Corporations and Other Business Associations

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Corporations and Other Business Associations

Cases and Materials

Ninth Edition

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Preface

This book provides material for the introductory Corporations or Business Associations course. Our users typically divide among those who emphasize closely held businesses, those who emphasize the public corporation, and those who devote substantial time to both, as well as between teachers who primarily emphasize the corporation and those who introduce business entities more broadly. This book can be adapted to any of these approaches with ease. We have structured the chapters so that most topics can be moved and used effectively out of their original order. The book can also be adapted to teach an advanced course with several different emphases—mergers and acquisitions, securities regulation, or business litigation. Nonetheless, the current organization reflects a coherent combination of material ordered in a way that will be helpful to someone who is approaching business associations for the first time.

This edition continues the commitment made to users at publication of the first edition—and with each subsequent edition—to provide a casebook that can grow and change with the subject it addresses while providing continuity to users. Thus, the core structure is designed not to reflect current fancy but rather to illustrate what we believe are central, recurring issues and themes. Each edition, therefore, continues to feel like an old friend to continuing users, though it contains new materials reflective of the constant changes in law, business enterprise, and society.

The corporate governance landscape is much different than a generation ago. Independent directors now hold the great majority of all board seats, institutional shareholders hold a supermajority of all shares in public corporations, and activist shareholders have become a recurring player in entity governance. Long gone is the view that shareholders are powerless and boards supine. One consequence of this change is the continuing evolution in the role of judicial review and the constant judicial tinkering with standards of review in deciding the extent to which courts will defer to directors or controlling shareholders. This evolution is on display in recent Delaware cases included in Chapters 4 and 8, setting out conditions for "cleansing" of conflicts by board and shareholder action that can produce review under the business judgment rule. In addition, new material in Chapter 3 continues our comprehensive treatment of the shareholder role in the modern corporation. The goal there is to help students grasp the interaction of traditional state corporate law, newer and still growing federal law, and the changing private motivations of institutions that arise outside of formal law.

The evolution in the law of closely held firms has also been dramatic over the last two decades, and this too is reflected in the ninth edition. LLCs now account for most new closely held businesses. Chapters 2, 3, 5, and 6 permit students to build their knowledge of the distinctive legal characteristics of the public corporation, the modification of those characteristics for closely held businesses using the corporate form, and the further modification of those same core principles in the LLC. In Chapter 6 we develop a distinctive part of LLC law that is particularly visible in Delaware. That state and its judiciary have focused on legal rules seemingly aimed at sophisticated entities (as contrasted with, for example, the traditional "mom-and-pop" enterprise that is more of the focus of Chapter 5) whose participants are willing to take the time and pay the costs of developing a specialized template to govern their business relationship. Thus, we have picked cases to illustrate the extent to which parties can waive the fiduciary duties provided by law or the ability of investors to seek involuntary dissolution from courts. Two new cases in Chapter 6 reflect the continued evolution of Delaware law for sophisticated users and the emergence of case law in other jurisdictions applying oppression-of-minority-investor approaches to deal with potential abuse of power by LLC majorities.

Building off of the seventh and eighth edition introduction of the benefit corporation, the ninth edition adds new material reflecting the continuing debate over the purpose of the corporation, which has received heightened public attention in the wake of the COVID-19 pandemic, and with growing evidence of inequality and climate change. Chapter 4 introduces the classic view that a corporation should be managed for the benefit of its shareholders, contrasts that position with modern commentary advocating in favor of a stakeholder governance model, and includes an updated discussion about the benefit corporation movement. Chapter 9 recognizes the expansion of the purpose debate with respect to corporations generally.

Any examination of the law of American business enterprises necessarily includes a discussion of the relative costs and benefits of using private ordering and markets versus government regulation in structuring collective entities. Two severe shocks to the financial system in the new millennium—the collapse of the dot-com bubble and the financial meltdown in 2008—leading to renewed government regulation and more recent efforts to revisit those rules, are discussed at various places in the book. In corporate law, this discussion of private ordering versus regulation often tracks the interaction of federal and state laws, as state law since the 1890s has taken a laissez faire approach and federal law a more regulatory approach to address perceived gaps. In Chapters 9-11, we provide the detail to fill out the initial survey of federal law contained in Chapter 3, including the issue of insider trading, which remains one of the most visible and accessible contexts for viewing the impact of law on corporate behavior. Mergers and other corporate acquisitions provide the most recurring context for federal law covered in this book. In putting most of the federal material after the presentation of the state law structure of these transactions in Chapters 8 and 9, we hope that students will better understand the factual setting and can better evaluate the legal rules.

Despite the growth of federal law, state law (and, in particular, Delaware law) remains the dominant source for legal rules for corporations. State law reflects a strong preference for private ordering; this law continues to be built around trusting directors to govern corporations and permitting them to make use of a variety of incentives and monitoring devices made available in the private sector and by government regulation. Under this view, the government's role is focused on providing essential background rules and a judicial forum for shareholders to bring fiduciary duties claims as a check on the broad power given directors to control "other people's money." This essentially common law process is visible throughout the book, but Chapter 4 is particularly designed to introduce this theme.

The ninth edition continues its emphasis on building blocks that enable students to digest these more advanced concepts. Unlike many of the "private" law courses found in the traditional first-year law school curriculum, corporation law does not respond to problems commonly experienced in discrete transactions or interactions between "strangers." Instead, the law of corporations and other business associations addresses the governance of a collective, relational enterprise. For example, the key recurring issue is the ongoing relationship of shareholders to directors and officers and the extent to which any individual or group can speak for or direct the enterprise. The corporations or business associations course is many law students' first extended contact with the intricacies of business relationships. Thus, it is especially important to help students grasp new terminology, develop an understanding of what motivates individuals to invest their human or money capital in a cooperative business venture, and recognize how law and private ordering interact to protect participants' reasonable expectations. Economic learning advances the discussion of these issues. An understanding of how markets work and of the incentives that commonly motivate people in economic transactions enriches students' ability to interpret and use the law, so we discuss these concepts in the early chapters. Understanding the economic concepts of "collective action" and "rational apathy" can help to explain why legal rules will be different for an enterprise with many dispersed passive participants than for one with a few close-knit investors.

Although we provide economic-based tools for understanding, the thematic framework of this book is how the law shapes collective business relationships. In the first few chapters, we compare the various forms of doing business: sole proprietorships, partnerships, limited partnerships, limited liability companies, close corporations, and publicly held corporations. A comparative analysis of these forms continues throughout the book in a variety of legal contexts.

We ask students to recognize the various methods used by law to regulate collective business relationships. In examining what legal constraints there should be on the behavior of those who control corporations, a student who has read this book will have considered:

- Voting and other governance rules imposed by law before any transaction has occurred
- Fiduciary duty applied by courts to specific transactions after they have occurred
- Disclosure rules mandating information to be provided in corporate relationships
- Specific legal remedies like appraisals or buyouts

This examination is designed to give students an appreciation for the different ways that law works and the relative advantage of each method as it is applied in particular circumstances, with consideration given to the possible market or private ordering alternatives. Is law supplemental or mandatory? Does it seek to provide the rules that the parties would have agreed to if they had thought carefully about the situation, or does it seek to impose a penalty or an incentive to encourage one side or the other?

At the beginning of each relevant part, section, or subsection, we have noted the statutory or regulatory material to which students should refer when studying that segment. This reflects our view that this material is best studied in close relation to the statutory law. Our comparative approach asks students to think about how the Delaware statute differs from the Model Business Corporation Act, the two most commonly referenced statutory guideposts for corporation law in this country. Throughout the casebook we use the Model Business Corporation Act to refer to the current version of that Act.

Many case, statutory, and other citations have been omitted from quoted material without indication. Most footnotes have also been omitted from quoted material without indication, but those that remain retain their original numbers. Bracketed material in a quoted source indicates transitional or summary materials that we have provided.

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Corporations and Other Business Associations

1 *Economic and Legal Aspects of the Firm*

A. Some Basic Concepts and Terminology

1. The Classical Firm

a. Introductory Note

The classical firm[1] is a business owned and managed by one person. In law, the classical firm is referred to as a sole proprietorship, and the owner as the sole proprietor. Traditionally, economists have examined the classical firm as a starting point for understanding the nature of more complex firms that are organized with multiple owners. In this part and throughout this chapter, we will highlight the most important insights and issues economists have uncovered. We begin with a look at how economists analyze and describe the classical firm.

b. The Entrepreneur

The central actor in the economic conception of the firm is the entrepreneur.[2] As Frank Knight described, the entrepreneur is the person who does two critical tasks.[3] First, the entrepreneur *directs* the business and exercises the ultimate *business judgment.* The entrepreneur decides what to make and how to make it. In the real world, this does not involve simply reacting to what consumers want. Rather, it involves forecasting whether, at what price, and in what quantities consumers would be willing to buy a particular product or service *if* it were produced and made available to the market.

1. The modifier "classical" has two connotations. First, the owner-managed firm dominated the economic landscape at the outset of the industrial revolution—the heyday, or "classical" period, of capitalism. Second, the owner-managed firm represents the purest, or most classical, form of economic organization because it avoids the problems of misaligned incentives that arise when authority and responsibility are divided between and among multiple owners, a problem that you will observe in different forms throughout your study of corporations and other business associations.

2. The sole proprietor is in economic parlance the firm's entrepreneur.

3. For the seminal analysis of the entrepreneur, see Frank H. Knight, Risk, Uncertainty, and Profit (1921).

It involves forecasting whether and how a *team* of employees can be hired and organized to produce the product or service at a cost that will produce a profit. In other words, it involves managing in the shadow of *uncertainty*.

The entrepreneur's second task is accepting full *responsibility* for his or her business decisions by being the residual guarantor and claimant. If the entrepreneur's business judgment proves faulty, and the business operates at a loss, the entrepreneur stands ready to draw on his or her personal wealth to satisfy the claims of the firm's employees and creditors. The entrepreneur is a fully responsible owner; stated in legal terms, the entrepreneur has *unlimited liability*. On the other hand, if the entrepreneur's judgment proves sound, and profits result, even immense profits, these rewards all belong to the entrepreneur. They are his or her just desserts for taking the risks of *responsible ownership*.

Consider the example of Mary, who decides to start a new business—a wholesale bakery, which she will own and operate as a sole proprietorship. Mary will be the bakery firm's entrepreneur. In deciding to start her business, and thereafter in running the business from day to day, Mary must solve innumerable problems. Being able to solve these problems, and being responsible if the problems are not solved, is the essence of being an entrepreneur. Some problems will be routine, but many will be complex and require forecasting. Mary must determine what bakery products her business can profitably offer to the market. She must determine how to house, equip, staff, supply, and finance her business. To solve each of these problems a certain amount of knowledge, business judgment, and skill is required. Moreover, solving these problems often involves convincing others (prospective employees, lenders, or suppliers) to invest their human or money capital in the bakery venture. Thus, Mary must be willing to demonstrate that she is a *responsible owner* who will make good on her promises. To do this, Mary, as a classical entrepreneur, must be confident enough in her own ability and judgment that she will be willing to be the firm's *residual claimant*. In other words, Mary will agree that she will pay herself last, and only if the bakery is profitable. Moreover, Mary will agree that if the bakery venture is a failure, she will use her own wealth to make good on the promises she has made to employers, suppliers, and lenders.

c. The Coasean Firm: Differentiating the Market and the Firm

Economist R.H. Coase[4] identified a "firm" as the antithesis of the market with respect to the means by which economic resources are allocated. In the idealized market economy often identified with Adam Smith, each producer and consumer separately calculates her own self-interest and chooses what to make and what to buy based on price signals received in the market. As a result, resources are allocated to their highest and best use, not in response to governmental orders or other communicated commands, but as if by an invisible hand, through the separate, self-interested choices of all producers and consumers. By contrast, inside a firm, resources are allocated pursuant to conscious orders or directions from the entrepreneur to her employees.

4. See Ronald H. Coase, The Nature of the Firm, 4 Economica, 386-405 (1937).

Return to our bakery hypothetical. Mary handles most of the baking, writes advertising copy, deals with customers, and so on. However, for certain parts of the production and sales process Mary uses the market. For example, Mary cannot efficiently produce the raw materials she uses. Instead, she buys eggs, flour, and butter from a supplier. Likewise, she purchases transport services from a trucking firm, accounting services from a local certified public accountant, and electricity from a utility company. But Mary does not rely solely on market transactions for the materials and services that she cannot self-produce. She also hires employees and directs them to perform the tasks—waiting on customers, keeping the premises clean, handling baking on weekends—that cannot as efficiently be handled via market transactions or by Mary herself.

From this Coasean perspective, the "firm" is what we call the set of relations that arise when the entrepreneur allocates resources via commands to her employees, rather than the set of relations that arise when an entrepreneur allocates resources via market transactions with outsiders. Thus, depicted as a circle and using Mary, the classical owner/entrepreneur, as an example, the Coasean firm includes Mary and her employees, but excludes the customers, suppliers, and creditors with whom Mary does business via contract or market exchanges.

From the Coasean perspective, the essence of the firm is the entrepreneur's management and conscious direction of resource allocation decisions. Thus, a firm is identified with an internal decision-making hierarchy. The entrepreneur is the responsible owner/manager who sits at the top of the hierarchy. All decisional authority resides in the entrepreneur, and is either exercised by the entrepreneur or delegated to employees to exercise. Decisions within the firm are made, not in response to price signals, but via conscious direction and command. Each employee surrenders the autonomy he would possess as a sole proprietor and agrees, instead, to follow the commands and directions of the entrepreneur.

2. The Business Association

Recall our simple bakery example, discussed above. Mary's firm is a sole proprietorship. She is the only owner; she is the entrepreneur. She and she alone has the authority to make and carry out business policies, including hiring, firing, and directing employees. Suppose, however, that Mary needs not only to hire employees and use market transactions to run her bakery, but also to obtain a substantial infusion of capital and management expertise to expand the bakery to serve a larger geographic area. Suppose, further, that the preferred way to obtain these new resources is to combine Mary's bakery with the bakery of a competitor, John, into one firm that will be jointly owned by Mary and John. Joining ownership will result in the functions of the classical owner/entrepreneur being divided between Mary and John in some fashion. The jointly owned firm that Mary and John will create is commonly referred to as a "business association." Most business associations are organized as a partnership, corporation, or limited liability company (LLC), the business forms that are the primary focus of this book.

Business associations run the gamut from firms jointly owned by two persons to multinational organizations whose owners number in the tens of thousands. Firms with a very small number of owners are commonly called "closely held." At the opposite extreme, firms with thousands of capital providers and employees are commonly called "publicly traded" because the ownership interests in such firms are widely traded via stock exchange markets or electronic trading markets that are accessible to the public.

3. The Modern Corporation and the Berle-Means Critique

At the beginning of the nineteenth century, the American economy was dominated by sole proprietorships, and thus, by the classical entrepreneur. By the end of the nineteenth century, a profound transformation was well under way. The ownership of a substantial and increasing percentage of America's industrial wealth was in the hands of business firms organized as corporations, whose owners numbered in the hundreds and thousands.

Writing in 1932,[5] Adolf Berle and Gardiner Means correctly predicted that the power of the modern corporation would continue to grow and that eventually in every industrial sector, ownership of the means of production would reside in an increasingly small number of corporations. Importantly, Berle and Means identified the key attributes of the "modern corporation" that thereafter would dominate the American economy. Unlike the sole proprietorship, or the closely held firm whose owners usually operated similarly to a sole proprietorship in terms of control of the firm's business, the modern corporation was characterized by a complete separation of ownership from control. In the modern corporation, the firm's managers did not own a controlling amount of the corporation's stock; instead, a great majority of the corporation's stock was in the hands of a large number of passive, geographically dispersed shareholders who had neither the means nor the will to monitor managers or engage in the process of electing the corporation's directors.[6] As a result, managers perpetuated themselves in office and enjoyed almost total discretion in the operation of the firm.

Berle and Means described the separation of ownership from control in the modern corporation as presenting a fundamental challenge to America's governing ideology. Free market ideology, rooted in the work of Adam Smith, viewed the individual entrepreneur—the sole proprietor who owned and managed her own firm—as the primary motor driving the economy from the producer side of the equation. In turn, private property in the means of production was justified as central to a system depending on the voluntary actions of each market participant. Private property in the means of production allows and creates incentives for the entrepreneur to use her talents and capital in an effort to maximize her own wealth and happiness. The entrepreneur's selfish use of her property—her effort to make a profit and accumulate

5. Adolf A. Berle, Jr., and Gardiner C. Means, The Modern Corporation and Private Property, 340-341 (Macmillan, 1932) (hereinafter "Berle and Means").

6. Berle and Means, at 5. Berle and Means found that in more than half of the 200 largest publicly traded corporations, management's stock ownership constituted such a small percentage of the voting stock as to be irrelevant in the election of directors. Id. at 94, 114, 117.

wealth—results in the best possible allocation of resources and the maximization of all citizens' wealth and happiness.

In Berle and Means's view, the modern corporation destroyed the theoretical underpinnings of the free enterprise system.

> It has been assumed that, if the individual is protected in the right both to use his own property as he sees fit and to receive the full fruits of its use, his desire for personal gain, for profits, can be relied upon as an effective incentive to his efficient use of any industrial property he may possess.
>
> In the [modern] corporation, such an assumption no longer holds. As we have seen, it is no longer the individual, himself, who uses his wealth. Those in control of that wealth, and therefore in a position to secure industrial efficiency and produce profits, are no longer as owners entitled to the bulk of such profits. . . . The explosion of the atom of property destroys the basis of the old assumption that the quest for profits will spur the owner of industrial property to its effective use.[7]

Berle and Means clearly worried about the agency cost problem associated with separation of ownership and control that became the center of subsequent developments by contractarian-oriented scholars described below. More broadly, however, Berle and Means were concerned about the problem of power. They identified the modern corporation, and the larger corporate system, as new institutions that compete with and threaten to supplant the nation-state as the dominant form of social organization. They worried because the modern corporation "involves a concentration of power in the economic field comparable to the concentration of economic power in the mediaeval church or of political power in the modern state."[8] Significantly, Berle and Means concluded that the corporation should now be analyzed as a social organization, and with a view to determining how managers' power should be constrained for the public good.[9]

Berle and Means categorized three types of possible responses to the economic power of the modern corporation and its managers. Society could bend the modern corporation and its managers to the will of the shareholders, so that shareholders, collectively, would act as real owners. Alternatively, society could recognize that corporate managers have absolute power, constrained only by their sense of morality and public duty. A third possibility would be to treat the interests of both managers and shareholders as subordinate to the paramount claims of society.

From the New Deal onward for nearly 50 years, federal law and policy makers often chose to pursue the third approach identified by Berle and Means—subordinating private property in the means of production to the legitimate claims of the larger society. The institution of private property that had given the entrepreneur almost total control over his business—the right to hire and fire whomever he wanted for whatever reason, the right to set wages and working conditions, the right to pollute air and water rather than incur costs for less environmentally harmful methods of production—would yield to competing interests within the larger society.

7. Berle and Means, at 8-9.
8. Berle and Means, at 352.
9. Berle and Means, at 353-357.

4. The Return of Free Market Ideology: The Firm as a Nexus of Contracts

By 1980, the New Deal ideology and its preference for government regulation of business gave way to a more deregulatory approach. Advocates of free markets, individualism, and elimination of government regulation recaptured political and intellectual influence in America, England, and within a decade, most of the first-world countries. Within corporation law, a similar ideological shift occurred.

The new dominant view of the firm traced its origins to the work of economists working out the implications of the principal-agent problem. These theorists, including prominently Michael Jensen and William Meckling,[10] emphasized the contractual nature of the firm rather than the distinction between the firm and the market. From this perspective, a firm is described as a nexus of contracts between the various claimants to a share of the gross profits generated by the business. Thus, depicted as a circle, and using Mary's bakery as an example, the firm includes not only the contractual relations between Mary and her employees, but also Mary's contractual relationships with customers, suppliers, lenders, independent contractors, communities in which plants are located, and others with whom Mary contracts in conducting business.

Strong-form proponents of the nexus-of-contracts view of the firm emphasize that the firm does not exist apart from its constituent relationships. To speak of a corporation as having social responsibility would reify the corporation in a way inconsistent with that view. Significantly, this contractarian view of the firm tends to focus attention away from the corporation as a social institution. Moreover, by its very nature, this microeconomic focus on the individual as the appropriate unit of analysis does not often lead to reform proposals advocating greater government regulation of the corporation or the economy.

5. Separation of Ownership and Control and Agency Costs

Principal-agent theorists provided new tools for understanding the relationship between passive shareholders and managers. First, theorists identified shareholders as the owners, or in agency terms, principals, of the modern corporation; managers are viewed as the shareholders' agents. This economic usage of the terms "principal" and "agent" differs from legal usage of these terms. In law, principals have legal rights of control and direction and agents have legal obligations of obedience. As economists use these terms, however, principals have no inherent right of control and agents have no inherent obligation of obedience. Instead, principals and agents contract with each other to determine how much control the principal will retain, and how much control will be ceded to the agent. From this view of the principal-agent relationship, the modern corporation represents a consensual choice by shareholders and managers to cede authority and power over the modern corporation almost entirely to managers. However, the power ceded is accompanied by the use of various contractual devices that, in the view of principal-agent theorists, operate to limit the ability of managers to

10. See Michael C. Jensen and William H. Meckling, Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976).

shirk—to use corporate resources in ways that diverge from the best interests of shareholders. These agency-cost-limiting devices include (1) direct monitoring of managers' actions, (2) bonding agreements by managers that will result in the imposition of penalties or other costs if certain objectively verifiable events do or do not occur, and (3) incentive schemes to align managers' interests with those of shareholders. All of these devices to limit agency costs involve expenses that reduce the net value of the return from operation of the modern corporation. Moreover, some amount of shirking—the *residual loss*—will occur despite the implementation of agency-cost-limiting mechanisms. Thus, the gains for the shareholders/principals from operating as a modern corporation will be reduced by the sum of (1) the cost of agency-cost-limiting mechanisms and (2) the residual loss. At the margin, agency-cost-limiting mechanisms are justified only to the extent that the net return to shareholders is greater than would be the case without such expenditures.

Thus, from the principal-agent perspective that came to dominate policy-maker views in the last three decades of the twentieth century, separation of ownership and control is not the central problem posed by the modern corporation. Rather, separation of ownership and control is the optimal state of affairs—the contractual allocation of rights and responsibilities for which owners and managers have bargained. Writ large, the contractarian view sees the corporation as a consensual association of value maximizing individuals whose contractual autonomy must be acknowledged and protected. In this ideological and theoretical rethinking of the modern corporation, the role of government as regulator, and the interests of non-shareholder constituents and society as a whole, take a back seat to the goal of shareholder wealth maximization.

6. The New Millennium: Corporate Scandal, Financial Crises, Corporate Governance, and Government Regulation

The new millennium saw three significant shocks to the American economy and, particularly, to the nation's faith in corporate executives and in the wisdom of investing in corporate stock. The first shock, in 2001, commonly identified with the collapse of Enron, involved fraudulent accounting by numerous corporations for the purpose of artificially inflating the value of corporate stock. The second, commencing in 2008, involved the collapse of major financial and industrial institutions that had undertaken excessive risk. The third was the stock market drop and economic shutdown precipitated by the global COVID-19 pandemic that began in March 2020. These events reinvigorated debate about the nature of firms and the role of government regulation. While insights from the contractarian view of the corporation and the principal-agent theorists have not been discarded, these views are now placed in a broader context. As you journey through this book, you will have many occasions to evaluate the various theories of the firm, and assess their strengths and weaknesses. Clearly, however, there is renewed interest in exploring two topics—governance and government regulation—and clearly there is more awareness of the fundamental insights of Berle and Means.

The renewed emphasis on governance builds on Berle and Means's insight that the modern corporation does not have a traditional entrepreneur/owner. Rather, the corporation has managers who in most cases own a very small percentage of the corporation's stock. The renewed emphasis on governance takes seriously the power of the modern corporation highlighted by Berle and Means, and both the potential for good and the threat to society that this power poses. In addition to concern for wealth maximization and protection of shareholders, the current debate includes the influence of the modern corporation on broader issues—human health and happiness, climate change, global poverty, and women's roles in male-dominated societies.

The current focus on governance addresses central questions, whose answers are of interest not only to shareholders but also to other corporate constituents, and to society as a whole. How is the modern corporation governed? How should it be governed? How will decisions be made concerning the allocation of resources within the firm? Who will decide whether to locate a new plant in America or Uganda? Who will decide whether to dedicate 1 percent of the firm's gross revenue to charitable contributions, improve health and safety standards, or increase dividends to shareholders? Who will decide the short- and long-term goals of the firm? What structures, systems, and processes will yield the optimum operation of the firm for the benefit of owners, managers, employees, and society as a whole?

The new millennium also has seen an increased emphasis on government regulation of the modern corporation, both in the United States and abroad. More so than in prior periods, the federal government has exercised its legislative and regulatory authority to shape how American corporations are governed. These changes include requirements that corporate boards of directors be more independent, federal bailout of troubled financial and industrial firms, limits on the amount and structure of executive pay, creation of costly new accounting regimes, increased financial disclosure requirements, and expansion of shareholders' rights to initiate changes in corporate governance structures. Not since the New Deal have we seen government so active in the regulation of the modern corporation.

B. Organizing the Firm: Selecting a Value-Maximizing Governance Structure

1. Business Planning: The Role of the Corporate Lawyer in Organizing a Firm

Where do firms come from? How are they created? In order to understand the modern corporation (which will be a primary focus of much of this book), you must understand how a basic business association is created and governed. You must also understand the fundamental, creative, value-maximizing role played by the corporate lawyer.

The corporate lawyer is a planner. At the birth of a firm, she will assist the prospective venture in the creation of an appropriate initial governance structure, and as the venture grows she will assist in adapting the organization as required by changed circumstances. The experienced corporate lawyer will understand and apply several concepts that will be introduced in the remainder of this section. First and foremost she will be a transaction-cost engineer. She will understand that human beings are cognitively limited, usually seek to promote their own self-interest, and have a propensity to act opportunistically in certain circumstances. Necessarily, then, the planner must understand when opportunism is likely, and suggest an organizational structure that will minimize the expected costs of future opportunistic behavior by employees, managers, or owners. However, to students steeped in law school's emphasis on litigation, we stress an important point that all experienced corporate lawyers keep in mind: owners and managers of firms have a strong, usually rational, preference for private ordering over court ordering. That is, when a firm encounters a need, or asserted need, to adapt to changed circumstances, it is usually more efficient, and often more consistent with the pre-dispute expectations of owners and managers, for those disputes to be resolved pursuant to the internal decision-making processes of the firm, rather than by resort to litigation and a judicially imposed solution. Accordingly, the corporate lawyer must understand how to select and modify governance structures so as to optimally minimize the use of litigation as a governance tool, while preserving the availability of litigation to deal with circumstances that cannot be appropriately governed solely by private ordering. Moreover, the good corporate lawyer must understand the governance role of markets and intra-firm culture. To the extent these extra-legal institutions can be expected to give managers and employees strong incentives to voluntarily use their best efforts on behalf of the firm, the experienced corporate lawyer will recommend organizational structures that de-emphasize governance via court ordering.

2. The Goal of Informed Rational Choice Between Competing Investment Options

a. Comparative Search for Best Investment

Participants in our market economy are constantly faced with investment decisions. Every participant has a store of human capital — a set of skills or an ability to render services. And many participants also have money capital — cash, cash equivalents, or other investment property that can be valued in terms of money. Economists assume that a rational person chooses her career, and adjusts that choice as circumstances change, in order to maximize the value of her human capital. Likewise, rational individuals with money capital deploy and redeploy those resources in a search for maximum value.

The search for maximum value requires rational investors to take both a comparative and an ex ante perspective.[11] The perspective is comparative because a determination of the best investment decision involves a weighing of plausible alternatives. The perspective is ex ante because the goal is to predict which investment strategy will yield the optimal result. It may turn out afterwards, from an ex post perspective, that some road other than the one actually taken would have been more advantageous. Nevertheless, all of us must make our investment decisions before actual outcomes are known.

Consider the investment situations of Sharon and Jake. Sharon is a sales representative for a national brewery. Jake, a friend of Sharon, is the head brewmaster at a different firm. Jake and Sharon have discussed the possibility of joining forces in

11. *Ex ante* literally means "from before." The choice of heads or tails before a coin is flipped is a decision made from an ex ante perspective — that is, before we know the outcome. *Ex post* literally means "from after." Once the coin is flipped, we know the outcome. Any decisions related to that outcome are made from an ex post perspective.

a brewing venture. Jake's role would be to manufacture a high-quality beer with a unique and pleasing taste. Sharon's role would be to develop a substantial market for this product. Recently, Sharon inherited $200,000. She is now considering the following three alternative uses of her human capital and the inherited money capital.

Alternative 1. Sharon can continue to work for her current employer and invest $200,000 in U.S. Government bonds, maturing in one year and paying interest at the rate of 8 percent per year. At the maturity date Sharon would be entitled to receive $216,000.

Alternative 2. Sharon can continue to work for her current employer and invest $200,000 in bonds issued by the Atomic Energy Corporation, which mature in one year and promise to pay interest at the rate of 20 percent per year. At the maturity date, Sharon would be entitled to receive $240,000.

Alternative 3. Sharon can quit her job and invest both her human and newly acquired money capital in the brewery venture with Jake. Sharon believes that a $200,000 investment in the brewery could be worth $500,000 in one year, but realizes that less favorable outcomes are quite possible.

In the following sections we will identify the economic factors that might influence Sharon's investment decision. Keep in mind that should Sharon favor Alternative 3, she will be able to pursue it only if Jake also believes that the proposed venture is the best use of his capital.

b. Risk and Return

In comparing investment options, individuals attempt to determine the likely return from alternative investment choices. Financial theorists describe this process as a determination and comparison of "expected return." For some investments a rational person might foresee only one possible outcome. In such cases, the one foreseeable outcome is also the expected return from the investment. But for most investments there will be a range of possible outcomes. The expected return for these investments is determined by first multiplying each possible return by its probability, and by then summing these products.

For example, as hypothesized above, Sharon is considering three investment options. Alternatives 1 and 2 have different promised outcomes: Alternative 1 promises to pay Sharon $216,000 in one year, while Alternative 2 promises to pay Sharon

Alternative 1

(Investment of $200,000 with Promised Return of $216,000)

Possible Return	*Probability*	*Possible Return × Probability*
$216,000	1.00	$216,000
		Expected Return = $216,000

Alternative 2

(Investment of $200,000 with Promised Return of $240,000)		
Possible Return	*Probability*	*Possible Return × Probability*
$240,000	0.90	$216,000
-0-	0.10	-0-
		Expected Return = $216,000

$240,000 in one year. Under the assumptions outlined below, however, each of these investments has an expected return of $216,000.

While Alternatives 1 and 2 have the same expected return, Alternative 2 is "riskier" than Alternative 1 (which, in fact, would be described as a "risk-free" investment). As used here, "risk" means the degree to which the various possible outcomes will differ from the expected return. When the range of possible returns is zero, as in Alternative 1, the investment is risk-free. If Sharon purchases the Atomic Energy Corporation bonds, she runs a greater risk of receiving less than the expected return. On the other hand, the Atomic Energy Corporation bonds hold out the promise of a higher return than the U.S. Government bonds 90 percent of the time. Thus, risk is not necessarily bad, for with it comes the chance of greater reward.

Whether Sharon will prefer Alternative 1 or 2 depends on her taste or preference for risk. To some extent that preference may be a deeply ingrained behavioral characteristic over which Sharon has no control. Nonetheless, Sharon's risk preference is likely to be affected by the magnitude of a particular risk in relation to her existing wealth, and by the effect of this new investment on the riskiness of her existing portfolio.

Investors are generally characterized as "risk averse," "risk neutral," or "risk preferring." If Sharon is risk averse, then she will prefer the risk-free government bonds to the riskier corporate bonds. If Sharon is risk neutral, then she will be indifferent to a choice between Alternatives 1 and 2. Each promises the same return, and, since Sharon is risk neutral, she is unaffected by the greater risk presented by Alternative 2. If Sharon is risk preferring, then she will choose Alternative 2, gambling in effect that she will avoid the 10 percent chance of no return and receive the greater return promised, but not guaranteed, by Alternative 2.

An investor's risk preference will likely differ according to the circumstances. For example, if a relatively small amount is at stake, normally risk-averse individuals may actually be risk preferring, or at least less risk averse. A good example is a $1 lottery ticket. Many normally risk-averse investors might prefer lottery ticket A, which has one chance in one thousand of paying $600, to lottery ticket B, which has one chance in two of paying $1.20, even though both tickets have an expected return of $0.60. Likewise, Sharon is likely to have a greater taste for risk if the $200,000 she is investing is but a small part of her wealth than if she is investing a significant portion of her money capital.

Risk-averse investors often minimize risk by diversifying their portfolios. For example, suppose that Sharon has a total of $400,000 in money capital—the recently inherited $200,000 and a $200,000 investment in bonds of United Airlines Corporation. Furthermore, assume that the United Airlines bonds and the Atomic Energy Corporation bonds Sharon is considering buying have an identical expected return and riskiness. Finally, assume that the events that will cause either of these bonds to deliver a $0 payout can be identified and will not overlap. In such circumstances, a risk-averse Sharon would actually prefer Alternative 2 because such investment will decrease the overall riskiness of her portfolio.

If a $0 return occurs with respect to Sharon's investment in United Airlines bonds, it will be partially offset by a $240,000 return on the Atomic Energy Corporation bonds. If, instead, Sharon invests her inherited funds in U.S. Government bonds (Alternative 1), a $0 return on the United Airlines bonds will be offset by only the $216,000 return promised by Alternative 1. In the described circumstances, Alternative 2 is actually a less risky investment for Sharon than Alternative 1, the so-called risk-free investment.

In technical terms, Sharon is able to achieve a less risky portfolio by diversifying her holdings so that the range of possible outcomes varies less from the expected return—or mean of possible outcomes—than before. In other words, the more diversified the portfolio becomes, the less will be the possible disparity between actual and expected total returns.

Of course, Sharon will only pursue a portfolio diversification strategy if she is risk averse. Moreover, such a strategy depends for its success on being able to discover that the events that will cause one investment to produce a lower than expected return will cause another investment to produce a higher than expected return.

The foregoing analysis draws on Sharon's options for investing her money capital. However, the same analysis is appropriate for human capital investments. Sharon must not only consider the expected return from various uses of her human capital but also the riskiness of such paths. Her current job may offer a lower expected return on her human capital than does the contemplated venture with Jake (Alternative 3), but it also may offer a much more certain return. Moreover, since it is impossible to own another human being, it will be difficult for Sharon to diversify against risks inherent in certain uses of her human capital.

3. Transaction Costs and Choice of Organizational Form

a. Introduction

As we bring Alternative 3 into focus, the proposed brewery venture with Jake, the complexity of the ex ante investment selection process increases. If Sharon and Jake choose to pursue the brewery venture, they must agree on how to structure their relationship.

We can assume that at the outset of their venture Sharon and Jake share two expectations: (1) that both will use their best efforts to make the venture successful, and (2) that profits will be divided according to their relative contributions. To maximize the probability that these expectations will be fulfilled, Sharon and Jake could embody their understanding in a long-term contract. Alternatively, they could structure their relationship as sole proprietor and agent, a partnership, a limited liability company, or a corporation. This section introduces the role of transaction costs in determining the most efficient solution.

b. Transaction Cost Factors

Transaction cost economists, principally Ronald Coase, Armen Alchian, and Oliver Williamson, have identified the behavioral and economic factors that explain why particular transactions are most efficiently organized in a particular way. In discussing transaction costs, economists commonly use three terms that will be helpful to your study of corporations and other business associations. These terms, discussed below, are *bounded rationality, opportunism,* and *team-specific investment.*

Bounded rationality. While individuals intend to act rationally, there are cognitive limits, or bounds, on their ability to do so. There are simply too many variables to be considered. Thus, Sharon will intend to value accurately Alternative 3, the brewery venture, and will intend to structure her relationship with Jake in a value-maximizing way. Nonetheless, bounds on her rationality will limit the accuracy of her judgments.

Opportunism. Economists assume that individuals pursue their own self-interest in economic matters. However, there are two categories of self-interest seeking. In simple, or open, self-interest seeking, economic actors prefer their own interests to those of other economic actors, but do so while being honest and aboveboard in their dealings. Opportunism is self-interest seeking with guile: individuals who act opportunistically seek to further their own ends by taking advantage of the information deficits of those with whom they deal. An opportunistic actor seeks to extract an advantage that would be denied him if the party with whom he deals had full information. As Oliver Williamson puts it, "opportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse."[12]

Team-specific investment. If Sharon and Jake pursue the brewery venture, they may usefully be described as a team, and their collective activities in making and marketing beer may be described as team production. When a person or asset has a higher value in its current team use than its value in its next best use, the person or asset is said to have team-specific value.

Suppose, for example, that Sharon owns and operates a generic beer distributing business and that Jake owns and operates a generic beer brewery. Sharon buys generic beer for resale to grocery stores. She currently buys from Jake, but there are other brewers who would supply generic beer on similar terms. Likewise, Jake currently sells his product to Sharon, but there are other distributors who would purchase his output on similar terms. If Jake and Sharon stopped dealing with each other, thereby terminating their team, neither would experience any loss in the value of their human or money capital because they could continue to earn the same return by dealing with others. Accordingly, neither Jake's nor Sharon's investments are team-specific.

On the other hand, suppose that Sharon is in the business of distributing only the special beer that Jake produces and that there are no other suppliers who can give her

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12. Oliver E. Williamson, The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting, 47 (1985).

an equivalent product on similar terms. Further, suppose that Jake distributes his beer only through Sharon and that there are no replacement distributors who would purchase the same volume or pay the same price as Sharon. If Jake and Sharon stopped dealing with each other, thereby terminating their team, both would experience a loss in the value of their human or money capital. Thus, Jake's and Sharon's investments would be described as having team-specific value.

c. Discrete and Relational Contracting

One response to the problem of opportunism is to negotiate and execute a contract that specifies the rights and duties of the parties, thereby creating an explicit team. The appropriate contractual strategy depends on the team's expected duration and need to adapt.

In *discrete contracting*, the parties have no preexisting obligations to each other. As they approach a contemplated venture, they negotiate a contract that anticipates and provides a rule governing all contingencies. Nothing is left to be worked out in the future. For example, Sharon and Jake might enter into a long-term contract specifying both their initial obligations and how, if at all, such obligations will be affected by future events. Jake might be required to produce a certain quantity and quality of beer, which Sharon is required to purchase at a set price. However, the contract might specify, in detail, what objective factors would entitle either party to a price or quantity change.

Discrete contracting is most likely to be successful when the team's expected duration is short and the number of exchanges between team members will be few. As the duration and frequency of exchange increase, bounded rationality makes it increasingly more likely that the parties will specify an inappropriate rule for a particular contingency, or that the parties will fail to identify and specify a result for a relevant contingency.

Relational contracting is a response to the defects of discrete contracting. In relational contracting, parties do not attempt to provide an answer to all contingencies at the time the relation commences. Instead, they attempt to build a governance structure that will allow them to solve problems when, and if, they arise. The goal of relational contracting is to reinforce the relation itself. The hope is that cooperation and harmony will become ingrained norms of the relationship, and that the parties will continue to deal with each other in good faith even when facing difficult adjustment problems.

Contracts that contain relation-reinforcing provisions will not eliminate the threat of opportunism. By giving parties express permission to seek renegotiation, the risk of opportunistic refusal to renegotiate may be less than in a discrete contract, but the threat of opportunistic requests for readjustment may be greater. Moreover, because of bounded rationality, courts may find that a contract is discrete when the parties intended it to be relational, and vice versa.

d. Deciding to Organize as a Firm

When a team is organized via contract, team members retain ownership and control over the productive assets used to produce their part of the team's goods or services. The autonomy of each team member makes it difficult for a team to adjust to changed circumstances and exposes the team to the costs of opportunistic threats of withdrawal. If a team member becomes less valuable than was expected ex ante, he may be reluctant to agree to a readjustment of his contract that accurately reflects his current value to the team. Likewise, if a team member becomes more valuable than was expected ex ante, other team members may be equally reluctant to grant an upward adjustment in the payment that team member will receive. Additionally, team members may request adjustments when an omniscient observer, but not other team members, would be able to see that the request is unjustified. As a result, teams organized via contract will experience substantial costs from having team members' compensation and incentives misaligned and from the haggling to correct these misalignments that results.

The advantage of organizing as a firm is the avoidance of these haggling costs. As Coase noted, a key aspect of a firm is the allocation of resources at the direction of the entrepreneur. The owner's power to make unilaterally all management decisions—what is made, how it is made, who is hired and fired, and who is paid what—allows the firm to adapt quickly to changed circumstances.

The potential disadvantage of organizing as a firm for an employee is that in surrendering autonomous control over her own business she becomes subject to the employer's opportunism. Thus, a key organizational problem for all firms is how to optimally minimize the risk to which the employee is so exposed. A key organizational problem for jointly owned firms is how to allocate management rights and responsibilities between and among co-owners and how to ensure that the entrepreneurial function carried out by the entrepreneur in the classic firm is carried out efficiently in a firm where ownership power is not united in one person.

4. State-Provided Governance Structures

a. Entity and Employment Law as Standard Form Contracts

When individuals choose to organize their business relationship by assuming roles within a firm, they do so with certain reasonable expectations in mind. It may be necessary to protect some of these expectations by contract, but it will not be necessary to draft contracts from scratch to cover every possible expectation or concern. Instead, by structuring the relationship as that between employer and employee, or as a corporation, partnership, or LLC, the parties receive the benefit of state-provided rules and dispute resolution processes. Thus, the employer-employee relationship, the corporation, the partnership, and the LLC are often described as state-provided standard form contracts.

b. Default Versus Immutable Rules

Most of the off-the-rack rules found in each state-provided standard form are "enabling" in the sense that they provide parties with default rules that govern the relationship if the parties do not provide otherwise. To the extent that parties prefer, they may modify or change these default rules.

In some instances, however, the rules provided by law are immutable and cannot be "trumped" by private ordering. Some such mandatory rules exist because lawmakers fear the negative effect on third parties of allowing firms to adopt a different rule. Other immutable rules may be designed to protect firm members from their own contracting mistakes.

Every good business lawyer must know the standard form rules—the legal bargain—that are provided by the employment relationship and by corporate, partnership, and limited liability company law. However, it is critically important to understand which of these rules are default in nature, how the default rules of each form differ, and what makes these rules efficient or inefficient for a particular set of prospective team members. It is equally crucial to understand which rules are immutable, and whether these immutable rules will serve the interests of a particular member of the firm.

As you proceed through this book, be sure to determine whether a rule falls into the default or immutable category. And do not be surprised if you encounter some rules that are partially default and partially immutable. For each rule consider what economic or legal factors explain both its content and its immutable or default character. And be ever on the lookout for misguided paternalism.

c. Tailored, Majoritarian, and Penalty Default Rules

If lawmakers are efficiency-minded,[13] they will set default rules so as to maximize team members' ability to adapt to changed circumstances while minimizing their exposure to opportunism. To choose the appropriate rule, lawmakers must appreciate the difference between tailored, majoritarian, and penalty default rules.

Tailored rules are designed to give contracting parties the exact rule that they would themselves have chosen if they had been able to bargain costlessly over the matter in dispute. The availability of tailored results via ex post judging allows parties to avoid the costs of negotiating and executing a contract specifically covering all possible contingencies. However, providing tailored rules is a very problematic undertaking because of bounded rationality. How is a lawmaker to know what rule the particular parties would themselves select?

Any default rule could be said to be a tailored rule for parties that do not vary the rule by contract. But how do we know that their failure to vary was not the product of ignorance? How do we know that they did not simply trust each other's good faith and assume that the default rules would be adjusted as, and if, appropriate?

If the tailored result is to be provided by ex post judging, then bounds on the knowledge of judge and jury will make it difficult to determine the rule for which the parties would have bargained if transaction costs had been zero. Each party will have her own, perhaps opportunistic, account of the past. Each party will be represented by counsel who seeks to persuade the court of the merits of her own case.

Even if courts are able to arrive at "tailored" results, such an achievement may often be hollow. Society and the parties themselves bear substantial litigation costs in arriving at the tailored result. Since no two firms or set of team members are exactly the same, the availability of tailored results to be provided by ex post judging may discourage settlement of disputes because there is no "normal" rule that the parties can

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13. Credit for coining the wonderful term "efficiency-minded lawmakers" goes to Ian Ayres and Robert H. Gertner, Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules, 99 Yale L.J. 87 (1989).

expect will apply to their unique case. Moreover, the availability of tailored rules to be provided by ex post judging may discourage ex ante contracting because it is not clear what rule is to be contracted around.

Majoritarian rules are designed to provide investors with the result that most similarly situated parties would prefer. By abandoning the search for tailored rules, lawmakers may make assumptions about the contracting needs of prospective members of a firm and provide rules that will suit a large number of them. Those who do not like the rules provided may vary them or simply choose another business form that has a more suitable set of rules.

Both tailored and majoritarian rules can be described as designed to provide contracting parties with the rule that they would have bargained for in a cost-free environment. However, advocates of tailored rules are speaking literally. They seek the result each particular litigant actually would have chosen. Advocates of majoritarian rules speak metaphorically. In essence they seek the rule that will best protect the rational ex ante expectations of parties similarly situated to the contracting parties.

Penalty default rules are designed to motivate one or more contracting parties to contract around the default. The goal of penalty defaults is not to economize on ex ante transaction costs. Instead, the goal is to force the parties to specify their own rules ex ante, instead of relying on a default rule provided by law. For example, a default rule might be intentionally set so as to penalize some or all of the parties as a means of forcing them to negotiate a rule that they prefer. Such a rule may be motivated by a desire to force the parties to share information with each other about their true intentions, rather than allowing the parties to simply adopt a set of standard form rules without revealing their true intentions. Or it may be motivated by lawmakers' desire to avoid the social cost of providing rules to parties via ex post judging, the cost of which is partially subsidized by society.

As you encounter the state-provided default rules for each form of business association, consider whether they can best be explained as an attempt to provide tailored, majoritarian, or penalty default rules. If possible, identify the factors that explain why the particular rule is so structured.

5. Nonjudicial Mechanisms That Supplement and Reinforce Private Ordering

a. The Governance Role of Markets

A variety of markets play an important role in the governance of firms and in how efficiency-minded lawmakers design the rules of business associations. These markets act to ensure that team members perform their services diligently and loyally, and otherwise to protect the reasonable expectations of investors in jointly owned firms. In so doing they make it less necessary for team members to engage in costly private ordering and make it less necessary for lawmakers to intercede.

The product market. Firms compete against each other in the production and sale of goods and services. If team members perform without sufficient skill and diligence, the firm will be at a competitive disadvantage. If the lack of skill and diligence is extreme, the firm may actually go out of existence.

The capital market. From time to time firms need to raise additional capital. To do so, they must compete with other firms that also seek capital. Prospective capital providers will seek the best return on their investment. Firms that are not well run will find that their costs of capital, in the form of interest charges, for example, are higher than the costs of efficiently run companies.

The national securities markets. The ownership rights (commonly called "stock") of most larger firms will be frequently traded in one or more of our national securities exchanges. These markets provide liquidity to investors by permitting them a rapid and near costless means of buying or selling their investments. As discussed in more detail in Chapter 3, these markets are thought to provide a constantly changing, accurate measure of the relative value of publicly traded firms, and by extension, an accurate measure of the value of their managers. To the extent that this is true, the need for judicial and regulatory checks on managers' conduct may be lessened.

The labor markets (including the market for managerial services). Most individuals realize the value of their human capital by selling their services in the labor market. Once they obtain employment, they cooperatively compete with other employees for various rewards, including the good reputations that will make it possible to advance within the firm or change jobs. If an employee is not considered to be diligent and loyal, he is unlikely to advance within the firm and is unlikely to receive good evaluations while employed or good recommendations upon departing. If his performance is sufficiently unacceptable, he may be discharged from the firm—imposing a costly reputational mark. But even if a team member is not identified by other team members as a slacker or worse, the team member's reputation may suffer if the firm, as a whole, is doing poorly.

Thus, the discipline of the labor markets may significantly reduce the need for ex ante contracting or the setting up of costly monitoring systems. For senior executives, this discipline is supplemented by the valuations made by the stock markets. Moreover, the reputational costs imposed by exposure as a negligent or dishonest team member may deter such conduct more effectively than fear of legal action.

b. The Role of Trust

Trust and trustworthiness are factors that economists generally leave out in analyzing why firms serve, or can be structured to serve, the interests of team members better than organization via contracts between autonomous producers. Consider the comments of Professors Blair and Stout:

> Social scientists have long argued that evolution can favor the development of a capacity for altruism in social organisms such as *homo sapiens*. This is because "irrationally" cooperative behavior within a particular group (including but not limited to trust and trustworthiness) often enhances the group's overall welfare. If the group does well, members of the group on average also do well. . . .
>
> For similar reasons, cooperative behavior can be an important factor in the evolution not just of social organisms but also of social *institutions*. This is because groups whose members cooperate with each other can often thrive and grow at the expense of groups whose members do not

> cooperate. Social institutions that can promote and support trust among their participants can, as a result, have an evolutionary advantage over institutions that cannot.

Margaret M. Blair & Lynn A. Stout, Trust, Trustworthiness, and the Behavioral Foundations of Corporation Law, 149 Pa. L. Rev. 1735, 1753-1754 (2001). How best to foster trust between employees and the entrepreneur in the classic firm, and between all participants in the more complex publicly traded firm, is obviously a key issue for both lawmakers and business planners.

c. The Role of Norms

Most activity within a firm is governed not by judicially enforceable contracts, but by norms—non-legally enforceable rules and standards (NLERS). Firms that have effective NLERS get more loyal and diligent performance from team members than firms that do not, and, therefore, are more likely to succeed than firms with less effective NLERS.

> What are the NLERS? To some extent, this will depend on the individual firm. For example, the famous dress code of IBM in the 1960s requiring white shirts, ties, and dark suits was an IBM-specific NLERS. Most everyone did it, you were expected to do it, and you were sanctioned, either formally or informally, if you did not. Less trivially, the promotion of teamwork is an NLERS practiced in many firms. Other firms, however, may promote individual effort.
>
> One useful way of thinking of NLERS is that they form a great part of what is sometimes referred to as the firm's "corporate culture." Corporate culture can serve a coordinating function, making it more likely that employees will do what they are supposed to do when they are supposed to do it. NLERS play the intrafirm coordinating role that contracts play in market activity. Those that live up to or outperform the contract or NLERS expectations are credited, while those who do not are penalized with a range of sanctions including demotion, suspension, or dismissal. A principal difference, however, between NLERS and contracts is that when the parties disagree as to whether performance has been satisfied, courts can impose penalties in the latter case, but only the parties can do so in the former. . . .
>
> Within a firm, NLERS operate at many different levels. . . . For example, "discharge only for cause" in a world of employment-at-will is one of the prime NLERS that protects employees. Promotion from within to reward outstanding performance or seniority is another employment NLERS.
>
> Other NLERS involve the manner in which the firm determines whether an investment project should be undertaken. The use of discounted present value for this purpose is an NLERS observed in many firms. . . .
>
> NLERS also are not invariably efficient, socially beneficial, or conducive to the success of the firm. Some seem to help the firm succeed, like the NLERS of high-tech firms that lead engineers to work intensely on critical projects. Others may interfere with success, like the NLERS of not working too hard that emerges in some industrial work places. In historically regulated industries, all types of suboptimal, cost inefficient practices thrived and were protected and reinforced by the suppliers, unions, and others that benefited from them. These NLERS were sanctioned by the firms but were not socially efficient. For decades, racial, religious, and ethnic discrimination was an NLERS openly practiced by blue-chip firms. In some boardrooms, an NLERS is to accede to the wishes of the CEO regardless of her value to the firm. The decision by the board of Occidental Petroleum to build the Armand Hammer museum to house the CEO's unremarkable art collection was the result of such an NLERS. This type of NLERS is supportive of the executive officers but not the shareholders.

Edward B. Rock & Michael L. Wachter, Islands of Conscious Power: Law, Norms, and the Self-Governing Corporation, 149 U. Pa. L. Rev. 1619, 1642-1643 (2001).

C. The Firm and the Law of Agency

1. Introduction

In this section, we examine the role of agency law in the governance of the firm. Agency law may be thought of as a set of standard form rules that provide a backdrop for contracts or market transactions among team members. Agency law governs both relations between team members in a firm and relations between the firm and outsiders. Our examination of both the sole proprietorship and agency law is limited. We focus only on the fundamental factors that affect the decision to operate as a firm, and on those elements of agency law that have direct relevance for both the sole proprietorship and the jointly owned firm. We will then be ready to begin our study of the partnership and corporate forms.

2. Agency Law and the Choice of Sole Proprietorship Form

Restatement (Third) of Agency §§1.01, 1.02, 1.03

A firm is created simply by unifying the ownership and control of the team in the hands of one or more owners, referred to in agency law as the principal, while other team members agree to serve as employees, generally referred to as agents. A principal signals her entry into the firm by investing her own money capital to acquire assets needed by the team, and by agreeing to employ one or more agents to carry out, under the principal's control, a portion of the team's work. Other team members signal their entry into the firm simply by agreeing to provide services to the firm subject to the dictates and control of the owner. At common law this mutual assent creates the relationship of principal and agent—the owner being the principal, the employees being the agents. Unless otherwise agreed, this relationship may also be terminated at will by either the principal or agent. However, so long as the relationship exists, the agent is subject to the principal's control with respect to the services that the agent has agreed to perform.

In a world where organization as a firm is legally indistinguishable from organization via contract, the firm would appear to pose the same risks and transaction costs as does organization via contract. The principal's power to discharge an agent at will gives the principal substantial power opportunistically to discharge, or threaten to discharge, an employee. Likewise, an employee can opportunistically threaten to withdraw, or can withdraw and thereafter convert to personal use information or skills acquired while in the firm's employ. Thus, in contemplating organization as a firm in this hypothetical world, it would often be necessary for principal and agent to enter a discrete contract specifying in detail what their various rights and duties will be.

In all jurisdictions, however, there is a significant difference between organization as a firm and organization outside of a firm via long-term contract. The right of selfish action by proprietor and agent is not absolute. The law of agency imposes a fiduciary duty on agents, and other legal doctrines impose some limits on the principal's right to discharge an employee. Thus, the need to limit contractually the right of action of either the proprietor or her agents depends, in part, on the extent to which adequate protection will be provided by ex post judicial enforcement of these state-provided rules. We examine these judicially supplied limits in the next two sections. To the extent these limitations obviate the need for contractual protection, organization as a firm may be less costly than organization via contract.

3. Fiduciary Limits on Agent's Right of Action

Organizing team production via market exchange between autonomous individuals maximizes the ability of individual team members to adapt to changed circumstances. However, team members will have minimal incentive to make team-specific investments. For example, suppose that Sharon and Jake organize a brewery venture as an implicit team—Sharon owns and operates a beer distributorship, and Jake owns and operates a brewery. Initially, Jake sells all of his product to Sharon, and Sharon develops a network of dealers to whom she sells Jake's beer. After the distributor network is well established, Jake may be tempted to deal directly with Sharon's customers, thereby appropriating the profit attributable to Sharon's sales efforts. Because there is no contractual relationship between Sharon and Jake, Sharon may have no legal remedy. Consequently, Sharon will be unlikely to develop the distributorship in the first place without obtaining contractual protection for her investment.

Suppose, instead, that the brewery venture is organized as a sole proprietorship, with Sharon serving as owner and Jake as an employee. Under the common law of agency, Jake now owes a fiduciary duty to Sharon. He must deal with her in total candor, must account to her for all profits flowing from information he receives in her service, must not use or disclose Sharon's trade secrets, and may not carry on a competing business until after the agency relationship is terminated. In short, Jake, as an agent, is required to prefer Sharon's, his principal's, interests to his own.

It is easy to look at fiduciary duty from a moralistic standpoint. After all, Sharon *owns* the brewery business. It is only *right* and *fair* that Jake be required to submerge his own self-interest in favor of Sharon's good. But this view may tend to obfuscate the function of fiduciary duty.

In part, if not completely, fiduciary duty is a contractual device supplied to Sharon and Jake by the state. As such, fiduciary duty substitutes for an express contractual specification of exactly what an agent may or may not do. A rational person in Jake's shoes might wish to make the promises inherent in fiduciary duty in order to convince Sharon that he will not act opportunistically during the course of the venture and, thereby, to induce Sharon to make a needed investment. Thus, we might say that in agreeing to become Sharon's agent Jake has impliedly acquiesced to the restrictions imposed by fiduciary duty. If Jake does act opportunistically, he runs the risk that a court will find that Jake has violated his fiduciary duty.

What, then, is the substantive content or meaning of fiduciary duty? You should begin to answer that question as you read the following cases. Since fiduciary duty is a central feature of both partnership and corporate law, you will have many occasions to revisit this question.

Community Counselling Service, Inc. v. Reilly

United States Court of Appeals, Fourth Circuit, 1963
317 F.2d 239

HAYNSWORTH, CIRCUIT JUDGE.

Community Counselling Service, Inc. sought an accounting from a former salesman-employee based upon allegations of disloyal promotion of his conflicting interests prior to the termination of his employment. The defendant, Reilly, filed a counterclaim seeking the recovery of salary and commission payments which the employer had withheld as an offset against its claim. . . .

CCS is a professional fund raising organization, working principally for Catholic parishes and institutions. Reilly, without prior experience in this type of professional fund raising, was employed by CCS in March 1957. Assigned as an associate director, he assisted in the conduct of a campaign and later, as a director, conducted campaigns to which he was assigned by CCS. In 1959, Reilly indicated an interest in a transfer from the operations division to the sales division of CCS. The transfer was effected, and, on July 1, 1959, Reilly became regional sales representative of CCS for the area between the northern boundary of Maryland and Georgia. As such, he was expected to seek out likely prospects and to convince them of the desirability of use of the services of CCS. He worked under the direction of CCS's sales manager in New York, to whom he was required to submit daily reports. He was assisted by his employer's distribution in the area of promotional materials and advertisements which featured Reilly as its regional representative who should be contacted by interested persons.

Campaigns for which Reilly secured contracts were not conducted by him or anyone in the sales division, but by the employees in the operations division.

For his services as regional representative, Reilly received a salary of $140 per week, plus commissions on an ascending scale, based upon sales in his area cumulated over the period of each year.

For a period of three weeks in November 1959, Reilly was temporarily assigned to operational work in Florida. Upon his return to the District of Columbia area and his resumption of his duties as Regional Representative, he failed to submit the written daily reports of his activities which were required of him.[1] The plaintiff's sales manager requested the resumption of daily reporting, but such reports were not forthcoming.

On January 4, 1960, Reilly presented himself at the New York office of CCS, and there informed the Vice President in charge of sales that he intended to resign. As the reason for his resignation, he stated that he wished to earn more money, that he wanted to do less travelling, and that his wife was ill. He stated that he thought he would go back to work for the federal government or into teaching, in which he had experience. The next day he wrote a formal letter of resignation, in which he stated that he was acting because of "urgent personal reasons."

1. There were some telephone conversations with his superior about his work. His last written report was dated October 30, 1959. While engaged in the conduct of the campaign in Florida during November no reports were required of him. After termination of his employment, Reilly submitted a cumulative sales report containing references to his contacts with St. Ambrose Parish. Before that report was made, however, the defendant had firmly secured the St. Ambrose campaign for himself, as will later appear.

The contract of employment required thirty days' notice of termination, but it was agreed on January 4, 1960 that Reilly's resignation would be effective as of January 29, a Friday.

Before the end of January 1960, a letter from the Archbishop of the Roman Catholic Archdiocese of Washington was received by CCS in its New York office. In this letter, the Archbishop stated that St. Ambrose Parish had already engaged the services of CCS for a campaign, and that two other campaigns were in the offing, and, if those eventuated, they would be in touch with Reilly as Regional Representative of CCS. Because the New York office had heard nothing from Reilly of the St. Ambrose Parish campaign, it asked Reilly to come to New York on January 25.

CCS's Vice President in charge of sales testified that at the conference in New York on January 25, he inquired of Reilly about St. Ambrose Parish. Reilly responded by saying that Monsignor Brown of St. Ambrose did not want the services of CCS but he wished those of Reilly. To the suggestion that until the end of the month he was obligated to undertake to sell the services of CCS rather than his own, he responded, according to the Vice President, "Do you expect me to walk out of here next Friday and not have a job?"

According to the Vice President, during the January 25th conference in New York Reilly also stated that Father Cahill and Monsignor Kennedy, pastors, respectively, of Our Lady of Mercy Parish and the Parish of St. John the Evangelist, wished him to run campaigns for their parishes.

There is no doubt but that Reilly actually conducted a campaign for Monsignor Brown's St. Ambrose Parish, commencing on February 8, 1960 and lasting into March. Reilly conducted a campaign for Our Lady of Mercy beginning in March 1960 and lasting until April. He conducted a campaign for St. John the Evangelist beginning in May 1960. For these three campaigns, respectively, he received fees of $6,720, $3,840, $6,720.

Though the campaign for St. Ambrose Parish actually began on February 8, 1960, Reilly, at the trial, testified he had not reached an agreement with Monsignor Brown, of St. Ambrose, until sometime after January 30. In his pretrial deposition, he had clearly and unequivocally testified that he had agreed to run the St. Ambrose campaign on some date between January 10 and January 29. Monsignor Brown, as a witness at the trial, testified that he had agreed with Reilly in January that Reilly would conduct the St. Ambrose campaign after the first of February or "at such time as he would be free to do it," or "after he got rid of the contract with the CCS people."

Reilly, as CCS's sales representative, had been in touch with Father Cahill, of Our Lady of Mercy, in October 1959. Father Cahill was undertaking the formation of a new parish and was interested in procuring the services of CCS. Because of conflicting campaigns, however, he did not obtain permission of the Archbishop to actually conduct the campaign until sometime after the end of January 1960. Meanwhile, he remained in touch with Reilly. Father Cahill testified that early in 1960 he learned from Reilly of Reilly's intention to leave the employ of CCS. He testified that there may have been discussions between him and Reilly regarding Reilly's availability to conduct the campaign for Our Lady of Mercy.

According to the testimony for CCS, Reilly spoke on January 25th of the fact that Father Cahill wished him to conduct the imminent campaign for Our Lady of Mercy.