charters; conversely, if states are racing to the bottom, freezes protect shareholders from management depredation.⁷² Charters for smaller businesses are much more analogous to contracts, and there is no compelling reason to bar parties to such contracts from agreeing to freeze out potentially undesirable legislative amendments to company laws.⁷³ Finally, this Article shows that, paradoxically, when the freeze makes the most sense as the default transition rule, it is least likely to become the law.⁷⁴

A. Transition Policy & the Inapplicability of Conventional Approaches

The fundamental black letter rule of legal transitions, “[t]he principle that statutes operate only prospectively, while judicial decisions operate retrospectively,”⁷⁵ is not without policy justification. Because courts must wait for disputes to reach them before declaring legal principles, they cannot choose their own agenda and thus are less able than legislators to make significant and unexpected changes in the law. In addition, “judges articulate and tend to adhere to established principles.”⁷⁶

The principle behind the differing presumptions about legislative and judicial transition rules seems to be that it is unfair to apply large and surprising new legal rules retroactively—something supposedly done by legislation, and only by legislation. “Fairness arguments about retroactivity are based on principles of equity and justice. Commentators have suggested that fair retroactivity rules should

71. See *infra* Part III.C.

72. See *infra* Part III.D.

73. See *infra* Part III.E.

74. See *infra* Part III.F.

75. *Rivers v. Roadway Express, Inc.*, 511 U.S. 298, 311–12 (1994).

76. RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 19.2, at 571 (5th ed. 1998).

provide notice of applicable legal standards and protect reliance interests Fairness concerns are typically raised in support of prospective application of new legal rules."⁷⁷

Even those who agree that fairness should determine transition policy have attacked the classical institutional approach to transition policy—legislative prospectivity and judicial retroactivity. Jill Fisch points out that some legislative innovations are modest and entirely expected⁷⁸ and that some judicial innovations are significant and unexpected.⁷⁹ Thus, she rejects the classical approach. In its place, she proposes an "evolutionary theory" for transition policy: evolutionary legal change (small, incremental transitions) should apply retroactively, while revolutionary change should not.⁸⁰ Those making transition policy, then, must examine legal changes on a case-by-case basis. Notice and reliance will depend on many contextual facts. How clear was the existing rule? Was change predictable? Is the change really novel, or just a slight tweak?⁸¹ This more nuanced approach, Fisch argues, would "provide notice of applicable legal standards and protect reliance interests . . ."—in other words, it would be fair.⁸²

In an enabling system, the concerns of fairness (notice of legal change and reliance on existing law) are non sequiturs. Indeed, the freeze helps firms avoid surprises that may undermine reliance interests. The freeze, then, is an important tool in letting the legislature amend enabling rules as it pleases, leaving it to individual firms to opt out in advance (freeze) or ex post, or to accept new rules. Fisch's distinction between evolutionary and revolutionary change is similarly irrelevant for company law. If virtually every party in every firm wants a revolutionary change, the legislature undermines no expectations or reliance interests by "meeting demand" and changing the law to suit companies' desires. And again, the freeze enables the remaining firms to avoid surprises and maintain reliance interests.

77. Jill E. Fisch, *Retroactivity and Legal Change: An Equilibrium Approach*, 110 HARV. L. REV. 1055, 1084–85 (1997).

78. *Id.* at 1109–10. For example, the minor 1972 amendments to the U.C.C., discussed *supra* notes 63–65 and accompanying text, in large part merely clarified the finer points of existing rules.

79. Fisch, *supra* note 77, at 1107–08; *see also*, e.g., *Brown v. Bd. of Educ.*, 347 U.S. 483, 500 (1954) (reversing *Plessy v. Ferguson*, 163 U.S. 537, 552 (1896), and deeming state-sponsored segregation an Equal Protection violation); *Erie R.R. Co. v. Tompkins*, 304 U.S. 64, 79–80 (1938) (reversing *Swift v. Tyson*, 41 U.S. (16 Pet.) 1, 22 (1842), and holding that federal courts must apply state common law in diversity cases).

80. Fisch, *supra* note 77, at 1105–11.

81. *Id.*

82. *Id.* at 1084.

Unsurprisingly, those who believe that efficiency considerations, rather than fairness, should dictate transition policy, disagree with the classical justification for the legislative prospectivity and judicial retroactivity, as well as Fisch's equilibrium approach for fair transition policy.⁸³ Louis Kaplow has made perhaps the most powerful statement of the efficiency reasons to apply laws retroactively, regardless of whether they are legislative or judicial, evolutionary or revolutionary.⁸⁴ He argues that sound government policy is ultimately driven by exogenous factors such as technological change and citizens' preferences. These independent variables may change incrementally or radically and are largely unpredictable. Kaplow's key observation is that consumers should treat legal uncertainty no differently than they treat other types of uncertainty: *they should make plans with full knowledge that changing conditions may lead the government to change course (i.e., change some laws)*. Any transitional relief offered by the government merely reduces individuals' incentives to deal with legal risk using the same tools they use to deal with other risk (e.g., insurance or diversification). Forcing people to bear the risk of their own acts is more efficient than subsidizing them with transition relief.⁸⁵

Kyle Logue raises one important caveat to Kaplow's efficiency analysis.⁸⁶ To the extent the government uses laws as incentives to induce behavior, it must not retroactively change the rules in the middle of the game. Rather, lawmakers must avoid retroactivity by grandfathering pre-existing actors under the old rule. If the state fails to provide transition relief in those areas where it uses "incentive subsidies," it will develop a reputation for breaking promises. Once it has such a reputation, the state will have to offer higher subsidies to induce desired actions. If people know the government changes rules mid-stream nine times out of ten, they will demand incentives ten times as great as they would demand if the government always kept its word and provided transition relief.⁸⁷ Logue emphasizes, however, that Kaplow's no-transition-relief rule holds outside of those areas in

83. Fisch herself notes: "efficiency is generally viewed as favoring retroactivity." *Id.* at 1088.

84. Louis Kaplow, *An Economic Analysis of Legal Transitions*, 99 HARV. L. REV. 509, 511-15 (1986).

85. *Id.* at 527-32.

86. See Kyle D. Logue, *Tax Transitions, Opportunistic Retroactivity, and the Benefits of Government Precommitment*, 94 MICH. L. REV. 1129, 1129-32 (1996).

87. See *id.* at 1132 (describing "inefficient increase in the default premium that the government must pay taxpayers to compensate them for the risk of tax transitions").

which the government uses the law to create incentives for private actors.⁸⁸

Neither the efficiency case for retroactivity nor Logue's exception to it provide any grounds to suggest that the charter freeze is undesirable. The gist of the efficiency argument for retroactivity is that the law should provide private actors no relief from the risk of legal change just as the law generally provides no relief for most other risks. Society achieves optimal results when people rationally plan for new laws.

This argument, however, applies only to *mandatory* laws; it has no application to enabling laws. When the government changes tax laws, environmental laws, and other mandatory rules, a regime of retroactive application forces private actors to anticipate potential legal change and thus tailor their economic decisions to changing social needs. This analysis, however, is irrelevant for enabling laws such as company statutes. The purpose of these laws is not to bring private acts into line with social needs; enabling laws merely aim to save costs in private transactions without any affect on third parties. Society is not harmed when companies decline to adopt new default intra-firm governance rules; if such choices had a negative impact on anyone outside of the company, society would make the rule mandatory instead of optional.

Moreover, the charter freeze actually serves efficiency in a manner somewhat analogous to the efficiency argument for retroactivity. The freeze is a tool that can help firms manage the risk of legal change to enabling rules. To the extent the government chooses rules unsuited for some firms, efficiency analysis positively supports the use of charter freezes. Company law, like tax law, constantly changes and the point of the efficiency story is that we want to encourage actors, to the extent possible, to anticipate change and plan for it. The freeze is a very forward-looking measure to deal with the prospect of change; it is analogous to investing in securities whose value will be unaffected by changes in the tax code (instead of searching for loopholes that may disappear overnight). The freeze enables firms to insulate themselves from the risk of untoward legal change.

The enabling nature of company law also makes Logue's "incentive exception" to efficiency analysis inapplicable to the charter freeze. Company law does not attempt to create incentives to alter

88. See *id.* at 1154-58.

behavior in specific ways; rather, business enterprise laws broadly aim to facilitate whatever private actors wish to do.

Generalizing the arguments made in the previous paragraphs, fairness, efficiency, and incentive rationales for transition rules simply do not apply to laws. In mandatory areas of law in which transition issues are usually litigated, it is generally not possible for rules to leave everyone better off *ex post*. Although citizens will desire efficient tax rules *ex ante* (before they know how the rule will impact them), changes in mandatory rules usually create winners and losers. Thus, it is impossible to adopt any new tax law if the losers have the power to opt out. This is simply not true for enabling legal regimes. If the legislature picks the rule desired by the majority, and the minority can opt out, then we can have some winners while insuring that there are no losers. The charter freeze is a cheap and powerful tool for those who anticipate that they generally will not favor any statutory innovation.

B. Inapplicability of Justifications for Mandatory Rules of Substantive Corporate Law

Beyond general theories of legal transitions, company law scholarship has developed models to explain the exceptional circumstances in which rules governing business entities should be mandatory rather than enabling. This Part shows that none of the justifications for mandatory company laws weighs in favor of a mandatory rule against charter freezes.⁸⁹ Indeed, some of the rationales suggest that the freeze should be mandatory, or at least the default transition rule.

When a company's acts potentially impact third parties, the justification for mandatory rules is clear. Most rules regulating the external relations of business entities come from outside of company statutes. For example, firms are liable for common law torts and statutory violations just like any other legal person. Company statutes do, however, address a few external concerns. They contain

89. Black argues forcefully that mandatory corporate law rules are irrelevant. Black, *supra* note 4, at 551–62. He argues that corporate law will usually adopt rules that most parties desire; that advance planning, especially choice of state of incorporation, can circumvent most mandatory rules; that unpopular rules are subject to great pressure for change; and that remaining mandatory rules concern trivial matters. For a similar argument, see ROMANO, *supra* note 40, at 90–91. If mandatory rules, as Black contends, are truly irrelevant, then any mandatory rule against charter freezes would be irrelevant (either firms did not desire the freeze, or some states permitted the mechanism). Thus, for the sake of argument, this Part assumes that mandatory rules are not entirely irrelevant.

provisions requiring firms to file addresses to facilitate service of process.⁹⁰ Capital requirements and dividend tests, albeit weak, provide creditors with some protection against payments to owners that render the firm unable to pay its debts.⁹¹ These external affairs, however, are peripheral concerns for company law. Company law focuses primarily on internal firm governance: relations between managers and owners, and among owners.⁹² The charter freeze, governing transition rules affecting only owners, fits completely within this intra-company model and hence falls outside the narrow categories of company statutes containing mandatory rules.

Coffee has noted that modern contract law imposes a few mandatory terms on the parties to all contracts, such as the U.C.C.'s requirement of good faith and fair dealing, and argues that these requirements should apply among the parties to company contracts no less than in other consensual settings.⁹³ It is difficult to argue, however, that a charter freeze is a bad faith measure or that including one is unfair dealing. Potential owners or managers who think the freeze unwise or unfair can simply elect to invest or work elsewhere.

This point, however, overlooks the possibility of opportunism among co-owners of a company. Original charters receive, in effect, unanimous support, since those who do not like the charter simply decline to invest. Charters can be amended by less than unanimous votes, however, and this raises the possibility of a majority owner opportunistically taking advantage of a minority. Parties may enter company contracts with expectations, only to see them frustrated by such mid-stream changes. Rational investors will foresee this possibility and will be wary of buying shares in the first place. In public corporations, dispersed and disorganized shareholders will worry that managers, with their control of the proxy machinery,⁹⁴ will

90. DEL. CODE ANN. tit. 8, § 102(a)(2) (1996 & Supp. 1998); N.Y. BUS. CORP. LAW § 402(a)(8) (McKinney 1986 & Supp. 1999); MODEL BUS. CORP. ACT § 2.02(a)(3) (1999).

91. E.g., DEL. CODE ANN. tit. 8, §§ 170, 172, 174 (distributions to shareholders and director liability for unlawful shareholder distributions); LA. REV. STAT. ANN. §§ 12:26, 12:92 (West 1994 & Supp. 1999) (capital requirements); OHIO REV. CODE ANN. § 1701.12 (West 1994 & Supp. 1998) (capital requirements); TEX. CORPS. & ASS'NS CODE ANN. pt. 3 art. 3.02 (West 1996) (capital requirements); MODEL BUS. CORP. ACT §§ 6.40, 8.30 (1999) (capital requirements). Other theories for recovery, such as fraudulent conveyance law, provide creditors with more effective remedies. CLARK, *supra* note 5, at 610.

92. See *supra* note 3 and accompanying text.

93. John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919, 937 (1988) (citing U.C.C. § 2-719); see also Coffee, *supra* note 66, at 1653-54 (noting the rarity of mandatory intra-owner rules).

94. See CHOPER ET AL., *supra* note 5, at 522.

continually amend the charter in order to enrich themselves. In small enterprises, minority owners may worry that the majority will amend the charter to take a disproportionate share of earnings.

Managers or majority owners raising capital can charge more for a given share of ownership if they can somehow assure potential investors that the managers or owners will not opportunistically amend the charter down the road, after investors have committed their funds.⁹⁵ In the jargon of agency cost economics, managers need a "bonding" device to assure investors that they will not be double-crossed later.⁹⁶ If insiders cannot signal their fidelity, there is a "market for lemons" problem⁹⁷ and trustworthy managers and owners will be unable to realize a premium for their sincere intent to avoid opportunistically altering the charter.⁹⁸ Somewhat analogous to Odysseus tying himself to his ship's mast to enable him to resist the seductive song of the Sirens,⁹⁹ insiders may wish to contract away their right to alter course in the future.

One extreme solution, going far beyond a freeze, would be to make charters unamendable except by unanimous consent.¹⁰⁰ This option, however, gives every owner (no matter how small her stake) veto power, and may create holdout problems. In addition, unanimity in effect means the firm will be unable to adapt to change. High supermajority requirements present the same problems.¹⁰¹

Jeffrey Gordon argues that less drastic state-crafted mandatory rules provide the most effective way for managers and majority owners to make credible promises to dispense with opportunistic mid-stream charter amendments.¹⁰² The idea is that the legislature will change mandatory rules if they become undesirable, and that this

95. See Lucian Arye Bebchuk, *The Debate on Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 1395, 1399-1404 (1989); Coffee, *supra* note 93, at 941-50; Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1573-74 (1989) (describing "opportunistic amendment hypothesis").

96. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

97. See George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488, 488-92 (1970) (describing process where, if higher-quality suppliers cannot credibly signal consumers of their quality (and thus command a higher price), they may be driven out of the market by lower-quality, lower-cost competitors despite demand for higher-quality goods at the higher price).

98. See Coffee, *supra* note 93, at 947-49.

99. HOMER, *THE ODYSSEY*, bk. XII, 39-54 (Richmond Lattimore trans., Harper & Row Publishers 1967).

100. Shareholders can always alter non-mandatory rules by unanimous vote, because there is no party left to object to a unanimously-adopted charter amendment.

101. Gordon, *supra* note 95, at 1575.

102. *Id.*

possibility of legislative response to changing circumstances is more flexible and credible than requiring unanimous or high supermajority votes to change a particular charter provision.¹⁰³ Nevertheless, Coffee argues for slightly more flexibility. Rather than limit firms to a single mandatory rule against opportunistic amendment, Coffee thinks company statutes should offer "a choice among quality-controlled alternatives Opting out then needs to be quality constrained, but neither forbidden nor blindly accepted."¹⁰⁴

Whatever the proper tool for bonding against opportunistic mid-stream charter amendments, the charter freeze presents no such threat of opportunism and, thus, this rationale for mandatory company law rules does not suggest a mandatory rule against the freeze. Indeed, as discussed in this Article, to the extent incumbent management and majority owners exert influence over the lawmaking process, the freeze itself may be an effective bonding device to assure investors that those in control will not attempt to alter the charter later via their friends in the legislature.¹⁰⁵ Further, privately selected transition rules seem sensible for mandatory rules designed to assist contracting parties. Mandatory rules designed to help bond insiders to their promises are part of the central purpose of company law—*intra-firm governance*. To the extent charter freezes are desirable for enabling governance rules, they likewise are desirable for this special species of mandatory company law provisions.

C. *Concerns External to Companies*

Mandatory rules designed to assist contracting parties are a relatively small part of the universe of mandatory company law rules. The main rationale for mandatory legal rules, whether for individuals or business entities, is the potential for seemingly private acts to effect third parties (negative external effects). Most laws designed to encourage actors to weigh the possibility of adverse impact on others, such as the common law of torts or the environmental statutes, apply to firms no less than flesh and blood persons. Company laws do include special rules designed to protect creditors. The first part of

103. Note that a rule that requires a supermajority vote is effectively somewhere between a purely enabling and a mandatory rule. To see this, consider the extreme case of a rule requiring unanimous shareholder consent to opt out. In a public corporation, with numerous shareholders, attaining every last vote is virtually impossible and thus the rule is effectively immutable. Generally, the higher the supermajority vote required to opt out of a statutory default, the more closely the rule approaches immutability.

104. Coffee, *supra* note 93, at 972–74.

105. See *infra* Part III.D, III.E.

this Section shows that the freeze, far from threatening creditor interests, extends further protection (again) as a device for bonding the firm to take some measures and forego others.

The second part of this Section deals with the much less common phenomenon of *positive* external effects. Common use of a set of legal rules, no less than common use of a given keyboard layout or computer operating system, may generate benefits based on common use alone—past, continuing, and future. Charter freezes facilitate “defections” from the use of new statutory default provisions. Intuition, and some scholarship,¹⁰⁶ suggest that the possibility of such defection can undermine the benefits of common use of company laws. The Section concludes by rejecting this assertion and arguing that charter freezes pose no threat to the positive external effects that result from common use of statutory defaults.

1. Creditor Protection & the Freeze

When making loans, creditors must weigh, *inter alia*, the possibility that the legislature will change creditor protection rules and increase the likelihood of default. Legal change, no less than recession or new competition, poses a risk to borrowers’ financial health. Seen in this light, charter freezes reduce one risk faced by creditors: automatic change in the borrowers’ charter imposed by the legislature. Indeed, creditors might request a freeze as a limited form of protection from the firm later lobbying the legislature to change the contract between the creditor and the firm. Creditors could supplement this protection by obtaining promises that borrowers will not engage in certain activities permitted by existing or future company law.

Creditors, at least of large public corporations, can and do impose precisely such restrictions in omnipresent bond covenants. The most common bond covenants, such as restrictions on share issuance and repurchase, further debt, payment of dividends, changes in board of directors, mergers, and the sale of substantially all assets, effectively freeze some provisions of the borrower’s charter.¹⁰⁷ These contractual promises trump any legislative change in default rules.

106. See *infra* text accompanying note 124.

107. See Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “The Economics of Boilerplate”)*, 83 VA. L. REV. 713, 740–42 (1997) (summarizing event risk covenants governing share issuance and repurchase, mergers, asset sales, changes in board of directors, and dividend policy); Clifford W. Smith & Jerold B. Warner, *On Financial Contracting*, 7 J. FIN. ECON. 117, 123 (1979) (listing most common types of bond covenants).

Far from undermining creditor reliance, charter freezes extend borrowing firms' credibility in bonding with creditors and forsaking the opportunity to take later steps that increase the likelihood of default.

2. Network Externalities

The very fact that many firms use common rules of governance and that they, along with new firms, will continue to use them creates benefits for all—so-called network externalities.¹⁰⁸ “A product exhibits network externalities when its value to a consumer depends on the number of other consumers that use that product (or a compatible one).”¹⁰⁹ Computer operating systems are a canonical example of network externalities. Knowledge of a given computer environment is more valuable if many others use the same environment. So too with company law. “[F]irms that use a particular contract term form a ‘network’ analogous to the network of PC users”¹¹⁰

Network externalities are one of two general categories of positive external effects generated by common usages, denoting “advantages . . . available to a firm that adopts a contract term that is or will become contemporaneously used by many firms for a significant period of time.”¹¹¹ This does not include “positive externalities that earlier users of a contract term confer on later users,” which form a separate category called learning externalities.¹¹² While network externalities run between all participants, learning externalities implicitly involve subsidies conferred by earlier users on later users.¹¹³ Thus, to take a legal example, past precedents on a particular statutory provision are learning externalities that benefit new companies; the prospect of additional precedents in the future are network externalities created by new as well as existing firms.

108. See Philip H. Dybvig & Chester S. Spatt, *Adoption Externalities as Public Goods*, 20 J. PUB. ECON. 231, 231–33 (1983); Joseph Farrell & Garth Saloner, *Installed Base & Compatibility: Innovation, Product Preannouncements, and Predation*, 76 AM. ECON. REV. 940, 940–43 (1986).

109. Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 VA. L. REV. 757, 763 (1995).

110. *Id.* at 775. “Other classic examples include videocassette recorders, typewriter keyboards, telecommunications equipment, and thread sizes on nuts and bolts.” *Id.* at 763 n.14.

111. Kahan & Klausner, *supra* note 107, at 725.

112. *Id.* at 724.

113. Marcel Kahan & Michael Klausner, *Path Dependence in Corporate Contracting: Increasing Returns, Herd Behavior, and Cognitive Biases*, 74 WASH. U. L.Q. 347, 350 (1996).

Common use of company governance provisions creates a host of benefits. Bodies of court opinions construing particular terms serve to "reduce uncertainty by providing substantive detail ... or by providing a procedural safe harbor."¹¹⁴ Unambiguous terms in turn help foster common business practices that reduce costs. Further, clearly understood rules enhance competition for legal services by making lawyers interchangeable, just as widespread use of Microsoft Windows and applications running under it reduces the cost of hiring workers with such skills.¹¹⁵ Finally, investors will feel more comfortable with well-defined governance rules and hence will pay more for securities issued by firms using provisions clarified through long lines of precedent.¹¹⁶

Numerous dispersed private actors do not always settle on optimal standards. The process of choosing standards may go awry in at least three ways.¹¹⁷ First, private actors may settle on a standard that is least costly at the outset, but that yields network externalities so much below alternatives that, even discounting to present value, it is inefficient in the long run. Second, private actors may choose standards leading to excess uniformity. Third, dispersed actors may settle on the opposite: excessively divergent standards. These latter two possibilities require further discussion, as they have important implications for the desirability of the freeze.

To understand how excessive uniformity can occur, imagine that there are two distinct types of participants (T1 and T2) who would choose different standards *ex ante* (S1 and S2) based on their distinct preferences. If most of the early participants are type T1, S1 will predominate. Although T2 entrants inherently prefer S2, widely-used S1 offers more than offsetting learning and network benefits. If each T2 latecomer could be sure that current and future T2 entrants would choose S2, then each would choose S2. It is often prohibitively expensive for dispersed participants to coordinate their behavior, however, and each isolated T2 latecomer will likely choose the established S1 over the risky S2.

114. Klausner, *supra* note 109, at 777.

115. *See id.* at 782 n.82.

116. *See id.* at 780. There is evidence that underwriters tell firms to use standard terms and that unusual terms may scare off buyers. Henry T. Greely, *Contracts as Commodities: The Influence of Secondary Purchasers on the Form of Contracts*, 42 VAND. L. REV. 133, 152-58 (1989).

117. Kahan & Klausner, *supra* note 107, at 734-36.

This excess uniformity story may explain the failure of specialized close corporation codes.¹¹⁸ Although a number of states, including Delaware, have enacted corporate law provisions tailored specifically for privately-held firms, the overwhelming majority of such firms have rejected these offerings and instead use general corporate laws designed for public corporations.¹¹⁹ This empirical truth is hard to square with the observations that close corporations are significantly different than public corporations¹²⁰ and that legislatures design general corporation statutes for public corporations.¹²¹ Thus, there should be demand for specialized close corporation rules of governance that provide a better fit for such firms than statutes designed for quite different entities.

This lack of demand for close corporation rules partly results from the fact that public corporations predate close corporations.¹²² Close corporations thus face the distorted choice faced by the T2 entrants. Although special close corporation statutes offer a set of preferable rules, they are used by relatively few firms and hence offer fewer learning externalities in the short run and create a significant risk that they will offer fewer network externalities in the long run. Close corporations, then, may select general corporate law rules despite unanimous preference for tailor-made rules. Commentary on reaction to Delaware's special close corporation provisions seem to tell just such a tale.

[S]tatutory close corporations have not found particular favor with practitioners. Practitioners have for the most part viewed the complex statutory provisions underlying the purportedly simplified operational procedures for close corporations as legal quicksand of uncertain depth and have

118. See Tara J. Wortman, Note, *Unlocking Lock-in: Limited Liability Companies and the Key to Underutilization of Close Corporation Statutes*, 70 N.Y.U. L. REV. 1362, 1386-91 (1995).

119. See F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 1.19 (3d ed. 1986 & Supp. 1997). Interestingly, Delaware and other states with special close corporation codes did not mandate that existing close corporations migrate to the new code. This is inconsistent with the general rule that changes in the company statute effectively are inserted to all existing firms of a given type. It is consistent with the general rule that while minor statutory changes apply retroactively, major legislative innovation generally does not. See *supra* Part III.A.

120. See *supra* Part III.A; see also CLARK, *supra* note 5, at 761 (describing application of rules designed for public corporations to close corporations as "clumsy").

121. Henry G. Manne, *Our Two Corporate Systems: Law and Economics*, 53 VA. L. REV. 259, 268 (1967) (declaring that historically, corporation statutes "were adopted with the publicly held corporation almost exclusively in mind").

122. See Kelvin H. Dickinson, *Partners in a Corporate Cloak: The Emergence and Legitimacy of the Incorporated Partnership*, 33 AM. U. L. REV. 559, 561 (1984).

adopted the view that the objectives sought by the subchapter are achievable for their clients *with considerably less uncertainty* by cloaking a conventionally created corporation with the panoply of charter provisions, transfer restrictions, by-laws, stockholders' agreements, buy-sell arrangements, irrevocable proxies, voting trusts or other contractual mechanisms which were and remain the traditional method for accomplishing the goals sought by the close corporation provisions.¹²³

This leads to "excess uniformity," in the sense that, if the close corporations coordinate their behavior at reasonable cost, they would all elect to use laws better suited to their needs.

Private, dispersed actors may settle on the opposite of excess uniformity—excess diversity. If there is no coordinating mechanism, then a thousand isolated actors may choose a thousand different standards. Gordon defends mandatory corporate law rules in part based on this insight, arguing that corporate law is a public good with positive external effects that would be destroyed by excessive customization of governance rules.¹²⁴ Mandatory rules assure some minimal common core of company law and hence may be desirable, despite other drawbacks, as a means to prevent disintegration of the standard company contract. This argument applies with even greater force to the freeze, which will tend to create smaller groups of firms sharing common governance rules.

Michael Klausner argues convincingly that, in the context of company law, Gordon's fear is misplaced.

Whereas Gordon argues that an individual firm has an incentive to customize at the expense of firms already using the common term, [network externality analysis] demonstrates that the opposite concern is actually greater. A firm choosing between a term already in common use and a customized term may be *too strongly inclined* to opt for the network externalities immediately available from the former. . . .

The presence of network externalities offers a slim basis for the use of mandatory rules in corporate law. To the extent that coordination is needed, a default term can be used.¹²⁵

123. DAVID A. DREXLER ET AL., DELAWARE CORPORATION LAW AND PRACTICE § 43.01, at 43-1 (1996) (emphasis added).

124. See Gordon, *supra* note 95, at 1567.

125. Klausner, *supra* note 109, at 835-36.

A slightly different way to make the same point is to note the efficiency of the coexistence of corporations and partnerships, each having long served business owners with different preferences. A single-minded focus on network externalities would lead lawmakers to eliminate all but one business entity in order to generate the largest possible mass of precedents behind one set of rules.

The network benefits of complete homogeneity, however, are likely outweighed by the value of some amount of choice in selecting a business entity. Company law must "promote an optimal balance of uniformity and diversity in corporate contract terms."¹²⁶ Thus, legislatures should provide, and indeed long have provided, a menu of business entity options, each designed for a set of actors with relatively uniform preferences. This set of options serves heterogeneity among enterprises in general terms; charter freezes serve heterogeneity in more specific ways. Once a firm has selected a type, it may wish to exercise greater than normal control over the evolution of its charter. If the legislature does its job, by definition only a minority of firms will feel the need to preemptively reject alterations of default rules.

D. Public Corporations: Which Way Are We Racing?

The policy analyses of the last three Sections provide no grounds to oppose charter freezes and relatively weak support for such provisions. General transition policy simply did not apply to enabling transitions. Justifications for mandatory rules of corporate law, including external effects, weigh in favor of the freeze. Evaluating the normative desirability of permitting charter freezes requires us to step down from the perspective of high theory and examine the context of company governance.

The key distinction is between widely-owned public entities and privately-owned firms. The desirability of permitting public corporations to freeze their charters turns on whether competition between states for lucrative public incorporation fees and corporate tax revenues leads to rules favoring management or shareholders. This is the famous "race" debate among corporate law scholars. Until fairly recently, most scholars accepted Carey's landmark thesis that competition for corporate charters led to a "race to the bottom": states vying to win reincorporations by favoring management over shareholders in their corporate statutes.¹²⁷ The pejorative label

126. *Id.* at 765; *see id.* at 831-32, 837-38.

127. *See* William L. Carey, *Federalism and Corporate Law: Reflections Upon*

"bottom" is normatively appropriate: rules favoring management are a license to steal from shareholders in myriad ways (e.g., self-dealing, excessive compensation, and expropriating attractive business opportunities). These modes of theft are just as inefficient as simple property theft, discouraging enterprise and raising monitoring costs.

A growing chorus of scholars has challenged this thesis, arguing that markets, especially capital markets, constrain opportunistic reincorporation jurisdictions favoring management. Investors (especially large institutional investors) know which states have such rules, and will pay less for the shares of firms incorporating in these states which in turn raises firms' cost of capital and makes them less competitive. Reincorporating in states that cater to their welfare, as opposed to shareholder welfare, may damage managers' reputations for trustworthiness. These market monitoring mechanisms, so the argument goes, put pressure on managers to incorporate in states with rules favoring shareholders. This in turn causes states to engage in a "race to the top": a continual quest for efficient rules that cater to investors.¹²⁸

The outcome of this debate is dispositive of the charter freeze's desirability for public firms. If states are engaged in a race to the bottom, then statutory innovations will usually harm shareholders. In such a world, the charter freeze is a powerful tool for policing management, because all changes to the charter must garner at least a majority shareholder vote. Management's control of the proxy machinery, along with dispersed shareholders' rational apathy, may enable management to obtain such votes, but the freeze at least forces a vote. If, on the other hand, states are engaged in a race to the top, then management would use charter freezes to reject statutory innovation favoring shareholders. Management's control of meeting agendas might prevent shareholders from ever obtaining a vote on desirable new default provisions.

Unfortunately the "race" debate remains unresolved. The race to the top thesis rests on the assertion that the market for corporate securities is relatively efficient. This means that security prices reflect

Delaware, 83 YALE L.J. 663, 663-70 (1974). The idea of a race to the bottom, along with the terminology, dates back at least to Justice Brandeis's dissent in *Liggett v. Lee*, 288 U.S. 517, 557-60 (1933) (Brandeis, J., dissenting).

128. For an early attack on the race to the bottom thesis, see Ralph K. Winter, Jr., *State Law, Shareholder Protection, & the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 258-62 (1977); see also Daniel R. Fischel, *The "Race to the Bottom" Revisited: Reflections on Recent Developments in Delaware's Corporation Law*, 76 NW. U. L. REV. 913, 915-22 (1982) (questioning the accuracy of the race-to-the-bottom thesis). For a thorough defense of the race to the top thesis, see ROMANO, *supra* note 40, 14-17.

at least all publicly-known information, including each state's corporate laws. There is strong empirical evidence to support this version of the efficient markets hypothesis.¹²⁹ In addition, a series of statistical studies ("event studies") have demonstrated that the stock prices of firms do not generally decline before or after they reincorporate in Delaware (the state winning the race, up or down) and may actually rise.¹³⁰ The fact that shareholders suing management of Delaware corporations invariably choose Delaware's courts, when they have the option of selecting another venue, also supports the race to the top thesis.¹³¹

One skeptic, however, argues that even capital markets suffer from some inefficiencies, giving managers the ability to engage in at least modest levels of self-interested behavior without noticeably impacting the firm's cost of capital.¹³² Executives can also use their control of meeting agendas to package self-interested measures with "sweeteners," such as special dividends, and thus obtain shareholders' consent to their own exploitation. Further, there are some complications with the event studies cited by race to the top proponents. Firms often reincorporate either right before or soon after good news, explaining any rise in price observed on reincorporation in Delaware.¹³³ It is possible (in a race to the bottom world) that share prices would rise even more if firms did not reincorporate in the wake of good news.¹³⁴ Note too that, if a race to the bottom is complete (i.e., all states have roughly similar pro-management corporations statutes), we would not expect to see much change in share price on reincorporation because firms merely would be moving from one management-friendly jurisdiction to another.¹³⁵

Further complicating the debate, the race need not be entirely to the top or bottom. On some issues, markets may help shareholders curtail such behavior. There are strong reasons to believe that corporate voting rules are efficient.¹³⁶ On the other hand, even the

129. See, e.g., RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 290-300 (4th ed. 1991).

130. EASTERBROOK & FISCHER, *supra* note 3, at 213-15 (surveying event studies and collecting cites); ROMANO, *supra* note 40, at 20-22 (summarizing results from event studies literature and finding support for the race to the bottom thesis).

131. ROMANO, *supra* note 40, at 41.

132. See Lucian Arye Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1458-67 (1992).

133. See *id.* at 1449.

134. See *id.*

135. *Id.* at 1450.

136. See EASTERBROOK & FISCHER, *supra* note 3, at 70-72 (discussing voting).

most ardent race to the top advocates admit that the rash of anti-takeover measures enacted since the mid-1980s are inefficient and serve largely to entrench incumbent management.¹³⁷

Strong evidence exists that managers of large public corporations lobbied for these anti-takeover provisions.¹³⁸ Their enactment illustrates strikingly just how much statutory amendments are charter amendments obtained by alternative procedures. “[S]ince most restrictions imposed by [valid anti-takeover] statutes can be adopted voluntarily by charter amendment without an authorizing statute, management’s lobbying for legislation clearly implies that it believes it is easier to convince a state legislature than shareholders of an anti-takeover provision’s desirability.”¹³⁹

When management can make an end-run around shareholders simply by obtaining new statutory provisions, the attractiveness of charter freezes is obvious. As a first cut, we might posit that shareholders should freeze out changes only in those areas where there was a race to the bottom driven by management’s influence in the legislature. Indeed, race to the top advocates have suggested what amounts to limited charter freezes to address the problem posed by legislation enacted at the behest of management—the requirement that shareholders affirmatively opt in to new statutory defaults that replace *mandatory* rules, rather than automatic application (as was the case with almost all anti-takeover statutes):

[W]here important changes in the relationship between shareholders and management are at issue, legislation that relaxes mandatory rules should always require an affirmative shareholder decision to ‘opt in’ to the change rather than merely permitting shareholders to opt out. This will prevent management from extracting more from the legislative process than it could obtain from the charter amendment process.¹⁴⁰

Romano similarly, but more narrowly, argues that, at least as to anti-takeover statutes, legislatures should require firms to take affirmative steps to opt in, instead of making anti-takeover rules effective for firms until they affirmatively opt out.¹⁴¹

137. See *id.* at 221–22; ROMANO, *supra* note 40, at 84.

138. See ROMANO, *supra* note 40, at 80–83.

139. *Id.* at 84; see also Black, *supra* note 4, at 568 (agreeing with Romano); William Carney, *The Production of Corporate Law*, 71 S. CAL. L. REV. 715, 752 (1998) (same).

140. Gordon, *supra* note 95, at 1555.

141. See ROMANO, *supra* note 40, at 56.

Limited freezes, however, are prey to the unending creativity of the legal mind. There is always "the risk that lawmakers will provide new options that weren't anticipated when a company went public. [Supermajority voting] provisions can't protect shareholders of existing companies against this risk."¹⁴² A general charter freeze prevents all creative evasion of shareholder voting requirements in one fell swoop. Limited freezes simply do not go far enough.

It is possible, at the other extreme, to enact overly stringent versions of the freeze. Gordon uses the term "freeze" to describe a charter made absolutely unamendable.¹⁴³ Although he does not seem to contemplate freezing out legislative change, it is conceptually easy to extend his freeze to preclude legislative as well as shareholder charter amendments. This is in effect a unanimity rule. If everyone agrees, they can alter the charter (or merge, or dissolve) at will. There is nobody left to complain and sue. Gordon and others have rejected unanimity rules as too inflexible. Because it is so difficult to obtain unanimous approval for any measure, the firm likely will forego many desirable statutory amendments in the process of freezing out undesirable ones.¹⁴⁴

A general charter freeze, requiring only a majority (or perhaps a modest supermajority) vote to include statutory amendments in the charter, strikes a balance between locking out all, or accepting all, statutory change. It gives shareholders a chance to accept desirable amendments and to reject undesirable amendments that benefit only management. It is important to reiterate that if *any* portion of the corporate statute is subject to a race to the bottom (e.g., anti-takeover measures), freezing only those portions of the charter will not be effective because management will always be able to find creative, formally distinct provisions to achieve self-interested ends. A general charter freeze is thus desirable for public corporations if there is even partial truth in the race to the bottom hypothesis.

Even if states engage in a race to the top as to every facet of corporate law, shareholders in public corporations still have two reasons to enact a general charter freeze: the self-interest of lawyers' groups and the incompetence of legislatures. The bar is very influential in drafting corporate laws, nowhere more so than in

142. See Black, *supra* note 4, at 567-68.

143. See Gordon, *supra* note 95, at 1575, 1580-81.

144. Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1856-58 (1989); Gordon, *supra* note 95, at 1582-84.

Delaware.¹⁴⁵ Corporate lawyers in many ways have economic interests at odds with shareholders. They have incentives to favor rules that require extensive legal planning and cause litigation—especially expensive, protracted litigation. Jonathan Macey and Geoffrey Miller, the first to explore interest group motives in detail in the context of Delaware law, concluded:

[T]he Delaware bar is likely to be more successful than other groups in transforming Delaware's competitive advantage into profits. This group enjoys significant advantages in organizational structure as well as economies of scale in obtaining information about the effects of changes in Delaware law on the demand for corporate charters and legal services. In addition, the bar is not plagued with the same start-up costs and free-rider problems that confront other groups. The bar is not the only interest group within Delaware that benefits from the state's dominance in the market for corporate charters, but its gains are disproportionately high relative to those of the groups with which it competes.¹⁴⁶

To the extent legislation benefits lawyers instead of shareholders, the freeze may serve as an effective screening device. Managers as well as shareholders stand to gain by freezing out statutes that impose excessive legal costs on public corporations.

Finally, shareholders and managers might enact a charter freeze to protect their corporation from consistently inefficient rules enacted by an incompetent legislature. Although this is directly at odds with the purpose of company law, there is no guarantee that every legislature at all times enacts default rules desired by most firms. The fact that Delaware's Constitution requires a two-thirds majority in both houses of its legislature to amend its corporate code may reflect worry about inappropriate legislation.¹⁴⁷ Admittedly, the competition

145. See ROMANO, *supra* note 40, at 60; Andrew G.T. Moore II, *A Brief History of the General Corporation Law of the State of Delaware and the Amendatory Process*, in 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, *DELAWARE LAW OF CORPORATIONS & BUSINESS ASSOCIATIONS* H-19 (2d ed. 1990 & Supp. 1997) ("It is a hallmark of the General Assembly's respect for the expertise of the [Delaware State Bar Association Section on General Corporate Law] that it will rarely consider or adopt any changes in the General Corporation Law which have not been sponsored by the Section.").

146. Jonathan R. Macey & Geoffrey P. Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 522-23 (1987); see also Carney, *supra* note 139, at 720-28, 737-41 (analyzing incentives of corporate bar in jurisdictions other than Delaware); David A. Skeel, Jr., *The Unanimity Norm in Delaware Corporate Law*, 83 VA. L. REV. 127, 158-62 (1997) (arguing that unanimous decisions by Delaware Supreme Court benefit Delaware corporate bar).

147. DEL. CONST. art. IX, § 1.

among states for public corporation chartering business provides a powerful market corrective to senseless legislation; firms can always reincorporate in a state with wiser legislators.¹⁴⁸ Nevertheless, the freeze offers *additional* protection when shareholders and executives of public corporations fear foolish corporate law innovation.

E. Close Corporations & Other Privately-Held Firms

There is little if any state competition for the charters of small, privately-held firms, because they usually operate in only one state and the costs of incorporating elsewhere exceed the benefits.¹⁴⁹ Thus, there is less pressure on legislatures to enact efficient governance rules, and private firms have more to fear from legislative ineptitude. Private firms may find charter freezes a helpful defensive measure. Even if the legislature is competent, its focus on public corporations often means that close corporations are forgotten step-children.¹⁵⁰ If legislators tailor corporate law for public corporations, then private firms have another reason to freeze out automatic change to their charters and individually evaluate each legislative measure.¹⁵¹

More generally, if a legislature is incompetent in choosing default governance rules for small enterprises, the freeze can serve as a *signal* of consumer (firm) disapproval. Public firms unhappy with a state's corporate law simply reincorporate elsewhere (usually in Delaware). Private firms have no real exit option. If a majority of a given type of business entity enact charter freezes, a strong signal would be sent to the legislature that its statute is failing to achieve its fundamental purpose—providing default rules that most firms desire.

Even if legislatures generally select efficient rules for close firms, a large minority of these firms may wish to reject many new provisions. Close firms, to a much greater extent than their public counterparts, are products of explicit bargaining, with give and take on a variety of issues. Changes in statutory defaults are likely to

148. Black, *supra* note 4, at 574–75.

149. Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L.Q. 365, 372–78 (1992).

150. See *supra* notes 119–23 and accompanying text (discussing corporate law's traditional focus on large public corporations).

151. Ayres demonstrates that courts have effectively voided many rules that are inappropriate for close corporations. Ayres, *supra* note 149, at 377; see ROMANO, *supra* note 40, at 26. Interestingly, legislatures have usually acquiesced, either by enacting a statute following the innovative decision or by refusing to legislatively reverse the decision. This solution to the problem of corporate rules unfit for close corporations, however, raises a similar problem: later courts may inappropriately apply the innovative rule for close corporations to public corporations.

upset complex compromises embodied in the charters of closely-held firms. Vestal demonstrates that the RUPA changes important fiduciary duty and dissolution rules.¹⁵² Though the Act gives existing partnerships a window of time to alter their charters before the RUPA governs them, a looming (mandatory) transition¹⁵³ will give partners benefitting under new rules a powerful negotiating position. Based on the primacy of partners' intent, as embodied in the explicit and default rules specified in their charter, Vestal argues that partnerships formed under the UPA should remain governed by the UPA despite a state's adoption of the RUPA.¹⁵⁴

Vestal's prescribed transition rule is much like a charter freeze—it maintains an older set of default rules for existing firms when the legislature adopts a new set of default rules. Of course a company could achieve the same effect by including specific rules in its charter on every issue contemplated in the statute; as discussed earlier, such explicit terms trump both old and new statutory defaults.¹⁵⁵ Forcing firms to take this step, however, imposes much of the transactions cost that company statutes are supposed to eliminate. Charter freezes allow firms to achieve the same ends with one sentence: "To the extent permitted by law, this firm elects to be covered by the [entity] statute as it existed on the date this entity was formed."

As the product of specific bargains, close company charters exhibit greater heterogeneity than their public counterparts. Thus, we would expect a higher percent of them to reject statutory defaults. Even if the legislature chooses perfectly, then, many close firms whose governance rule preferences diverge from the plurality of their peers will want to opt out of the statute. Firms especially averse to statutory innovation are in the best position to identify themselves, and a charter freeze allows them to plan ahead cheaply. Contract is the first and best source of company governance rules, and the freeze is a powerful, forward-looking tool for effecting the parties' intent. Furthermore, widespread use of charter freezes might give legislators more room to innovate. When they know that most firms wary of change have enacted freezes, they can adopt rules desired by the

152. See Allan W. Vestal, *Should the RUPA of 1994 Really be Retroactive?*, 50 BUS. LAW. 267, 274–79 (1994).

153. REVISED UNIF. P'SHIP ACT § 1006, 6 U.L.A. 122 (1995 & Supp. 2000). The ULLCA has almost exactly the same transition rule. See UNIF. LTD. LIAB. CO. ACT. § 1205(b), 6A U.L.A. 507 (1995 & Supp. 2000).

154. See Vestal, *supra* note 152, at 285–88 (arguing for a "coexistence model," with UPA governing existing partnerships and RUPA governing partnerships formed in future).

155. See *supra* note 18 and accompanying text.

plurality that would, absent charter freezes, pose problems to firms with relatively unusual preferences.

In addition to these special problems, close corporations share some of public corporations' fears about legislative innovation. Bar lobbying groups play no less a role in shaping private company law than they do for public entities. Ribstein and Kobayashi make a strong case that lawyers involved in drafting and promulgating the Uniform Limited Liability Company Act (ULLCA) included a host of rules likely to require legal advice and foster litigation.¹⁵⁶ The RUPA may suffer from the same defects.¹⁵⁷ Neither statute has been adopted widely.¹⁵⁸ Just as shareholders in public corporations may worry about the legislative clout of management, minority owners in close companies may be wary of majority owners' ability to obtain legislatively what they cannot enact within the firm. Majority owners can use corporate funds and pooled clout via business groups to lobby for measures that would require a supermajority vote or for measures that would look like a breach of fiduciary duty if enacted by an interested party.

F. Should the Freeze be the Default Transition Rule for Corporate Law?

The previous sections concluded that there may be good reasons to permit both public and private firms to adopt charter freezes. This Section considers the next natural question: Should the freeze be the default transition rule inserted into charters? To restate the question, should firms be required to state explicitly in their charters that they wish to adopt legislative innovations automatically?

At first blush, this is a shocking default rule. It seems tantamount to a legislative declaration that "in the future, we are likely to promulgate company default rules that most firms would not choose." If the legislature had such serious doubts about its own wisdom, making freezes the default transition rule would help most firms block undesirable legal change. It seems unlikely that any legislature would take such a dim view of its (and its successors') abilities. Moreover, such an inept legislature might well be better served by getting out of the business of providing company statutes altogether.

156. Ribstein & Kobayashi, *supra* note 9, at 963-68 (discussing mandatory fiduciary duties, liability for wrongful distributions, derivative-like member suits, and the indefinite standard for dissolution).

157. See Ribstein, *Revised Uniform Partnership Act*, *supra* note 45, at 79-81.

158. See *supra* note 8.

It is possible, however, that in certain circumstances the freeze may be a sensible default rule. As in Part III.E, it is helpful to analyze close and public companies separately. There are at least two situations in which a legislature confident in its abilities might rationally select the freeze as a default rule. First, if there is extreme diversity among close firms, the plurality that favor many default rules may be quite small. In this case, most firms will wish to reject most statutory innovation, thus making the charter freeze a sensible default. Second, we may need to distinguish between relatively sophisticated close firms that receive legal advice when drafting and amending their charters and unsophisticated firms that do it on their own. Lawyers for the former group are in a good position to choose whether or not to insert a freeze provision based on their familiarity with clients. Unsophisticated firms, however, are unlikely to think about the possibility of future legal change. Thus, the legislature should focus on unsophisticated close firms in deciding whether or not to select the freeze as a default. If, for example, most close firms are sophisticated and have a systematic preference for rules that do not suit unsophisticated firms, the freeze makes sense as a default rule. Sophisticated firms will contract around the default, and the freeze will protect unsophisticated parties from new rules unsuited to their needs. Note that under the stated assumptions, this result is not limited to freeze provisions: it may be rational to draft the entire statute to suit the needs of those without expert advice. The assumptions seem to suggest that there may be a need for two distinct company statutes. If the legislature provides distinct statutes catering to the special needs of each group, the freeze no longer would be a sensible default rule.

For public companies, again the key empirical question is whether legislatures generally enact corporate laws favorable to management (in a race to the bottom) or to owners (in a race to the top). In a race to the top world, the freeze is an undesirable default, as it enables management to evade statutory changes that likely benefit owners. Conversely, under a race to the bottom, the freeze is an efficient default rule; it prevents managers from using their lackeys in the legislature to enact provisions allowing them to expropriate corporate wealth. There is, however, a paradox here. By assumption in a race to the bottom world, lawmakers would not choose a default transition rule favorable to shareholders. Instead, they would choose the existing default—automatic insertion of statutory innovations (favoring management) into charters.

Finally, if the bar plays a significant role in shaping company law to its own advantage, it is unlikely to choose the freeze as the default transition rule. The freeze helps firms evade statutory amendments that force them to use lawyers more often (e.g., to comply with inefficient formalities) and that breed litigation among parties to the company contract. Such an outcome clearly is not in the legal profession's self-interest.

CONCLUSION

The last subpart seemingly turns company law on its head. This Article opened by acknowledging that state business entity statutes are "off-the-rack" governance rules that most owners prefer. The state saves each firm the cost of drafting a company charter from scratch. As the normative analysis of Part III revealed, however, reality may diverge from this ideal. Instead of adopting efficient rules that owners would prefer, influential groups (managers, majority shareholders, and lawyers) warp the contours of company laws. Under such adverse circumstances, owners will find charter freezes very appealing.

In the complex and continually evolving legal environment, it is unlikely that owners face legal changes uniformly harmful to their interests. It is equally unlikely, however, that changes in company law always benefit owners. The legal world is more nuanced. States may be engaged in a race to the top on some public corporate law issues and a race to the bottom on others. The legal profession may enact self-interested business entity provisions at some times, while bowing to firm demand at others.

In addition to these general problems, specific firms may have their own individuated reasons for fearing amendments to company laws. Each company is in the best position to gauge the threat posed by legal change, and to deploy protective legal mechanisms. Part III argued that there is no policy reason to forbid each firm from choosing its own transition policy for enabling company law rules. The freeze is simply one of the choices that firms should have to deal with potentially harmful alterations to company laws.

Charter freezes, along with other tools to manage the risk of legal change, are particularly important given the current flux in company laws. Partnership law may be shifting from the UPA to the RUPA. Legislatures continue to reshape LLC statutes significantly. Corporate law is more volatile than in earlier eras. Firms, thus, have strong grounds to argue that charter freezes are permissible tools for

insulating themselves from the risks of untoward business entity legislation.