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BARGAINING FOR FIDUCIARY DUTIES: PRESERVING THE VULNERABILITY OF THE DISADVANTAGED?

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The first section of this Commentary briefly discusses Professor Johnston's specific analysis of opting in and out of fiduciary obligations in closely held firms, commenting on its value as a contribution to the body of literature of which it is a part. The second section presents a short discussion of some of the assumptions employed in Professor Johnston's model that seem to qualify significantly the utility of the conclusions to which it leads. Finally, the third section offers a brief discussion of the relation between the model and a few cases in the field.

I.

Professor Johnston's article is an important advance in the economic analysis of closely held firms. True to tradition, he begins by building on and critiquing what has gone before. In this instance, that means the well-known agency-cost analysis that a group of distinguished scholars, principally associated with the University of Chicago, applies to the problem of controlling costs associated with the employment of agents in firms. These writers begin with a contractarian view of small firms and assume that participants are rational maximizers. The participants therefore make contracts that optimize the irrespective interests in the circumstances under which they enter into business relationships. This is, of course, the familiar bargaining-under-constraints model. They go on to assume, with charming simplicity and directness, that any arrangement that we do not find they do not want. This perspective is derived from a rather longer and more distinguished intellectual tradition than is generally acknowledged: the Holmesian view that life is a battle in which the law should not intervene so long as it appears that the field on which the game is played is reasonably level.

This qualification provides Professor Johnston's point of entry. The Chicagoans conclude from the lack of cases in which managers in closely held firms contract out of the default rule—under which they have no

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protection against arbitrary dismissal—that most parties prefer the default rule. This conclusion may not follow, Johnston observes, for a number of reasons. First, if parties think about the law at all, they must recognize and intend that the courts will draw some inferences about their intent and expectations should a dispute arise under the contract. And they do not necessarily intend that each party reserves the right at any time to exercise his express powers in a manner detrimental to the interests of the other party unless the agreement otherwise provides.[1]

Second, if the playing field is not level, that is, if there are significant barriers to bargaining out of the existing rule, then, as Johnston points out, the absence of provisions that contract out of the default rule loses the significance upon which the Chicagoans' argument depends.[2]

Johnston's analysis seems to be closely and accurately reasoned. The model he develops and on which his subsequent analysis is built represents an important advance beyond the level of insight reached in prior work. To establish the points that he draws from it, he assumes that from the public policy standpoint the most desirable rule encourages managers who hold minority interests in closely held firms to increase their firm-specific investments. Protection against arbitrary dismissal would certainly seem to have this effect, as he asserts. For this purpose, Johnston assumes that the optimal arrangement is a rule that enables non-strategic ("good," in his terminology) majority shareholders to reveal themselves, and at the same time subjects "bad" majorities to fiduciary obligations.[3]

His conclusion that neither a tenure nor a no-tenure default rule achieves this result is not surprising and would disappoint only the most hopeful of readers. But there are some surprises. Professor Johnston finds that his model leads rather convincingly to two important and counterintuitive policy conclusions. The first is that a default rule that

1. *Cf.* U.C.C. § 2-306(1) (1977) (requiring the parties to requirements or output contracts to limit their demands to amounts approximating any quantity that was the subject of prior dealings). This is a matter that the parties could have specified in a written agreement; similarly, in exclusive dealings contracts the statute requires that parties exercise their "best efforts" respectively to supply and to require the goods involved. U.C.C. § 2-306(2) (1977).

2. In this connection, he notes that the Chicagoans are highly selective in the empiricism that purports to support their rather Panglossian view of the world: they assume a world in which courts frequently imply good-faith obligations, so that the parties may quite reasonably anticipate such judicial implication, and then infer from the parties' silence that the parties agreed that they did not want such good faith to be implied. Jason Scott Johnston, *Opting In and Opting Out: Bargaining for Fiduciary Duties in Cooperative Ventures*, 70 WASH. U. L.Q. 291 (1992).

3. *Id.*

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provides no protection against such dismissal provides more opportunity for parties to reach the optimal arrangement for this purpose than does a rule that requires good faith toward the minority managers unless the parties contract out of it.[4]

The second is that the type of enterprise in which the case for imposing a fiduciary duty is weakest is the symmetrical relationship in a two-party partnership. Because the fiduciary relationship in this enterprise is reciprocal, there is a one-to-one relationship between the obligation imposed and the opportunity of each obligor-beneficiary to exploit it. In contrast, the majority-minority situation in a close corporation affords the majority shareholder who is so disposed a greater opportunity to exploit the minority than vice versa.[5]

II.

The results models predict are only as good as the assumptions on which they are based, as Johnston recognizes, and he proceeds to relax some of the narrow and unrealistic assumptions that limit the predictive ability of his analysis.[6] There are, however, other assumptions that need to be questioned. Johnston recognizes that the frequency of both misconduct by those in control and abuse by minorities of any protection they are afforded are important in any effort to assess the costs and benefits of the alternative arrangements that he considers. However, he accepts as do the Chicago writers the suggestion that minority abuse significantly increases the cost of giving close corporation minority shareholders a bail-out right through an involuntary dissolution proceeding.[7] It appears from such empirical data as is available, however, that profitable firms are almost never liquidated as a result of involuntary dissolution decrees, and that buyouts usually follow suits for such relief; in fact, a buyout of the plaintiff is the most common outcome even when dissolution is denied.[8] Consequently, it appears that the once commonly voiced criticism of this remedy, that it results in the destruction of profitable firms, is mistaken. It would appear, then, that critics of the remedy must retreat

4. *Id.*

5. *Id.* at 314-15.

6. *Id.* at 318-23.

7. *See* Frank Easterbrook & Daniel Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271 (1986).

8. J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 28 (1977).

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to the fall-back position that the resulting buyout prices are extortionate. On closer examination, there seems to be very little to support this conclusion. It is true that a minority shareholder may be able to state a plausible "oppression" claim under a statute. But consider the risks the claimant faces: the costs of undertaking litigation in relation to presumably quite limited resources of the plaintiff; proof of the alleged factual basis of the claim, surely a high-risk venture in the case of unwarranted claims; the court may consider that the facts asserted, if proved, do not amount to oppression; or the court may consider that, although oppression has been established, dissolution is not called for under all the circumstances, a not unlikely eventuality if the defendant establishes any plaintiff misconduct.

If dissolution is decreed, the parties are almost certain to bargain over a buyout, and the resulting price likely will be higher than it would have been in the absence of the decree. There seems to be no chance, however, that it will exceed the plaintiff's pro rata share of the going-concern value of the firm. The price of the minority's shares should not be discounted because of the majority's control, just as in the distribution of proceeds after a sale following dissolution all shares will participate equally. Since the ground for the dissolution is oppressive conduct by the majority, which often will have involved an appropriation of benefits from which the minority ought not to have been excluded, it seems rather partisan to be concerned about this possibility to the point of opposing the availability of any relief. It must be remembered that, in price negotiations, the minority as a rational maximizer has no reason not to settle for an amount in the range of what it would net following a post-dissolution sale of the business. On the other hand, since in the absence of a decree the majority would normally expect to buy out the minority for less than its pro rata share of the going-concern value (an illiquidity discount), it is likely to feel aggrieved. I see no reason to deplore this result since the majority is very likely to have collected at least the amount of the discount because of the very behavior the court found to be oppressive in awarding the decree.

Further, if following dissolution the business is sold, the majority is in a better position to buy it than any competitor because it would only have to put up enough cash to pay off the minority. It is true that if, for some unlikely reason, there is a bid from an outsider that the majority cannot or will not meet, the majority will be forced to sell out. There is no principled ground to object to this outcome, unless one is prepared to

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argue that, although minorities may be forced out in a variety of majority-controlled circumstances, majorities should not be subject to this risk when they have abused the statutory rights of the minority. If, nevertheless, the firm is worth more to an outsider than the majority is able or willing to pay, it is highly likely that the majority has been shirking or otherwise appropriating control rents, which is, once again, the ground upon which relief is likely to have been granted.

Finally, a factor that Johnston's model does not take into account seems to me critical. The model assumes that each entrepreneur and manager knows his own predatory proclivities, or the lack of them, when they enter into their relationship. It takes no account of the fact that the behavior of people in close, long-term business (and other) relationships is dynamic and changes in ways that are not, and cannot be, anticipated. The unrealism introduced by the assumption that motives and behaviors are essentially static is contrary to common experience. Over time, entrepreneurs may come to feel that managers have been generously and perhaps excessively compensated for their contributions, and managers may come to think that their merits are not fully appreciated and rewarded. With the passage of time, behavior that would not have been contemplated at the beginning of the relationship may come to be justified in the mind of each participant. Meanwhile, the mobility of the manager may diminish as his human capital is committed to the firm and his vulnerability to dismissal increases.[9]

Professor Johnston's discussion of the game assumes that the strategic propensities of some players are known to the individuals who possess them and that what is being played is a game in which "bad" people seek to hide their strategic propensities. The uncommunicated intent on the part of one party to violate an agreed contract term calling for renegotiation of an agreement at a later time has been found to be fraudulent,[10] but reliance on an initially cordial cooperative arrangement or one built

9. Professor Stewart Schwab has suggested, in an article reviewing the apparent progression of the law's sporadic retreat from the at-will dismissal rule, that employment ought to be divided into stages over time: the beginning period when little firm-specific investment has been made, during which no employment security should be imposed; the middle period when the employee has made substantial human-capital investment in the firm for which protection is warranted; and finally a period of decline when the employee may have little marketability so that a greater degree of protection against dismissal without compensation is warranted, largely on hardship grounds. Stewart Schwab, Shirking, Opportunistic Firings, and Implied Contract Limitations on At-Will Employment (Nov. 15, 1991) (unpublished paper presented at University of Virginia workshop).

10. Helms v. Duckworth, 249 F.2d 482 (D.C. Cir. 1957).

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up over time on the basis of repeated assurances poses much more difficult questions.[11]

The effects of the passage of time most commonly give rise to antagonistic behavior by the parties in close corporations. At this point, the consequences of the failure to bargain for a good-faith obligation on the part of the majority manifest themselves. The consequences of mutual antagonism, as Professor Johnston points out, are not shared equally by the parties. The majority has a strategic advantage when it comes to oppression: it can act first and far more effectively than the shareholder-manager.

Ironically, it thus appears that a common—perhaps the most common and thus the most dangerous—barrier to bargaining for protection against strategic behavior by the majority is the trust that accompanies the formation of the association. Trust may well be the most valuable and efficiency-enhancing component in the formation of small firms. The analyses favored by Easterbrook, Fischel, Epstein and Posner, and to a lesser extent by Professor Johnston, impose the consequences of the loss of mutual confidence on the weaker party who failed to bargain for protection because the situational constraints against strategic behavior are less effective against managers than entrepreneurs. As Johnston points out in commenting on Professor Epstein's defense of employment at will,[12] this is a dubious proposition. Johnston concludes, nevertheless, that in the absence of barriers against bargaining for protection (and presumably paying therefor), the minority manager should be denied judicial protection against exploitative behavior by the majority. This is the test that he applies in his brief examination of cases in the final discussion section of his article.

III.

The great advantage of the rule under which the majority is able to dismiss the minority manager without cause is not that this will be done, but that the right to do so provides a relatively costless means of discour-

11. There are other situations in which the majority may appropriate benefits not shared with the minority, which is apparently not disadvantaged by the majority's behavior. This type of situation, which was involved in Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975), is not within the reach of Johnston's model. Cases of this sort are relevant to the discussion, however, because they are based on a broad duty of equitable sharing among shareholders in close corporations, which could well be read to embrace the situations Professor Johnston analyzes.

12. Johnston, *supra* note 2, at 305-06.

aging and disciplining shirkers. The costs, of course, are the risk of mistakes, the opportunities for deliberate abuse of the majority's prerogative to dismiss, and the reduction in managers' firm-specific investments because of the insecurity of their position. Professor Johnston's model leads to a solution that attempts to preserve the disciplining effects of the rule while minimizing the costs of possible abuse.

As Professor Johnson explains, whether the courts ought to impose a duty of loyalty on one coventurer in favor of the other depends first on whether imposing such a duty would tend to increase the firm-specific investment likely to be made by the party to whom the duty is owned, and second, on whether there were significant obstacles to the weaker party's negotiating for such a duty at the inception of the relationship. The argument is that the weaker party's failure to bargain for such protection may be excused only if there was no barrier to such contracting when the parties formed their relationship. In this situation, one may fairly infer that the beneficiary freely chose not to bargain for protection against arbitrary dismissal. Johnston then proceeds to discuss this duty in three contexts: partnerships, close corporations, and dismissals of at-will employees to trigger stock repurchase rights in the employer. These three situations are briefly discussed in order.

a. Partnerships

As previously noted, Professor Johnston finds the case for the imposition of the duty of loyalty to be least persuasive in this situation. Because the parties are equals, barriers to bargaining are least likely to be present, and any duty imposed would be reciprocal. He does not discuss *Meinhard v. Salmon*,[13] the case containing the most famous and emphatic statement of the reciprocal obligations of loyalty among joint venturers. In *Meinhard*, the parties were joint venturers sharing the benefits of a twenty-year lease that was within four months of expiring when the events occurred that gave rise to the litigation. As generations of law students know, the managing partner, without disclosure, appropriated a business opportunity related to the leased property that was to follow the expiration of the lease. Termination of the business relationship was therefore not being initiated by the defendant. The facts do not meet even the entry level requirement of Johnston's model because from the beginning the plaintiff was intended to be, and was, a passive investor in

13. 164 N.E. 545 (N.Y. 1928).

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the enterprise. There was no question of increasing his human-capital investment in the firm. Therefore, there would be no reason to reach the second issue involving the presence of barriers to bargaining for protection against appropriation of business opportunities by the active partner. Further, to include the opportunity the defendant obtained, any fair-dealing duty imposed on the defendant would have to include an obligation to disclose and perhaps to share in any further opportunities the defendant obtained to develop the leasehold, either separately or in conjunction with other property, after the expiration of the lease. That the passive investor would have thought to request such an entitlement, or to have requested it had he thought of it twenty years before, seems far-fetched indeed.

Apart from Johnston's theory, any conventional analysis of the case likely would be based on a business opportunity analysis: the case would be seen as involving the surreptitious appropriation of a business opportunity arising out of the subject matter of the joint venture. At the narrowest point in the court's holding, Judge Cardozo indicated that perhaps a minimalist view of the defendant's duty would require revelation of the opportunity to the plaintiff to enable him to compete for it on an equal footing.[14] Whether even this narrow duty should be read into the limited business-sharing arrangement between the parties was thought to be a hard call: the Court of Appeals was divided four to three. Of course, Johnston's approach reaches the same result as the dissenters, and it is possibly a more satisfactory way to get there: the first question is easily answered (imposing a duty does not increase Meinhard's contribution to the business, nor was this a result the parties desired), therefore the defendant's responsibilities should be confined to the operational duties agreed upon by the parties and should not be broadened to spill over to related activities after the expiration of the joint venture. (But suppose the defendant had arranged only for the continuation of the same lease?) The cautionary rule is that passive financing partners who want to share in post-project opportunities turned up in the course of the firm's operations must bargain and pay for their interest. This may be a reasonable rule that would fully conform to most parties' expectations. Parties investing human capital in an enterprise may have quite different expectations. The law is quite inconsistent with Professor Johnston's suggested approach in this case, as in the cases he discusses.

14. *Id.* at 547.

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b. Close Corporations

Unfortunately, Professor Johnston's discussion of the implications of his model in this most important area (judging from the number of litigated cases) focuses on the case of the "bad" entrepreneur. Johnston suggests this person would be unlikely to opt into a fiduciary obligation, and that if he did so, the minority thereby would be afforded little protection because of the entrepreneur's superior ability to loot the business and, perhaps, to force the manager to depart voluntarily. He also notes, as was discussed earlier in his article, that the "bad" entrepreneur has much less to lose from assuming a good faith obligation than the "good" entrepreneur because the threat of an involuntary dissolution suit is much less serious to one who has already looted the enterprise than it is to a "good" entrepreneur who will be exposed to serious risk of exploitation by a "bad" manager if the entrepreneur opts into a fiduciary duty.

This line of reasoning needs to be subjected to so many qualifications that it is quite unpersuasive. First, as Johnston noted earlier, abusive dismissals seem to be quite infrequent. Second, as I noted earlier, the consequences of an involuntary dissolution proceeding are not as disastrous as he and other commentators have so relentlessly asserted. Third, the risk of error in the event that an unwarranted oppression claim is brought is, so far as one can tell, so small as to be unimportant for two reasons. I know of no data that suggests that unwarranted oppression cases are more likely to be commenced than unjustified dismissals are to occur.[15] If they do occur, however, and if some percentage of them is successful, the result, as noted earlier in this Comment, is not the gross economic imposition on majorities that is assumed. Under these circum-

15. The expense and the uncertainty involved in such litigation, and the presumably limited resources of the plaintiff, combine to suggest that such cases will be infrequent. An undocumented but likely cause of potentially abusive dismissals is bad legal advice: lawyers for majority interests in closely held firms tend to hold an expansive view of their clients' prerogatives, to regard minorities as irresponsible, and to advise their clients accordingly.

Curiously, the distrust of the irresponsible minority theory is carried a step further and applied only to small minorities in the New York statute, which permits only minorities holding at least 20% of the shares to sue for relief because of oppression. N.Y. BUS. CORP. LAW § 1104-a (McKinney 1986 & Supp. 1991). No one would think that only larger minorities are likely to be exposed to oppressive conduct, so the theory of the statute must be that smaller minorities are more likely to behave irresponsibly. Since in New York the court can order a buy out and fix the price (N.Y. BUS. CORP. LAW § 1118(b) (McKinney Supp. 1991)), and since the smaller the minority, the less the inconvenience of the buy out to the buyer, the decision to provide no protection against small minorities seems unnecessary and is, I think, unjustifiable.

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stances, it seems perverse to argue that policy should be based on concern for this risk.

There seems to me to be a significant difficulty in applying Professor Johnston's model to what I will call the "typical" involuntary dissolution case. Assume the entry level hurdle is passed and that protection against unjust dismissal would increase the minority-shareholder manager's human capital investment in the firm, an assumption that often will be difficult to document. We then reach the question of barriers. It would seem that a person in the position of the manager in the case Professor Johnston discusses[16] easily could have bargained for job security before joining the firm. But one cannot be sure; is it good policy to punish him for trusting his new friends who knew of his reliance on their good will? If one is not sure, what of Joseph Donahue, a shop foreman who rose to plant manager when he was offered a chance to buy stock?[17] Does not a demand for security risk the displeasure of the majority who were exhibiting their good will toward him by offering him a chance to buy shares? And should the law impose upon Wilkes, who bought a quarter of the stock in the new nursing home and then worked there, an obligation to demand protection against a future falling out as a price for protecting himself against the risk of loss of his position and any return on his (no doubt undiversified) investment?[18] In the present state of our scholarship, we simply do not know which default rule more effectively promotes the formation of closely held firms.

c. *Dismissal of At-Will Employees to Activate Stock Repurchase Rights*

Professor Johnston correctly finds that this problem and the cases in which it has been litigated are readily amenable to analysis under the prescriptive analysis he developed from his model. The plain purpose of various types of employee stock purchase arrangements is to increase human-capital investment in the enterprise, and there seems to be no reason to question that this is the likely effect. Similarly, the right of the employer to dismiss the employee without cause, or to withhold price-relevant information when the employee triggers the employer's repurchase right by leaving the firm voluntarily, undercuts this very purpose. An employer might, of course, prefer a less effective scheme that preserves its right to behave strategically. Given the history of judicial dis-

16. *In re* Topper, 433 N.Y.S.2d 359 (Sup. Ct. 1980).

17. Donahue v. Rodd Electrotype Co., 328 N.E.2d 505 (Mass. 1975).

18. Wilkes v. Springside Nursing Home, Inc., 353 N.E.2d 657 (Mass. 1976).

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approval in related situations[19] and developments in the law of insider trading, the emerging default rule's imposition of liability for such employer behavior was, I think, predictable. It seems that Johnston's theory does not account for the force behind the emerging rule: what moves the law in this area is fairness in contractual relationships, not the careful cost-benefit analysis that he has constructed to reach the predicted outcome. Here it seems that there must be some acknowledgement that more than just efficiency moves the law in this area, however regrettable this may seem to some commentators. The basis of the emerging rule can perhaps be more clearly seen by imagining a contract in which the employer undertakes to negotiate out of a duty of fair dealing:

> Employee understands and agrees that the employer may dismiss him at any time solely for the purpose of depriving him of an expected increase in the value of shares purchased under this agreement, and that should the employee resign, the employer may repurchase shares held by the employee hereunder at a price that does not take account of price-relevant information known only to the employer.

One is struck in this area by what seems to be the obsessive concern of policymakers, commentators, and, on occasion, judges over the perceived risk that persons in relatively disadvantaged positions—employees at will[20] and small minorities in close corporations[21]—will behave strategically when dealing with those who occupy dominant and controlling positions. Preserving the vulnerability of the disadvantaged in these business relationships becomes a policy goal. The point here is not, of course, that there is no risk of such behavior: it is the implicit normative judgment that the allocation of rights (and wealth) produced by past business arrangements is "right" and that any movement toward reallocation is presumptively undesirable.

CONCLUSION

Professor Johnston's model is a welcome, important, but limited improvement of the analysis of the Chicagoans who seem compulsively committed to preserving the prerogatives of majorities and the vulnerability of at-will employees and close corporation minorities as essential to the maintenance and enhancement of the productivity of business enterprises. Yet the world changes: whatever importance is justifiably as-

19. Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947).
20. Johnston, *supra* note 2, at 304-06; *id.* at 302-03.
21. *See supra* note 16.

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signed to efficiency as a goal of the common law, it is not the only public policy objective to which the law responds. Justifiable reliance on understandings and informality in dealings among business associates are not only important productive components in our economic system, they also deserve protection independently because they are part of the quality of life in a society that strives to be humane and just. Professor O'Neal's life work demonstrated that the grosser forms of abuse of majority power in close corporations are increasingly unacceptable by modern standards. Economic decisionmaking is invariably based on expectations concerning future events, and, as Professor Johnston's analysis suggests, some legal effort to protect such equitable and productive expectations from exploitative behavior may be at least a small step toward greater productivity. It is surely a step toward an economically more just society.

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