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The Modern Business Organization: Bargaining Under Constraints

William A. Klein†

This Article presents a perspective, a system of classification, a way of thinking, and some theories about joint economic enterprises, about how people organize the pooling of resources in a business venture. Drawing concepts from both law and economics, it suggests that the most useful way to analyze the modern business enterprise is to interpret the terms of the economic arrangements of a firm (partnership, corporation, cooperative) and the terms of the related economic arrangements that should not be analyzed separately from the firm (distributorship, loan agreement, employment contracts) as a series of bargains subject to constraints and made in contemplation of a long-term relationship.[1]

The four basic elements of the series-of-bargains model are risk of loss, return, control, and duration; the three major constraints that limit bargaining over those elements are government regulation, limitations on specificity, and conflicting interests and goals. Lawyers and economists who want to understand and work with the problems of business organi-

† Professor of Law, University of California, Los Angeles. I am indebted to Geoffrey C. Hazard, Jr., and John A.C. Hetherington for comments on a draft of the Article and to my colleagues, Alison G. Anderson and Stanley Siegel, for a continuing dialogue that has left me unable to recall which ideas were originally theirs.

1. This idea is similar to the "set of contracts" perspective developed in Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288, 290 (1980). Similar ideas are developed in Jensen & Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 310 (1976); Leibenstein, *Aspects of the X-Efficiency Theory of the Firm*, 6 BELL J. ECON. 580 (1975).

Business associations can also be thought of as a subset of the set of relational contracts. *See* Macneil, *The Many Futures of Contracts*, 47 S. CAL. L. REV. 691, 720 (1974) (distinguishing transactional and relational contracts). Unfortunately for our purposes, our understanding of relational contracts is still at a relatively primitive stage of development. *See* Macneil, Restatement (Second) of Contracts *and Presentation*, 60 VA. L. REV. 589, 609 (1974).

zation[2] should focus on these underlying economic concepts rather than on legal (and at times legalistic) categories such as partnership and corporation or on relatively simplistic economic concepts such as firms and markets.

The theory developed here does not necessarily assume that people engage in bargaining. Indeed, if one balks at this notion, one can think in terms of a bargain (an outcome) rather than bargaining (a process). To the extent that people involved in the outcome are at least generally aware of its terms, it seems unimportant that they may not have engaged in an active or inventive bargaining process. For most participants in a business venture—however broadly defined—that level of awareness can reasonably be assumed.

Perspectives and systems of classification are never simply true or false. They are only more or less useful as compared with alternative descriptions or ways of thinking. Thus, this Article does not advocate the rejection of different models of business organization. Rather, it suggests that existing theories do not pay adequate attention to various important issues.

Most scholarly work on the nature of business organization may be divided into three categories. These categories, however, are related; a complete theory should integrate all three. Economists whose field of study is sometimes called industrial organization[3] wrestle with the question of why production and distribution are sometimes organized within firms and other times by market transactions; that is, they seek to explain horizontal, vertical, and conglomerate integration. In recent years, much of their work has centered on the effects of transaction costs.[4] In general, the transaction cost phenomenon is taken as a given; the literature focuses on the consequences of the phenomenon rather than on its anatomy.

Economists on business school faculties, in contrast, examine the "internal" management and operation of firms, the formal and informal rules that enforce these organizational mechanisms, and the form of "internal" organization that maximizes economic efficiency.[5] Their work, sometimes

2. Lawyers usually use the phrase "business organization" to refer to the organization of firms—for example, to refer to the legal rules for the organization of corporations or partnerships—and sometimes more broadly to include, inter alia, the legal rules for distributorship agreements and employment contracts. Economists normally use the phrase in connection with the microeconomic issues associated with vertical and horizontal integration and the structure of industries.

3. *See, e.g.*, Cyert & Hedrick, *Theory of the Firm: Past, Present, and Future; An Interpretation*, 10 J. ECON. LIT. 398 (1972); Williamson, *The Modern Corporation: Origins, Evolution, Attributes*, 19 J. ECON. LIT. 1537 (1981).

4. *See* Williamson, *Transaction-Cost Economics: The Governance of Contractual Relations*, 22 J. L. & ECON. 233 (1979).

5. *See* W. MCEACHERN, MANAGERIAL CONTROL AND PERFORMANCE (1975).

called organization theory, deals with a process, with the transactions and relationships that develop among those who participate in the day-to-day operation of a firm.

Finally, lawyers study the legal rules and formal agreements used by individuals who engage in joint economic activity and, more particularly, the relationships among investors and between investors and management.[6] Their field is sometimes defined by the phrase "forms of organization." Most of their work focuses on transaction problems within a firm, rather than among firms (across markets). Thus, they provide no insight into industry structure.

Currently popular economic theories of the firm do not accommodate enough of the variety of economic life to allow for meaningful inquiry into many questions economists and lawyers find intriguing. The notion that activity is organized either within firms or across markets does seem useful in examining such matters as the conditions leading to vertical integration.[7] The types of organization people use to accomplish their economic goals, however, vary greatly; one can draw a clear line between firms and nonfirms only by adopting simplistic and unhelpful definitions. More realistically, one should envision a spectrum with varying degrees of "firmishness"[8] and treat the firm not as an entity, but as an abstraction that facilitates the examination of complex relationships among different actors.[9]

6. *See, e.g.*, W. CARY & M. EISENBERG, CASES AND MATERIALS ON CORPORATIONS (5th ed. 1980); W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS (rev. perm. ed. 1982); W. GREGORY, HANDBOOK ON THE LAW OF AGENCY AND PARTNERSHIP (1979).

7. *See* Spence, *The Economics of Internal Organization: An Introduction*, 6 BELL J. ECON. 163, 164 (1975) (viewing firms as "nonmarket institutions" whose function is to deal with resource allocation in the presence of informational constraints that markets handle poorly or do not handle at all). In contrast to those economists who seek to explain why economic activity is organized within firms rather than across markets, *see* Coase, *The Nature of the Firm*, 4 ECONOMICA (n.s.) 386 (1937), my concern is more with how firms (very broadly defined) are organized.

8. Consider, for example, the organization of the delivery of legal services. At one extreme one might find several lawyers sharing office space; plainly not a "firm." At the other extreme might be an association of four partners, each entitled to one quarter of net receipts, each sharing equally in control, and each expecting the relationship to endure indefinitely: a very "firmish" firm. In between might be larger firms with more centralized control—for example, with all important decisions reserved to an executive committee—with frequent changes in membership and with compensation based on a complex formula reflecting the member's value to the firm. Within such a firm there might be some members with a great deal of autonomy and others with very little. This degree of autonomy will depend on such factors as relationships with clients and degree of specialization.

One of the most interesting and important determinants of "firmishness" is the method of compensation. Law firms vary considerably and show great ingenuity in their compensation formulas. *See, e.g.*, Cantor, *How To Cut a Plump Melon*, 13 LAW OFFICE ECON. & MGMT. 13 (1972); Moldenhauer, *Formula and Nonformula Systems for Distributing Partnership Net Income*, 13 LAW OFFICE ECON. & MGMT. 21 (1972). The more the lawyer's compensation is determined by current productivity, the less "firmish" the firm.

9. Two recent articles by economists avoid the kinds of errors described in the text and take an approach quite similar to the one developed in this article. *See* Fama, *supra* note 1; Jensen & Meckling, *supra* note 1. It is a bit curious that both articles refer in their titles to a theory of "the

The systems of classification found in the legal literature concern themselves too much with doctrine and too little with economic function. At one level, they distinguish types of organization—most notably, corporations and partnerships. These two forms, however, are merely legal devices that can be used to accomplish similar economic objectives; the choice between the two is often determined by tax and psychological considerations. At another level, legal classificatory schemes rely on categories such as directors, dividends, shareholder voting, and reorganization that have little utility except as retrieval devices or as checklists for those with some knowledge of business organization. Finally, at a somewhat more functional level, the concepts of principal and agent in the law of agency (employment) and partnership and the corresponding notions in the law of corporations (rules relating to the rights and obligations of shareholders, directors, officers, and other employees) seem formalistic and simplistic. They stem from anachronistic notions of autocratic masters and their faithful or unfaithful servants.

The proposed model serves several important practical purposes. First, by isolating the elements of the bargain, it facilitates theorizing about the relationships among those elements. For example, it suggests that risk and control need not necessarily go hand in hand.[10] Existing legal models do not offer the opportunity for such speculation. Second, it can serve as a checklist to help insure against overlooking important elements of a transaction. Such a checklist is especially useful during the formation of a business organization, when basic economic elements are being shaped and articulated, but before technical legal problems have been confronted. It is especially useful, that is, in connection with "deal points" as opposed to "boilerplate." Third, by calling into question several key elements of the currently dominant legal model, the model highlights the disparity between those elements and the business reality they are supposed to reflect. Fourth, it shows that conflict is an unavoidable feature of joint economic activity.

More fundamentally, the series-of-bargains approach rests on concepts that are central to an adequate theoretical understanding of business organization. It points out and underscores the dangers of entity theories of

firm." The following passage from Jensen & Meckling seems particularly apt:

> *The firm is not an individual.* It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals (some of whom may "represent" other organizations) are brought into equilibrium within a framework of contractual relations. In this sense the "behavior" of the firm is like the behavior of a market; i.e., the outcome of a complex equilibrium process. We seldom fall into the trap of characterizing the wheat or stock market as an individual, but we often make this error by thinking about organizations as if they were persons with motivations and intentions.

Id. at 311.

10. *See infra* pp. 1559-61.

business organization.[11] The concept of the corporation (or partnership, cooperative, bank, or government agency) as a separate entity should be used only as a convenient, perhaps even necessary, shorthand device for communication, but such a device can be both deceptive and misleading.[12] A business organization can only be fully understood when it is viewed as a group of actors with conflicting interests and legally specified powers and duties.[13]

The approach explained in this Article rejects the notion that corporate status is a "privilege." It views corporation codes as a device "to reduce the transaction costs of private bargaining by providing a code of standard legal arrangements."[14] Such codes are, under this approach, contracts that can be modified by those who participate in the arrangement.

The suggested approach also points out the weaknesses in those models of the business venture based on role or status.[15] It suggests that managers are not faithful servants standing beneath "owners" (shareholders, for example) and their more direct representatives (corporate directors); instead, they are partners in an economic venture.[16] Having adopted this perspective, one should be more receptive to the thought that standard black-letter rules of fiduciary obligation can be modified by private agreement[17] or to

11. For a scholarly review and discussion of entity theory, see A. CONARD, CORPORATIONS IN PERSPECTIVE 416-45 (1976); Note, *Constitutional Rights of the Corporate Person*, 91 YALE L.J. 1641 (1982).

12. *See* Stone, *The Place of Enterprise Liability in the Control of Corporate Conduct*, 90 YALE L.J. 1, 9 n.32 (1980).

13. *See* Klein, *Income Taxation and Legal Entities*, 20 U.C.L.A. L. REV. 13, 52-57 (1972).

14. R. WINTER, GOVERNMENT AND THE CORPORATION 1 (1978); *see also* A. DEWING, THE FINANCIAL POLICY OF CORPORATIONS 4 (5th ed. 1953) ("Most legal writers, in their efforts to emphasize the definitive power of the sovereign authority which grants the corporation its charter, fail to recognize that the association of human beings, bound together in order to achieve a purpose, is the fundamental and teleological basis for the coming into existence and the continuing in existence of a corporation."); Ratner, *Corporations and the Constitution*, 15 U.S.F. L. REV. 11, 12 (1981) (while in earlier centuries "corporations really were instrumentalities of the state," in modern times "corporation law . . . has become a species of contract law"). For a history of the several views of the corporation that have dominated Anglo-American jurisprudence, see Note, *supra* note 11, at 1645-51.

Some rules found in corporation codes cannot be modified by private agreement; they operate as constraints on people's freedom to make their own deals. To that degree, the codes are designed to regulate, not just facilitate.

15. For an analysis of the corporation in those terms, see J. COLEMAN, POWER AND THE STRUCTURE OF SOCIETY 13-31 (1974); Note, *supra* note 11, at 1652-57. I am puzzled by such concepts—perhaps because I tend to think of all modern-day relationships, at least in a free society such as ours, in bargain terms, even where the bargain is rigid in its provisions, widely applied, and of long standing.

16. *See infra* p. 1532. Likewise, the series-of-bargains approach does not sharply distinguish the role of suppliers, distributors, and other such actors from that of investors and managers. *See infra* p. 1533. In other words, it treats as potentially misleading the distinction in law between servant-type agents and independent contractors, and the distinction in economics between transactions within a firm and transactions across markets. For a description of the economic distinction, see W. KLEIN, BUSINESS ORGANIZATION AND FINANCE 11-12 (1980). I do not deny that these distinctions can be meaningful. I suggest, rather, that for many purposes there is a more interesting and useful way of looking at the problems of business organization.

17. The law does allow for such modification, and the agreement to modify can be implicit,

the thought that managers may have a legitimate interest in sharing not only profits but also control.

This Article offers a positive, not a normative, theory.[18] To suggest that it is useful to think of a business organization as a series of bargains is by no means to assert that people should be free to arrive at any bargain they consider mutually advantageous. To offer a system that isolates control from other elements of the bargain, such as risk of loss and return, is not necessarily to deny that there may be sound policy reasons why people with given risks or profit shares should be in control of a firm.

The series-of-bargains approach, however, does have normative implications. The descriptive separation of risk of loss, return, and control, for example, makes much of the discussion of separation of ownership and control seem vacuous.[19] Most analyses of this separation are founded on the unstated normative premise that there is only one proper relationship between the element of control and the attribute of residual claim. Once one looks separately at control and its relationship to other elements and thinks about those instances in which control is not held by the residual claimant, the limitations of the unstated normative premise become apparent.[20]

I. Participants and Bargains

In traditional legal analysis, only those individuals whose claim to

though much of the discussion of the fiduciary obligations of corporate officers and directors ignores this possibility. *See* W. KLEIN, *supra* note 16, at 67-68.

18. More would be needed to make the model normative; a normative model should specify the criteria for good rules—criteria such as fairness, economic efficiency, protection of the weak, and objectivity. In the legal and economic literature on business organization one does not encounter explicit arrays of such criteria and systematic testing of rules in light of them. To that extent, the literature seems seriously incomplete. By contrast, the tax-policy literature frequently refers to explicit arrays of criteria. *See* W. KLEIN, POLICY ANALYSIS OF THE FEDERAL INCOME TAX 103-38 (1976).

19. *Cf.* Fama, *supra* note 1, at 289 (attacking presumption that "corporation has owners in any meaningful sense"). In contrast, Alchian and Demsetz state that:

> It is this entire bundle of rights: 1) to be a residual claimant; 2) to observe input behavior; 3) to be the central party to all contracts with inputs; 4) to alter the membership of the team; and 5) to sell these rights, that defines the *ownership* (or the employer) of the *classical* (capitalist, free-enterprise) firm.

Alchian & Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 783 (1972). Since, under that definition, one would expect to find "owners" only in very small firms, the definition seems sterile.

20. This Article uses many examples involving transactions and arrangements that are relatively small and atypical (such as motion picture productions). Such transactions and associations permit greater flexibility and variety in the structuring of terms than do transactions in which many people are involved and for which it is useful to adopt forms of association readily understood through long and widespread use. See 1 F. O'NEAL, CLOSE CORPORATIONS §§ 3.01—5.39 (1971) for a description of the many options available to organizers of closely held corporations. For very large organizations, other conceptual approaches may be more useful. *See, e.g.*, Coffee, *Beyond the Shut-Eyed Sentry: Toward a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977) (developing models of bureaucratic behavior); Stone, *supra* note 12 (same).

profit is exposed to the highest risk of loss—that is, holders of the principal residual claim (usually shareholders and partners)—are regarded as members of the business organization; the right to control, the traditional view asserts, is a natural concomitant of maximum risk. In contrast, in standard economic analysis, the firm is seen as including not only holders of the principal residual claim, but also top-level managers. Shareholders in large public corporations, in fact, are sometimes thought of as outsiders, as mere suppliers of capital. A more realistic model would bring within the organization a variety of other participants: lenders, suppliers, distributors, customers, and franchisees. These participants all contribute capital or services to the enterprise on a continuing basis, and share a significant interest in its success.[21]

Another traditional legal notion is that in each organization one central individual or group (for example, equity holders, possibly acting through their agents, the managers) engages in separate bilateral bargains with various other participants. It is more realistic, however, to view a business organization as a series of bargains in which each bargain affects and is affected by all other bargains. This perspective emphasizes the variety of ways an individual can participate in a business venture.

A. *Promoters and Finders*

Promoters and finders are included in the list of participants because they often play a crucial role in the formation of business organizations. In addition to finding projects and bringing together entrepreneurs and investors, promoters and finders are likely to shape the terms of participation in business ventures.

21. *See* J. MARCH & H. SIMON, ORGANIZATIONS 89-90 (1958); Alchian & Demsetz, *supra* note 19; *see also* Birdzell, Book Review, 32 BUS. LAW. 317, 323-24 (1976) (reviewing R. NADER, M. GREEN & J. SELIGMAN, CONSTITUTIONALIZING THE CORPORATION: THE CASE FOR THE FEDERAL CHARTERING OF GIANT CORPORATIONS (1976)) (discussing different roles of participants in business organizations). I do not include nonmanagerial employees in this group of participants, though a strong case could be made for doing so in some instances. Union-negotiated contracts do limit managerial discretion, but unions do not share control in the normal sense of the term, nor do they ordinarily wish to do so. Nonmanagerial employees may be eligible for bonuses, and to that extent share in profits, and have much to lose if the employer goes out of business. This claim, however, is more remote and attenuated than that held by those we normally think of as residual claimants. Thus, I am prepared, though with some uneasiness, to accept the traditional view that employees are hired inputs rather than members of the organization (in a structural sense). *See* W. KLEIN, *supra* note 16, at 157-58. Similarly, Chandler states that:

> Union influence, however, directly affected only one set of management decisions—those made by middle managers relating to wages, hiring, firing, and conditions of work. Such decisions had only an indirect impact on the central ones that coordinated current flows and allocated resources for the future.

A. CHANDLER, THE VISIBLE HAND: THE MANAGERIAL REVOLUTION IN AMERICAN BUSINESS 493 (1978).

B. *Residual Claimants*

Traditionally, the residual claim[22] has been analyzed in both the economic and the legal literature as the right to whatever is left over after all prior claims to the profits or assets of a firm have been satisfied. That analysis fails to capture the variety of the carved-out residual claims.

1. *Common Shareholders and Partners*

Common shareholders and partners are probably the prime examples of residual claimants. The terms governing the relationships among shareholders are found in corporation codes and in the articles and bylaws of the corporation. The terms of the agreement among partners are found in state statutes (usually following the Uniform Partnership Act) and in express or implied individualized agreements. The status, claims, rights, and obligations of shareholders and partners are also determined in large part by the express or implied terms of contracts with other participants in the enterprise.

2. *Option Holders*

Holders of options to buy common shares of a corporation[23] have a residual claim, much like that of common shareholders. To the extent that their rights depend on the acquisition of common shares, the terms of their participation in the venture are determined by the corporation code, the corporate articles and bylaws, and all other rules and agreements affecting the claims of common shareholders. In addition, privately negotiated terms will specify price and duration, and possibly other matters such as protection against dilution. An option on a partnership interest or other residual claim is, of course, analogous to an option on common shares.[24]

22. I use the notion of residual claim rather than the more customary concept of equity participation because the latter combines a residual claim and the power to control. The participants I list under this heading do not necessarily have control and, in any event, it seems useful to distinguish control and residual claims.

23. For a more complete explanation and discussion of the ideas set forth in this subsection, see W. KLEIN, *supra* note 16, at 180-86. For an economic analysis, see Smith, *Option Pricing: A Review*, 3 J. FIN. ECON. 3 (1976).

24. Options may also be issued by an individual residual claimant, in which case the option is referred to by economists as a "side bet," a transaction with no direct impact on the firm (that is, on the other participants). An option issued by an individual is thus "outside the firm."

A firm may also issue options directly. When issued to investors (as opposed to employees) these options, which are usually called "warrants," may be said to be "inside the firm." Their effect is that all residual claimants sell a claim to a portion of their interest in the firm.

Issuance of an option on a residual claim transforms the underlying residual claim into a fixed claim; the option holder either pays the option price at the expiration date (or earlier) or loses the claim. If, at the expiration date, the value of the residual claim is greater than the option price, the option will be exercised and its holder will make a profit. An option is always a leveraged claim and often the leverage is quite high.

3. *Profit Participants*

Part of the compensation of a managerial employee may consist of a share of profit.[25] Since the employee will presumably have accepted reduced fixed compensation in return for the contingent claim, the employee is in a position similar to that of other residual claimants.[26] People may also have profit shares even though they have no other significant continuing role in the business. For example, the sale price of a business may be a fixed payment plus a contingent payment based on profits or some other measure of performance of that business often called an "earn-out."[27] Thus, the sellers will have a residual claim on their former business.

4. *Members and Patrons*

Cooperatives and mutuals claim that they are not run for "profit."[28] If successful, however, they do generate "net margins" or some such accounting surplus or residual. In such cases, the firm may have spare cash available for distribution to those with whom it has done business ("members" or "patrons"). Distributions are usually computed pro rata based on patronage. If there is no spare cash, the members or patrons may receive written evidence of their claim to a share of the residual. This claim may eventually be followed by a cash payment, depending on the written agreement and on the success of the firm. Thus, individuals who do business with such a firm have at least a short-term residual interest in its

A special form of option is the conversion privilege of a convertible bond. The number of shares of common stock to which the holder of the convertible bond is entitled is specified and the consideration for the exercise of the option is the relinquishment of the fixed claim of the bond.

Option holders normally do not have the right to vote—they do not share in control—though it is possible to negotiate for such a right (which can be given in the corporate context by the grant of a proxy).

25. *Cf.* W. LEWELLEN, THE OWNERSHIP INCOME OF MANAGEMENT 6 (1971) (discussing importance of "contingent 'ownership' items" in executive compensation packages).

26. Independent motion-picture producers and other principal participants, for example, may share in "net profits" (usually defined in detailed provisions that give the phrase unusual meanings). *See* PRACTICING LAW INSTITUTE, *Legal and Business Problems of Financing Motion Pictures 1979*, in PATENTS, COPYRIGHTS, TRADEMARKS AND LITERARY PROPERTY COURSE HANDBOOK SERIES NO. 110 68-72, 93-96 (reprinting profit division agreements of Warner Bros., Inc., and Avco Embassy Pictures Corp.); *The New Economic Game: Money and Movies*, in THE SIXTH ANNUAL UCLA ENTERTAINMENT SYMPOSIUM 558, 558-71, 595-618, 626-41 (G. Stiffelman, C. Cuddy & M. Lauer eds. 1981). For good discussions of the definitional issues, see Ziffren, *The Structure and Negotiation of Distribution Agreements in the Selling of Motion Pictures in the 80's: New Producer/Distributor/ Exhibitor Relationships*, in THE FIFTH ANNUAL UCLA ENTERTAINMENT SYMPOSIUM, 184, 193-203 (P. Dekom, M. Adler, D. Ginsburg & M. Lauer eds. 1980); Zimbert & Ziffren, *The Studio Deal*, in THE SECOND ANNUAL UCLA ENTERTAINMENT SYMPOSIUM 213 (P. Dekom, L. Mortoff & M. Sherman eds. 1977). For a brief description of a typically complex association for producing a motion picture, see Carnegie Prods., Inc. v. Commissioner, 59 T.C. 642 (1973).

27. Such "earn out" provisions are widely used. Gunther, *Contingent Pay-Outs in Mergers and Acquisitions*, J. ACCT., June 1968, at 33.

28. *See* Klein, *supra* note 13, at 31-39.

success.

Cooperatives and mutuals plow some or all of the net margins back into the business. In this way, they will presumably improve their ability to provide favorable prices or better services. Thus, current patrons may—altruistically, unconsciously, or unavoidably—bestow benefits on future patrons. Alternatively, current patrons may anticipate that they will continue to be patrons and will benefit in the future from the retained residual.[29]

The basic terms of the bargain among patrons and members of cooperatives and mutuals are found in state and, in special cases, federal statutes comparable to the codes governing ordinary corporations and in documents similar to the articles and bylaws of such corporations. There is, however, room for privately negotiated arrangements.

C. *Semi-Residual Claimants*

Semi-residual claims are senior to true residual claims, but, like residual claims, depend on certain aspects of the success or failure of the enterprise. Common examples include royalties, licensing fees, and percentage leases. Semi-residual claims are not as burdensome to residual claimants as fixed claims (since their amounts often decrease when the business is not successful).

The terms of semi-residual claims are the result of private negotiation, though commonly used terms do develop for particular activities.[30] These claims are especially interesting because they show the potential variety of

29. This future benefit is likely to be especially valuable if, as is often the case with farm cooperatives, there are significant limitations on the firm's willingness to do business with new patrons. The right to do business with the firm may be freely transferable, nontransferable, or transferable subject to limitations (for example, only with a transfer of a farm whose owner has been a patron in the past). The rules on transferability obviously will affect the value of the patrons' right to do business with the firm.

Status as a residual claimant becomes most concrete upon liquidation of the business or its termination as a cooperative or mutual company. A good illustration is a mutual savings and loan association transformed into a private, for-profit corporation. Imagine such a firm in which residuals have been retained and reinvested over a long period of time, or in which the value of assets has risen due to market forces or inflation, giving the firm a substantial net value. The people who deposited money with the firm (as "members") in the early days may have some claim to that value, but they may be hard to find. Consequently, the usual approach on transforming the mutual association into a private corporation is to allocate the existing value (pro rata and based on average amount of deposits) among those people who have been members over some relatively short, recent period. The current or recent members (depositors) are then are entitled to receive without payment, or to buy at a bargain price, a share of the entire equity of the transformed firm. Sometimes, however, such people are unaware of the value of their entitlements or may be unwilling or unable to make the additional investment, and those who do invest capture the profits. *See* Jones v. H.F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969).

30. For example, a one-eighth royalty is customarily paid to the owner of land leased to an operator for oil drilling. A fairly elaborate set of terms has developed in the drilling business by custom and common usage over the years. Such terms, however, can be modified by the parties. *See* 2 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 422 (1981).

business-organization bargains and the ingenuity applied in adapting the terms of those bargains to the needs of the participants.[31]

D. *Fixed Claimants*

Fixed claims are traditionally reified in much the same way that entity theories reify the firm itself. That is, the claims are thought of as expenses, not as forms of participation in the firm. Fixed claims are better viewed as the product of explicit or implicit bargaining between participants with differing investment objectives and possibly differing kinds of contributions.

1. *Lenders*

The fixed claim of a lender is to periodic payments (interest) plus a terminal payment (principal). The terms of loans of moderate to long duration are embodied in large part in covenants—that is, private agreements. Many of the terms are relatively standardized ("boilerplate"). Key provisions, however, may be the subject of serious negotiation between representatives of the borrower (issuer) and representatives of the lender,[32] especially when such securities are placed with a single individual or institution and not with the public.[33]

2. *Trade Creditors*

Trade creditors are an important source of capital for many firms. The

31. The semi-residual claim resulting from the "stacking" of profit shares is illustrative. Perhaps the best-known example is the claim of preferred shareholders, who have some priority over common shareholders as to dividends and to assets on liquidation but are not entitled to demand payment at a specified time.

A semi-residual claim is also created when the owners of a business sell an equity interest but retain an option to repurchase that interest at some higher price, thereby putting a "cap" on the residual claim of the purchaser of that interest and transforming it into a semi-residual claim. Such claims may, depending on the circumstances, be thought of by the parties as close substitutes for loans (fixed claims). "Carved out" oil payments are an example of such claims. After the presence of oil has been confirmed with reasonable certainty, the owner of the "working interest" may sell a right to a given number of barrels or to the next $*X* worth of oil produced by the well. *Id.* Since the payment is virtually assured at the time such interests are sold, the similarity to secured loans is clear. *See* I.R.C. § 636 (West 1982).

32. In the case of debt instruments sold to the public, the representative is likely to be the underwriter, who will have conflicting obligations to the issuer and the buyers.

33. The terms of debt securities sold to the public are determined in part by the federal Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa—77bbb (1976 & Supp. V 1981). Another important set of rules affecting the claim of lenders is found in the provisions of the bankruptcy law, limiting the degree to which equity holders are able to subordinate their claims to those of lenders. *See infra* p. 1554.

Recently loans have increasingly provided for periodic payments that vary with the prime rate (or some other measure of market rates) to reflect expectations about inflation. Variable interest rates are the result of an external economic phenomenon rather than a desire to make the lender more dependent on the success of the business.

trade creditor's claim is like that of any other general creditor, but a separate listing seems appropriate to emphasize the fact that, while trade creditors have a fixed claim for the amount due on goods and services already delivered, they may extend credit not only to make current sales but also in the hope of making future sales. Thus, they may have a quasi-residual interest or expectation tied to their fixed claim.

3. *Lessors*

Lessors ordinarily have a fixed claim to periodic rent payments, possibly for long periods of time. The basic terms of the bargain are found in a privately negotiated document called a lease, but many significant aspects of the relationship (for example, the procedures for enforcement through eviction) are determined by state and local property law.

4. *Employees*

Employees have a fixed claim to wages and salaries for a period of time determined by the express or implied terms of their contracts of employment or by the practical requirements of the business.

E. *Managers*

My view shares with economic models the notion that managers are not simply hired hands; they are members of the organization, just as residual claimants are.[34] This position does not depend on possible residual claims (for example, bonuses or stock options), but on the importance of the firm to the managers' welfare and on the vital role they play even in firms substantially supervised by investors. The term "manager" should include executives other than the chief executive officer; in large firms, it should include what is sometimes called the management team.

The terms of the bargains between a firm's other participants and its managers are found mostly in common-law rules of contract and agency law and in written contracts of employment. In addition, within a management team, a series of implicit bargains or understandings will determine or affect the allocation of responsibility, authority (control), and reward (return).

F. *Distributors and Franchisees*

The success or failure of a firm can depend heavily on distributors and franchisees. The terms of the bargain with these actors may define, to a

34. *See supra* p. 1525.

significant degree, the nature of the firm and the extent of its control over operations. Even when the sales and distribution component of a venture is legally independent of the manufacturing or service-supplying component, each may be heavily dependent on the other in practice. When there is such dependence, the two components can be thought of as parts of a single organization and their relationship analogized to a partnership.[35] Similar relationships exist when a manufacturer or supplier of a service has only a small number of customers or when a customer has only one source of supply.

II. Bargain Elements

Under the model presented in this Article, the bargain underlying a joint venture, the agreement as to how the many participants will share resources, profits, and losses, consists of four elements—risk of loss, return, control, and duration—and three constraints—limitations on specificity, conflicting interests and goals, and government regulation. The four elements describe deal points—the truly important issues that must be settled in forming an economic enterprise. In general, each participant demands some level of each element; it is unusual, for example, to find a bargain in which one participant is subjected to the full risk of loss and another bears no risk at all.

The elements of the model are closely interrelated. For example, while a given risk of loss may be unacceptable to an individual with little control over an enterprise, it might prove more palatable when associated with a high degree of control. Thus, no element can be understood in a vacuum; each needs to be analyzed in terms of its relation to the other elements. It follows that the decision to begin with any particular element is arbitrary.

A. *Risk of Loss*

Participants in a joint venture contribute or promise to contribute money, other property, services (time), or reputation at a specified time or as needed. In return, they may receive various kinds of claims embodied in such legal instruments as common stock, promissory notes, options, and employment contracts. The initial contribution is important in determining the bargaining position of each participant as to each of the various elements whose allocation or specification will ultimately define the terms

35. I suggest, therefore, that courses on business organization should include materials on distributorship agreements. A good distributorship problem will raise all the basic issues presented to a lawyer asked to form a partnership or corporation—all the issues embodied in the basic elements of the bargain (risk of loss, reward, control, and duration).

of the deal.[36] Once the terms of the bargain are settled, however, and the venture begins, these contributions become a "sunk cost." Thus, the prospects for gain and the risk of loss of the various participants depend on the nature of their claims, not on their contributions, though two types of contributions, reputation and guarantees, are not so readily transformed into claims and will therefore be considered separately.[37]

Traditionally, claims are grouped in three major categories according to their degree of risk: high-risk (equity-type, contingent, or residual claims), low-risk (debt-type or other fixed claims), and hybrids.

1. *High-Risk Claims*

At one end of the risk of loss spectrum lie those true residual claims that entitle their holders to what is left after all other claims have been satisfied.[38] Within the general category of high-risk claims there are, of course, claims with varying degrees of risk. The highest-risk claim is an option or warrant. Then come classic equity claims such as common stock and interests in partnerships. Finally, come claims of employees and others to a share of profits.

These high-risk claims need not be "inside" the firm.[39] For example, options issued by individual equity holders, rather than by the firm, may be thought of as "outside" the firm. In contrast, warrants are issued only by firms; they are always "inside" the firm.

2. *Low-Risk Claims*

At the other end of the risk spectrum are the claims to a fixed sum at a specified time, regardless of the success of the business. Again, there are different degrees of risk within this general category. In an ascending order of risk are the claims of first-priority secured lenders, lower-priority secured lenders, general creditors, and those who have agreed to subordinate their debt claims to the claims of general creditors.[40] Rent and salary are also low-risk, fixed claims. The lessor is in a position similar to that of a secured creditor; if the lessee fails to make a required fixed payment, the lessor can take back the property, though not without some de-

36. People may, for example, feel that a contributor of money should have a different kind of claim than a contributor of services (even if the money-equivalent value of the services is genuinely agreed upon).
37. *See infra* pp. 1536-38.
38. Such claims are normally called "leveraged claims." A fixed claim is said to create leverage for a residual claim because the presence of the fixed claim magnifies the effect on the residual claim of any change in total return. *See* W. KLEIN, *supra* note 16, at 222-27.
39. *See supra* note 24.
40. When people with significant equity positions have made loans to the firm (trade creditors, for example), they may insist on subordination of those loans to their own claims.

lay and expense.[41] The employee's claim, in contrast, is not secured.

Debt issued by an equity participant using the equity claim as collateral is "outside" the firm.[42] In contrast, salaries and debts incurred directly by the firm represent claims "inside" the firm.[43]

3. *Hybrids*

Hybrids may take a virtually infinite variety of forms. Two prototypes can be used to illustrate their basic attributes. First is the claim of the preferred shareholder of a corporation to a fixed periodic payment, which the board of directors may, in its discretion, decline to make.[44] Nonpayment is not an act of default like the nonpayment of a fixed claim such as interest or rent.[45] On liquidation, the preferred shareholders' claim (usually par value plus dividend arrearages) is senior to that of common shareholders, but the former have no power to force liquidation. Thus, they are in a vulnerable position, lacking the powers of common share-

41. Risk is eliminated to the extent that the rental value of the property is equal to or higher than the rent provided in the lease. The lessor's claim for any shortfall is the claim of a general creditor. The amount of any such claim will depend, of course, on the duration of the lease. A short-term lease, however, may provide the lessee little, if any, relief from the obligations of a long-term fixed claim, since the property may be vital to the business and the only alternative to renewing the lease and making rental payments may be to close the business down.

42. Perhaps the best-known example is the "margin" loan for the purchase of shares in a public corporation. Through such loans, a shareholder can create leverage. The lender is in a position similar to that of a holder of a fixed claim issued by the corporation. Probably the most significant difference between the two relates to ease of enforcement. A margin loan is easily and effectively enforced. The collateral can be sold without significant delay or expense, and the lender's claim will be fully satisfied before the borrower gets a penny. With debt issued by the corporation, by contrast, federal bankruptcy laws come into play. *See infra* p. 1554. Under these laws, enforcement of the terms of the loan may be delayed for long periods and the lender may have to settle for less than the amount purportedly owed, even though the borrower retains part of the collateral.

Another illustration of investor-issued debt is found in tax-shelter ventures such as oil and gas drilling. The promoter may arrange for a line of credit and require investors to borrow from an outside source a pro rata share of the amount needed. Presumably such an arrangement makes the venture more readily salable to investors than would a plan leaving them to their own devices to borrow funds. Prepackaged individual loans may also be easier to administer and enforce than a loan to the entity with a series of individual guarantees.

43. The claim is similar to that of a lessor. If an employer with a long-term employment contract fails to pay, employees can sell their services to someone else, preserving a claim (as general creditors) against the original employer if the pay at the new job is less than at the old. As with leases, salaries and wages may give rise to the kind of risk to the employee associated with a fixed obligation of longer formal duration, since the alternative to continued payment of the salaries and wages may be termination of the business. This is one of the reasons why employers may want employees to accept compensation contingent on the success of the business. *See infra* note 91.

44. The only adverse consequence to the corporation is that no dividends can be paid on the common stock until the preferred dividends (including cumulated dividends) are paid; the preferred shareholders may also become entitled to representation on the board (possibly a majority position, depending on state law and the terms of the agreement).

45. Normally no interest is payable on the unpaid preferred dividends. Corporations may, and sometimes do, continue to operate for years without paying dividends to the preferred shareholders. *See* Guttmann v. Illinois Cent. R.R., 189 F.2d 927 (2d Cir. 1951). Even then, the preferred shareholders are not entitled to boot out the common shareholders.

holders and the rights of fixed claimants.

The other prototypical hybrid claim is reflected in a convertible bond. The hybrid character of the claim arises from the combination of two components—a low-risk pure debt element (that is, a claim to fixed periodic payments, interest, and a lump-sum terminal payment at a specified time) and a high-risk option to relinquish that debt element in return for a specified number of common shares.[46] Since the position of a convertible bond on the risk spectrum can be varied by manipulating its terms to alter the relative values of the two elements,[47] the convertible bond is a good example of how creative financial experts can produce claims with almost infinitely varying degrees of risk.[48]

4. *Reputation*

Another significant and inadequately recognized source of risk of loss is reputation.[49] Suppose that a highly regarded movie director agrees to direct a movie, or a successful business executive agrees to take over a failing automobile manufacturing company, or a restaurant manager agrees to manage a new restaurant. In each situation, the people accepting the job will probably have some form of compensation contingent on the success of the venture. To that extent, they will be subject to a risk of loss like any other holder of a residual claim. But, beyond that, the person may be endangering his reputation and risking the loss of future earning power. If the motion picture is an artistic and box-office failure, if the automobile company produces cars that no one will buy, or if the restaurant closes after six months of poor service and bad food, the director, the executive, and the manager may find it difficult to convince anyone else

46. A similar financial result is achieved by issuing common shares and giving their holders a "put," that is, an option to sell to the corporation at a specified price within a specified time, while giving the issuer a "call," an option to buy at a specified price within the same specified time. The major difference is that the holder of the common shares with a "put" would normally not be entitled to a fixed periodic payment comparable to the interest on the convertible bond.

47. For example, to increase the relative value of the option, and, consequently, the risk of loss of the package, one might increase the number of common shares obtained by exercising the option, and lower the interest rate on the bond.

48. Investors can, of course, achieve the same result without any help from the firm. Suppose that a corporation issues no security other than common stock. Investors who buy the common stock can increase leverage and risk of loss by borrowing against the security of the stock in any amount they choose. Alternatively, they can decrease risk by selling options. Or, if the corporation issues both common stock and bonds, they can buy any combination that suits their fancy. The interesting question, then, is why corporations ever issue any securities other than common stock, or, at least, why they ever issue complex securities such as convertible bonds. *See* Klein, *The Convertible Bond: A Peculiar Package*, 123 U. PA. L. REV. 547 (1975).

The most plausible explanation for the issuance of debt by corporations has to do with tax considerations, but the analysis is far more complex than one might imagine. *See* W. KLEIN, *supra* note 16, at 243-52.

49. *See* Fama, *supra* note 1, at 292.

that the failure was not their fault. Their losses may be far greater than the loss suffered by any other participant in the venture. Since the responsibility for bad outcomes is not easily ascribed to one person or another, the director, executive, or manager may suffer for the sins of others.

Reputation is, of course, a contribution, not a claim. The claim received by a person or firm in return for a contribution of reputation may be one of the types described above. There is, however, one unique attribute of the contribution of reputation: normally the person making the contribution will expect not only some kind of claim similar to those of other participants, but will also expect, or at least hope for, the preservation of the asset. In this respect, the contributor of reputation is like a lessor of tangible property. But often the risk of damage to reputation is much greater than the risk of damage to other property.

5. *Guarantees*

Guarantees may be implicit or explicit. Partners, for instance, implicitly guarantee all debts of the firm. They stand to lose not just the amount they invest in the enterprise from time to time, but any of their assets that might be needed to meet the firm's debts.[50]

Similar commitments may stem from custom or economic necessity. For example, a venture capital firm might make a deal on the basis of an estimate of the funds necessary to float a risky business venture. The parties to the transaction may recognize that if events turn out badly, the venture capital firm may be required to supply more funds to preserve the value of its initial contribution.[51] Thus, the original suppliers of venture capital may be at risk for significantly more than the amount initially invested.

As with reputation, guarantees are contributions, not claims, and the claim issued for the guarantee can take any of the available forms. Guarantees deserve special attention because consideration for the claim might be thought of as a future payment contingent on the failure of the firm to

50. Other people may guarantee the performance of certain obligations by the firm. For example, in an independent motion picture production, the "completion guarantor" may guarantee that the production of the film will be completed. This person may have no other role in the venture. *See* PRACTICING LAW INSTITUTE, *supra* note 26, at 339-88.

51. Other sources of funds may be unavailable, especially if the original venture-capital investor is known to have funds available for investment. The original venture capital investor will know the business; anyone else will be required to spend considerable time investigating it. The value of the business to the new investor will be less, by the amount of the cost of the investigation, than it is to the original investor. Thus, the potential new investor may not be willing to pay what the business or share of it is worth to the original investor. Moreover, if the original investor has funds available for investment and wants to sell to a new investor, the new investor might assume that the original investor has unfavorable information about the business that the new investor has been unable to discover.

meet some other obligation.[52] The guarantor who does not receive cash at the outset may wind up with two kinds of interests in the success of the enterprise, one embodied in the contingent liability of the guarantee and another embodied in a claim received in return for that guarantee.[53] As a result, the guarantor may have conflicting interests. For example, if the claim consists of options to buy common stock and the guarantee is for the payment of a loan, as holders of the claim embodied in the option, guarantors will prefer a corporate investment strategy involving a high degree of risk. As guarantors of the debt, however, they will prefer a far more conservative strategy.

B. *Return*

Return on a contribution is that which a participant expects to receive if a business venture is successful.[54] A claim to profits, for instance, becomes valuable if a joint venture prospers; if the business fails, however, the claimant loses the expectation embodied in that claim. While risk of loss and return could therefore sensibly be treated as a single element, establishing separate categories underscores the differences in outcomes between success and failure. This separation seems consistent with the way participants are likely to think. Moreover, there are some participants for whom risk of loss and return are nonreciprocal.[55] Returns may be divided into the three major categories: residual, semi-residual, and fixed.

1. *Residual Returns*

Common shareholders hold residual claims whose expected return can be thought of as the anticipated stream of dividends, including liquidating dividends, received over the life of the firm.[56] It is a mistake, however, to

52. This observation might be misleading in cases where the guarantor is required to set aside or provide a security interest in property to back up the guarantee.

53. The guarantor can also be thought of as making a present commitment equal to the expected value of the contingent future payment.

54. "Return" is used here to refer to all the money and property received, rather than just the profit or gain from one's investment.

55. For example, a guarantor may receive a fixed fee at the outset for providing the guarantee. The fixed fee is the return. The risk of loss is for the amount that the guarantor might later be required to pay if the principal obligor defaults.

56. Total dividends should be deemed to include disguised dividends in the form of excessive salaries, perquisites, and other benefits. The existence of disguised dividends means that not all common shareholders have the same de facto expected return.

The view of the return on common shares put forward in the text avoids the troublesome question of the relationship between earnings and value; the question of expected gain in share value as part of the total return; and the question whether dividends are more valuable to shareholders than retained earnings. It is consistent with the modern view that the value of common stock is a function solely of expected dividends over the life of the firm. *See* W. KLEIN, *supra* note 16, at 211-13. *But see* Schiller,

assume that shareholders all have the same interest in return.

Shareholders subject to high marginal tax rates, for example, may prefer that the firm retain and reinvest spare cash, even if the rate of return on corporate investments is lower than the rate of return on investments available outside the firm.[57] In contrast, low-bracket taxpayers may prefer current dividends.[58] Wholly apart from tax considerations, shareholders may differ as to whether the corporation should distribute part of its wealth as dividends. Some shareholders may think that the corporation is well situated to invest money that otherwise would be paid as dividends. Others may prefer to receive the dividends and make their own investment decisions. It is clear, then, that among people with the same claim to returns, there will be conflicts as to how those returns should be realized. In addition, there may be similar conflicts between managers and shareholders, with managers perhaps preferring to retain assets and expand their "empire" or increase the future profits they might share.[59]

The return of partners is much like that of common shareholders. Partners have an abstract legal claim to their share of the profits of the firm, but their "draw" (comparable to dividends) is determined, in the absence of some other agreement, by majority vote.[60]

A different type of residual claim is that held by the holders of options and warrants. They have highly leveraged claims based on the claim of the underlying common stock. Their interests on matters of investment strategy and dividend policy are in conflict with those of the owners of the underlying shares.

There is usually no need to define what common shareholders and partners have a right to. For example, it is not necessary to define "earnings" to understand the return to these residual claimants; it is sufficient to know that they are entitled to everything left over after all other claims have been satisfied.[61] In analyzing other residual claims (for example,

Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends? 71 AM. ECON. REV. 421 (1981) (arguing that stock price volatility cannot be attributed to uncertainty about future dividends).

57. Such corporate investment strategies may increase the net after-tax return to these shareholders by converting presently taxed ordinary income into capital gains taxed, if at all, at some time in the future.

58. Shareholders who pay no income tax (for example, certain pension funds) or whose rates are low will be at odds with the high-bracket shareholders on this issue. The focus on earnings as well as dividends highlights such conflict.

59. This conflict is reduced or eliminated if managerial compensation is a function of the size of the dividend.

60. The amount of the draw will not, however, have any tax effects. Since partners are taxed on the profits of the firm without regard to the amount paid out, the distribution of the profits as partner draw is not a taxable event (though it does reduce the partner's basis in his partnership interest). *See* I.R.C. §§ 701, 705 (West 1982).

61. The definition of "earnings" for purposes of determining the amount to which other claimants are entitled may, of course, determine indirectly the amount to which the ultimate residual claimants

those of managers entitled to a share of profits), however, it is important to give careful thought to the definition of terms such as "net profit."[62] Despite the differences among claims to residual returns, the holders of all such claims share an acute concern with the operational efficiency of the enterprise.[63]

2. *Semi-Residual Returns*

Royalties are an example of a claim to a semi-residual return. Royalty holders are willing to take some risk; they are likely to be optimistic about the success of the venture and to believe that the royalty claim is worth more than the fixed payment they might have obtained instead. They may be unwilling, however, to allow their returns to depend on the efficiency with which, for example, a record company distributes records or an oil company drills for oil.[64] Royalty holders are willing to gamble on the product[65] but not on the ability of others to conduct a business venture efficiently. Thus, the royalty is one of a variety of techniques and devices that apportion returns to fit the special needs of the participants.[66]

are entitled. Moreover, the definition of earnings or profits may be relevant as a limitation on the amount of a corporate dividend payment permitted by state law, though it is unusual for corporations to contemplate dividends that approach the limit.

62. For example, deducting research and development costs in arriving at profits might create perverse incentives. *See infra* note 129. The definition of "net profits" for participants in a motion picture production may be highly specialized, with little relationship to the normal concept of net profits. *See supra* note 26. Similarly, the treatment of outlays as maintenance expenses rather than as capital improvement costs can significantly affect the rights of the holders of income bonds. *See* Mc-Connell & Schlarbaum, *Returns, Risks, and Pricing of Income Bonds, 1956-76 (Does Money Have Odor?)* 54 J. BUS. 33, 54-56 (1981).

63. One rather troublesome aspect of return deserves brief mention—namely, that business people may believe that there are limits of "fairness" on return, even in the context of a willing bargain between sophisticated participants. An expression sometimes used in connection with business negotiations is that one must "leave something on the table," as opposed to taking all that one could demand. For example, suppose that a financier considers lending money to an entrepreneur for a venture of doubtful viability; suppose further that to justify the investment, the financier would require 90% of the equity and that the entrepreneur, having no better alternative, is willing to accept this level of return to the financier. The financier might reject the deal on the ground that such ventures are not likely to be successful unless the entrepreneur thinks that he is being treated fairly. The word "fair" here is no doubt used as shorthand to refer to a complex psychological phenomenon experienced by business people: a return may be demoralizing even if it is the best the recipient can do.

64. In fact, there may be a clear conflict between a royalty holder and a residual claimant over such questions as how much to spend on advertising and promotion. A person entitled to royalties on a musical recording will want the distributor of the record to spend heavily on anything that might increase sales. The distributor, on the other hand, will only engage in those expenditures that enhance its overall profitability. As a practical matter, expenditure decisions will be determined by the interest of distributors, not royalty holders.

65. Royalty holders such as owners of land who accept a royalty in oil-drilling ventures may be willing to gamble because they may believe that they have nothing to lose. They may have forgone an alternative fixed payment but, for reasons that may be difficult to explain, people often fail to attach much value to property they could have had but in fact never did have. *See* Kelman, *Consumption Theory, Production Theory, and Ideology in the Coase Theorem*, 52 S. CAL. L. REV. 669 (1979).

66. "Stacked" claims are also adaptations to needs. Suppose, for example, that an entrepreneur has approached a venture capitalist seeking to raise $1,000,000 for his struggling start-up electronics

Another important kind of semi-residual claim is the interest of managers (and other employees) in continued employment and advancement. Managers tend to thrive when their firms thrive and to suffer when their firms suffer. If a firm prospers and expands, jobs tend to be secure and opportunities for advancement good. If a firm struggles and contracts, prospects for advancement within the firm become bleak, jobs may be lost, morale may sag (psychic returns may decline), and reputation may suffer (deservedly or not). Since finding a job with another firm can be a costly and risky venture, the semi-residual claim to continued employment has a significant impact on managerial behavior and attitudes and, consequently, on the interests of other claimants.

3. *Fixed Returns*

Lenders do not share the interest of residual claimants in maximizing firm profits. The fixed return of the debt claim is designed to appeal to an investor whose aversion to risk is higher than that of a residual claimant in the same firm or to an investor who does not want to be concerned with the profit-maximization decisions of the firm. In some circumstances, however, a firm's profit-maximizing strategies may adversely affect a lender's position; hence, lenders sometimes insist on covenants that con-

corporation and that the venture capitalist has demanded 50% of the equity of the corporation. The entrepreneur is, however, concerned about loss of control in the long run (knowing that in the short run not much can be done to change the way in which he is doing business) and about the size of the venture capitalist's share. He may be extremely optimistic about the prospects for the firm and may think that a 50% interest will soon be worth at least $10,000,000. The venture capitalist, on the other hand, hopes to triple her investment within two years, but thinks that there is only a negligible chance of doing much better than that. A deal might be struck in which the entrepreneur sells the 50% equity interest to the venture capitalist for $1,000,000 but retains an option to repurchase that interest for $3,000,000 any time within the next two years. The entrepreneur thinks he has gotten an important and valuable concession, while the venture capitalist thinks she has given up virtually nothing.

The venture capitalist may also be very anxious to have an assured "exit vehicle"; she may want some way to get her money out if the business has not caught on after some reasonable time. This might be accomplished by giving the venture capitalist a right to put (sell) her equity interest to the corporation for, say, $1,300,000 at the end of two years. Again, this kind of provision may be acceptable because of the difference of perspective of the parties. The entrepreneur may be so certain of the success of the firm that he considers the put of no significance, while the venture capitalist may think that it has considerable value. Moreover, a demand by the venture capitalist for such a right may place the entrepreneur in a "put-up-or-shut-up" position. The entrepreneur, in negotiations, will no doubt have expressed virtual certainty of the success of the enterprise. Having done so, it will be difficult for him to treat the granting of the put as anything other than a very minor concession.

The net result of these negotiations, then, is a stacked set of claims in which the venture capitalist is entitled on demand, at the end of two years, to the first $1,300,000; if that right is not exercised, presumably because the business is worth more than $2,600,000, the venture capitalist and the entrepreneur share the first $6,000,000 equally; any additional value goes to the entrepreneur. If the business does not turn out nearly as well as the entrepreneur had hoped, he may regret the bargain. This might adversely affect his attitude and incentives, which in turn might adversely affect the interests of the venture capitalist. A sophisticated investor (such as most professional venture capitalists) will be aware of this danger. The solution suggested here might be the best available alternative.

strain the borrowers' freedom to make business decisions.[67]

Though lessors also tend to be risk averse and to dislike active involvement in management of the business, they may be more concerned than lenders with the success of the firm, since a successful firm may be more likely to renew its lease and thereby eliminate the costs associated with the termination of a lease.

An employee's salary is a fixed claim, but managerial employees are likely to want to be involved in decisions affecting profits. They may also be no more risk averse than residual claimants. This taste for involvement and for risk is not, however, a function of the fixed salary claim. It is rather a function of the employee's enjoyment of the activity of management plus an interest in reputation and an expectation that the successful firm will create avenues for advancement.

By appreciating the various claims participants may have on returns, one comes to appreciate the variety of deal-points involved in structuring a joint enterprise and the variety of interests that may be accommodated by adjusting returns and other elements of the complicated bargain the joint venture represents.

C. *Control*

Traditionally, students of business organizations assume that control should be in the hands of "owners." Such a view of ownership in the modern business organization is simplistic. One should think, instead, of control as one element of a complex bargain. The allocation of control reflects the bargains made as to the other elements as well as the underlying economic realities those bargains reflect and create.

1. *Shortcomings of the Legal Model*

Most of the legal writing on problems of control in business organizations seems to flow from a naive application of the concepts and rules of the law of agency. The business organization is conceived as a set of relations between principals and agents. The principal is the master, the boss;[68] the agent, the faithful servant, the hired hand.[69] Even though the

67. *See infra* note 137.

68. In the case of a corporation, there is some conceptual difficulty in identifying the "principal" due to the legal model in which the board of directors is an independent institution. *See* M. EISENBERG, THE STRUCTURE OF THE CORPORATION 2 (1976). It seems fair to say, however, that the people who run the corporation (the officers or, in the terminology of this article, the managers) are agents responsible to shareholders, whose interests are represented by the directors. The subservient role of these agents, not the relationship between the directors and the shareholders, is the key to the present analysis.

69. *See* Easterbrook & Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1191 (1981) ("So long as it continues to be lawful to form

agent may be placed in charge of the business, the principal retains the power to control not only general strategy, but also the details of how the agent performs his duties.[70] The legal model fails in at least three important respects.[71]

First, the model does not take into account the managers' legitimate interest in control.[72] Managers' compensation and reputation may depend on the success of the business;[73] as a result, they must be concerned with control to protect and enhance that bargained-for element of their compensation.[74] In fact, managers are understandably and legitimately concerned about control even when only salary is at stake; it can be costly for a manager, even a very good one, to move from one job to another. Thus, managers are likely to have strong financial incentives to perform well, to be free from interference by investors (who are, after all, less skilled in management), and to monitor and control the performance of other members of the management team.[75]

None of these considerations is necessarily inconsistent with the retention of "control" by "owners," provided that control is given a specific, rather than a general, meaning. They are inconsistent, however, with the notion of control that seems to underlie much of the discussion of the sep-

corporations for profit, shareholders are entitled to hire managers dedicated to the shareholders' interests alone. The duty of management is to operate efficiently and thus maximize the return to shareholders."). Easterbrook and Fischel fail to examine the possibility that barriers to takeovers provide managers with a form of employment security they accept in lieu of higher salaries and other benefits; shareholder wealth might therefore be diminished by removing those barriers. *See* L. THUROW, GENERATING INEQUALITY 81 (1975) (describing pernicious effects of wage competition in construction industry and possible effects of similar employment system in university hiring).

70. *See* RESTATEMENT (SECOND) OF AGENCY § 2 (1957).

71. *See* Coffee, *supra* note 20, at 1198-99; Hetherington, *When the Sleeper Wakes: Reflections on Corporate Governance and Shareholder Rights*, 8 HOFSTRA L. REV. 183, 190-99 (1979).

72. *See* A. CHANDLER, *supra* note 21, at 87 (Because railroad managers "had a far greater personal, if not financial, commitment to the continuing health of the enterprise, they came in time to have almost as much say about financial policies and the allocation of resources as did the owners and their representatives.").

Economists now accept the view that the goals of managers tend to differ significantly from the presumed goal of investors (profit maximization). There is an active debate, however, over what it is that managers seek to maximize (subject to the very important constraint that they must produce some acceptable level of profits). For an excellent review of the literature and some original contributions, see W. MCEACHERN, *supra* note 5.

73. *See supra* note 43.

74. Investors may be seeking a quick profit while managers may be concerned with the effect of the firm's output on their reputation. For example, a motion picture producer may want to produce a film of high quality while the investor (distributor) may be concerned only with immediate profits. Similarly, the shareholders of a manufacturing corporation may want to produce shoddy goods and then, when the consuming public realizes that the goods are of uneven quality, terminate that line of business, leaving the president of the corporation with the complaints and possibly with a bleak future. The opposite may be true as well: the manager may seek quick profits at the expense of the long-term interests of the investors. Usually, however, this will be the result of incentives or directions for which the investors will have been responsible.

75. *But cf.* Fama, *supra* note 1, at 292-94 (Board must also include independent directors to act as "professional referees" and prevent "collusion and expropriation of shareholder wealth.").

aration of ownership and control in large public corporations—the notion that investors can reasonably expect control to be exercised exclusively and unfailingly in their immediate, direct interests. Even if it were possible to enforce such a standard, investors who did so might find themselves unable to hire good managers.

In addition, the legal model with its emphasis on "owner" control is unrealistic because it is unusual for single equity investors to own a significant portion of a firm's equity or to have a substantial portion of their wealth invested in one firm.[76] Thus, shareholders are left with little incentive to take an active role in the business. Moreover, even if they were willing and able to express themselves in some meaningful way, it is likely that their interests would not be unitary.[77] The legal model fails to disaggregate equity holders and to account for competing objectives.

Finally, the legal model fails to take account of the role of contracts affecting control. Despite the general rule of agency law that the principal has the power to direct the actions of the agent, the board of directors of a corporation cannot tell the chief executive officer to perform menial tasks. Corporate managers have at least an implicit contract defining what it is that they can be asked to do. Beyond that, top-level managers sometimes bargain for the legal right to make certain kinds of decisions. For example, the chief executive officer (c.e.o.) might bargain for the power to act in a manner consistent with the role of executive as defined in the bylaws of the corporation at the time he was hired. Any effort by the board of directors to reduce the traditional role of the executive in making business decisions would then be a violation of that contract, giving rise to an action for damages.[78]

2. *Specialization, Diversification, and Discretion*

Problems of control should properly be thought of as a product of three interrelated phenomena: specialization, diversification, and discretion.[79] Specialization affects not only the operation of the modern business ven-

76. *See infra* pp. 1544-45.

77. For example, shareholders whose income is taxed at low rates may prefer generous dividends while shareholders whose income is taxed at high rates may prefer no dividends. *See supra* note 57. Or shareholders may differ in their willingness to take risks (either because of differences in the degree of their aversion to risk or because of different estimations of the volatility of the future returns of the business). Nonetheless, shareholders may be tied together by a belief that the prospects of the corporation are not adequately reflected in the market price of the stock. *Cf.* W. BAUMOL, THE STOCK MARKET AND ECONOMIC EFFICIENCY 84 (1965) (discussing differing objectives among shareholders).

78. Contracts giving managers such rights relating to control are rare, but many directors are aware of the interests of managers in control. A good manager, after all, can impose damages on investors by quitting if his demands for control are not met.

79. *See* Anderson, *Conflicts of Interest: Efficiency, Fairness and Corporate Structure,* 25 U.C.L.A. L. REV. 738 (1978).

ture, but also (though this is less frequently recognized) its organization or formation. Individuals with different contributions and different tastes for returns on their contributions are able to combine their resources and establish mutually satisfactory claims. For example, people with money or other assets often form alliances with people with managerial skills. The contributors of capital may be well aware of the opportunities for cheating, shirking, and even stealing by the managers, and of the costs that will be incurred in trying to control such behavior.[80] Managers may resent sharing the product of their efforts with the contributors of capital and may wish that they were entitled to all profits. Both parties may be aware of potential conflicts over business strategy. Yet, in the face of all these problems they come together because the combination seems to further their mutual interests.[81]

A second set of problems that must be faced in structuring a joint venture results from the need of participants to reduce risk by diversification. In sizable ventures, promoters and managers may seek investors even if such outsiders were not absolutely essential to provide the necessary financing. Moreover, the number of investors is likely to be large, thereby making it difficult for them to communicate and to agree on objectives. Furthermore, investor control of management is attenuated, since, as suggested above, individual investors hold small proportions of the claims entitled to control and, perhaps more significantly, no investor has enough of his or her total wealth invested in the venture to make it worthwhile to devote significant time to reviewing and influencing the behavior of management.[82]

A final aspect of the problem of control is that managers must exercise discretion; they are hired for their skill in making business decisions. Without this discretion, specialization between management and the suppliers of capital would not lead to significant problems of control. The exercise of discretion, however, increases the probability that managers will engage in self-serving conduct, making decisions that benefit themselves at the expense of other claimants, particularly residual claimants.[83]

80. These costs are now commonly referred to as "agency costs," a phrase introduced by Jensen & Meckling, *supra* note 1. *See* Easterbrook & Fischel, *supra* note 69, at 1170. Another commonly used descriptive term is "opportunism." *See* O. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 26-30 (1975).

81. "Only to the extent that frictions associated with one mode of organization are prospectively attenuated by shifting the transaction, or a related set of transactions, to an alternative mode can a failure be said to exist." O. WILLIAMSON, *supra* note 80, at 20; *see also* Easterbrook & Fischel, *supra* note 69, at 1170 ("If separation [of ownership and control] were not highly functional, investors would not entrust their money to managers.").

82. *See supra* p. 1544.

83. It is, of course, implicit in this discussion that the interests of managers may conflict with those of other participants in the venture and that managers can be expected to maximize their own interests regardless of the terms of their bargain with the other participants.

3. *Representation and Communication*

In large-scale enterprises diversification, as we have seen, leads to large numbers of investors with inadequate incentives to exercise control. In the corporate model this problem is met by interposing between investors and managers a representative institution, the board of directors. That model posits a hierarchy in which shareholders elect directors who in turn control managers.

Under a series-of-bargains approach, with its greater recognition of the interests of managers, one would more likely recognize that monitoring is only one function served by the board of directors.[84] The board also serves as a vehicle for communication between managers and shareholders, and as a vehicle for managers to explain their goals, problems, and achievements to investors in a manner that will lend credibility to the explanations.[85]

D. *Duration*

Duration is an essential element of every business association, though its significance and its relationship to other elements of the bargain are often ignored both by scholars and by participants in business ventures. The longer the expected term of a relationship, the more important and complex become the bargains over some of the other elements of that relationship, particularly control, and the more the relationship begins to resemble a firm rather than just a contract.[86] In short, "firmishness" tends to increase with duration.

1. *Withdrawing from the Venture*

Suppose that an investor can fully and unqualifiedly withdraw at any time and receive a pro rata share of the value of the firm's assets. If a substitute for the withdrawing investor can be found, withdrawal may create no significant problem for those who wish to remain with the venture. Often, however, it is difficult to find a substitute; the information costs for a new investor may be high, especially in the case of a small firm, where much relevant information is in the heads of the existing investors, who may have good reasons to be disingenuous. The investors

84. *See* Leach & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 BUS. LAW. 1799 (1976).

85. In the case of the very largest corporations, however, the board may not be capable of performing even these limited functions effectively. *See* Coffee, *supra* note 20, at 1132-47.

86. For example, an association formed to build a single building and then sell it, or to drill a group of oil wells and do nothing more than operate those wells, differs markedly from an association formed to enter into business, for an indefinite period of time, to erect and sell buildings or to drill for and sell oil.

who wish to continue may be unable or unwilling to buy out the withdrawing investor. Thus, withdrawal by an investor (or set of investors) with a significant stake in the venture might lead to a forced sale or liquidation of the business at a distress price.[87] The possible loss creates an opportunity for threats of withdrawal designed to extract value from the other participants. Such behavior, or even its possibility, might undermine the good will and spirit of cooperation that make certain ventures attractive, especially small ones in which investors also contribute services as decision-makers or managers.

A long-term commitment eliminates this possibility, but not without costs. As duration increases, the number of contingencies investors should be concerned with also increases, which in turn can lead to further problems of specificity and control.[88] While the possibility of extraordinary losses from premature termination may seem to make a long-term commitment advisable, such a possibility may, in fact, make a legally enforceable commitment unnecessary. When rational investors know that they stand to lose by the termination of their association, and when no substantial psychic costs result from remaining in such an arrangement, they are likely to continue the association.[89]

The relationship between investors and managers illustrates different features of the duration element.[90] The manager's salary is likely to be the major component of his income, while payment of that salary is likely to have relatively little effect on investor income. Thus, as to salary, managers are likely to be more risk averse than investors, and both stand to benefit if the risk of loss of the salary is borne by the investors. At the same time, investors may want some assurance that a manager who is successful will not defect to another firm or, by threatening to do so, extract a higher salary than would have been paid under a long-term contract. A long-term contract with fixed compensation satisfies a manager's interest in security and the investors' interest in acquiring managerial services at a reasonable cost. A long-term commitment (with or without a fixed salary) also helps resolve problems that arise when an employee develops skill or knowledge specific to a particular employer. As skills and knowledge become more specific, the employee may become more valuable to his present employer and less valuable to others. In the absence of a

87. Moreover, the mere possibility of withdrawal may deprive the firm of the ability to make otherwise advantageous long-term commitments.

88. *See infra* p. 1555.

89. If there are substantial psychic burdens, termination may be appropriate despite the financial costs. Perhaps this is why the rules of partnership law assume that termination should be available in the absence of an agreement to the contrary. *See infra* p. 1562.

90. *See* Hashimoto & Yu, *Specific Capital, Employment Contracts, and Wage Rigidity*, 11 BELL J. ECON. 536 (1980).

long-term commitment, the resulting relationship invites discord and costly strategic behavior.

The long-term fixed-salary contract, however, does represent a fixed commitment and, as such, exposes the investors to risk. The manager cannot expect the investors to take that risk without getting something in return, in all probability a lower salary. Because of differences in risk-bearing capability, both the manager and the investors may benefit from that bargain.[91]

2. *Agreed-Upon Term*

The agreed-upon term of a business relationship may be express, implied, or supplied by law. Its possible duration can usefully be divided into three basic categories: at will, specified term, and indefinite term. A prime example of a relationship at will is the typical relationship between employers and employees, which, absent an agreement to the contrary, is legally terminable at the will of either party.[92] For managers there is likely to be some relatively short implied term,[93] so that duration is not

91. Two other problems with the long-term employment contract cannot be dismissed so easily however. First, there is a "moral hazard"—a danger that the manager with the security of a long-term contract will not work as effectively as one who can be fired without cause. It is hard to imagine how a contract could be drafted that would mean anything to the manager if it did not create this danger to the investors. The danger can be reduced by substituting contingent forms of compensation for fixed salaries. It is by no means easy, however, to devise formulas for contingent compensation that provide proper incentives. *See* Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 524-28 (1981). Moreover, to the extent that a manager accepts contingent compensation he accepts a risk, and investors may be required to give up more than they want to. Contingent compensation nonetheless may leave both managers and investors better off. *See infra* note 136 (discussing "gap-closing" function of risk sharing).

The second difficulty with the long-term employment contract is a "one-way-street" problem arising from the difficulty of enforcing the manager's obligation. Sports contracts, for instance, often seem to have little de facto legal effect if the athlete or coach is successful, for there is no way to force the employee to give his all. The same is true for entertainers. *See* Lumley v. Wagner, 42 Eng. Rep. 687, 693 (Ch. 1852) (holding that court cannot compel specific performance of contract to sing).

Much the same phenomenon occurs with managers. Imagine that a manager has entered into a five-year contract at a salary that seemed very generous at the outset. If he does a mediocre job and the business struggles, ordinarily he will not offer to take a lower salary. Suppose, however, that the manager does well, the business turns out to be extremely profitable, and the manager receives an offer from another firm at a far higher salary. It might be foolish for investors to hold the manager to the contract. If they do not release him or raise his salary, they may be entrusting their investment to a malcontent manager, whose work habits, sense of obligation, and concern with reputation may be insufficient to overcome an inclination to be lazy. That conduct might have a significant adverse effect on the business and still not be sufficient to make it profitable for the investors to terminate the employment, especially if the manager's conduct is not so deficient as to permit termination without liability for damages. Like the problem of moral hazard, the "one-way-street" problem can be mitigated by contingent compensation, but not easily or without costs.

92. *See* 3A A. CORBIN, CORBIN ON CONTRACTS § 684 (1960). *But see* Pugh v. See's Candy, Inc., 116 Cal. App. 3d 311, 171 Cal. Rptr. 917 (1981) (recognizing implied obligation of employer not to discharge long-term executive without good cause).

93. For example, an agreement to pay a given sum each month will imply one renewable term of one month.

strictly at will, but the practical significance of brief mutual obligations is trivial. Another notable example of an at-will relationship is the partnership; partners have the legal right (absent agreement to the contrary) to withdraw at any time,[94] though partners, investors, and managers often agree that their relationship will continue for a specified term or until the occurrence of some contingent event.

The relationship between lender and borrower may be at will (loan callable on demand) but often is for a specified term. The relationship among shareholders of a corporation (including the relationship between common and preferred shareholders) is ordinarily of indefinite duration; the corporation continues until terminated by a majority of the shareholders or, in unusual circumstances, by judicial decree.[95]

3. *Enforcement*

The effects of a specified or indefinite term depend, in part, on the legal consequences of violating that portion of the agreement. Those consequences vary considerably depending on the relationship between the parties. In the relationship between lenders (fixed claimants) and borrowers (residual claimants) under a fixed-term loan, once money has been transferred to the borrower, the lender cannot terminate the loan before the expiration of the term; the lender cannot renege on its promise, get the money back, and pay damages. Similarly, the borrower cannot force the lender to accept early payment, though it is common for agreements between lenders and borrowers to provide for prepayment subject to some sort of "prepayment penalty," or "call premium."[96] In a sense, once the money has been transferred to the borrower, the durational element of the bargain is self-enforcing.

The relationship among shareholders in a corporation is also self-enforcing. Ordinarily a majority (unless acting in bad faith[97]) can vote to terminate at any time,[98] but disaffected minority shareholders have no power to renege on their "contract." They do not have the option of ter-

94. *See infra* p. 1562. Technically, withdrawal causes a "dissolution" of the partnership. Practically, the other partners must at this point either buy out the withdrawing partner at a mutually agreeable price or "wind up" the business, paying off all debts and dividing the remaining proceeds, if any. *See* W. KLEIN, *supra* note 16, at 85-87.

95. *See* MODEL BUS. CORP. ACT §§ 83, 94, 97 (1979).

96. Such provisions seem in some ways comparable to liquidated-damages provisions in other kinds of contracts. If the prepayment penalty or call premium is too high its effect will be to foreclose prepayment, just as liquidated damages of sufficient amount would tend to foreclose breach of a contract.

97. *See In re* Security Finance Co., 49 Cal.2d 370, 317 P.2d 1 (1957); Hetherington, *The Minority's Duty of Loyalty in Close Corporations*, 1972 DUKE L.J. 921, 933.

98. The shareholders, however, can agree that a higher percentage is required. *See* DEL. CODE ANN. tit. 8, §§ 216, 271, 275 (1975); MODEL BUS. CORP. ACT §§ 55, 84, 143 (1979).

minating subject to an obligation to pay damages. This inability to "withdraw" from the corporation can lead to the familiar problem of the dissatisfied but "locked in" minority shareholder.[99] Judicial intervention is not required to keep the minority to its durational bargain, nor to allow the majority to take advantage of that bargain.

Unlike the relationships between lender and borrower and among shareholders in a corporation, the relationship between employer and employee is not self-enforcing. Suppose that the president of a corporation has a five-year employment contract with a fixed monthly salary. Despite the apparent durational element of the agreement, the board of directors (acting for the investors) has the power to dismiss the president at any time, though the corporation is liable for damages (if any), determined by the president's ability to find new employment and by the liquidated damages specified in the employment contract. The president has no power to force the investors to abide by what the bargain appears to call for on its face.[100] Thus, when investors say that they will hire managers for a fixed term, they mean (disregarding any sense of moral obligation) that they will employ those managers for the term or else pay damages. Similarly, the managers cannot be compelled to remain at the job. They can leave the firm at any time, subject to the possible payment of damages to the investors. In both cases, judicial intervention, if required, will be limited to establishing the amount of the damages and perhaps enjoining certain kinds of alternative performance of services.

The durational aspect of the relationship among partners is an amalgam of the rules previously discussed. Partners are legally like employees

99. It is a slight exaggeration to say that the minority shareholder is completely locked in. It seems likely that in all but the most exceptional cases there is some price at which the minority shareholder could sell (most likely to the majority shareholder or shareholders). But the price is not likely to be "fair"—that is, a price reflecting the minority's pro rata share of the total value of the corporation. A legal right to withdraw increases the price that the majority will be required to pay the discontented minority. *See* Hetherington & Dooley, *Illiquidity and Exploitation: A Proposed Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 4-6 (1977). Nothing in the law of corporations stands in the way of buy-out agreements to cope with the lock-in problem.

100. The power to dismiss subject to liability for damages is an implicit term of the contract that cannot be altered by agreement. That is, the parties cannot effectively provide that the president must remain in the job. Courts will not enforce such an agreement. *See* Kronman, *Specific Performance*, 45 U. CHI. L. REV. 351 (1978); Rubin, *Unenforceable Contracts: Penalty Clauses and Specific Performance*, 10 J. LEGAL STUD. 237 (1981); Schwartz, *The Case for Specific Performance*, 89 YALE L.J. 271 (1979). The parties can make the liquidated damages provision very tough, though not so tough as to amount to an impermissible "penalty." *See* Goetz & Scott, *Liquidated Damages and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977). The law's attitude that damages are an adequate remedy seems inconsistent with the idea that "promisees know better than courts whether the damages a court is likely to award would be adequate because promisees are more familiar with the costs that breach imposes on them." Schwartz, *supra*, at 277. Thus, some commentators argue that while it might be futile to force a manager to continue to supply services, *see supra* note 91, it "should be the promisee's choice whether to risk the possible defects of a coerced performance." Schwartz, *supra*, at 304; *see* Kronman, *supra*, at 376.

in that they can withdraw from the partnership at any time, despite an agreement to the contrary, subject to liability for damages.[101] The potentially disruptive effect of withdrawal is recognized in special partnership rules relating to the powers of the continuing partners and to the valuation of the withdrawing partner's interest.[102] Partners who withdraw in contravention of the agreement are entitled to the value of their interests, less the value of good will and the amount of any damages. The remaining partners may continue to use the partnership property, and, by posting a bond, defer payment to the withdrawing partner.[103] Nonetheless, the rules seem to leave partnerships excessively vulnerable to losses from premature termination.[104]

4. *Transferability*

The significance of a long-term association depends in part on the extent to which a participant is permitted to transfer rights and obligations. Generally, an employee cannot, without the consent of the employer, delegate the performance of personal services called for by an employment contract.[105] Partnership law is also premised on a notion of agency (in this instance, mutual) and of a corresponding personal obligation of each partner to the others.[106] Consequently, in the absence of an agreement to the contrary, a partner cannot substitute another person as "a member of a partnership without the consent of all the partners."[107] (He can, however, assign his financial interest in the partnership.[108]) This rule seems consistent with the withdrawal-at-will rule of partnership law, and, in turn, with the notion that each partner (partly because of personal liability for debts of the partnership) wants and needs to participate in control.

In contrast, shareholders are thought of more as passive investors. The personal elements of the partnership relationship are thought to be missing. Consequently, shares are freely transferable. The shareholders, however, may modify the usual rules by bargaining for continuation or buy-

101. *See infra* p. 1562.

102. *See infra* p. 1562; *supra* p. 1549.

103. UNIF. PARTNERSHIP ACT § 38(2) (1969). It is not clear how long payment to the withdrawing partner can be deferred. *See* A. BROMBERG, CRANE AND BROMBERG ON PARTNERSHIP 429 n.79, 430 n.84 (1968).

104. *See* W. KLEIN, *supra* note 16, at 88-89. Hetherington and Dooley's proposal for a mandatory corporate buy-out provision, *supra* note 99, is insufficiently sensitive to this danger.

105. *See* 4 A. CORBIN, *supra* note 92, § 865.

106. *See* A. BROMBERG, *supra* note 103, at 43-44, 272-75; Fellows & Painter, *Valuing Close Corporations for Federal Wealth Transfer Taxes: A Statutory Solution to the Disappearing Wealth Syndrome*, 30 STAN. L. REV. 895, 929-30 (1978).

107. UNIF. PARTNERSHIP ACT § 18(g) (1969).

108. The person to whom the interest is assigned "is only entitled to receive . . . the profits to which the assigning partner would otherwise be entitled." *Id.* § 27(1).

out agreements.[109] Shareholders will pay attention not only to the durational element of the associational bargain but also to all other elements.[110]

While transferability may fulfill some of the same functions as the right of withdrawal, it is by no means a perfect substitute for withdrawal. For example, when a majority of the shareholders runs a business according to its own interest and at the expense of the minority, the right of the minority to sell its shares may be of small comfort. No buyer will pay a price that reflects the pro rata claim of the minority shares since every prospective buyer will assume that the majority will continue to run the business in its own interest.[111] This problem is not limited to closely held corporations, although in public corporations the possibility of a takeover may constrain self-serving actions on the part of the majority or of entrenched management.[112]

5. *Special Provisions*

A number of special provisions may modify the durational terms of an agreement. The call provision in a corporate debenture or bond, for example, gives the borrower the right to repay the loan, usually at a slight "premium" over the face amount.[113] Perhaps the best reason for including a call feature in a debt obligation is to allow the borrower to avoid restrictive covenants that have become unduly burdensome.[114] With a call provision, the lender's control over the borrower's business decisions[115] can be

109. *See* W. KLEIN, *supra* note 16, at 89-90, 133-34.

110. For example, a suitable buy-out agreement may solve the control issue. One who expects to be locked into a corporate investment might insist on veto power over certain kinds of corporate decisions; given the right to sell his shares to the other participants at a reasonable price, the person might be willing to relinquish the veto right.

111. This assumption is reflected in the (judicially accepted) notion that minority shares are worth less than controlling shares.

112. *See* W. KLEIN, *supra* note 16, at 119-20, 131.

113. *Id.* at 163-64; J. WESTON & E. BRIGHAM, MANAGERIAL FINANCE 509 (6th ed. 1978).

114. Call provisions can also serve a "gap-closing" function. *See infra* note 136. Suppose a financially shaky firm seeks to borrow and finds that it must pay a high rate of interest. The manager may be optimistic about the future of the firm, but the lender may not share that optimism. The manager will want to be able to refinance at a lower rate when his optimistic expectations eventuate. *See* Barnea, Haugen & Senbet, *A Rationale for Debt Maturity Structure and Call Provisions in the Agency Theoretic Framework*, 35 J. FIN. 1223 (1980). If the manager were confident in his optimism, the sensible strategy would be to borrow for a term just long enough for the firm to prove itself a better risk. The call provision is a way of hedging one's bet on that kind of expectation. Viewed from this perspective, long-term debt with a call provision is similar to short-term debt with an option to renew.

A call provision also allows a firm to deprive lenders of unexpected windfalls from increments to the value of their equity as a result of changes in corporate strategy such as dividend reduction or lower-risk investment. *See* W. KLEIN, *supra* note 16, at 164.

115. For example, a bond convenant may require a specified, conservative ratio of debt to equity or current assets to current liabilities and may thereby effectively preclude investments the borrower might consider attractive, or prohibit mergers or substantial changes in the business without consent of

eliminated by terminating the debtor-creditor relationship.[116]

Contingent returns can also affect the durational aspect of business associations. Suppose, for example, that one group of investors sells a business to another. If agreement cannot be reached on price, the amount paid may consist of a fixed payment, plus some future payment dependent on the success of the business. The sellers may retain a substantial stake in the business and will be concerned, among other things, with control. Thus, the contingent payment extends the selling investors' involvement with the business.[117]

III. Constraints, Conflicts, and Bargains

Participants in business arrangements will bargain over the elements of risk of loss, return, control, and duration subject to three major constraints: government regulation, limitations on specificity, and conflicting interests and goals. These constraints contribute to the background against which participants act in structuring transactions. The terms of a given bargain, for example, will often be manipulated in response to conflicting interests and goals. Thus, in structuring agreements, practitioners should be aware of the relationships among the four elements of the model presented here, and of the tradeoffs available in forming joint ventures.

A. *Constraints*

Constraints play an important role in the structuring of transactions. For example, in response to the need for disclosure under the federal securities laws, entrepreneurs may decide to seek capital from a single source, rather than from a number of individuals; the difficulty of specifying outcomes can lead to vertical integration rather than market transac-

the lender.

116. The relationship will be terminated only if the principal, even with the call premium, is a reasonable price to pay to avoid the burdensome covenant. When interest rates have risen significantly since the issuance of the bond or debenture, callability may become a largely meaningless right.

Another important provision affecting the durational element of a business association is the option to buy the interest of a participant (a call) or to sell one's interest to someone else (a put). These are especially interesting when one equity participant has a put to another such participant or a call on another such participant's claim in the enterprise. *See supra* note 46.

117. A similar phenomenon occurs with employment relationships. Suppose that a corporation is negotiating to hire a president. At the outset of negotiations, both sides agree that the relationship should be terminable at will. The bargaining may then expand to include contingent compensation, based on the future profits of the business. A simple terminable-at-will agreement is no longer possible. The corporation could still be free at any time to tell the president to stop performing, thus relieving itself of any obligation to pay a salary; the president may also be free to walk away without liability. But some agreement must be reached about what happens to the contingent compensation when the president stops supplying services, and therefore some relationship between the parties could endure. *See supra* note 43.

tions;[118] conflicts among participants may be minimized by attempting to align their interests. The notion of constraints in the context of joint business ventures is a relatively familiar one and has been referred to, at least implicitly, in the preceding sections. Consequently, it will be presented briefly, without development.

1. *Government Regulation*

For the purposes of the present discussion the most significant sets of governmental rules affecting business associations relate to the issuance of securities[119] and to the enforcement of debt obligations. Federal securities laws[120] may impose substantial costs and delays on those seeking to raise capital.[121] Some cost and delay would no doubt occur in the absence of regulation; investors do, after all, need information. In the case of large public offerings of securities, the added costs and delays associated with federal regulation, as compared with what would be required by business realities in the absence of regulation, may be few. With small offerings, however, the parties might often be content with much less information than the regulatory laws require and might prefer a greatly expedited process, but they do not have the option of waiving the protections of the securities laws. Furthermore, in some states, the parties may be subject to statutory rules that preclude certain kinds of bargains with prospective investors, no matter how anxious the investors are to enter into them.[122]

Under the federal bankruptcy laws debtors can prevent their creditors from enforcing the terms of the debt agreement relating to default.[123] The debtor's right to do so cannot be waived. In other words, a prospective borrower cannot effectively agree that, upon default, the lender can take

118. *See supra* p. 1522.

119. We may bias our perspective on the appropriateness of regulation by speaking abstractly of regulating the "issuance" or the "sale" of securities rather than more concretely, and more realistically, of regulating the terms of relationships among people wishing to join together in a business venture.

120. Securities Act of 1933, 15 U.S.C. §§ 78a-78kk (1976 & Supp. V 1981).

121. *See* R. JENNINGS & H. MARSH, SECURITIES REGULATION, CASES AND MATERIALS 106-27 (4th ed. 1977).

122. *See* W. CARY & M. EISENBERG, *supra* note 6, at 1329-34; R. JENNINGS & H. MARSH, *supra* note 121, at 1263-65; Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?*, 1976 WIS. L. REV. 79; Ptacek, *Blue Sky Considerations in Structuring a Public Offering*, 21 DRAKE L. REV. 225 (1972).

123. *See* 5 COLLIER ON BANKRUPTCY ¶ 1100.01 (15th ed. 1981); W. KLEIN, *supra* note 16, at 160-63.

Difficulties of enforcement also arise as a consequence of state laws relating to possession of property. Consider, for example, the position of a tenant who has failed without excuse to pay rent but who nonetheless refuses to quit the premises. The inability of the landlord to regain possession without delay seems to be the natural product of the basic decision that government should monopolize the use of force. Federal laws relating to insolvency reorganization reflect the notion that it is a good idea to protect debtors from the consequences of their defaults—in other words, to make certain promises relating to the enforcement of debt obligations unenforceable.

over the business or any asset of the business and satisfy its claim without interference. Moreover, the result of judicial proceedings affecting debtors who fail to meet their obligations may well be that the people who agree to bear the burden of the debt wind up with a stake in the surviving business, even if the creditors are not fully satisfied. These rules have a significant effect on the availability and cost of credit.

2. *Limitations on Specificity*

One important aspect of the general problem of specifying outcomes or decisions for all contingencies is the difficulty of anticipating contingencies, planning for them, and devising verbal formulations that accurately express desired solutions.[124] Another aspect of this problem, more familiar to practitioners than to scholars, is the danger of "queering the deal."[125] Drawing attention to certain potential difficulties (for example, what to do if a partner dies or if the partners cannot agree about business policy) may trigger emotional reactions that prevent the formation of an organization that, from a strictly rational economic perspective, should have been formed.

3. *Conflicting Interests and Goals*

Conflicts among participants in business ventures arise as a result of differences in objectives and in perceptions on which strategies will maximize returns. Generally, individuals who choose high-risk, residual claims are more optimistic about the prospects of the business than those who choose low-risk, fixed claims. The degree of a claimant's optimism, how-

124. *See* Farnsworth, *Disputes Over Omission in Contracts*, 68 COLUM. L. REV. 860 (1968); Macneil, *supra* note 1, at 726; Macneil, *A Primer of Contract Planning*, S. CAL. L. REV. 628, 636 (1975); *supra* p. 1547. Williamson adopts the phrase "bounded rationality" to describe the specificity problem. The phrase seems to enjoy in style what it lacks in content. O. WILLIAMSON, *supra* note 80, at 9. In a more recent work, Williamson ties together the problems of opportunism and bounded rationality:

> The two behavioral assumptions on which transaction-cost analysis relies—and without which the study of economic organization is pointless—are bounded rationality and opportunism. As a consequence of these two assumptions, the human agents that populate the firms and markets with which I am concerned differ from economic man (or at least the common caricature thereof) in that they are less competent in calculation and less trustworthy and reliable in action . . . . But for the *simultaneous* existence of both bounded rationality and opportunism, all economic contracting problems are trivial and the study of economic institutions is unimportant.

Williamson, *supra* note 3, at 1545; *cf.* Simon, *A Behavioral Model of Rational Choice*, 69 Q.J. ECON. 99, 114 (1955) ("[I]f we assume the global kinds of rationality of the classical theory, the problems of the internal structure of the firm or other organization largely disappear.").

It is important not to overemphasize limitations on specificity. Lawyers spend much time specifying outcomes in various contingencies and their efforts are to some considerable degree successful. A good illustration can be found in bond covenants. *See infra* note 137.

125. W. KLEIN, *supra* note 16, at 56-57.

ever, is likely to affect his judgment of the effect of potential business strategies or projects on the value of the firm. Optimists and pessimists may then be in conflict over whether to pursue such strategies and projects.[126]

This conflict arises in part from differences of judgment as to how to maximize the value of the firm. More dramatic conflicts can arise where one set of participants is in a position to improve its position at the expense of another set, even though that strategy will diminish the value of the firm.[127] In some circumstances, the concern of managers to protect their jobs may lead them to adopt strategies too conservative to maximize the value of the residual claim.[128] In other circumstances, managers may

126. Often, people do not like to think about potential conflicts. Also, the rules of the game often seem so well settled by custom, based on sound business considerations, that the conflict seems not worth worrying about. Sometimes, however, those rules should be modified in the interests of protecting legitimate expectations and creating an optimal bargain. For example, ordinarily lenders do not expect to control or even to share control over matters of business strategy. As a general proposition, that may make a good deal of sense. In certain circumstances, however, lenders may want some protection against changes in the way the borrower conducts its business. They might want to require that no changes be made in a corporate borrower's management or board of directors without the lender's approval. Often lenders also insist that the borrower maintain certain financial conditions. Such limitations may have the effect of requiring their consent to new business commitments. On bond covenants generally, see AMERICAN BAR FOUND., COMMENTARIES ON INDENTURES (1971); J. KENNEDY & R. LANDAU, CORPORATE TRUST ADMINISTRATION AND MANAGEMENT, 19-44, 228-44 (2d ed. 1975); Garret, *A Borrower's View of the Model Corporate Debenture Indenture Provisions*, 21 BUS. LAW. 675 (1966); Rodgers, *The Corporate Trust Indenture Project*, 20 BUS. LAW. 551 (1965); Simmons, *Drafting of Commercial Bank Loan Agreements*, 28 BUS. LAW. 179 (1972); Simpson, *The Drafting of Loan Agreements: A Borrower's Viewpoint*, 28 BUS. LAW. 1161 (1973); Smith & Warner, *On Financial Contracting: An Analysis of Bond Covenants*, 7 J. FIN. ECON. 7 (1978). Lenders can also try to protect their interests indirectly, through the exercise of control, by aligning the interests of the manager with their own (and in opposition to the holders of the residual claim). One way to do this is to require managers to invest a substantial portion of their own funds in the firm, to the point at which the manager's aversion to risk coincides with the lender's. Another possibility is to defer some significant portion of the manager's compensation until the debt is repaid (or the risk of nonpayment becomes minimal).

At the same time, lenders may object to managerial compensation, such as stock options, that aligns the interests of managers with the residual claimants. The residual claimants may be willing to acquiesce in lender demands for lender-protective managerial compensation systems because that may be the only way to obtain funds or because they are compensated by a lower rate of interest or less restrictive covenants. *See* W. KLEIN, *supra* note 16, at 169-70; Ross, *The Determination of Financial Structure: the Incentive-Signalling Approach*, 8 BELL J. ECON. 23 (1977). This kind of outcome makes clear that traditional notions of the fiduciary obligations of managers may be inadequate or misleading. *See supra* p. 1542.

127. For example, suppose that the preferred shareholders of a corporation have a claim to past unpaid dividends in an amount far in excess of the value of the assets of the corporation. It might then make sense for common shareholders to adopt a go-for-broke strategy with some possibility of a future return, even though the expected value of that strategy might be small in relation to safer strategies unlikely to produce gains sufficient to pay off the preferred shareholders. *See* W. KLEIN, *supra* note 16, at 188-90. Similarly, by adopting high-risk strategies, common shareholders can cause the market value of their shares to increase at the expense of the market value of fixed claims. *Id.* at 167-69; Galai & Masulis, *The Option Pricing Model and the Risk Factor of Stock*, 3 J. FIN. ECON. 53 (1976).

128. It is worth noting, however, that the insolvency of the firm does not necessarily mean loss of employment by its managers. Often insolvency means only a change in the identity of the holders of the residual claim (and of control). A talented manager who has tried to maximize the value of the

adopt a highly risky strategy to maximize the expected value of their claim to a bonus, even though that strategy will diminish the present value of the common shares. Or the terms of the bargain may be such as to induce managers to avoid making sound investments.[129]

Similarly, efficiency, which benefits all participants, requires managerial specialization and discretion, thereby creating opportunities for shirking, cheating, and stealing.[130] These activities are costly to control. One can adopt rules prohibiting such behavior, but such rules may be costly to specify and even more costly to enforce.[131]

B. *Bargaining Under Constraints*

The role of constraints in the series-of-bargains model is not static; the interplay between bargains over elements and constraints is significant. As an example of this interplay, it is useful to examine ways in which transactions can be structured in the presence of conflicting interests and goals. In dealing with the conflict between managers and shareholders it is possible, of course, to rely on standards of fiduciary obligation[132] or on the bulwarks of trust—morality, self-esteem, and concern for reputa-

firm should be retained even if the strategy adopted has failed; at least, such a manager should not have difficulty finding another job. By the same token, overly conservative managers should suffer in the long run. Unfortunately for both investors and talented, rational managers, complete and fully accurate information on ability is rarely available and results may be used as a surrogate for such information.

129. Suppose, for example, that a manager is entitled to a share of profits and that one of the outlays deducted in arriving at the amount of profit is the cost of research and development. Such a formula may induce the manager to avoid investing in research and development even though the investment has a very high expected return for common shareholders. Conflict can also be created by stock options, which provide managers with an incentive to retain earnings rather than pay dividends. *See* W. BAUMOL, *supra* note 77, at 87-88.

130. This kind of behavior may be called, for short, "opportunism," *see* O. WILLIAMSON, *supra* note 80, at 9, 26-30, or "self dealing," *see* W. KLEIN, *supra* note 16, at 26.

One peculiar aspect of the problem of shirking (and to a lesser extent of cheating and stealing) deserves brief mention: the problem is likely to be reflected in the bargain and to have an adverse impact on both sides. If, for instance, an investor takes the possibility of shirking into account in setting the manager's compensation and if the manager behaves as the investor feared, then to the extent compensation has been reduced, the investor has not in fact been cheated. Shirking, cheating, and stealing result in a loss not just to the "victim," but to the potential perpetrator as well. Jensen and Meckling note that the investor will take account of the potential shirking but then seem to err in asserting that the cost of the shirking falls on the investor. Jensen & Meckling, *supra* note 1, at 312.

Because of practical limitations on the investor's ability to monitor the manager's performance, a person in a position that affords the opportunity to shirk, cheat, or steal may be unable effectively to offer and be paid for the most honest and diligent performance he is capable of delivering. *See* W. KLEIN, *supra* note 16, at 27-28.

131. Anderson, *supra* note 79, at 744-45 (efficiency gains maximized by reliance on discretion and trust).

132. *Id.* at 760 (discussing efficiency of standardized fiduciary duties); *see also* W. KLEIN, *supra* note 16, at 61-69 (viewing fiduciary duty as means to effectuate presumed intention of partners in areas where no express agreement exists); Brudney & Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 999 (1981) (discussing role of fiduciary obligations in promoting efficiency by facilitating specialization).

tion[133]—to curb incentives for shirking, cheating, or stealing. These devices, however, are of limited scope; a far more effective remedy is to allocate risks and rewards in a manner designed to align, to the extent possible, the interests of the participants.

The tension between managers and shareholders can be reduced by means of a management compensation package consisting in significant part of some share of the profits or gains in value of the enterprise. This approach has three attractive effects. In addition to aligning the interests of management and the holders of the principal residual claim,[134] this scheme for sharing risk reduces the risks of other participants[135] and can sometimes close a gap in negotiations.[136] In general, the experienced practitioner seeks to structure the claims of participants in business ventures to

133. *See* K. ARROW, THE LIMITS OF ORGANIZATION 23, 26 (1974) (referring to such "invisible institutions" as "important lubricant of a social system" and as "extremely efficient"); McKean, *Economics of Trust, Altruism, and Corporate Responsibility*, in ALTRUISM, MORALITY AND ECONOMIC THEORY 29 (E. Phelps ed. 1975) ("[G]reater ability to trust each other to stick with agreed-upon rules would save many costs and make life much pleasanter."). Even more helpful is the ability to trust each other to stick to those rules that were not agreed upon but would have been if the issue had been raised.

134. *See supra* note 59. If too much of a manager's compensation consists of a share of profits, however, the manager may become too risk prone for the tastes of the other residual claimants. By the same token, a manager's exposure to a risk of liability for debts or to a loss of an investment may lead to excessive caution, though such caution may indirectly benefit shareholders by protecting lenders and thereby reducing the cost of borrowing. For the importance of proper criteria for management bonuses and the perverse effects of badly designed formulas, see Meadows, *New Targeting for Executive Pay*, FORTUNE, May 4, 1981, at 176.

135. A manager, a lender, or a lessor who accepts a residual claim as partial compensation for services or for the use of funds or property will presumably receive a lower fixed claim, thereby reducing the risk to the principal residual claimants.

136. Suppose, for example, that an oil and gas promoter is trying to raise funds for a drilling venture. The promoter claims that the venture has a high probability of success, at which point the investors may say, in effect, "If you're so sure of success you ought to be satisfied with a share of profits as your sole compensation." The promoter is hardly in a position to resist. The promoter might agree to accept 25% of profits as his sole compensation, thinking that the expected value of his share of the profits is $250,000. At the same time, the investors may think that the expected value of that share of profits is $125,000 and may be content to pay that much.

The same kind of gap-closing can occur in hiring a manager for an operating business. The principal residual claimants, thinking the bonus is not worth much, may offer a bonus based on profits, while the manager may accept that bonus, thinking, with the kind of self-confidence a manager perhaps ought to have, that it is worth a great deal.

Another example of the gap-closing function of risk sharing occurs when a business is sold for a fixed sum plus an additional future sum dependent on the success of that business—the "earn-out" deal. *See* Gunther, *supra* note 27. Suppose, for example, that the sellers of the business claim that its future is bright and that its value is at least $7,000,000. The buyer claims that the selling group's estimate is far too optimistic and that the business is not worth more than $5,000,000. One solution to the impasse is for the buyer to pay, say, $4,000,000 at the outset and additional sums up to $3,000,00 more if the business meets the goals the sellers claim it can meet. This solution however, creates grave problems—defining the goals, agreeing on control, deciding what to do if a merger opportunity arises in the future—and gives rise to extremely difficult tax and securities-law questions.

Perhaps the most sophisticated and complex risk-sharing devices are found in motion picture transactions, where, for example, a producer may share in "profits" under a complex formula involving penalties for exceeding the film's budget that can be avoided by obtaining approval for over-budget outlays. *See supra* note 26.

minimize the effects of antagonistic interests.

C. *Relationship Among Elements*

The negotiation over control and return that can lead to an aligning of the interests of managers and shareholders illustrates the importance of understanding the relationship among the different variables in the model. Bargains as to one element have implications for the outcome of negotiation over other elements.

1. *Risk of Loss and Control*

The needs of the participants for control and the consequent likelihood that they will have control usually can be predicted given their risk of loss. Bargainers can cope with problems of control by varying risk of loss; they can cope with concerns over risk by allocating control. Generally, it seems reasonable to expect that those who bear the greatest risk will have the greatest degree of control over the enterprise, partly because they have the greatest need to protect themselves and partly because the people with control should have residual claims to preserve incentives to exploit wealth-maximizing opportunities. Thus, common shareholders and partners typically have control or at least the power of control.

We are troubled by large organizations in which control by holders of the principal residual claim is attenuated or nonexistent, since the exercise of economic power by individuals who lack an "ownership" interest is inconsistent with the traditional defense of private ownership that states that the optimal allocation of resources results from owners pursuing their own interests. At the same time, we should expect that managers whose compensation depends largely on the success of the enterprise (through bonuses based on profits, stock options, and other such devices) will want and to some degree receive significant control. We should not be surprised, and perhaps not even troubled, that the management team may exercise virtually unfettered control in corporations in which its members risk a greater share of their wealth than any individual shareholder.

By the same token, lenders normally do not have any significant degree of control as long as the borrowing firm is doing reasonably well. When the firm begins to encounter difficulty, however, the risk to the lenders increases, and the terms of the loan may empower them to offer suggestions or give orders. The most obvious device for accomplishing this result is to make certain outcomes acts of default, thereby giving the lender the right to demand payment of the loan principal.[137]

137. For example, the failure of the borrower to maintain a comfortable ratio of current assets to current liabilities may be a violation of the terms of the loan and thus may give the lender a right to

Despite the usual link between risk of loss and control, in some situations the holders of the principal residual claim may be entirely content not to have control.[138] In fact, under the Uniform Limited Partnership Act, limited partners must avoid taking part in control of the venture or else risk personal liability for its debt.[139] Even when protection from liability is not of much practical importance—for example, when debt is nonrecourse and tort liability can be covered by insurance—limited partners may not be interested in control.[140] They may instead place their faith in the general partner, the promoter, who will have an incentive to perform well to enhance his own return from present and future projects. The limited partners may feel that they have little to offer and, more significantly, that others like themselves should have no voice in managing the venture. In other words, they may not just be willing to accept lack of control; they may find lack of control in the group of which they are members to be a virtue.[141] Such an attitude might well be encountered,

demand payment in full. One expects, therefore, to find more restrictions on operation of the business in the covenants of a subordinated debenture than in those of a first-mortgage bond. *See* AMERICAN BAR FOUND., MORTGAGE BOND INDENTURE FORMS (1981) (containing many covenants protecting the lender's interest in the property securing the debt, but few other restrictive covenants). If payment in full is demanded, the borrower is likely to find it difficult to obtain funds from other sources. The lender is not likely to be anxious to push the borrower to default and will certainly want to avoid winding up with nothing but a claim in bankruptcy. But the lender, as a condition for waiving its right to demand present payment, may insist on a change in managers or in the business practices of existing managers. The borrower is likely to be receptive to the lender's suggestions.

Bankers are sometimes concerned about potental liability to other creditors or shareholders if they share control of the business and about possible detriment to their status in the event of bankruptcy. *See* Douglas-Hamilton, *Creditor Liabilities Resulting from Improper Interference with the Management of a Financially Troubled Debtor*, 31 BUS. LAW. 343 (1975); Nassberg, *Loan Documentation: Basic but Crucial*, 36 BUS. LAW. 843, 851-52 (1981); *see also* Comment, *Indirect Liabilities of Construction Lenders in a Development Setting*, 127 U. PA. L. REV. 1525 (1979) (examining scope of lenders' liability); Schmitt, *Farah's Suit May Help Define When Banks Can Assume Control to Assure Repayment*, Wall St. J., Nov. 2, 1981, at 25, col. 4 (reporting on suit seeking damages for wrongful exercise of control).

138. Limited partnerships provide a good example of this phenomenon. In a real estate development venture, for example, the limited partners may put up all the money, while the general partner finds the project, brings together the investors (limited partners), and supervises the development and sale or operation of the project.

139. *See* Holzman v. De Escamilla, 86 Cal. App. 2d 858, 195 P.2d 833 (1948); UNIF. LIMITED PARTNERSHIP ACT § 7 (1980).

140. As long as the power to make decisions is reserved to the general partner, the limited partners do not have control, even though the general partner may consult with them before making decisions. Consequently, limited partners do not lose their limited liability by discussing decisions with the general partner. *See, e.g.*, Silvola v. Rowlett, 129 Colo. 522, 272 P.2d 287 (1954); Trans-Am Builders, Inc. v. Woods Mill, Ltd., 133 Ga. App. 411, 210 S.E.2d 866 (1974); UNIF. LIMITED PARTNERSHIP ACT § 303(b)(2) (1980).

141. *Cf.* Alchian & Demsetz, *supra* note 19, at 788, 789 n.14. When limited partners have the power to vote on the election or removal of the general partner, on termination of the partnership, on amendment of the partnership agreement, or on sale of all or substantially all of the partnership assets, *see* Larson v. Commissioner, 66 T.C. 159 (1976), their de facto control may be essentially the same as that of the shareholders of public corporations (especially when one recognizes the fiduciary obligations of the general partner to the limited partners); *see, e.g.*, CAL. CORP. CODE § 15,507 (West 1977) (limited partner not liable as general partner unless he participates in control of business);

however, only in arrangements like tax shelter limited partnerships, where the activities of the venture are well defined and management input occurs over a relatively short period. In those circumstances, the power of investors to control managers, even if legally retained by the investors, may be of little practical importance.[142]

2. *Risk of Loss and Duration*

Generally, a lender's risk of loss increases with the duration of a loan. The lender may respond to the risk associated with longer duration by demanding a higher fixed payment or by insisting on collateral or other protections uncommon with short-term loans. The short-term loan does, however, create a special kind of risk for the lender—namely, that at the end of the term the market rate of interest will have declined.

For borrowers, a short-term loan creates a risk that at the end of the term the cost of borrowing may have increased (perhaps to a point where the business is no longer viable). In contrast, a long-term loan creates a risk that the borrower will be saddled with funds costing more than competitors must pay. This risk can be reduced by including a prepayment privilege (the call feature of bonds and debentures) with little or no penalty. Such a provision, however, normally results in higher interest payments.[143]

CONN. GEN. STAT. § 34-15 (1981) (same). This is evidence not that limited partners seek control over the operations and the strategies of the firm, but that shareholders in public corporations do not have control and presumably do not mind.

142. The practical unimportance of short-term investor control over management may also help explain the existence of options. Options are the riskiest residual claim. Yet holders of publicly traded options do not participate in control. The best explanation for this nonparticipation may be that these options are of relatively short duration—nine months at most. In that time span, control over management is not likely to have much impact, at least for companies whose shares are the subject of publicly traded options.

The existence of warrants cannot be explained in the same way. Warrants are often of longer duration than options, and the interests of warrant holders may not coincide with those of common shareholders, who have control. Warrant holders certainly are in direct conflict with common shareholders over dividend policy and often over investment strategies (with warrant holders preferring riskier strategies). *See* W. KLEIN, *supra* note 16, at 186.

143. *See* J. VAN HORNE, FUNCTION AND ANALYSIS OF CAPITAL MARKET RATES 123-24 (1970). Long-term employment contracts also create a substantial fixed obligation increasing the employer's risk of loss. At the same time, a long-term employment contract can (if enforcement is feasible) protect the employer against the risk of an increase in the market price of the employee's services. Risk to the employee depends largely on the employee's mobility. For employees who cannot easily transfer skills to another employer, the longer-term contract provides an important protection against risk of loss of earnings. At the same time, where firm-specific skills make employers dependent on their employees, a long-term contract may (depending on the practicality of enforcement) deprive employees of the power to extract higher returns for their services.

As with many other aspects of private contract, durational obligations may be implied by notions of fairness. Such obligations may be enforceable not by any action based on contract law, but only by informal sanctions (if at all). Imagine, for example, an engineer who has been working for a firm without a contract because both the engineer and the firm agree that it would be too difficult to take account of all the contingencies that might affect duration, level of compensation, and so forth. Sup-

3. *Control and Duration*

In short-term relationships, where there are few unexpected contingencies, control issues are susceptible to resolution by express or implied advance agreement among the parties to a business venture. As the expected duration of the relationship increases, however, the number of contingencies increases and our capacity to anticipate them diminishes. The only feasible mechanism for coping with potential conflicts among the participants over business and financial strategy may then be to allow all participants some power of control.[144]

Control may be correspondingly less important when the relationship is easy to terminate. For instance, absent agreement to the contrary, a partnership is terminable at the will of any partner.[145] Thus, while partnership decisions are made by majority vote,[146] any partner who disagrees with the way the majority is running the business can, in effect, withdraw and insist on being paid off. Since withdrawal may result in financial sacrifice, partners may be forced to accept some dissatisfaction with the way the business is being run or the way they are being treated. But the minority partner is by no means powerless; consequently, partners need not be as concerned with control as must participants in relationships that are not so readily terminable.[147]

pose that the engineer has been involved in the design of a major new product and has been responsible for setting up a plant to make that product. The engineer's knowledge is vital to the success of the product and the cost of replacing him at a critical time might be very high. At that time, the engineer might be able to extract a large part of that amount by threatening to quit. Most of us would call such an action "unfair," and that is probably the most parsimonious way of describing it. A threat to quit would be inconsistent with the expectations of individuals who think that they need not pin down every detail of their relationship to those with whom they do business.

There may be no legal remedy for unfairness of the sort that might occur in this hypothetical. But one would expect that if the engineer did threaten to quit and the firm decided to pay the amount demanded, it would want to fire the engineer as soon as his services were no longer critical or to apply other sanctions to punish the breach of trust. One would also expect other employers to be reluctant to hire such a person.

144. This discussion may help to explain why the life of a typical corporate bond is seldom more than 30 or 40 years. If a longer relationship were contemplated, the lenders might become excessively concerned about the general nature of the corporation's business. They might feel a need to protect themselves by sharing broadly in control. W. KLEIN, *supra* note 16, at 156.

145. UNIF. PARTNERSHIP ACT § 31(1)(b) (1969); W. KLEIN, *supra* note 16, at 85.

146. UNIF. PARTNERSHIP ACT § 18(h) (1969); W. KLEIN, *supra* note 16, at 80.

147. The minority partner's power to withdraw may threaten the firm with disaster. As a result, the minority partner may have more power than any of the partners would have thought appropriate at the inception of the enterprise. Thus, the basic rule of partnership law relating to duration does not well serve the needs of most partnerships. Although one would presume that most partnership rules supply a form contract that should effectuate the likely intention of the parties, the basic rule apparently fails to fulfill that function. Perhaps the explanation lies in the fact that buy-out agreements cannot sensibly be provided by general rule. The partnership rule providing for full payment on demand may be the best solution to the problem of duration possible under a general rule, even though it is not the best solution in any but the most unusual case.

By contrast, the "lock-in" problem of shareholders in closely held corporations stems from the rules of corporate law that, absent agreement to the contrary, shareholders are not entitled to withdraw

In other words, assuming investor democracy with majority rule, the power of investors to control the destiny of a venture (and to promote or protect their own interests) is partly a function of the duration of that venture. If a participant can withdraw too easily, he or she may have too much power—that is, more power than the other participants would have thought appropriate if they had considered the matter at the outset. If, on the other hand, the right of withdrawal is very limited, each participant is a potential victim of the tyranny of the majority.

Conclusion

The modern business organization can best be understood as a series of bargains made under constraints. A wide variety of actors must be regarded as participants in this bargaining and not, as in much of the legal and economic literature, as appendages to it. Under a multi-party bargain perspective, the notion of "ownership" loses most of the importance it has in existing systems of thought. Organizational forms, such as the partnership and the corporation, come to be explicitly understood as devices reflecting the terms of the different bargains.

The nature of the joint venture is defined by reference to the four basic business or economic elements of the bargain—risk of loss, return, control, and duration. By focusing on the ways in which these elements may be shaped and the ways in which they interact, one begins to understand the subtlety and flexibility of the notion of a "firm" and the importance of recognizing the virtually infinite variety of arrangements available to those who intend jointly to pursue a business venture.

The series-of-bargains approach should contribute to the richness and to the realism of theoretical studies. By emphasing the importance of the underlying (and often conflicting) economic objectives of the participants and by encouraging a search for the possibilities that emerge as one shifts attention from one element to another, the series-of-bargains approach should also suggest to practitioners opportunities for solving difficulties encountered in creating a business organization.

Both practitioners and theorists must constantly bear in mind that the bargain over the basic elements is negotiated under con-

their share of the corporate assets, and that decisions are made by majority rule. The laws of some states do, however, provide judicial relief from this general rule. *See, e.g.*, CAL. CORP. CODE § 1800 (West 1977); PA. STAT. ANN. tit. 15, § 2107 (Purdon 1967).

To be fully protected, minority shareholders must be given the right to sell at will. *See* W. KLEIN, *supra* note 16, at 128, 134; 2 F. O'NEAL, CLOSE CORPORATIONS § 807 (1971); Kahn, *Mandatory Buy-Out Agreements for Stock of Closely Held Corporations*, 68 MICH. L. REV. 1 (1969).

As with partnerships, the basic rule of corporation law seldom serves well the needs of investors in a corporation. Once again, that rule may nonetheless be the best possible rule of general application—the best standard-form contract rule.

straints—government regulation, limitations on specificity, and conflicts of interest—that must be acknowledged if the results of the bargain are to satisfy the needs of the participants. Only a theory that focuses on the variety of deal points left open in this system of constraints can capture the diversity of options open to modern business organizations.