Opting In and Out of Fiduciary Duties in Cooperative Ventures: Refining the So-Called Coasean Contract Theory

Charles Rogers O'Kelley Jr.
OPTING IN AND OUT OF FIDUCIARY DUTIES IN COOPERATIVE VENTURES: REFINING THE SO-CALLED COASEAN CONTRACT THEORY

CHARLES ROGERS O'KELLEY, JR.*

I. INTRODUCTION

Professor Johnston's provocative article explores a familiar problem in the law of closely held business associations—the alleged exploitation of weaker or minority investors by stronger or majority participants. The fact pattern is simple. At the outset of the cooperative venture, a stronger participant assumes the role of proprietor, partner, or majority shareholder, while a weaker participant assumes the role of agent, partner, or minority shareholder. For whatever reason, the venturers do not explicitly guarantee or protect the weaker participant's right to income or continued participation in the venture. Consequently, at some later date the stronger participant reduces or eliminates the weaker investor's participation in or return from the cooperative venture. The weaker investor then seeks equitable relief, claiming that the stronger venturer's actions violate the implied fiduciary duties owed to the weaker participant.

Under what Johnston calls the Coasean Contract Theory, courts should resolve such post-harmony disputes in cooperative ventures by providing the specific result the parties would have wanted had they been able to contract for an explicit solution. Johnston identifies two problems with the Coasean Contract Theory as currently interpreted. First, Coasean theorists have incorrectly concluded that a broad, implied fiduciary duty would be economically inefficient as a general proposi-

* Professor of Law, University of Oregon.
tion. Second, the current theory inadequately accounts for strategic incentives in bargaining around the law. In addressing these defects, Professor Johnston attempts to develop a more accurate account of how Coasean judges can determine what parties would have wanted in the way of implied fiduciary duties when the parties have not bargained for explicit fiduciary-like protection.

In Parts II and III of my Comment, I argue that (1) Johnston's proposed revision of the Coasean Contract Theory is inconsistent with both the portions of current theory that he accepts and with his own assumptions as to venturers' rationality; and (2) as a result, he has misinterpreted the views of Coasean Contract Theory proponents. I also argue that Johnston's arguments reveal a gap-filling theory more appropriate to discrete transactions between strangers than to long-term, relational contracts. In the process, I hope to shed some light on how efficiency-minded judges should apply the Coasean Contract Theory, and, thus, some light on the theory itself.

II. THE SIGNALLING FUNCTION PERFORMED BY INITIAL FORM SELECTION

A central insight of transaction-cost economists, embedded in the so-

4. See Johnston, supra note 1, at 295-98.
5. See id.
6. Almost all contracts have relational elements. Nonetheless, it is important to differentiate between short-term contracts with little relational content, sometimes called discrete contracts, and long-term contracts or firms that are highly relational. This distinction is captured by Ian R. Macneil, The Many Futures of Contracts, 47 S. CAL. L. REV. 691 (1974):

The gas purchase is a [discrete] transactional event in the sense that, except for the expectation of the driver that the station would have gasoline available and the expectation of the station that any driver stopping would have some means of paying, the exchange has no past. There are no precedent relations between the parties. Nor will there be any future relations between the parties. As to the present, two general characteristics dominate the transaction: it is short; it is limited in scope. A few minutes measure its duration, and no one, even the most gregarious, enters into anything approaching a total human relationship in such a situation. In such a transaction the measured exchange, gallons/dollars, is what matters. . . . Contrast this service station stop with a traditional marriage relation. The latter consists not of a series of discrete transactions, but of what happened before (often long before), of what is happening now ("now" itself often being a very extended period), and of what is expected (in large measure only in the vaguest of ways) to happen in the future. These continually form the relation without a high degree of consciousness of measured transactions.

Id. at 720-21.

https://openscholarship.wustl.edu/law_lawreview/vol70/iss2/5
called Coasean Contract Theory, is that rational prospective venturers engage in a comparative ex ante search for the best investment opportunity, which includes a search for the best governance structure. Before rational investors will enter into a prospective venture, this search must proceed through three not necessarily discrete steps. First, each investor must conclude that the prospective venture promises a better return on her human and money capital than do alternative investment opportunities. Second, the investors must agree upon the organizational form that offers the optimal balance between adaptability to changed circumstances and opportunism. The obvious candidates are spot contracting, long-term contracting, sole proprietorship, partnership, limited-liability company, and corporation. Finally, if the organizational form chosen is a partnership, corporation, sole proprietorship, or limited-liability company, the parties must decide whether explicit contractual modifications to the state-provided default rules will maximize value.8

Critical to Johnston’s analysis is the assumption that participants are extremely rational and that they are able to understand the relative advantages and opportunistic risks attendant to extending fiduciary protection to the weaker venturer.9 Given this degree of rationality, the Coasean Contract Theory presumes that prospective venturers will choose organizational form while taking into account both the adaptive advantages and opportunistic risks of the form chosen.10 These adaptive


9. Johnston’s “model assumes extremely rational parties whose bargains account for the incentives that the duty of good faith creates.” Johnston, supra note 1, at 329.

10. The trade-off between adaptability and risk of opportunism is not uniform among governance structures. Thus, rational investors search for the structure offering the optimal balance. Oliver Williamson makes this point succinctly.

Many of the interesting issues with which transaction cost economics is involved reduce to an assessment of adaptive, sequential decision-making. Contingent on the set of transactions to be effected, the basic proposition . . . is that governance structures differ in their capacities to respond effectively to disturbances. To be sure, those issues would vanish were it not for bounded rationality, since then it would be feasible to develop a detailed strategy for crossing all possible bridges in advance. It would likewise be possible to adapt effectively [pursuant to agreed upon general rules] were it not for opportunism. Confronted, however, by the need to cope with both bounded rationality and opportunism, comparative institutional assessments of the adaptive attributes of alternative governance structures must necessarily be made. WILLIAMSON, supra note 8, at 56-57.
advantages and opportunistic risks are widely and easily understood. Proprietorship form gives minimal protection to at-will employees, but maximum adaptability and freedom from opportunism to the proprietor. Corporate form also gives minimal protection to minority shareholders’ employment expectations, but gives greater equitable protection, via fiduciary duty and involuntary dissolution proceedings, to a minority shareholder’s nonhuman-capital investment expectations. However, the protection provided to minority shareholders comes at the expense of the adaptability and freedom from minority opportunism that sole proprietorship form would give the stronger participant. Partnership-at-will form gives the greatest protection to weaker participants’ nonhuman-capital expectations, via dissolution-at-will and fiduciary duty. Again, this greater protection for the weaker participant comes at the expense of the adaptability and freedom from minority opportunism that the stronger participant could expect if the firm were organized as a sole proprietorship or corporation.

Given this picture of how rational stronger and weaker venturers choose investment form, how would courts who follow the Coasean Contract Theory decide whether to grant fiduciary duty protection to a weaker participant when the venturers did not bargain for an explicit rule covering the matter in dispute? Under the Coasean Contract Theory, as I interpret it, the answer is simple. If the state provides sufficient standard forms and the parties are presumed rational enough to have appreciated the relative adaptability and exposure to opportunism that

11. It is unclear whether Professor Johnston would agree with this statement because he makes the following somewhat puzzling assertion.

[M]any general partners ... do not bargain with an acute awareness of the incentive effects of the implied duty of good faith. If this assumption is warranted, then efficiency has nothing to say about the implication of the duty of good faith. Parties who are completely unaware of legal rules cannot be affected by legal rules.”

Johnston, supra note 1, at 330 (emphasis added). Professor Johnston appears to assert that venturers who choose partnership form often do so without understanding the adaptive characteristics and relative opportunistic risks posed by that governance structure. Clearly, empirical evidence is unsatisfactory on this issue. See Robert W. Hillman, Private Ordering Within Partnerships, 41 U. MIAMI L. REV. 425, 431 (1987). Nonetheless, it is commonly assumed that venturers choose organizational form aware of the corresponding tax benefits or limited liability rules. Why, then, should such investors also not have, or obtain via expert advice, at least a general understanding of the adaptive rules and opportunistic risks posed by the standard-form governance structures?

such forms offer, then the Coasean judge provides weaker participants with the level of implied fiduciary protection common to the form chosen. For example, in typical close corporation cases, the Coasean judge considers extending equitable relief to the complaining minority shareholder, but such relief is not automatically granted or fashioned after partnership law’s dissolution-at-will provisions. Instead, the court places some burden of proof or persuasion on the complaining minority shareholder to preserve both the balance between adaptability and opportunism and the amount of majority discretion for which the parties, being rational, presumably bargained.

Two circumstances make the Coasean judge’s task more difficult. First, if the available standard forms are insufficient, and if transaction costs are relatively high, the Coasean judge may conclude that a form was chosen for tax or liability rules, and that, but for transaction costs, an entirely different governance form would have been selected. Second, if the participants in a cooperative venture are not sufficiently rational or informed to appreciate the relative balance between adaptability and opportunism that a particular standard form presents, a Coasean judge may conclude that the parties did not in fact contract for the normal rules attendant to the form that they chose.

Professor Johnston rejects this model. He argues that courts should

---

13. Some commentators have argued that close corporations are analogous to general partnerships and, therefore, dissatisfied minority shareholders should have an absolute right to have their shares repurchased by the majority investors. See 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 (1977). Such a norm would fundamentally change corporate form. However, no state has adopted such a rule, either legislatively or judicially. For criticism of this proposal, see Frank H. Easterbrook & Daniel R. Fischel, Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, 286-90, 297-300 (1986).

14. In other words, it is wrong to criticize the outcome of a particular close corporation case simply because the minority carried her burden of proof. It would be appropriate to criticize the result if the minority were required to carry no burden at all.

15. The Limited Liability Company is a business form that offers investors the limited liability rules common to corporate form, the tax treatment common to partnership form, and governance norms similar to those found in general partnership law. This form was adopted by Wyoming in 1977, by Florida in 1982, by six additional states in 1990 and 1991, and is being considered in a number of other states. Once this form is generally available, it should be less necessary for rational investors to forgo partnership governance rules to receive the tax and liability treatment desired.

16. This presents a dilemma for the Coasean judge. By attempting to second guess the parties’ form selection, she may make mistakes and take away the very result for which the parties did in fact bargain. These errors will devalue the form. Thus, efficiency-minded judges must weigh the potential gains from correcting for irrational form selection against the costs in form devaluation resulting from such erroneous second guessing.
not imply and enforce limits on opportunistic action by stronger venturers unless two conditions are satisfied. First, the fiduciary duty sought must be efficient. In other words, the judge must conclude that the specific rule that she fashions ex post would have drawn forth greater team-specific investment if explicitly agreed to ex ante. Second, the risk of opportunistic misuse of such duty must be so great that no nonopportunistic stronger venturer would have agreed to it ex ante. Implicitly, Johnston argues that courts need not consider why rational investors would have chosen a particular business form at the outset.

Since Professor Johnston constructs his model by analyzing how hypothetical rational investors would decide whether to opt in or out of fiduciary duty, why he ignores the signalling effect of initial form selection is puzzling. This puzzle increases when we recall Johnston's use of extremely rational investors in his analysis. For if, as Johnston hypothesizes, investors are rational and informed enough to appreciate the opportunistic risks fiduciary duties create, surely they are also rational and informed enough to choose an organizational form that does not expose them to that risk, or to tailor the chosen form to eliminate that risk.

For example, suppose that a stronger prospective venturer, Jane, insists on maximum adaptability and minimal exposure to an opportunistic use of fiduciary duty, and that the weaker prospective venturer, Barry, agrees to invest on those terms. Proponents of the Coasean Contract Theory would expect such venturers to organize as a sole proprietorship with the weaker party as an at-will employee, or as a corporation with the minority shareholder explicitly agreeing that his employment is terminable at will and that the corporation can repurchase his shares in the

---

18. Fiduciary duty is efficient if its inclusion will "increase[] the total expected surplus from cooperation." Id. at 299.
19. For example, in In re Topper, 433 N.Y.S.2d 359 (Sup. Ct. 1980), the rule might be described as follows: If you relocate and invest your life savings in this venture, and if you perform your end of the bargain in terms of setting up the pharmacy and getting it going, and if we terminate you with or without cause prior to your realizing the benefits of an extended relation with the venture, then we will either repurchase your shares at their then fair market value or dissolve the corporation.
20. Johnston, supra note 1, at 328. An efficient term "protects against exploitation and therefore encourages firm-specific investment by trustworthy or minority shareholder/managers . . . [but] includ[ing] such a duty also threatens to redistribute surplus from entrepreneur/majority shareholders to opportunistic minority shareholder/managers." Id. at 299.
21. Id. at 329.
event of such termination.\textsuperscript{22}

Suppose Jane and Barry do organize their venture as a sole proprietorship, with Jane becoming the proprietor and Barry an employee. Furthermore, suppose it will be impossible for a court to determine ex post whether Jane and Barry actually intended to grant Jane the adaptability and freedom from fiduciary duty restraints contract and tort law normally affords proprietors. Finally, suppose that shortly after the venture commences, Jane discharges Barry without cause.

If Barry, the weaker venturer, seeks judicial relief on the grounds that Jane owes him expansive fiduciary duties, how should an efficiency-minded court rule? Johnston argues that the court should imply expansive fiduciary duties if it concludes that such fiduciary duty would be efficient—that is, would have drawn forth more team-specific investment if expressly provided ex ante.\textsuperscript{23} As I interpret the Coasean Contract Theory, an efficiency-minded court would not engage in such inquiry because the organizational form the venturers chose, as modified by any express agreement, is the best possible indicator of how much fiduciary protection they desired.\textsuperscript{24}

As presently cast, Johnston's arguments assume that venturers adopt an organizational form and then must either opt in or opt out of fiduciary duty restraints on the stronger venturer, depending on what the form provides as a starting point.\textsuperscript{25} However, it is far more common in the closely held setting for venturers to negotiate from an initial position of no agreement at all. Professor Johnston's model assumes that venturers face a simple choice—either stay with the fiduciary rules that the chosen form provides, if any, or opt for an alternative rule. In the more typical case, the venturers must decide whether to enter into the venture at all, and if so, which organizational form and attendant level of fiduciary duty to adopt.\textsuperscript{26} Professor Johnston must address this more complex situation

\textsuperscript{22} Coaseans would not expect to see such ventures organized as at-will partnerships, because the choice of such form would allow the weaker partner to use both dissolution and fiduciary duty opportunistically.

\textsuperscript{23} Johnston, \textit{supra} note 1, at 330-33.

\textsuperscript{24} Once a Coasean court concludes that the parties most likely preferred a certain level of fiduciary protection, it is axiomatic that the court will not grant a greater level of protection. To grant greater relief would be inefficient—that is, would reduce the value of prospective similarly situated investments. If such greater relief were granted, then future similarly situated investors must either bear the expense of opting out of the unwanted fiduciary duty implied by the court or must forgo the venture entirely.

\textsuperscript{25} Johnston, \textit{supra} note 1, at 300.

\textsuperscript{26} In other words, in the typical case prospective venturers face two related opt in choices—
if he is to convince us of the role that strategic bargaining incentives play in initial form selection and of how efficiency-minded courts should take that knowledge into account.

III. GAP FILLING IN THE RELATIONAL CONTRACT SETTING

Early in his article, Professor Johnston notes that "deciding whether or not there is a gap in the contract is neither simple nor necessarily distinct from answering the next question, which is how to fill the gap."27 This unclarity as to the difference between identifying a gap and deciding how to fill a gap permeates Johnston's paper. Accordingly, I now explain (1) the difference between identifying and filling a gap; and (2) the relationship between the Coasean Contract Theory, as I interpret it, and the gap-filling task closely held, relational ventures present. I illustrate these points by reference to the well-known partnership case, *Page v. Page*, 28 which Professor Johnston discussed extensively in his paper.29

In *Page* the partners entered into an oral partnership to operate a laundromy business. Each contributed capital. The stronger partner served as managing partner, and through a separate corporation supplied linens and machinery to the partnership. After eight years of operation the partnership had suffered total losses of sixty-two thousand dollars and owed the stronger partner's corporation forty-seven thousand dollars. Upon the establishment of Vandenberg Air Force base in the laundry's vicinity, the partnership's business began to prosper. Despite, or perhaps because of, this change of fortune, the stronger partner apparently indicated his desire to dissolve the partnership. Fearing the consequences of dissolution, the weaker partner sought declaratory relief. The trial court held that the partnership was for an implied durational term extending until partnership debts were repaid out of profits and, thus, any premature dissolution would be wrongful.

The Supreme Court of California reversed, holding that the weaker partner had "failed to prove any facts from which an agreement to continue the partnership for a term may be implied."30 But the court did not

---

27. Johnston, supra note 1, at 295.
30. 359 P.2d at 43.
stop there. It proceeded to advise the partners concerning the rights the weaker partner enjoyed even though the partnership was at will:

A partner at will is not bound to remain in a partnership, regardless of whether the business is profitable or unprofitable. A partner may not, however, by use of adverse pressure "freeze out" a co-partner and appropriate the business to his own use. A partner may not dissolve a partnership to gain the benefits of the business for himself, unless he fully compensates his co-partner for his share of the prospective business opportunity. . . .

Plaintiff has the power to dissolve the partnership by express notice to defendant. If, however, it is proved that plaintiff acted in bad faith and violated his fiduciary duties by attempting to appropriate to his own use the new prosperity of the partnership without adequate compensation to his co-partner, the dissolution would be wrongful and the plaintiff would be liable as provided by [UPA section 38(2)] for violation of the implied agreement not to exclude defendant wrongfully from the partnership business opportunity. 31

Professor Johnston argues that the dicta in Page unduly expands the stronger partner's fiduciary obligations and the reach of the wrongful dissolution provisions because the parties could have bargained for a definite term or a simple clause that the partnership would not be dissolved until the partners had earned back their initial capital contributions. 32 This criticism of Page reflects Professor Johnston's confusion about the difference between identifying a gap and filling a gap. More specifically, Johnston's criticism reflects both an interpretation of when contractual gaps exist that is appropriate to short term, discrete transactions among strangers, but not to long-term, relational contracts, 33 and a misunderstanding of the gap-filling signalling effect provided by venturers' choice of organizational form. 34

In effect, Johnston argues that by selecting at-will partnership form, the partners have left no gaps concerning how the partners will adapt to future contingencies. But from a relational-contract perspective, the partners have not made substantive gap-filling decisions. Instead, they have indicated both how gap-filling authority is allocated among the partners and what the courts' general gap-filling role will be. In other words, business firms and other relational contracts are very different from the classical fully contingent contract in which each party fully

31. Id. at 44.
32. Johnston, supra note 1, at 331-32.
33. See supra note 6.
34. See supra notes 12-14 and accompanying text.
specifies its substantive rights and duties at the outset. Indeed, the contract between partners and shareholders in closely held firms is mostly gaps. As long as the venture functions optimally, the partners or shareholders themselves will fill these substantive gaps, in good faith, and as the need arises. If, however, harmony ends, or in the worst case an opportunist strikes, the standard form rules, as modified by the parties' explicit contract, determine what adaptive or gap-filling rights the stronger and weaker partners have, and what gap-filling role an efficiency-minded court should play. 35

As I interpret the Coasean Contract Theory, the Page court did two very different things. First, it determined which organizational form the venturers had selected—partnership at will or partnership for a specified duration or undertaking. Then, after determining that the form selected was an at-will partnership, the court commented on the gap-filling role that the trial court should play if the weaker partner subsequently complained about the stronger partner's conduct in dissolving the partnership.

If the California Supreme Court had agreed with the trial court that the Pages' venture was a partnership for a term, any premature dissolution would have been wrongful. In other words, there would not have been a gap as to whether a particular dissolution was wrongful. 36 However, once the supreme court determined that the partnership was at will, it had to decide whether any dissolution would be non-wrongful or

35. Selection of partnership form indicates that future adaptations are to be made either by collective consensus, or by one or more partners' withdrawal from the firm. As such adaptations occur, substantive contractual gaps are filled. The court's role is to review such gap-filling actions whenever any partner asks for an equitable accounting. For the signalling effect of corporate form selection, see supra notes 12-14 and accompanying text.

36. Uniform Partnership Act (UPA) § 31(1) provides three circumstances in which a partnership can be dissolved without violation of the partnership agreement: (1) by unanimous agreement of the partners; (2) by the express will of any partner if the partnership is for no definite term or undertaking; or (3) by the completion of any definite term or specified undertaking. Uniform Partnership Act § 31(1) (1914). Under UPA § 31(2) a partnership may be dissolved in contravention of the agreement at anytime by the express will of a partner. Id. § 31(2). Thus, if a court determines that a partnership has an implied definite term or undertaking, and if the partnership is nonetheless dissolved by the stronger partner, such dissolution is in contravention of the partnership agreement and subjects the stronger partner to the gap-filling rules in UPA § 38. UPA § 38 favors the non-wrongfully dissolving partner in two significant respects. First, the wrongfully dissolving partner is liable for any damages to the other partner caused by the dissolution. Second, the wronged partner has the option of continuing the business without the bad actor, or liquidating the assets; in other words, the wronged partner is given near exclusive gap-filling authority concerning the disposition of the partnership's assets. Id. § 38.
whether some subset of these dissolutions would be deemed wrongful as a violation of implied fiduciary duties. The court in *Page* concluded that there was a contractual gap as to which dissolutions of at-will partnerships were wrongful and which were not, and generally described those that would be considered wrongful.

Under the Coasean Contract Theory as I understand it, the court's ruling in *Page* was obviously correct. Rational prospective venturers would have realized that a term-partnership provides the weaker partner with greater protection against the stronger partner's opportunistic misuse of her dissolution power than does a partnership at will. Thus, in a case like *Page*, an efficiency-minded court should not impose fiduciary limits on the stronger Page's dissolution rights that are as severe as the limits to which he would have been exposed if he prematurely dissolved a partnership having an implied duration term.

Equally important, however, an efficiency-minded court should not conclude that selection of a partnership at will means that any dissolution will be unconstrained by fiduciary duty. Selection of a partnership at will would signal to a Coasean court that, in order to receive greater adaptability, the partners were willing to endure a greater risk of opportunistic dissolution than would be the case if a term were specified, but it does not suggest that no fiduciary protection is desired. To the contrary, general partnership form has historically imposed fiduciary duties on partners in a wide variety of circumstance. Moreover, if the Pages had wished to provide each other with unconstrained withdrawal rights, they could have organized as an implicit team, or the weaker Page could have been relegated to the status of lender. Thus, if the court in *Page* declared that it would impose no implied fiduciary constraints on the stronger partner's dissolution power under *any* circumstance, the court would be acting in a value-reducing way by ignoring the venturers' choice of partnership form with its implied fiduciary duty.

IV. Conclusion

Finally, I would like to comment briefly on Professor Johnston's fundamental assumptions about opportunism as a human characteristic and

37. Indeed, as Professor Johnston notes, the Page brothers were apparently aware of this difference because they bargained for duration in an earlier and separate partnership venture. *See* *Page* v. *Page*, 359 P.2d 41, 43 (Cal. 1961).

38. An implicit team is bound together by a web of mutual expectations and interests none of which is embodied in a legally enforceable contract.
about the significance of game theory analysis. Johnston posits that prospective venturers are of two types—opportunists and nonopportunists. He asserts that a major reason weaker investors are exploited ex post lies in their inability to determine ex ante whether the prospective stronger venturer is and will be an opportunist. Conversely, a major concern for nonopportunistic stronger venturers is their inability to determine whether a prospective weaker venturer will use fiduciary protection opportunistically.

While analytical clarity is enhanced by identifying as many aspects of the contracting problem investors face in cooperative ventures as possible, I do not think Johnston has made a convincing case for the factors he identifies. It seems likely to me that confirmed opportunists will gravitate to short term, discrete transactions, in which exploitation can occur before the opportunist's true character is revealed. Moreover, Johnston's assumption, that whether individuals are opportunists will be determined outside of the venture and despite how it is organized, is most likely true in short term, discrete transactions, and less true the more interdependent and enduring the relation. Thus, it seems that Professor Johnston's gap-filling theory will be most useful in connection with one shot, short-term ventures that are very similar to the classical discrete transactions between strangers (the stuff of the first-year contracts course), and of decidedly less importance in cases like *Meiselman v. Meiselman*, 39 *Donahue v. Rodd Electrotype Co.*, 40 or *Wilkes v. Springside Nursing Home*. 41 If my intuition is correct, then it also seems that the greatest shortcoming of current scholarship concerning closely held cooperative ventures is not the lack of game-theory analysis but, instead, the absence of systematic and sustained attention to the teachings of transaction-cost economists and relational contract theorists.