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Close Corporations and Agency Costs

Frank H. Easterbrook*
Daniel R. Fischel**

The economic analysis of publicly held corporations has exploded in recent years.[1] Yet there has been little attention to the more common corporate form of organization, the closely held corporation.[2] This is not because one analysis will cover both. There is a fundamental difference between closely and publicly held corporations. Risk bearing and management are separated in publicly held but not in closely held corporations. The presence or absence of this separation of functions determines the governance mechanisms that have evolved in the two types of firms.[3]

One central problem in the academic work on closely held corporations is the extent of conflicts of interest. Some econo-

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** Professor of Law, University of Chicago. We thank Timothy Brennan, George W. Dent, Jr., Thomas Jackson, Geoffrey Miller, Steven Shavell, and the participants in workshops at Georgetown, Harvard, and New York University for helpful comments on earlier drafts. This essay is part of a larger project, *The Economic Structure of Corporate Law*, on which the authors are at work.

1. The work is too extensive to cite in detail. For a small sample, see R. WINTER, GOVERNMENT AND THE CORPORATION (1978); Easterbrook & Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698 (1982); Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857 (1984); Manne, *Mergers and the Market for Corporate Control*, 73 J. POL. ECON. 110 (1965). Economists, lawyers, and even sociologists have joined the effort to understand the economic basis of corporate law. *See* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS (J. Pratt & R. Zeckhauser eds. 1985).

2. The only systematic attempt to analyze the law of closely held corporations from an economic perspective is Manne, *Our Two Corporation Systems: Law and Economics*, 53 VA. L. REV. 259 (1967).

3. This dichotomy between closely and publicly held corporations is useful for purposes of analysis even though it does not capture all of the variations. Managers in publicly held corporations, for example, typically own a significant amount of their firm's shares so that they bear some risk. *See* Demsetz & Lehn, *The Structure of Corporate Ownership: Causes and Consequences*, 93 J. POL. ECON. 1155 (1985). On the other hand, many "close" firms are financed by venture capital, separating management functions from risk bearing. We employ the dichotomous treatment in the text to illustrate the different kinds of incentives and structures in play, not to suggest that firms fit only two molds.

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mists argue that because the same people typically are both managers and residual claimants in closely held corporations, agency problems are minimized.[4] Other scholars believe that shareholders in closely held corporations face unique risks of exploitation.[5] This group of commentators has proposed legal rules ostensibly drawn from partnership law, including especially strong fiduciary duties and rules allowing shareholders of closely held corporations to withdraw their investment from the firm.

Neither side has made a very good case. It is not useful to debate whether conflicts of interest are more or less severe in closely or publicly held corporations. Each organizational form presents its own problems, for which people have designed different mechanisms of control. At the margin, the problems must be equally severe, the mechanisms equally effective—were it otherwise, people would transfer their money from one form of ownership to the other until the marginal equality condition was satisfied. Because the world contains so many different investment vehicles, none will offer distinctively better chances of return when people can select and shift among them. Most people can work for either public or closely held firms, and public firms pay in cash or tradable shares. A closely held firm that insists on joint management and investment must offer a better deal to attract capital. Even if there are some skills for which there is no market in publicly held firms, there are tens of thousands of closely held firms that must compete against each other for talent and capital. This competition requires firms to make believable (i.e., enforceable) promises of an equal or greater anticipated return in order to attract capital. Closely held firms may generate some special returns; if family owned ventures reduce the agency costs of management, there will be gains for all to share. The most the controlling parties of any closely held firm can do is to deny outside investors these extra gains, which economists call rents. The parties who possess the scarce resource, the elusive ability to create these gains, will get rents. The firms, however,

4. *See* Fama & Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Fama & Jensen, *Agency Problems and Residual Claims*, 26 J.L. & ECON. 327 (1983).

5. *See, e.g.*, Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 6 (1977) ("The position of the minority in a close corporation is as unique as it is precarious: no other form of business organization subjects an owner to the dual hazards of a complete loss of liquidity and an indefinite exclusion from sharing in the profitability of the firm."); *see also* F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS (1975).

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must promise to outsiders, and on average deliver, at least the competitive risk-adjusted rate of return available from other sorts of ventures.

Things may go awry in closely held firms, as in other firms. Promises may be disavowed and expectations dashed. But the anticipated return, taking into account the prospect of such ill events, must be equal at the margin for all kinds of firms. As a result, there is no reason to believe that shareholders of either closely or publicly held corporations will be more or less "exploited." No *a priori* case can be made for greater legal intervention in closely or publicly held corporations.

This paper proceeds as follows: Part I discusses the economic structure of the closely held corporation. Part II analyzes the contractual monitoring mechanisms designed to minimize agency problems in close corporations and discusses the enforceability of these contractual arrangements. Part III focuses on the costs and benefits of legal rules designed to assist minority shareholders in closely held corporations and analyzes critically the argument that legal rules for closely held corporations should approximate those for partnerships. Part IV is a conclusion.

I. The Economic Structure of Closely Held Corporations

Closely held corporations tend to have certain common characteristics. Most importantly, they tend to have relatively few managers, who tend to be the largest residual claimants.[6] Because the firm's principal investors are also its managers, it is often necessary to restrict the investors' ability to alienate their shares. Such restrictions increase the probability that those who manage will be compatible. When the firm begins as a familial venture, the restrictions also ensure that control remains in the family, which may aid in reducing opportunistic conduct. Both the restrictions on alienation and the apportionment of jobs become more important when, as often happens, the firm decides to distribute its profits as salary; salaries are (usually) deductible to the firm and thus reduce the taxes it pays. Once the distribution of profits is divorced from formal ownership of shares, it is

6. These characteristics also describe sole proprietorships and moderately sized partnerships. *See* Fama & Jensen, *Organizational Forms and Investment Decisions*, 14 J. FIN. ECON. 101 (1985).

essential to use contractual devices to keep people in a position to receive the return on their investment.

When the same people both manage and bear the risk of investment, the firm loses the benefits of specialization of function. Because those who manage must also be willing to put up capital and bear risk, the pool of qualified managers is smaller. Similarly, investors in closely held corporations have large percentages of their wealth tied up in one firm and lack access to capital markets. Thus they are less efficient risk bearers than investors in publicly held corporations, who may diversify a larger portion of their portfolios. Nevertheless, when projects are sufficiently small that they do not require a large number of managers with specialized expertise or enormous amounts of capital, closely held corporations may have a comparative advantage.

The primary disadvantage of the closely held corporation—lack of specialization—is also its primary advantage. Because the number of participants is small and because they both manage and bear the costs of their actions, each is more likely to find that what is good for him is also good for the firm (and for the other participants). All else equal, managers who own a large percentage of the outstanding shares of a firm will work harder and engage in less self-dealing than managers who own a smaller percentage. Moreover, the relatively small number of residual claimants in closely held corporations facilitates contracting (as discussed in part II below) and monitoring to reduce agency problems.

Participants in closely held corporations frequently have familial or other personal relations in addition to their business dealings. The continuous and non-pecuniary nature of these relationships reduces agency problems. The bond between parents and children, for example, constrains conflicts of interest.[7]

On the other hand, investors in closely held corporations lack a public market for claims. (We refer to claims as shares or equity, but the debt in close corporations also may be a residual claim.)[8] The absence of a liquid market has profound implica-

7. It is thus no accident that some of the famous cases dealing with closely held corporations involve situations where these informal bonds have broken down as a result of death or divorce. *See, e.g.*, Galler v. Galler, 32 Ill. 2d 16, 203 N.E.2d 577 (1964); *In re* Radom & Neidorff, Inc., 307 N.Y. 1, 119 N.E.2d 563 (1954).

8. There is no fundamental difference between debt and equity claims from an economic perspective. *See* Modigliani & Miller, *The Cost of Capital, Corporate Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). Both may bear risk, which makes both "residual" claims

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tions. Many assume that it invites a unique risk of exploitation. Because minority shareholders cannot dispose of their shares, the argument runs, a majority can "oppress" them by diverting a disproportionate share of the firm's income to itself, eventually forcing the minority to sell their shares at a distress price. But this argument really has little to do with the absence of a market. Consider the extreme case in which a majority shareholder appropriates 100 percent of the firm's income for himself. Even if a minority stockholder had an unrestricted ability to sell his shares, nobody would buy them. Illiquidity is not the problem.

There are, however, at least four ways in which the lack of an active market for shares can injure investors in closely held corporations. First, the absence of a secondary market makes valuation of residual claims highly uncertain. Because there is no market price for shares, and because contractual restraints limit the number of possible buyers, even permitted transfers of shares will be made more difficult by high transaction costs. The investor in a closely held corporation who wants to disinvest, for example, is likely to face costly haggling that may frustrate the attempt.[9] The alternative is a preset formula price, which may prevent transactions altogether when the formula price inevitably diverges from the actual value of the stock.

Second, the lack of an active market in shares creates conflicts over dividend policy and other distributions. For example, an investor in a closely held corporation who needs a large amount of cash at a particular time might be prejudiced if the firm re-

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in the sense that the payoff turns on the fortunes of the firm. Venturers often structure their transactions so that some claims receive an automatic payoff and a priority. We conventionally call these less risky claims "debt" and refer to the claims that stand to gain the full value of increased returns as "equity," but nothing turns on this. To the extent debt claimants bear significant risk in any venture, they are residual claimants in our terminology; to the extent these debt claims are held by investors other than the managers of the firm, there is separation of management from riskbearing. When the risky debt claims are held by the managers, however, there is no separation. When debt claims held by strangers are secured or sufficiently small to be of low risk, there is no effective separation. The existence of separate debt and equity claims may give rise to new problems, such as the incentive of managers to increase the riskiness of the firm's projects in order to increase the payoff to the equity claims while subjecting the debt claimants to uncompensated risk, but this wrinkle is beyond the scope of this essay. *See* Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 117 (1979).

9. *See* Beerly v. Department of Treasury, 768 F.2d 942 (7th Cir. 1985); Metlyn Realty Corp. v. Esmark, Inc., 763 F.2d 826, 834-38 (7th Cir. 1985). It is as if every transaction required an appraisal, the difficulties of which are notorious. *Cf.* Fischel, *The Appraisal Remedy in Corporate Law*, 1983 AM. B. FOUND. RESEARCH J. 875; Kanda & Levmore, *The Appraisal Remedy and the Goals of Corporate Law*, 32 U.C.L.A. L. REV. 429 (1985).

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tained a large percentage of its earnings. If lenders are unwilling to accept the stock of the firm as collateral, the investor might be forced to sell his shares to the corporation (the other shareholders) at a discount. The shareholder in a publicly held corporation with the same needs, by contrast, would be unconcerned about the firm's dividend policy. The ability to create "homemade dividends" by selling in the secondary market in publicly held corporations eliminates the use of retention of earnings as a weapon against minority shareholders.[10]

Third, the absence of an active market in shares precludes reliance on the stock market as a monitoring device. The takeover mechanism—which both constrains managers' conduct that does not maximize investors' wealth and transfers assets to higher valued uses—helps align managers' interests with those of investors in publicly held corporations. In closely held corporations, where the ability of outsiders to acquire shares is restricted, the market for corporate control is unimportant in creating incentives to operate efficiently. Similarly, publicly held corporations can structure compensation packages that link managers' wealth to changes in share prices; closely held firms cannot readily do so.[11]

Fourth, the lack of a liquid market in shares deprives uninformed investors of the protection of purchasing at a market price. Many buyers and sellers compete to acquire information about public corporations; the competition and ensuing trading cause the price of securities to reflect reasonably well the available information about their value.[12] This in turn provides those in control who want to raise capital with incentives to make credible commitments to potential investors to reduce their rational fears. Otherwise, outsiders will pay less for shares. This incentive to make credible commitments does not depend on the sophistication of every potential investor so long as the market price reflects the likelihood that those in control will exploit

10. *See* Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699 (1981); Miller & Modigliani, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411 (1961).

11. On the role of the market in corporate control, see *Symposium on the Market for Corporate Control*, 11 J. FIN. ECON. (1983); on the success of managers' compensation devices, see *Symposium on Management Compensation and the Managerial Labor Market*, 7 J. ACCT. & ECON. (1985). *See generally* Easterbrook, *Managers' Discretion and Investors' Welfare: Theories and Evidence*, 9 DEL. J. CORP. L. 540 (1984) (summarizing much of the evidence).

12. *See* Gilson & Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); J. Gordon & L. Kornhauser, Efficient Markets, Costly Information, and Securities Research (Dec. 1984) (unpublished manuscript).

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other investors. In a public market, even a few active searchers can drive the price close to the accurate one. In other words, it is very hard for an investor in a publicly held corporation to make a bad deal, at least *ex ante*. He is protected by the informed traders who set the market price. This is not true in closely held corporations, for there is no market price.

But it is a mistake to conclude that shareholders in closely held corporations face unique risks of oppression. It is also a mistake to argue the opposite—that shareholders in publicly held corporations face unique risks of exploitation because of the separation of ownership and control. It is much more helpful to understand the different agency problems in the two types of firms and the different mechanisms that have developed to control them.

II. Governance in Closely and Publicly Held Corporations

Investors in any venture are concerned about the possibility that the actions of others will reduce their return. Those who attempt to attract other people's money have incentives to adopt governance mechanisms that respond to potential investors' concerns. Closely and publicly held corporations tend to have different types of governance mechanisms because of their different economic structures.

A. *The Relation Between Management and Risk Bearing*

Where management and risk bearing are separate, as in publicly held corporations, managers' incentives to act efficiently are weak because they neither bear the costs nor reap the benefits of their actions. Moreover, it is difficult (costly) for investors to monitor managers' behavior. Investors frequently own shares in many firms but only a relatively small percentage of outstanding shares in any one firm. Thus they do not have access to much information. The costs of acquiring (and evaluating) information exceed the benefits any investor can capture from the search; even an informed investor cannot determine the firm's acts, so it does not pay to become informed.

Publicly held corporations have developed a wide array of governance mechanisms that align managers' interests more

closely with those of investors.[13] For example, independent directors, accountants, investment bankers, and analysts typically monitor managers' conduct. Residual claims are freely traded and carry voting rights. This facilitates efficient risk bearing, accumulation of large blocks of shares, and transfers of control while ensuring that management teams have incentives to maximize the value of the firm. Similarly, compensation agreements link changes in managers' wealth to the performance of the firm. These mechanisms reduce the inevitable divergence of interest resulting from the separation of the management and risk bearing functions.

Because closely held corporations do not separate management from risk bearing, monitoring is less costly. There is less need for outsiders to monitor managers.[14] But the lack of separation calls forth other types of governance mechanisms. We have mentioned that firms restrict the alienability of shares to ensure that those who are investors are also compatible as managers. The restrictions also preserve an agreed on division of profits. When a manager retires or dies, he or his estate no longer receives the salary component of the return to investment. Any time an active manager leaves his job, it may be necessary to transfer his shares as well. Buy-out agreements address problems of illiquidity. Dividend agreements, which require the firm to pay dividends if the corporate treasury has a certain amount of funds, may serve the same function.

Another common concern for minority investors in closely held corporations is that those in control will prefer themselves when distributing earnings. Any system that distributes profits in part through salary presents this danger. There is no presumption that those who have invested equal amounts are entitled to equal salaries in their role as managers. Thus those in control, undisciplined by outside monitors, may declare disproportionately high salaries for themselves. Potential investors who recognize this possibility will be reluctant to become residual

13. For a more extensive discussion of governance mechanisms in publicly held corporations, see Easterbrook, *supra* note 11; Fischel & Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law: A Theoretical and Empirical Analysis*, — CORNELL L. REV. — (1986) (forthcoming); *see also* Easterbrook & Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 673-92 (1984) (showing how managers select these devices in their own interest).

14. The smaller size of closely held corporations also makes it less worthwhile for the participants to incur the extra costs of independent monitors.

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claimants. But contractual mechanisms have evolved in response. These include high voting and quorum requirements as well as employment and compensation agreements that make it difficult for those in control to act without the consent of minority shareholders. Agreements to keep people in office enable those not in control to get some return on their investment.

The more power minority shareholders have, the more likely is deadlock. The possibility of deadlock also exists where the number of shareholders is small and shares are distributed so that votes can be evenly split. When deadlock may be a problem, parties frequently create some way out—e.g., arbitration, voting trusts, and third parties who have the right to vote only to break deadlocks. No way is costless; indeed, the easier it is to escape deadlock, the more deadlocks there will be. Deadlocks often arise from rent-seeking (each party opportunistically demands a larger share of the pie), and mechanisms that make deadlock very costly to escape may be rational responses to the costs of rent-seeking. We return to this below when discussing dissolution.

B. *The Relation Between Legal Rules and Governance Mechanisms*

Courts once viewed unusual contractual mechanisms in close corporations with suspicion. Today courts tend to enforce rules adopted by the parties. The evolution of corporate statutes from prescriptive rules into enabling laws has provided participants in both types of ventures with considerable flexibility in structuring the firm.[15] Some states have also enacted special close corporation statutes in recognition of the particular needs of participants in these firms.[16] These statutes, like enabling laws generally, im-

15. The classic example of an enabling statute is the Delaware Code, which provides investors in both publicly and closely held corporations with a set of standard form terms which they can vary by agreement. *See, e.g.*, DEL. CODE ANN. tit. 8, § 141(a) (1974) (business of corporation shall be managed by or under direction of board of directors unless otherwise provided in certificate of incorporation); *id.* at § 141(k) (directors may be removed with or without cause unless certificate of incorporation provides otherwise); *id.* at § 212(a) (each stockholder is entitled to one vote per share unless otherwise provided in the certificate of incorporation).

16. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 341-356 (1974); ILL. REV. STAT. ch. 32, §§ 1201-1216 (Supp. 1985); PA. STAT. ANN. tit. 15, §§ 1371-1386 (Purdon Supp. 1985). For an example of the modern trend allowing participants in closely held corporations maximum flexibility, see Report of Committee on Corporate Laws, *Proposed Statutory Close Corporations Supplement to the Model Business Corporation Act*, 37 BUS. LAW. 269 (1981). The American Bar Association Committee on Corporate Laws adopted the Supplement on June 21, 1982. *See* Report of Committee on Corporate Laws, *Statutory Close Corporations Supplement to the Model Business Corporations Act*, 38 BUS. LAW. 1031 (1983).

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pose minimal constraints on the participants' ability to enter into whatever contractual arrangement they wish unless they injure third parties.

The common law has followed the legislatures in deferring to contractual arrangements. At early common law, transactions between an interested director and his corporation were void or voidable regardless of circumstances.[17] Nothing of the sort happens today. If directors disclose transactions and obtain review by monitors who act in investors' interest—whether independent directors or courts evaluating "fairness"— they can pretty much do as they please.[18]

Many early decisions were hostile toward private arrangements, including restraints on alienation,[19] voting agreements,[20] and agreements limiting the discretion of directors.[21] The reasoning in these decisions frequently was mechanical; the judges did not know or care what the parties were trying to accomplish by the agreement in light of the economic structure of closely held corporations. In the famous case of *McQuade v. Stoneham*,[22] for example, the court held invalid an arrangement between a majority shareholder and two minority shareholders entered into at the time of the initial purchase of shares by McQuade, one of the minority shareholders. The agreement provided that the parties would use their "best efforts" to continue each other as directors and officers. The agreement designated McQuade to serve as treasurer at a salary of $7,500. The understanding further provided that there could be no change in salaries or other action that might "endanger or interfere with the rights of minority shareholders" without unanimous consent. As part of the

17. *See, e.g.*, Globe Woolen Co. v. Utica Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918).

18. *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Puma v. Marriott, 283 A.2d 693 (Del. Ch. 1971); Auerbach v. Bennett, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); DEL. CODE ANN. tit. 8, § 144 (1983) (interested director transactions not void or voidable if there is disclosure to disinterested directors).

19. Early cases sometimes viewed shares as property and ignored the mutual interests of the participants in restricting alienation contractually. For a discussion of the property-contract debate in this context, see Painter, *Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal*, 6 VILL. L. REV. 48 (1960).

20. *See, e.g.*, Bostwick v. Chapman (Shepaug Voting Trust Cases), 60 Conn. 553, 24 A. 32 (1890); Warren v. Pim, 66 N.J. Eq. 353, 59 A. 773 (1904).

21. *See, e.g.*, McQuade v. Stoneham, 263 N.Y. 323, 189 N.E. 234 (1934); Manson v. Curtis, 223 N.Y. 313, 119 N.E. 559 (1918).

22. 263 N.Y. 323, 189 N.E. 234 (1934).

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transaction, McQuade paid Stoneham, the controlling shareholder, $50,338.10 for his shares. Some time later, McQuade was replaced as treasurer, and he tried to enforce the agreement. The court refused, saying that "a contract is illegal and void so far as it precludes the board of directors, at the risk of incurring legal liability, from changing officers, salaries, or policies or retaining individuals in office, except by consent of the contracting parties."[23]

The court never considered why the parties had signed the agreement in the first place. McQuade was willing to invest $50,000 but wanted to minimize the possibility that the controlling shareholder, Stoneham, could deny him a return on his investment. To induce McQuade to invest, Stoneham guaranteed McQuade a minimum return (the $7,500 salary) and also gave McQuade a veto power over any material changes to the initial agreement. Without these inducements, McQuade would have been less likely to invest, would have paid less for his shares, or would have demanded a severence payment. Any of these could have been worse for all concerned. By invalidating the agreement, the court allowed Stoneham to welch on the guarantees that induced McQuade to invest. It is difficult to see what "public policy" this could serve.[24]

McQuade is a fossil. Today courts enforce voluntary agreements of all sorts among investors in close corporations. In *Clark v. Dodge*,[25] for example, the court that decided *McQuade* enforced an agreement specifying that a minority shareholder be continued in office and receive one-fourth of net income as salary or dividends.[26] Similarly, in *Galler v. Galler*,[27] the Supreme Court of Illinois upheld a shareholders' agreement providing for salary

23. *Id.* at 330, 189 N.E. at 237.

24. *See* Kaplan v. Block, 183 Va. 327, 31 S.E.2d 893 (1944) (unanimity agreements offend public policy because they create the possibility of deadlocks). The court in *Kaplan* ignored the trade-off faced by investors in closely held corporations. The parties in *Kaplan* may well have concluded that the protections of a unanimity rule outweighed the potential costs.

25. 269 N.Y. 410, 199 N.E. 641 (1936).

26. *See also* Zion v. Kurtz, 50 N.Y.2d 92, 405 N.E.2d 681, 428 N.Y.S. 199 (1980) (agreement requiring unanimous consent in conduct of business activities held valid as between the parties to it notwithstanding failure to comply with notice provisions in statute); Jones v. Williams, 139 Mo. 1, 39 S.W. 486 (1897) (a suprisingly astute decision enforcing an agreement to keep an investor in office). *But see* Long Park, Inc. v. Trenton-New Brunswick Theatres Co., 297 N.Y. 174, 77 N.E.2d 633 (1948) (unanimous shareholders' agreement invalid because it deprived the board of directors of the power to select management and operate the business).

27. 32 Ill. 2d 16, 203 N.E.2d 577 (1964).

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and dividend payments to the shareholders themselves as well as to their immediate families despite the death of an original signatory.[28] Other courts have upheld agreements that provide for the use of arbitrators or other third parties to break deadlocks[29] and restraints on alienation.[30] Many corporate law statutes codify this willingness to enforce whatever suits the investors in closely held corporations.[31]

The usual requirements of a valid contract—e.g., notice of the terms, absence of prejudice to third parties—apply to corporate agreements. Contractual restrictions on alienation generally must be noted conspicuously on share certificates and in the corporate charter.[32] Notice protects subsequent investors and potential transferees (including creditors) who were not parties to the original agreement. Agreements creating voting trusts, where the right to vote is separated from beneficial ownership of the shares, also are valid if notice is provided.[33] Similarly,

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28. *Galler* can be broadly interpreted as validating all agreements in closely held corporations absent prejudice to third parties. This interpretation of *Galler* was rejected, however, in Somers v. AAA Temporary Serv., Inc., 5 Ill. App. 3d 931, 284 N.E.2d 462 (1972) (unanimous shareholder amendment to corporate charter reducing the number of directors invalid because relevant statute provided that bylaws could be amended only by directors unless power expressly reserved in charter). *Galler* was distinguished on the ground that it did not authorize action "in direct contravention of the statute." One way to reconcile *Galler* with *Somers* is that the action by shareholders in *Somers* was prejudicial to a third party, the director, who would have been ousted and who may have relied on the statutory provision.

29. *See, e.g.*, Lehrman v. Cohen, 43 Del. Ch. 222, 222 A.2d 800 (1966); *In re* Vogel, 25 A.D.2d 212, 268 N.Y.S.2d 237 (1966), *aff'd*, 19 N.Y.2d 589, 224 N.E.2d 738, 278 N.Y.S.2d 236 (1967).

30. *See, e.g.*, Colbert v. Hennessey, 351 Mass. 131, 217 N.E.2d 914 (1966); Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 141 N.E.2d 812, 161 N.Y.S.2d 418 (1957). *But see* Rafe v. Hindin, 29 A.D.2d 481, 288 N.Y.S.2d 662 (1968) (contractual restriction on transferability void because certificates of stock are "property" and thus not subject to unreasonable restraints on alienation).

31. *See, e.g.*, MODEL BUS. CORP. ACT § 20(a) (Close Corp. Supp. 1984) ("The shareholder of a statutory close corporation may by unanimous action enter into one or more written agreements to regulate the exercise of the corporate powers and the management of the business"); *id.* at § 20(b) (agreements eliminating the board of directors or restricting their power are valid); DEL. CODE ANN. tit. 8, § 350 (1974) (shareholder agreement in a closely held corporation not invalid "on the ground that it so relates to the conduct of the business and affairs of the corporation as to restrict or interfere with the discretion or powers of the board of directors").

32. *See, e.g.*, *Biltmore Tissue*, 2 N.Y.2d at 534, 141 N.E.2d at 812, 161 N.Y.S.2d at 418; DEL. CODE ANN. tit. 8, § 202 (1974). There is an interesting parallel, which we do not pursue, to the role of notice statutes elsewhere in commercial law. *See* Baird, *Notice Filing and the Problem of Ostensible Ownership*, 12 J. LEGAL STUD. 53 (1983).

33. *See, e.g.*, DEL. CODE ANN. tit. 8, § 218 (1974). Curiously, Delaware law restricts voting trusts to a ten-year period. *Id.* Other jurisdictions have the same limitation. *See, e.g.*, CAL. CORP. CODE § 706(b) (West 1977). The new Close Corporation Supplement of the ABA's

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nonunanimous shareholders' agreements are subjected to greater judicial scrutiny than those that require unanimity because of the possibility of prejudice to nonparticipating shareholders.[34] Finally, shareholders' agreements, even if unanimous, can be invalidated if prejudicial to creditors.[35]

III. The Role of Corporate Law in the Absence of a Shareholders' Agreement

A. *Does the Rule of Law Matter?*

Corporate law, both statutory and judicial, is best understood as a set of standard terms that lowers the costs of contracting.[36] Because of the structural differences between the two types of corporations, different standard terms might be best for each. Thus many states supply automatic rules for involuntary dissolution in closely held but not publicly held corporations. Indeed, the much-heralded development of special close corporation statutes[37] recognizes the utility of a set of presumptive rules tailored to closely held corporations.

Model Act, however, has eliminated this restriction. Model Bus. Corp. Act § 34 (Close Corp. Supp. 1984). On the reasons why people may be skeptical of an extended separation of the vote from the residual claim, see Easterbrook & Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 403–06, 410–11 (1983).

34. *See, e.g.*, Odman v. Oleson, 319 Mass. 24, 64 N.E.2d 439 (1946); Christal v. Petry, 275 A.D. 550, 90 N.Y.S.2d 620 (1949).

35. *See, e.g.*, *Galler*, 32 Ill. 2d at 16, 203 N.E.2d at 577.

36. Robert Clark has argued that it is misleading to think of a corporation as a complex of explicit and implicit contracts. Clark, *Agency Costs Versus Fiduciary Duties*, in Principals and Agents: The Structure of Business, *supra* note 1, at 55, 59–71. He observes that many of the venturers do not contract explicitly, that they rely on legally created rules rather than private bargains, and that the content of "implicit" contracts is apt to be indeterminate. True enough. But because all of the players—be they contributors of labor, goods and services, debt capital, or equity capital—are playing the same game, there are no third party effects. Rules that create needless risk or fail to create available efficiencies will lead to adjustments in prices that make everyone worse off whether or not there are contracts. *Cf.* Epstein, *The Social Consequences of Common Law Rules*, 95 Harv. L. Rev. 1717 (1982) (contract- or expectation-defeating rules will not alter the relative wealth of the parties, although they may make all worse off). Every corporation, even the most rudimentary, is based on some very complicated explicit contracts. Any system of law that recognizes explicit contracts must deal with the gaps the drafters leave behind, and the drafters will leave gaps if only because conditions are bound to change after the initial contracts are signed. We think that it promotes clear thought to understand that the silence in the explicit contracts itself poses a problem of contract—the parties could solve it if they wished and were willing to bear the costs of transacting, and until they do, it is better to select the legal rule that promotes the joint wealth of the parties than to select a legal rule that defeats this (anticipated) preference.

37. *See, e.g.*, O'Neal, *Close Corporations: Existing Legislation and Recommended Reform*, 33 Bus. Law. 873 (1977).

The importance of such statutes, however, has been exaggerated. The statutes largely track the terms people have been negotiating for years, statute or no. So long as the statutory terms may be adopted or rejected by contract, as is true under modern enabling statutes, the primary contribution of special close corporation statutes is a savings, probably a minor one, in the costs of transacting to the preferred solution.

In several situations, the rule of law plays a more important role. The most obvious is dealings with third parties, where voluntary contracting is not feasible. Limited liability to tort creditors as well as rules of taxation are well-known examples. The rule also matters when it cannot be varied by agreement. Immutable rules are rare, but there are a few.[38] The rule matters most frequently, though, when parties are ignorant of it until a dispute arises; then they are bound by whatever the standard term happens to be. Many commentators have argued that such ignorance is widespread and that the law of closely held corporations is defective because it fails to protect ignorant investors, particularly minority shareholders, who do not know enough to protect themselves by contract.[39] The extent to which minority shareholders are ignorant of problems they might face and thus fail to protect themselves is impossible to tell. Some casual evidence suggests that close corporations often transact around rules (for example by abrogating their own limited liability). Certainly participants in closely held corporations are better informed about their legal rights and obligations than participants in either partnerships or public corporations. Investors in close corporations often put a great deal of their wealth at stake, and the lack of diversification (compared with that of investors in publicly held firms) induces them to take care. Partnerships can arise by operation of law without any express agreement between the parties; closely held corporations exist only as a result of formal documents and (typically) the assistance of an attorney. The attorney

38. *See, e.g.*, MD. CORPS. & ASS'NS CODE ANN. §§ 4-504, 4-601 (1975 & Supp. 1979) (prohibition of mergers or transfers of assets of closely held corporations absent unanimous consent which cannot be varied by agreement).

39. *See, e.g.*, O'Neal, *supra* note 37, at 881 ("Statutory protection is needed for minority shareholders who fail to bargain for and obtain protective contractual arrangements. Although most state corporation statutes validate . . . shareholders' agreements designed to protect minority shareholders, no statute . . . furnishes adequate self-executing protection for minority shareholders who have failed to bargain for special charter or bylaw provisions or for protective clauses in shareholders' agreements.").

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is a specialist provider of information; questions that never occur to the parties have been addressed and solved long ago by others, and attorneys transmit this accumulated expertise.[40] This process of learning (through counsel) from the mistakes of others seems to work reasonably well in assuring intelligently specialized contractual terms for closely held corporations. The ignorance theory predicts that investors in closely held corporations would fail to provide for restraints on alienation, but this is not the case.

According to our argument, if the organizing documents of a firm fail to provide, say, for dissolution at the will of any investor while at the same time providing for restraints on alienation, this implies that the parties desired the latter type of provision but not the former. Still, the failure of the parties to include a particular contracting term is ambiguous. It may mean that the parties did not want the term, but it *could* mean that they were ignorant. We cannot get much information from the frequency of a given device, either. If 90 percent of all close firms explicitly provide that dissolution is unavailable, this may mean that the other ten percent forgot this beneficial provision or that the other ten percent have an organizational difference that makes this provision unwise.

Drafters of the organizing documents of a closely held corporation cannot avoid a tradeoff. On the one hand, they must provide some protection to minority investors to ensure that they receive an adequate return on the minority shareholder's investment if the venture succeeds. On the other hand, they cannot give the minority too many rights, for the minority might exercise their rights in an opportunistic fashion to claim returns at the majority's expense. The drafters also must worry about the chance that judges will err in misconstruing the scope of the minority's entitlements. The right of dissolution at will and the imposition of strict fiduciary duties—the two entitlements whose omission is most commonly chalked up to ignorance—create precisely these types of problems. In light of the potential costs of these protections, it is conceivable, indeed certain, that there will be situations where all parties decide that they are better off without them. This makes it inappropriate to imply such terms as a

40. For a demonstration of the use of legal services to promote efficient economic transactions, see Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

rule. Moreover, the costs of certain contractual terms designed to protect the minority make it far from obvious that such terms should be implied by law, even if many or all of the parties were ignorant at the time of initial investment.

B. *Unconditional Buy-Out Rights*

Corporations have perpetual life. Because minority shareholders may be locked into a situation where they receive little or no return on their investment, corporate law has long permitted minority shareholders to obtain relief in the form of involuntary dissolution in a few kinds of situations, including deadlock. An involuntary dissolution requires a valuation of the business (either by a court or by sale of the entire business to a third party) and a distribution of the proceeds to the complaining shareholder. Alternatively, one or more of the parties can buy out the others in a negotiated transaction.

Courts have granted involuntary dissolution sparingly. Statutes typically require either a deadlock that makes operation of the business impossible or some form of serious misconduct by those in control. The Model Act, for example, authorizes involuntary dissolution if deadlock causes "irreparable injury" or if those in control "have or will have acted in a manner that is illegal, oppressive, fraudulent, or unfairly prejudicial" to the complaining shareholder.[41] Most statutes contain similar provisions.[42]

Even where the relevant statutory criteria arguably have been met, courts have been reluctant to grant involuntary dissolution. In *In re Radom & Neidorff, Inc.*,[43] to take one well-known example, the court declined to dissolve a profitable firm at the request of one of two equal shareholders, even though the other refused to sign salary checks and did not to contribute to the running of the business. Other courts have also been reluctant to order involuntary dissolution of profitable corporations despite allegations that those in control have acted wrongfully.[44] These decisions leave most commentators somewhere between perplexed and ap-

41. MODEL BUS. CORP. ACT § 16(a) (Close Corp. Supp. 1984).

42. ILL. STAT. ANN. ch. 32, § 157.86 (Smith-Hurd Supp. 1981); *See, e.g.*, N.Y. BUS. CORP. LAW §§ 1104-a, 1118 (McKinney Supp. 1984).

43. 307 N.Y. 1, 119 N.E.2d 563 (1964).

44. Polikoff v. Dole & Clark Bldg. Corp., 37 Ill. App. 2d 29, 184 N.E.2d 792 (1962); *See, e.g.*, Baker v. Commercial Body Builders, Inc., 264 Or. 614, 507 P.2d 387 (1973).

oplectic. Why should investors be locked forever in mortal combat, dragging down profitable businesses?

The answer is closely related to the reason why people do not put dissolution provisions in their contracts to start with. If it is easy to dissolve a firm, there will be more deadlocks, more claims of oppression. The threat to create a deadlock (or claim oppression) may be used to induce the other party to hand over more of the firm's profits. The anticipation of opportunistic behavior of this sort will make the entire business transaction less attractive as an initial matter. And when dissolution is readily available, the question of whether the parties can settle their differences after a threat to create a deadlock (or cry foul) becomes very touchy. Ordinarily, if the number of contracting parties is small enough and property rights are well specified, the parties will dicker to the optimal solution no matter what the legal rule may be.[45] The right to call on a judge may undermine the specificity of the property right because the parties must predict how a judge will decide. The more trouble they have predicting, the less likely they are to resolve their differences short of litigation, even when there are only two parties.[46] In short, the parties may want to make deadlock costly (so there will be less of it) and to keep the courts out when deadlock occurs (so they can settle their own disputes).

Restrictive legal rules concerning involuntary dissolution also create incentives for the parties to establish less expensive methods of adjusting conflicting interests. They may do this at the time they form the firm, for example by including buy-out provisions or voting agreements with some procedure for resolving deadlocks. Although negotiations in the absence of a prior agreement may be difficult because of problems of bilateral mo-

45. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960). Experimental evidence confirms this when the number of players is small, and much evidence shows that as the number increases it becomes harder and harder to strike a mutually beneficial bargain. *See* Hoffman & Spitzer, *The Coase Theorem: Some Experimental Tests*, 25 J.L. & ECON. 73 (1982), and their further work, *Experimental Law and Economics: An Introduction*, 85 COLUM. L. REV. 991 (1985); Libecap & Wiggins, *Contractual Responses to the Common Pool: Prorationing of Crude Oil Production*, 74 AM. ECON. REV. 87 (1984).

46. This is an implication of any of the available economic models of litigation. *E.g.*, Cooter, Marks & Mnookin, *Bargaining in the Shadow of the Law: A Testable Model of Strategic Behavior*, 11 J. LEGAL STUD. 225 (1982); Gould, *The Economics of Legal Conflicts*, 2 J. LEGAL STUD. 279 (1973); Landes & Posner, *Adjudication as a Private Good*, 8 J. LEGAL STUD. 235 (1979); Priest & Klein, *The Selection of Disputes for Litigation*, 13 J. LEGAL STUD. 1 (1984).

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nopoly,[47] the parties nonetheless have strong incentives to resolve their differences in one way or another to obtain the benefits of a profitable business.

Doubtless, a minority shareholder who has not bargained for any contractual protection will be in a relatively weak bargaining situation in the event of genuine oppression. The likely outcome of a private settlement in this situation will be a sale by the minority to the corporation or other shareholders on unattractive terms. Some commentators, sympathetic to the potential plight of minority shareholders, have advocated relaxing the standards for involuntary dissolution and allowing a minority shareholder to obtain dissolution whenever his "reasonable expectations" have been frustrated.[48] At least one court has adopted this test.[49] John Hetherington and Michael Dooley have gone further and argued that shareholders in closely held corporations should have the absolute right to force the corporation or other shareholders to purchase their shares at an agreed upon price or, failing agreement, at a price fixed by the court.[50] Only the automatic and nonwaivable buy-out right, Hetherington and Dooley argue, will solve the "unique" problems of illiquidity and exploitation faced by minority shareholders in closely held corporations.

These proposals, particularly the automatic buy-out right, implicitly assume that existing law does not adequately constrain the ability of those in control to take actions to the detriment of the minority and that allowing shareholders to force dissolution of the firm is costless. Neither assumption is accurate. The restrictive rule of involuntary dissolution based on fault does not leave the minority shareholder without any remedy but rather limits its use to egregious cases. Remedies other than involun-

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47. The problem of bilateral monopoly in closely held corporations is discussed in R. POSNER, ECONOMIC ANALYSIS OF LAW (3d ed. 1985).

48. *See, e.g.*, Afterman, *Statutory Protection For Oppressed Minority Shareholders: A Model for Reform*, 55 VA. L. REV. 1043, 1063-64 (1969); O'Neal, *supra* note 37, at 885-88.

49. Topper v. Park Sheraton Pharmacy, Inc., 107 Misc. 2d 25, 433 N.Y.S.2d 359 (Sup. Ct. 1980) (discharge of shareholder from employment constituted "oppressive" conduct within meaning of New York statute regardless of whether discharge was for cause). *Topper* transforms a fault-based statute into a strict liability statute.

50. Hetherington & Dooley, *supra* note 5; *see also* O'Neal, *supra* note 37, at 883 ("[A] minority shareholder in a close corporation, even though he has not bargained for the privilege of withdrawing from the business, should nevertheless, if he decides he wants to dispose of his interest, be able to liquidate his investment on terms that will insure him of receiving a fair share of the enterprise's accumulated earnings.").

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tary dissolution, such as suits for breach of fiduciary duty (discussed below)[51] or the appointment by a court of a custodian or provisional director,[52] are also available in egregious cases. If these remedies are insufficient in a particular case, investors have the option of bargaining for more protection.

The costs of automatic buy-out rights make it unlikely, however, that this right will be optimal for all investors in closely held corporations. Few firms other than banks and open-end mutual funds hold the liquid financial assets that permit withdrawal of investments on demand. When the firm holds illiquid assets, the right to withdraw capital is restricted to avoid having to sell firm-specific assets at distress prices. Size is immaterial; no shareholder has a right to send certificates to Exxon and get cash back. A firm might be willing to cash out its investors if it could either attract new investment or borrow money from a bank, but the terms of the new capital will not be favorable if anyone else can generate the problem anew. When investors double as managers, access to capital from third parties changes the nature of the firm, too, making it unlikely that the venturers meant to require this.

A right to withdraw capital from a firm that has no liquid assets and that does not have an active secondary market in shares also creates difficult (costly) problems of valuation. Any method of valuation is highly inexact; different appraisers will reach radically different conclusions regarding the value of the firm and a particular shareholder's proportionate interest.[53] These uncertainties compound the problem of negotiating.

Each of the effects of a right to withdraw capital from the firm—the possibility of having to sell firm-specific assets at distress prices and the uncertainties in valuation—encourages opportunistic behavior by minorities. The automatic buy-out right, in other words, gives minority shareholders who have a relatively smaller stake in the venture the ability to impose costs on other investors that is absent under a fault standard for involuntary dissolution.[54] Minorities can use this bargaining advantage to extract a disproportionate share of benefits from other investors.

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51. *See* text accompanying notes 56-66 *infra*.

52. *See, e.g.*, MODEL BUS. CORP. ACT § 16(b) (Close Corp. Supp. 1984); DEL. CODE ANN. tit. 8, § 353 (1975).

53. *See* note 9 *supra*.

54. On the problem of the opportunistic use of litigation by minority shareholders, see Fischel & Bradley, *supra* note 13.

The majority might be able to avoid the problem by selling the firm as a unit to a third party and paying off the minority; a threat to sell also might work. But in close firms, much of the value comes from the specialized services of the entrepreneur-managers; a change in the management and ownership structure may greatly reduce the value of the firm. A sale of the firm as a unit would destroy value unless the original managers bought the firm once again.[55] The venturers will wish to avoid the costs of this complex transaction.

An unconditional right to withdraw capital from the firm also may be prejudicial to creditors. Under the rule of limited liability, creditors look only to the assets in the corporate treasury for satisfaction. If any shareholder can withdraw assets from the corporate treasury for any reason, the likelihood that a particular extension of credit will not be repaid increases. Creditors will demand compensation for the new risk. Controlling shareholders will make their own adjustments, such as selling debt rather than equity to potential dissidents or charging more for shares, to the detriment of minority shareholders.

Ex ante, therefore, it is unlikely that an unconditional right to withdraw capital from the firm is desirable even from the perspective of minority shareholders. It would give them greater protection against opportunistic behavior by the majority, but at the cost of greater transaction costs as deadlocks multiply, an increase in the price of equity and debt capital, and perhaps the denial of any opportunity to invest. We therefore think it wise to observe what people actually do when they negotiate buy-out rights. Typically, shareholders do not have extensive rights to withdraw capital from the firm. They may do so only on certain events such as termination of employment, retirement, or death.

The failure of the parties themselves to provide routinely for a right to withdraw capital from the firm has important implications. It suggests, for example, that it would be inefficient to impose this provision on shareholders in closely held corporations and not allow them to opt out. It also suggests that courts should not readily infer a right to withdraw capital from the firm on behalf of minority shareholders.

55. *See* Baird, *The Uneasy Case for Corporation Reorganizations*, 15 J. LEGAL STUD. 127, 139-45 (1986); *cf.* Schwartz, *The Enforceability of Security Interests in Consumer Goods*, 26 J.L. & ECON. 117, 139-48 (1983).

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C. *Strict Standards of Fiduciary Duty*

Minority shareholders who believe those in control have acted wrongfully may bring an action for breach of fiduciary duty. Because the parties cannot anticipate every contingency, contractual arrangements of any complexity necessarily will be incomplete. Fiduciary duties serve as implicit standard terms in contractual agreements that lower the cost of contracting. Properly interpreted, fiduciary duties should approximate the bargain the parties themselves would have reached had they been able to negotiate at low cost.

The usefulness of fiduciary duties as a guide for conduct is limited, however, because it is often difficult for a court to determine how the parties would have contracted had they anticipated this contingency. Because of this and other problems with liability rules as a means for assuring contractual performance,[56] the parties have incentives to adopt governance mechanisms to resolve problems that cannot be anticipated. In publicly held corporations, for example, the existence of disinterested directors reduces problems of conflicts of interest. Shareholder agreements perform the same function in closely held corporations. In other situations, investors in closely held corporations will consciously decide to delegate the dispute resolution function to a court or simply fail to anticipate that disputes may arise. Courts then must decide how to deal with acts alleged to be to the detriment of one or more shareholders.

Courts rarely interfere with the decisions of managers of publicly held firms. It could be argued that judges should treat the acts of managers of close corporations with suspicion, however, because of the absence of the disciplinary effects of the stock market and other market mechanisms. One rationale for the business judgment rule is that managers who make errors (and even those who engage in self-dealing) are penalized by market forces while judges who make errors are not. Thus managers have better incentives to make correct business decisions than do judges. But if neither managers nor courts are disciplined by market forces, this justification has less force. On the other hand, the smaller number of participants in closely held corporations ensures that managers bear more of the costs of their actions and

56. For a fuller discussion of the limits of liability rules as a governance mechanism in the context of the publicly held corporation, see Fischel & Bradley, *supra* note 13.

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facilitates contractual arrangements between the parties to reduce the likelihood of self-dealing. The differences between publicly and closely held corporations, in other words, do not suggest unambiguously that the level of judicial scrutiny should vary or, if it does, in which direction.

Now courts might use the same *standard* of review for the two types of corporations but apply it differently based on the structural differences in corporate organization. *Michaels v. Michaels*[57] provides a good illustration of this approach. The question in *Michaels* was whether two shareholders had a duty to disclose the possibility of the sale of the company to a third shareholder, who had agreed to sell his shares after a falling out but had not yet sold them. In cases dealing with publicly traded firms, courts had held that preliminary merger discussions are not material information that must be disclosed to shareholders of publicly held corporations.[58] Whether the same standard of materiality applied in closely and publicly held corporations arose as one of the main issues. The Seventh Circuit stated that the standard was the same—what a reasonable investor would have thought important in making an investment decision—but that the application of the standard could lead to a different result in the two contexts. The court held that the manager should disclose the negotiations for two reasons: A minority shareholder in a closely held corporation, faced with a choice of selling out at a given price or continuing in a minority position after a falling out with no prospect of return on investment, would undoubtedly consider the possibility of the sale of the entire company important information; and, disclosure of preliminary merger discussions would present none of the problems it does for public firms.

This approach has implications beyond the duty to disclose. For example, a general fiduciary rule in publicly held corporations is that managers cannot engage in self-interested transactions unless they convince a court or disinterested decisionmakers within the firm that the transaction is beneficial. The same rule could be applied in closely held corporations, but its application would vary because of differences between the two types of firms. For example, the decision to terminate an employee in a publicly held corporation is a classic example of the

57. 767 F.2d 1185 (7th Cir. 1985).

58. Greenfield v. Heublein, Inc., 575 F. Supp. 1325, *aff'd*, 715 F.2d 751 (3d Cir. 1984), *cert. denied*, 105 S. Ct. 1189 (1985).

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exercise of business judgment that a court would not second guess. In a closely held corporation, by contrast, termination of an employee can be a way to appropriate a disproportionate share of the firm's earnings. It makes sense, therefore, to have greater judicial review of terminations of managerial (or investing) employees in closely held corporations than would be consistent with the business judgment rule. The same approach could be used with salary, dividend, and employment decisions in closely held corporations where the risks of conflicts of interest are greater.[59]

Many courts, however, apply a unitary business judgment rule in reviewing employment, salary, and dividend decisions in closely held corporations.[60] One defense of this result is again to create incentives for parties to protect themselves by contract or otherwise (for example, by arbitration). Although application of the deferential business judgment rule no doubt is harsh in some cases, it does have the advantage of limiting the judicial role to enforcing, rather than writing, contracts between the parties. It is one thing for a court to require disclosure as in *Michaels*; it is quite another for a court to regulate substantive contract terms as it must when asked to decide whether a particular dividend, compensation, or employment decision is appropriate.

If a court is unavoidably entwined in a dispute, it must decide what the parties would have bargained for had they written a completely contingent contract. The difficulties that result when a court misses this point are illustrated by the much applauded case of *Donahue v. Rodd Electrotype Co.*[61] The closely held corporation purchased the shares of its long-time manager, who had been with the firm for 35 years but was 77 years old and in poor health. He no longer owned a controlling stock interest. The controlling shareholders (the founder's sons) wanted him to re-

59. *See, e.g.*, O'Donnell v. Marine Repair Serv., 530 F. Supp. 1199 (S.D.N.Y. 1982); Exadaktilos v. Cinnaminson Realty Co., 167 N.J. Super. 141, 400 A.2d 554 (Law Div. 1979), *aff'd*, 173 N.J. Super. 559, 414 A.2d 994 (App. Div. 1980); Meiselman v. Meiselman, 309 N.C. 279, 307 S.E.2d 551 (1983).

60. *See, e.g.*, Gay v. Gay's Supermarkets, 343 A.2d 577 (Me. 1975); Gottfried v. Gottfried, 73 N.Y.S.2d 692 (Sup. Ct. 1947); Ziddell v. Ziddell, Inc., 277 Or. 413, 560 P.2d 1086 (1977). Some courts seem to apply both a stricter standard and the business judgment rule in the same case. *See, e.g.*, Alaska Plastics, Inc. v. Coppock, 621 P.2d 270 (Alaska 1980); Romanik v. Lurie Home Supply Center, Inc., 105 Ill. App. 3d 1118, 435 N.E.2d 712 (1982); Miller v. Magline, Inc., 76 Mich. App. 284, 256 N.W.2d 761 (1977); Masinter v. WEBCO Co., 262 S.E.2d 433 (W. Va. 1980).

61. 367 Mass. 578, 328 N.E.2d 505 (1975).

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tire and authorized the purchase of some of his shares. The remaining investor (the only one unrelated to the controlling family) then demanded that the corporation purchase her shares on the same terms. The corporation refused, stating that it did not possess adequate funds. The ensuing suit alleged that the controlling shareholders breached a fiduciary duty by causing the corporation to purchase some shares while refusing to extend the same benefit to other investors.

The trial court found that the price paid per share was less than either the liquidating or book value, that the purchase did not alter control or prejudice plaintiff or creditors in any way, and that the directors acted in good faith in approving the purchase. Based on these findings, the court of appeals found the purchase valid and held that neither the corporation nor its directors was under an obligation to buy shares ratably from all investors.[62]

The Supreme Court of Massachusetts reversed. Shareholders in closely held corporations, the court wrote, owe each other the utmost duty of good faith and loyalty, a higher duty than their counterparts in publicly held corporations. This higher duty requires controlling shareholders who use their positions to confer benefits on themselves to do the same for all investors. Thus the controlling group's purchase of shares breached its fiduciary duty. As a remedy, the court ordered the firm either to rescind the purchase or to offer to purchase plaintiff's stock at a price per share equal to that paid to Mr. Rodd.

Grave reflections on the plight of minority investors in closely held corporations and stirring proclamations of the fiduciary duty of the majority fill the opinion. Completely overlooked in all of this rhetoric was any consideration of the basic question—which interpretation of fiduciary duties would the parties have selected had they contracted in anticipation of this contingency? Although no one can answer such a question with certainty (precisely because the parties did not), it is most unlikely that they would have selected a rule requiring an equal opportunity for all. Buy-out arrangements on contingencies such as retirement are common in closely held corporations. Such agreements provide some liquidity and ensure that the identity of the managers and the investors remains the same, reducing agency problems. At

62. Donahue v. Rodd Electrotype Co., 1 Mass. App. 876, 307 N.E.2d 8 (1974), *rev'd*, 367 Mass. 578, 328 N.E.2d 505 (1975).

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the same time, the limits minimize the costs of requiring cash payouts or disrupting hard-won patterns of investment. No comparable commonly used agreement requires a firm to purchase all shares if it buys any. Firms often undertake to buy the shares of all who retire, and the court might have made something of this. The plaintiff was the widow of a long-time employee whose shares were not purchased when he died. Among the firms that have written explicit contracts concerning the repurchase of shares, some allow selective repurchases from departing employees and some make repurchase mandatory. It would have been difficult to determine into which category a firm such as Rodd best fit. The court did not pursue this line, however, and it did not suggest that anything turned on the employment history of the current owners of the shares.

The terms of the purchase in *Donahue* were not extraordinary. The trial court found them fair. The purchase appears to have been nothing more than an attempt to facilitate the retirement of a manager who, by virtue of advancing age and poor health, could no longer contribute. The firm doubtless was the better for his retirement. The court overlooked this obvious point; its zeal to articulate a strict standard of fiduciary duty to protect minority shareholders in closely held corporations led it to ignore the reasons for fiduciary duties.

Not surprisingly, courts have found the equal opportunity rule of *Donahue* impossible to administer. It is hard to imagine, for example, how closely held corporations could function under a requirement that all shareholders have an "equal opportunity" to receive salary increases and continue in office regardless of their conduct. Yet this is the logical implication of *Donahue*, which holds that the business justifications for unequal treatment are irrelevant. In light of this threat to the day-to-day functioning of closely held corporations, it was predictable that subsequent courts would either refuse to follow *Donahue* or limit its scope.[63] In *Wilkes v. Springside Nursing Homes, Inc.*,[64] for example, the court that decided *Donahue* stated that an employee and shareholder of a closely held corporation could be fired or de-

63. *See, e.g.*, Commolli v. Commolli, 241 Ga. 471, 246 S.E.2d 278 (1978); Toner v. Baltimore Envelope Co., 304 Md. 256, 498 A.2d 642 (1985); Wilkes v. Springside Nursing Home, Inc., 370 Mass. 842, 353 N.E.2d 657 (1976); *Ziddell*, 277 Or. at 423, 560 P.2d at 1091; Masinter v. WEBCO, Inc., 262 S.E.2d 433 (W. Va. 1980).

64. 370 Mass. 842, 353 N.E.2d 657 (1976).

nied a salary increase if there was a legitimate business purpose for the action that could not be furthered without disadvantaging the minority. The court in *Wilkes* inquired into the business purpose of the conduct at issue, precisely what it had forbidden in *Donahue*. Thus the court effectively repudiated the equal opportunity rule of *Donahue* and adopted instead a standard similar to the one used to review conflict of interest transactions in publicly held corporations. This standard, which gives some but not absolute protection to the minority, is in all likelihood closer to the bargain the parties would have reached themselves if transactions costs were zero.

Understanding fiduciary duties as implied terms in contractual agreements sheds light on the question whether minority shareholders owe fiduciary duties to the majority. Unanimity agreements, which exist in many closely held corporations, create a risk of deadlock. A minority shareholder may refuse to attend meetings so that a quorum does not exist or refuse to consent to corporate acts, paralyzing the firm. Although this right helps minority shareholders protect themselves against opportunistic behavior by the majority, it creates incentives for the minority to behave opportunistically toward the majority to extract disproportionate concessions.

Would fiduciary duties diminish the net costs created by the minority's ability to exercise veto power? Several courts have held that fiduciary duties are beneficial on net.[65] The issue is difficult because any constraint on the minority's veto power increases the probability that the majority will be able to exploit the minority notwithstanding the minority's bargained-for protection. One guide is whether the decision at issue might have a disproportionate effect on the minority. Thus a minority shareholder in a closely held corporation with a super-majority voting or quorum requirement would be justified in failing to attend a meeting and blocking the election of a new director who might act adversely toward him but might not be justified in failing to attend a meeting to authorize the purchase of a machine in an arms-length transaction. The veto in the former situation is con-

65. *See, e.g.*, Smith v. Atlantic Properties, Inc., 12 Mass. App. 201, 422 N.E.2d 798 (1981) (minority shareholder's use of veto power unreasonable). *But cf.* Neuman v. Pike, 591 F.2d 191 (2d Cir. 1979) (no implied covenant that minority shareholders vote reasonably). The need of a legal rule to protect the majority against the minority is questionable given the majority's ability to dissolve the firm or take other action to eliminate a minority shareholder. *See, e.g.*, Matteson v. Ziebarth, 40 Wash. 2d 286, 242 P.2d 1025 (1952).

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sistent with the purpose of the protection, while the same action in the latter situation is much more likely to be evidence of opportunistic behavior.[66]

D. *The Partnership Analogy*

That closely held corporations are really "incorporated partnerships" is a common refrain.[67] The participants in the venture view each other as partners; therefore, the argument runs, they should be governed by the law of partnerships. Equal sharing rules, automatic buy-out rights, and strict fiduciary duties are fundamental principles of partnership law and thus, proponents of the partnership analogy contend, should also be fundamental principles of the law of closely held corporations.

There is something to the analogy. We have conjectured elsewhere, and there is now some evidence, that participants in smaller firms who are unable to reduce risk by diversifying their investments are more likely to contract for equal sharing rules and to opt for other principles that constrain managers' discretion.[68] Still, there are problems with pushing the analogy to partnerships too far. First, at least with respect to automatic buy-out rights, the analogy is based on a misstatement of partnership law.[69] Although partnership law allows any partner (unless all agree otherwise in advance) to disinvest at any time and dissolve

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66. The problem of distinguishing legitimate exercise of contract rights from opportunistic behavior is pervasive in the law of contracts. *See, e.g.*, Aivazian, Trebilcock & Penny, *The Law of Contract Modifications: The Uncertain Quest for a Benchmark of Enforceability*, 22 OSGOODE HALL L.J. 173 (1984); Klein, Crawford & Alchian, *Vertical Integration, Appropriable Rents, and the Competitive Contracting Process*, 21 J.L. & ECON. 297 (1978); Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981); Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AM. ECON. REV. 519 (1983).

67. *See, e.g.*, Hetherington & Dooley, *supra* note 5, at 2 (close corporation is the "functional equivalent" of a partnership); Israels, *The Close Corporation and the Law*, 33 CORNELL L.Q. 488 (1948) ("the participants [in a close corporation] consider themselves 'partners' and seek to conduct the corporate affairs to a greater or lesser extent in the manner of a partnership"); O'Neal, *Preventive Law: Tailoring the Corporate Form of Business to Ensure Fair Treatment of All*, 49 MISS. L.J. 529, 533 (1978) ("Businessmen forming a close corporation frequently consider themselves partners; they incorporate only to obtain limited liability or other corporate advantages.").

68. Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985); Easterbrook & Fischel, *supra* note 1, at 736–37.

69. This point is forcefully made in Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1 (1982).

the firm,[70] the withdrawing partner may be liable in damages for "wrongful" termination[71] and may be able to disinvest only on disadvantageous terms.[72] Thus the Hetherington and Dooley proposal for automatic buy-out rights in closely held corporations, although supposedly based on partnership law, actually goes well beyond existing doctrine.

Second, the assumption that participants in closely held corporations want to be governed by partnership law is itself questionable. The participants incorporated for a reason. Perhaps the reason was only limited liability or favorable tax treatment, and in all other respects they wanted to be treated like partners. But this is not the only possibility. Corporate law is different from partnership law in many ways, and the venturers may desire to preserve these differences. Partners, for example, are entitled to share equally in the profits and management of the partnership,[73] are mutual agents for each other, have the right to veto any decisions made by the majority on matters outside the ordinary course of business,[74] and have the right to dissolve the partnership at any time if they are willing to bear the consequences. Corporate law treats each of these differently. Proponents of the partnership analogy assume that participants in closely held corporations are knowledgeable enough to incorporate to obtain the benefits of favorable tax treatment or limited liability but ignorant of all other differences between corporate and partnership law. There is no support for this assumption once you realize that people have to jump through a lot of formal hoops (assisted by counsel) to incorporate but could become partners by accident.

The right inquiry is always what the parties would have contracted for had transactions costs been zero, not whether closely held corporations are more similar to partnerships than to publicly held corporations. The failure to recognize the limited role of analogical reasoning can have significant consequences. The court that decided *Donahue* was apparently so concerned about

70. *See* UNIFORM PARTNERSHIP ACT § 31(1)(b), (2) (1914) (dissolution of partnership may be caused by express will of partner).

71. *See id.* at § 38(2) (partner who acts wrongfully in dissolving the firm is liable in damages).

72. *See id.* at § 38(2)(c) (dissolving partner not entitled to proportionate share of goodwill if remaining partners continue in the business).

73. *See id.* at § 18(a), (e).

74. *See id.* at § 18(g), (h).

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establishing the similarities between closely held corporations and partnerships that it never considered the possibility that its rule of equal opportunity might be inconsistent with the observed behavior of participants in both partnerships and closely held corporations. Both types of firms must provide some mechanism for dealing with retirements or terminations in situations where the firm will continue to exist. Most firms could not survive if the purchase of the interest of a retiring member required that everyone else be given the opportunity to sell out at the same price. Because the court never asked what the parties would have intended, it missed the boat.

Participants in business ventures are free to reflect their wishes explicitly in a written contract. Both partnership and corporate law enforce private decisions. When the parties do not or cannot contract explicitly, it will often be difficult to discern what they would have done if contracting were costless. This subtle inquiry is not made any simpler by asking whether closely held corporations are really partnerships. This latter focus simply puts everyone off the scent; indeed, it may be perverse because it directs attention away from the questions of why people formed the corporation and why, having done so, they did not adopt partnership-like rules by contract. Even if the parties did not consciously decide to opt out of the partnership rule, all this means is that they were asleep. What reason have we to think that if they were awake they would have selected the partnership rule?

One reason might be tax. Sometimes people pick the corporate form solely because of its tax consequences. This is not, however, a problem of drowsy investors. Whether they select the corporate form for tax reasons or for any others, the investors want to operate under the rules that maximize the expected return from the business venture. Investors who are aware of the tax consequences of the form they select are likely to be aware of other consequences; as we have emphasized, they commonly hire expert advice. A claim that people alert to the tax effects of incorporation were unaware of other effects is hard to take seriously, and when such people do not contract for the use of partnership-like rules, it is appropriate to apply corporate rules.

A second reason might be the anticipated triviality of the rule. It is costly to dicker for the application of a rule other than the standard term supplied by law. Parties (or their experts) must

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identify the problem and then transact in sufficient detail to solve it; the accumulation of cases under the existing legal standard supplies a level of detail that is costly to duplicate through private bargaining. Even if law firms, as private suppliers of legal rules, can specify the optimal solution, they cannot easily supply answers for all the marginal cases. No one firm can capture all of the gains from working out all cases, since the firm's answer can be copied by rival firms that do not pay for the service. The infrequent cases are also hard to anticipate, and so there may be a comparative advantage in the common law, a system that does not supply a solution until the problem actually arises and that then transfers the solution free of charge to other people similarly situated. To put it differently, some "contractual" terms for infrequently-occuring problems may be public goods.

If the gains from private bargaining are small— perhaps because the legal rule is only slightly inferior to some alternative, perhaps because it is sufficiently unlikely that events will bring a given legal rule into play, perhaps because the parties cannot appropriate all benefits of a new and better solution—people will not incur the costs of striking a bargain. If the costs of bargaining are high enough, we may be left with terminal ambiguity. We suspect, although we cannot prove, that this is not a frequent problem. Once lawyers identify a problem, new lawyers can reuse the solution the first lawyers develop. Different lawyers solve different infrequent cases.

Close corporations differ in size, and the larger ones will find it worthwhile to incur greater costs of transacting. (A one percent chance of encountering a problem is worth more to a $10 million firm than to a $100,000 firm.) Larger firms routinely have detailed provisions for handling deadlocks or buying out the shares of retiring employees, even though smaller firms may leave these issues unaddressed. Courts should observe how the larger firms tackle a given problem. These firms are the most likely to surmount any transaction cost hurdle and to spend the most time dealing with the problem once they have elected to do so. The solutions these larger firms offer may be copied and applied to other close corporations, unless there is some reason to think that the proper solution is a function of the firm's size. If larger firms elect not to address a subject through contract, then it is best to conclude that the presumptive rule does not need tinkering.

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IV. Conclusion

Close and publicly held corporations have different costs of management. Public firms achieve the benefits of the division of labor. They can attract managers without wealth, risk bearers without management skill. This arrangement creates substantial divergence of interest between managers and investors, and a basketful of devices—including specialized third party monitors—comes into play as managers try to attract capital. The closely held firm avoids agency costs of the same dimension, but the way it achieves this (by rolling investors and managers into one) creates difficult problems of continuity (what happens when an investor retires as a manager), opportunism, and deadlock. Experts—in this case lawyers rather than investment bankers—have devised another basketful of devices to control the special costs of closely held firms. Neither form of organization has a decisive advantage over the other; indeed, neither offers the marginal investor a better or worse deal. Because people select the organizational device in which to invest, at the margin the risk-adjusted returns must be the same. There is no basis for treating one form or one group of investors as favorites of the law, and there is every reason to treat both groups of investors as intelligent adults whose contracts should be enforced.

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