

OPTING IN AND OPTING OUT: BARGAINING FOR FIDUCIARY DUTIES IN COOPERATIVE VENTURES

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A frequently repeated story in the law of corporations and partnerships is that of a weaker partner or minority shareholder who complains that the stronger partner or majority shareholder terminated the weak partner/minority shareholder's participation in the firm solely to prevent her from realizing an increase in firm value. The weak partner or minority shareholder, having not gotten any explicit contractual protection against exploitation of this sort, typically asks the court to grant her relief on the ground that the strong partner/majority shareholder has violated her implied fiduciary obligations. The relief requested ranges from dissolution of the venture to a forced equal share of any gains realized by the more powerful party.

This apparently simple, generic story conceals enormous complexity and variety. It may describe a simple two-man partnership operating a laundry, which, after suffering years of losses, suddenly becomes profitable because of the propitious arrival of a military base.¹ The stronger partner, who does not need the weaker partner, decides to dissolve the terminable-at-will partnership and appropriate the new-found prosperity for himself. The weaker partner says that this would be a violation of his partner's fiduciary duties.

Our generic story describes equally well the case of a pharmacist who, after twenty years, switched jobs, invested his entire savings as a minority

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1. See *Page v. Page*, 359 P.2d 41 (Cal. 1961).

shareholder in a new pharmacy business across the country, and was discharged as an employee in the new business despite being its most active member.² The pharmacist asks the court to order the majority shareholders to buy out his corporate shares. Similarly, in a third scenario, a young securities analyst who was a minority shareholder in a financial consulting firm resigns and (under the terms of his contract) is required to sell his shares back to the corporation, but the majority shareholders never tell him of an impending sale of the corporation that would greatly increase the value of his shares.³

In each of these three true stories, the weaker party failed to bargain for protection up front: the laundry partnership was, after all, terminable at will; the pharmacist and the securities analyst were both terminable-at-will employees. What they did not provide for themselves *ex ante* they asked the courts to provide *ex post*, in the form of expansive fiduciary obligations and accompanying remedies for violation. And in these cases, the courts were at least partially sympathetic to the requests.

By definition, none of these cases involved a large public corporation, none involved the sums of money at stake in the megadeals of the 1980s, and none made the pages of our leading business publications.⁴ While small, cases like these are increasingly numerous.⁵ And, like the string quartet, their smallness should not be mistaken for simplicity. These cases raise an issue fundamental not just to the law of business associations, but to the structure and performance of an economy law constrains: whether the law should imply and enforce limits on opportunistic behavior in cooperative ventures, or instead leave the parties to whatever protection for which they explicitly bargained.

2. *In re Topper*, 433 N.Y.S.2d 359 (Sup. Ct. 1980). Cases of this sort are legion. *See, e.g.*, *Ferdinand Drexel Inv. Co. v. Albert*, 723 F. Supp. 313, 318-23 (E.D. Pa. 1989) (detailing the freeze-out of minority shareholder who had been the "driving force" behind a successful firm for over 30 years and finding no issue of federal law).

3. *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987).

4. This journalistic neglect seems to be ending. The New York Court of Appeals recently said that a firm could fire a minority shareholder who was an at-will executive employee, even if the only reason for firing him was to activate a stock repurchase agreement at a favorable price. *Gallagher v. Lambert*, 549 N.E.2d 136 (N.Y. 1989). *See also* *Ingle v. Glamore Motor Sales, Inc.*, 535 N.E.2d 1311 (N.Y. 1989) (holding that employee at will has no right, *qua* employee, not to be dismissed by corporation only so corporation could activate repurchase option at favorable price). *Gallagher* is discussed in Laurie Cohen & Wade Lambert, *Firms' Right to Fire 'At Will' is Bolstered*, WALL ST. J. Jan. 8, 1990, § 2, at 3.

5. In addition to the cases cited in the previous notes, see *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567 (11th Cir. 1990), and *Knudsen v. Northwest Airlines, Inc.*, 450 N.W.2d 131 (Minn. 1990).

To some, this issue may itself seem remarkable, for it is well established that every contract contains an implied covenant of good-faith performance.⁶ Yet, especially in the context of an implied fiduciary duty of good faith, the scope or extent of such a duty remains, perhaps inevitably, uncertain. And within the last decade, a number of commentators have argued that courts should be both reluctant to imply any fiduciary protections beyond those explicit in the parties' contract and willing to enforce the parties' explicit limitations on the fiduciary duty.

The commentary with which I am concerned may be dubbed, for want of a better term, the Coasean Contractual Theory.⁷ It is somewhat misnamed, for Ronald Coase's original insight, that the initial legal entitlement might not matter if parties could bargain, perfectly, to a Pareto superior entitlement,⁸ reflected a profound skepticism regarding the significance of legal rules and the capabilities of lawmakers.⁹ The Coasean Contractual Theory, by contrast, is the apotheosis of post-Realist activism: it says that because it is costly to bargain around the law, courts should imply standard form or "default" contract terms that mimic the terms that most parties would have explicitly included in their contracts. This will minimize the transaction costs incurred by those parties who do not like the default terms supplied by judicial implication and who in-

6. See Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 371 (1980).

7. For other recent articles dealing with this theory, see Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Jason Scott Johnston, *Strategic Bargaining and the Economic Theory of Contract Default Rules*, 100 YALE L.J. 615 (1990); Ian Ayres & Robert Gertner, *Strategic Contractual Inefficiency and the Optimal Choice of Legal Rules*, 102 YALE L.J. (forthcoming 1992); David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815 (1991).

8. R.H. Coase, *The Problem of Social Cost*, 3 J. L. & ECON. 1 (1960). Coase's predictions have been confirmed in some experimental tests. See, e.g., Elizabeth Hoffman & Matthew L. Spitzer, *The Coase Theorem: Some Experimental Tests*, 25 J. L. & ECON. 73 (1982). There is, however, contrary experimental and empirical evidence. See Stewart Schwab, *A Coasean Experiment on Contract Presumptions*, 17 J. LEGAL STUD. 237 (1988) (experimental); John J. Donohue III, *Diverting the Coasean River: Incentive Schemes to Reduce Unemployment Spells*, 99 YALE L.J. 549 (1989) (empirical). Most damaging of all, perhaps, is the very strong experimental confirmation of the "endowment effect," which is the phenomenon that individuals value a good more highly when it is included in their endowments than when it is not. See Daniel Kahneman et al., *Experimental Tests of the Endowment Effect and the Coase Theorem*, 98 J. POL. ECON. 1325 (1990), reprinted in RICHARD THALER, *QUASI-RATIONAL ECONOMICS* 167 (1991).

9. See George L. Priest, *Gossiping About Ideas*, 93 YALE L.J. 1625, 1635 (1984) (book review); Pierre Schlag, *An Appreciative Comment on Coase's 'The Problem of Social Cost': A View from the Left*, 1986 WIS. L. REV. 919, 925-26; Stewart Schwab, *Coase Defends Coase: Why Lawyers Listen and Economists Do Not*, 87 MICH. L. REV. 1171, 1196-98 (1989) (book review).

stead bargain for different, explicit terms. On this view, the law is merely suppletory, offering "off the rack" contract terms suitable for the typical contract. It follows that in a world in which judges follow the Coasean Contractual Theory, informed parties will often leave contract terms blank or vague in the expectation that judges will fill them in with what typical informed parties would want. Coasean judges literally write standard form contracts, and they do so by divining the preferences of the typical parties to a particular kind of deal.¹⁰

Both scholars¹¹ and judges have applied the Coasean Contractual Theory to all sorts of contract-related doctrinal areas.¹² In this Article, however, I will focus on its application to the law of business associations, and, even more particularly, to the three paradigm cases I described at the outset. In these cases, the issue, from the Coasean perspective, is whether judges should supply expansive implied fiduciary duties to discipline a stronger party's opportunistic behavior in a cooperative venture. Phrasing the issue in this way presents at least two difficulties. The first problem is how to decide whether the parties' silence is in fact an invitation for courts to read in expansive fiduciary duties. In our paradigm cases, for instance, the parties may have intended exactly what they explicitly provided and no more. The laundry partners may have literally intended a terminable-at-will partnership; the minority shareholders in the pharmacy and financial consulting firms were terminable-at-will employees; and in each case the parties may have intended terminable at will to mean terminable at any time, for any reason, with no judicially imposed ifs, ands or buts.

10. It is important to emphasize that the Coasean theory is objective in that it sets the default rule at what typical parties would want, not at what the actual parties to a particular transaction might have wanted had they thought of the matter. See Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 J. LEGAL STUD. 597, 606-08 (1990) (comparing "majoritarian" and "individualistic" approaches to the design of contract default rules). Cf. Charny, *supra* note 7 (comparing the methodologies of constructing hypothetical bargains under alternative assumptions regarding the underlying normative objective of interpretation).

11. For citations to some of the representative literature, see Charles J. Goetz & Robert E. Scott, *The Limits of Expanded Choice: An Analysis of Interactions Between Express and Implied Contract Terms*, 73 CAL. L. REV. 261, 262 n.4 (1985) (notable as one, if not the only, attempt by practitioners of the standard Coasean Theory to analyze its assumptions seriously), and Ayres & Gertner, *supra* note 7, at 89 nn.16-17, 90 nn.19-21 (1989). For an extremely insightful recent application of the Coasean Theory to the analysis of whether lost profits or market-price damages should be the default damage rule in contract law, see Robert E. Scott, *The Case for Market Damages: Revisiting the Lost Profits Puzzle*, 57 U. CHI. L. REV. 1155 (1990).

12. See especially the opinions by Judges Posner and Easterbrook in *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987).

Answering this initial question and deciding whether 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.¹³ In our paradigm cases, the question is how expansive to be in protecting the weaker party against the stronger's allegedly exploitive behavior. From the Coasean point of view, this question reduces to an inquiry into whether typical contracting parties generally would have contracted for expansive or instead restrictive majority-shareholder (or partner) fiduciary duties of good faith. From this point of view, the issue is whether expansive fiduciary duty terms are generally efficient.

Most commentators who take the Coasean point of view, such as Judges Posner and Easterbrook and Professors Epstein and Fischel, have found economic efficiency incompatible with a broad implied fiduciary duty of good faith.¹⁴ They have reached this same general conclusion in a variety of factual and legal settings in which fiduciary duties are at issue: the duty of employers to exercise good faith in terminating at-will employees,¹⁵ the rights of partners to terminate at-will partnerships,¹⁶ the duties of majority shareholders in close corporations to disclose information¹⁷ and refrain from "squeezing out"¹⁸ minority shareholders, and lenders' obligations to use good faith in exercising explicitly conferred contractual discretion, as in declaring a borrower in default.¹⁹ Remarkably, regardless of the context, these commentators always make the same argument against a broad implied fiduciary duty of good faith.²⁰ Indeed,

13. As Ian Ayres and Robert Gertner observe, there may not even be two questions, because if a judge is convinced, for example, that the parties would have wanted a fiduciary duty of good faith, he will see a gap in the explicit contract, whereas if a judge is convinced that the parties wanted no such duties, he will tend not to see a gap. Ayres & Gertner, *supra* note 7, at 119-20.

14. See RICHARD POSNER, *ECONOMIC ANALYSIS OF LAW*, §§ 11.4, 14.9 (1986) (finding broad implied fiduciary obligations inefficient in context of employment at will and corporate freeze-out); Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 *STAN. L. REV.* 271 (1986); Richard A. Epstein, *In Defense of the Contract at Will*, 51 *U. CHI. L. REV.* 947 (1984); Daniel R. Fischel, *The Economics of Lender Liability*, 99 *YALE L.J.* 131 (1989).

15. See Epstein, *supra* note 14.

16. *Id.*

17. See *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987).

18. See Easterbrook & Fischel, *supra* note 14. For a general and indeed seminal discussion of the varieties and circumstances of minority freeze-outs, see F. HODGE O'NEAL & ROBERT B. THOMPSON, *O'NEAL'S OPPRESSION OF MINORITY SHAREHOLDERS*, §§ 2:01 to 3:20 (2d ed. 1985).

19. See Fischel, *supra* note 14.

20. Recently, Judge Easterbrook explicitly argued that the principle governing the exercise of a lender's discretion in determining whether to continue to extend credit to a borrower is "identical to that governing a contract for employment at will: the employer may sack its employee for any reason

this argument may seem to many who do not "do" law and economics to be "the" economic analysis of the fiduciary duty of good faith. It is an argument that stresses the imperfections of legal rules and the perfection of market discipline through reputation, and I shall therefore refer to this well-established argument as the "Perfect-Markets" analysis of the scope of implied fiduciary duties.

The economic analysis of expansive fiduciary duties is, however, much more complex than the Perfect-Markets approach assumes. In this Article, my object is to reveal some of this complexity by examining a crucial assumption underlying the Perfect-Markets analysis: if a contract term is efficient and important, then the parties will explicitly include it if the law does not imply it. This assumption is crucial to the Perfect-Markets analysis of the expansive implied fiduciary duty in my paradigm cases. Because that analysis does not conclude that expansive fiduciary protections are always inefficient, but rather that they usually are, transaction costs incurred in bargaining around the initial legal rule will be lowest if the rule does not imply a broad fiduciary duty. Here I question the assumption that the parties for whom such an expansive duty *is* efficient necessarily will bargain to include it: if this does not hold, the Perfect-Markets analysis does not hold.

There may be a number of reasons parties would not bargain to include broad fiduciary protection even if such protection would be efficient. Some of these are quite well known in the general literature on contracting. For example, it might be impossible to specify in advance all the circumstances under which the parties would intend to permit a manager's dismissal and when they would instead view such dismissal as a violation of their implicit understanding. Such understanding must remain implicit, simply because the parties cannot perfectly and completely foresee the future.²¹

except one forbidden by law, and it need not show 'good cause.'" *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1358 (7th Cir. 1990).

21. This explanation for contractual incompleteness is at the center of the relational contracts approach. See Charles J. Goetz & Robert R. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981). It also figures crucially in economic models of implicit contracts. For implicit contracts models that suggest a role for fiduciary duties, see Andrei Shleifer & Lawrence Summers, *Breach of Trust in Hostile Takeovers*, in *CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES* (Alan Auerbach ed., 1988); Note, *Employer Opportunism and the Need for A Just Cause Standard*, 103 HARV. L. REV. 510, 518-23 (1989); PAUL C. WEILER, *GOVERNING THE WORKPLACE* 48-104 (1990). For an interesting analysis of incomplete contracts in the franchisee-franchisor context, which contains a very useful and comprehensive discussion of various non-strategic reasons for in-

Recent work by economists has revealed a number of other factors that might account for contractual incompleteness.²² Here I shall focus on a limitation on the parties' ability to bargain for efficient contract terms that has not yet been widely studied in the law and economics literature: strategic incentives in bargaining around the law.²³ My analysis of strategic incentives in the present context is grounded upon an important, central insight of the Perfect-Markets approach: the broader a fiduciary duty designed to protect employees, minority shareholders, and weak partners against opportunism by employers, majority shareholders, or strong partners, the easier it is for the very parties protected by the duty to abuse it in bad-faith litigation.²⁴ The Perfect-Markets argument holds that the risk of a bad faith, opportunistic lawsuit claiming a violation of the fiduciary duty of good faith is so great that the parties generally would not want courts to broadly interpret such a term, particularly given the variety of extra-legal market constraints (such as reputation) on employer/majority shareholder/strong partner opportunism.²⁵ That is, this argument holds that the legal process is so imperfect, relative to the discipline market reputation provides, that typical weaker parties would choose to rely on the market rather than on broad judicial protection to protect them from stronger-party opportunistic behavior.

After surveying the Perfect-Markets analysis in Section I of this Article, Section II explores some strategic implications of its central insight regarding the imperfection of fiduciary duty protection. My analysis begins from the observation that the imperfection of fiduciary duty protection is important only if the parties have imperfect information about each other. If a weak party knows that a strong party is trustworthy and

completeness, see Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 STAN. L. REV. 927 (1990).

22. For an excellent explanation of these factors and how they might account for for incomplete, long-term, relational contracts, see ALAN SCHWARTZ, *RELATIONAL CONTRACTS IN THE COURTS: AN ANALYSIS OF INCOMPLETE AGREEMENTS AND JUDICIAL STRATEGIES* (Yale Law School Program in Civil Liability Working Paper No. 141, 1991).

23. For recent articles beginning the analysis of this issue, see Ayres & Gertner, *supra* note 7; Johnston, *supra* note 7; Avery Katz, *The Strategic Structure of Offer and Acceptance: Game Theory and the Law of Contract Formation*, 89 MICH. L. REV. 215 (1990). For more informal, general applications of game-theoretic ideas to issues in the law of corporations and contracts, see, for example, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495 (1990); Robert E. Scott, *Conflict and Cooperation in Long-Term Contracts*, 75 CAL. L. REV. 2005 (1987).

24. For an application of this insight to the general analysis of extralegal sanctions, see David Charny, *Nonlegal Sanctions and Commercial Relationships*, 104 HARV. L. REV. 375, 406-07 (1990).

25. See *infra* notes 30-72 and accompanying text.

will not behave opportunistically, then the weak party does not need legal protection against opportunism; similarly, if a strong party knows that a weak party is trustworthy, then the strong party will not be concerned that the weak party will exploit the imperfect legal process with false allegations that the strong party breached her fiduciary duties. However, when the parties have only imperfect information about each other—in particular, about whether their co-venturer is trustworthy or opportunistic—then the efficiency of imperfect fiduciary duty protection varies with the type of enterprise. I develop a typology based on the stronger party's degree of sunk commitment to the enterprise and show that the efficiency of imperfect fiduciary duties decreases as the stronger party's commitment to the venture increases.

This theory has several implications for the law of partnerships and close corporations. It suggests that since the efficiency of imperfect fiduciary duties might vary systematically with an important and easily observable variable—the degree of the strong party's sunk investment—then the law ought to provide a menu of organizational forms that differ according to the scope of their implied fiduciary duties. This argument suggests that recent judicial decisions applying the broad fiduciary duty owed by partners to majority shareholders in close corporations²⁶ have been unsound by eliminating a socially desirable diversity of organizational default forms.

The argument also generates the interesting and empirically testable implication that, as the parties to a small business enterprise become more similar in the extent of their involvement, they will prefer less expansive fiduciary duties. This implication seems to contradict the apparently widespread use of the partnership form by businesses with similarly committed participants. The contradiction disappears, however, when we recall that the implication follows from the assumption that the parties are imperfectly informed regarding each other's trustworthiness: it may be that partnership form is most often adopted by parties who are well informed about each other and who are relatively unaffected by legal default rules on the scope of fiduciary duties. In cases in which the parties are not so well informed, however, my model implies both that there should be a diverse menu of default options on the scope of fiduciary duty protection, and, quite nonintuitively, that the scope of fiduciary

26. *Crosby v. Beam*, 548 N.E.2d 217 (Ohio 1989); *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270 (Alaska 1980); *Donahue v. Rodd Electrotpe Co.*, 328 N.E.2d 505 (Mass. 1975); *Tillis v. United Parts, Inc.*, 395 So. 2d 618 (Fla. Dist. Ct. App. 1981).

duty protection for weaker parties should be wider in organizational forms (such as the corporation and limited partnership) that parties with differing sunk commitments adopt than in forms (such as general partnerships) that parties with similar sunk commitments adopt.

After developing these points on the efficiency of imperfect fiduciary duties, Section II informally explains two types of strategic constraints on the ability of imperfectly informed parties to bargain into an efficient scope of fiduciary duty protection. I call the first of these constraints the "Redistributive Risk." When the parties have imperfect information regarding each other's type and are unsure whether the other side will indeed behave opportunistically if given the chance, even if an expansive fiduciary duty is socially desirable (because it protects against exploitation and therefore encourages firm-specific investment by trustworthy or minority shareholder/managers), proposing or agreeing to include such a duty also threatens to redistribute surplus from entrepreneur/majority shareholders to opportunistic minority shareholder/managers. If the probability of such minority shareholder/manager opportunism is high enough, majority shareholders will not agree to include a broad fiduciary duty, even though such a term increases the total expected surplus from cooperation. The asymmetry of information causes contracts to be incomplete, and inefficiently so.

This source of inefficient contractual incompleteness depends very much on the asymmetry of the assumed minority/shareholder manager and majority shareholder/entrepreneur relationship. It does not arise in a symmetric enterprise, in which both partners make firm-specific investments and share in control, because in such a relationship an opportunistic party can exploit both her control position (as can a majority shareholder) and also the fiduciary duties designed ostensibly to protect her from exploitation (as can a minority shareholder). In symmetric partnerships, therefore, the fiduciary duty is less likely to be efficient, but the parties will generally opt in to an efficient scope of fiduciary duty protection.

Section II concludes by briefly exploring a related, information-based reason parties may both fail to opt in to an efficient fiduciary duty, and fail to opt out of an inefficient (or unnecessary) fiduciary duty. I call this constraint "Strategic Information Revelation in Bargaining." This is the phenomenon in which proposing or accepting fiduciary duty limitations may often reveal private information that, for strategic reasons, the actor would rather conceal from the other party. Contemporary economic the-

ory clearly recognizes the importance of strategic information revelation.²⁷ Only very recently, however, have the implications of strategic information revelation for the economic analysis of contract default terms begun to be identified.²⁸ In the present context of proposals to opt in or to opt out of the fiduciary duty, analysis reveals a multiplicity of possible outcomes—to be more precise, equilibria. Some very plausible outcomes, however, greatly weaken the argument for relying on private contracts to supply all efficient terms: in particular, proposing a broadened fiduciary duty may, paradoxically, reveal a controlling shareholder to be an opportunist. And because of the adverse effect that the revelation of this information would have on investment by trustworthy minority-shareholder managers, the bad entrepreneur is better off not making the proposal at all.

As I said, however, there are many possible outcomes in this process, and, as I develop more formally and in greater detail elsewhere,²⁹ for some configurations of the relevant parameter values, either trustworthy or opportunistic entrepreneurs, or even both types of entrepreneur, may opt in to an efficiently broadened scope of fiduciary protection. In identifying fairly general and empirically measurable variables that determine the likelihood that parties will bargain into an efficient scope of fiduciary protection, I hope to have both extended the Coasean analysis underlying the Perfect-Markets approach to fiduciary duties and to have indicated potential areas for empirical investigation.

At the same time, by focusing just on strategic effects due to asymmetric information, the results in Section II are very limited and do not provide the backbone for a positive theory of opting in and opting out of fiduciary duties. Section III outlines how such a theory might proceed by considering a number of complicating factors that are important in the Perfect-Markets analysis and that also enrich the strategic approach

27. In the context of contract proposal games, see, for example, Roger B. Myerson, *Mechanism Design by an Informed Principal*, 51 *ECONOMETRICA* 1767 (1983); Eric Maskin & Jean Tirole, *The Principal-Agent Relationship with an Informed Principal: The Case of Private Values*, 58 *ECONOMETRICA* 379 (1990). The information-revelation phenomenon is also central in analyses of private disclosure of product information. For an analysis with application to this problem and also the related issue of information sharing by oligopolists, see Masahiro Okuno-Fujiwara et al., *Strategic Information Revelation*, 57 *REV. ECON. STUD.* 25 (1990).

28. See Ayres & Gertner, *supra* note 7; Johnston, *supra* note 8.

29. Jason Johnston, *Imperfect Contractual Enforcement and Bargaining with Adverse Selection* (January 1992) (mimeo, on file with Vanderbilt University).

in Section II. Section IV then applies my positive theory to selected doctrinal issues raised by the paradigm cases I described above.

I. THE PERFECT-MARKETS ANALYSIS OF FIDUCIARY DUTIES

A. *Close Corporations*

In this Section, I survey applications of what I have called the Perfect-Markets analysis of the fiduciary duty of good faith. It is, I think, remarkable that the argument differs so little with the precise legal context in which it is applied. This generality shows the importance of the argument, and it also shows why various assumptions underlying the argument are crucial.

Consider first the analysis of the fiduciary duties of majority shareholders in close corporations. Judge Frank Easterbrook and Professor Daniel Fischel have recently argued that statutes that make it easy for minority shareholders to dissolve a close corporation on the ground that the majority shareholders have violated fiduciary duties give too many rights to minority shareholders.³⁰ This is bad, they say, because minority shareholders will behave "opportunisticly": if the test for dissolution is majority oppression of the minority in violation of the majority's fiduciary duties, the minority will threaten to bring baseless oppression actions solely to induce the majority to "hand over" more of the firm's profits.³¹ For this reason, Easterbrook and Fischel oppose proposals that would give minority shareholders an automatic buyout right.³² They also oppose actual state statutes and decisions that provide for dissolution if the majority frustrates the "reasonable expectations" of the minority.³³

Easterbrook and Fischel recognize that a minority-shareholder employee in a close corporation is in an inherently vulnerable position and that this position might justify imposing a greater duty to disclose information and more protection against at-will employment termination.³⁴

30. Easterbrook & Fischel, *supra* note 14, at 285.

31. *Id.* at 287.

32. They are especially critical of 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, 6 (1977). Easterbrook & Fischel, *supra* note 14, at 288-89, 297-99.

33. Thirty-seven states now have statutes that allow a minority shareholder to petition for dissolution of the corporation on the ground of "oppressive" conduct by the controlling shareholders. Robert B. Thompson, *Corporate Dissolution and Shareholders' Reasonable Expectations*, 66 WASH. U. L.Q. 193, 206 (1988). At least eight states have broadened "oppression" to include a violation of the reasonable expectations of minority shareholders. *See id.* at 211-28.

34. Easterbrook & Fischel, *supra* note 14, at 292-93.

Still, they feel comfortable even with an extremely deferential business judgment rule, which does not protect minority shareholders much at all,³⁵ and believe also that courts should be very reluctant to grant involuntary dissolution.³⁶ The logic behind these ultimate conclusions is purely Coasean: because of the opportunism problem, most parties would not want broad involuntary dissolution or strict judicial structing, and by essentially refusing to protect the minority shareholder after the fact, courts create a strong incentive for the minority to get before-the-fact protection into the corporate contract.³⁷

In his dissent in *Jordan v. Duff and Phelps, Inc.*,³⁸ Judge Posner took and extended essentially the same view.³⁹ Conventionally phrased, the issue in *Jordan* was whether the majority shareholders of a close corporation had a duty to disclose ongoing merger negotiations to a departing minority-shareholder employee. The employee was at-will, and the terms of his contract required him to sell his shares back to the corporation when he left its employ. However, successful merger negotiations greatly increased the value of the employee's stock; if the employee had had this information, he might have altered or delayed his decision to leave the company.

Posner's dissent in this case turned largely on his answer to the first-stage Coasean inquiry, on his view, that is, that the contract clearly created terminable-at-will employment with no rights regarding the stock sale other than the right to get book value at the time of the sale. However, he went on to argue that the typical minority shareholder/young executive would have preferred such a severe contract over one with implied majority fiduciary duties. According to Judge Posner, such employee/shareholders are protected by market constraints against exploitation: the firm would have told a really valuable employee about the possible increase in the value of his shares, and employees as a group

35. *Id.* at 293.

36. *Id.* at 287.

37. *Id.* at 287, 293.

38. 815 F.2d 429, 444 (7th Cir. 1987) (Posner, J., dissenting).

39. Curiously enough, Judge Easterbrook wrote the majority opinion in *Jordan v. Duff & Phelps, Inc.* He defended and applied the Seventh Circuit's decision in *Michaels v. Michaels*, 767 F.2d 1185, 1194-97 (7th Cir. 1985), which created a broad duty to disclose premerger negotiations in the close corporation context. Judge Easterbrook said that "[o]ne term implied in every written contract and therefore, we suppose, every unwritten one, is that neither party will try to take opportunistic advantage of the other," 815 F.2d at 487, which is a line of reasoning rather at odds with the view taken in *Easterbrook & Fischel*, *supra* note 14, and, more recently, in *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351 (7th Cir. 1990).

“would rather take their chances on their employer’s good will and interest in reputation, and on their own bargaining power and value to the firm, than pay for contract rights that are difficult and costly to enforce.”⁴⁰ For Judge Posner, “the possibility that corporations will exploit their junior executives . . . may well be the least urgent problem facing our nation,”⁴¹ and the real opportunist in that case would have been the minority-shareholder junior executive, had he tried to “stick around merely to participate in an unexpectedly lucrative sale of Duff and Phelps.”⁴²

With Judge Posner’s elaboration, the argument against expansive majority shareholder fiduciary duties in close corporations runs as follows: fiduciary duties are uncertain and vague, and by threatening a lawsuit alleging majority violation of such duties, minority shareholders can appropriate a larger share of the gains from cooperation than that for which they originally were able to bargain. In a case involving threatened dissolution as a remedy for violation of the majority’s fiduciary duties, the problem of *ex post* minority opportunism is especially acute, because dissolution will often destroy most if not all of the firm’s going concern value. Anticipating such behavior, majority shareholders will be more wary in taking on new shareholders and employees and will lower their remuneration. Thus firm formation may be adversely affected.

On the other hand, minority shareholders do not need fiduciary duty protection, because firms will be eager to protect their reputation for fair dealing with their minority-shareholder employees, since the market will penalize an adverse reputation. Moreover, even if they do not trust all to the firm’s interest in preserving its reputation, prospective minority shareholders can bargain up front for such things as buyout rights and disclosure obligations. They will get these if their bargaining positions are strong enough, and if they do not get them, they should not have. Thus, the failure to observe *ex ante* contractual provisions that emulate *ex post* fiduciary duties is a strong indication that such duties are inefficient.

40. 815 F.2d at 448 (Posner, J., dissenting).

41. *Id.* at 449.

42. *Id.* at 450.

B. *At-Will Employment and Partnership at Will*

The argument against an implied majority shareholder fiduciary duty relies quite heavily on Professor Richard Epstein's earlier defense of the employment-at-will relationship.⁴³ If nothing else, Epstein's article demonstrates the power of the Perfect-Market's analysis of good faith, for it succeeds at the very least in showing the conventional academic literature on employment at will, a literature largely hostile to the doctrine, to be, at its best, seriously incomplete.⁴⁴ True to the Coasean contractual tradition, Professor Epstein views his objective as demonstrating that the contract at will "represents in most contexts the efficient solution to the employment relation,"⁴⁵ so that at will normally should be implied, both because it is "the dominant practice in a given class of cases and because that practice is itself regarded as making good sense for the standard transactions it governs."⁴⁶ In explaining why the contract at will "typically works to the mutual advantage of the parties,"⁴⁷ Epstein emphasizes the bilateral nature of rights under an at-will contract: such a contract lets the employer discipline the employee with the threat to terminate, while it also lets the employee credibly threaten to quit for any reason at any time.⁴⁸ It is a neat, clean solution to the mutual problem of opportunism in the long-term contract.⁴⁹

Epstein recognizes that an employer might be tempted to discharge an employee in bad faith, after realizing benefits from the employee's investment in skills and knowledge specific to the particular firm, but before following through on her own commitments to the employee.⁵⁰ For at least two reasons, however, he thinks this is not a serious problem. He relies first on a reputational argument: if an employer with many employees terminates in bad faith, other employees will feel less secure, the most

43. Epstein, *supra* note 14.

44. See *id.* at 948 n.4 for citations to this literature.

45. *Id.* at 951.

46. *Id.*

47. *Id.* at 957.

48. *Id.* at 963-67.

49. Professor Epstein is by no means alone in arguing for the efficiency of a relatively unfettered termination right as a means of giving employees an appropriate incentive to pursue firm objectives. See Goetz & Scott, *supra* note 21, at 1115-16; Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981); Benjamin Klein, *Transaction Cost Determinants of "Unfair" Contractual Arrangements*, 70 AER PAPERS AND PROCEEDINGS 356 (1980); G. Frank Mathewson & Ralph Winter, *The Economics of Franchise Contracts*, 28 J. LAW & ECON. 503 (1985).

50. Cf. Goetz & Scott, *supra* note 21, at 1139 (a principal's total discretion to terminate at will invites opportunistic behavior by principals).

valuable employees will view the increased probability of exploitive employer behavior as essentially the equivalent of a unilateral wage reduction, and “[a]t the margin some workers will look elsewhere.”⁵¹ Epstein’s second point relates to the first: he denies that there are any strong employee reputational effects; indeed he says resumé’s can be “misleading if not fraudulent” and employer references mostly perverse (as employers attempt to unload unsuitable employees).⁵² In this asymmetric world, the market does not penalize employees for quitting in bad faith, and, even more importantly (or at least more explicitly), employees who have made big investments in firm-specific human capital are not as vulnerable to bad-faith termination as it may seem, because the very poorly informed employer takes big risks in finding and training a replacement employee. Moreover, Epstein concludes, because the problem of opportunistic behavior really arises only because the parties get something from this relationship that they cannot get from other relationships available on the market (they realize economic rents from this relationship), employment at will has the general advantage of reducing legal rigidities in labor markets and increasing labor mobility, which should reduce the tendency for a particular relationship to yield especially high returns.⁵³

Epstein’s theory of employment at will thus essentially elaborates the reputational argument that plays an important role in Judge Posner’s analysis of fiduciary duties to minority-shareholder at-will employees in close corporations. Interestingly, Epstein’s one specific application is to the partnership at will.⁵⁴ The application is straightforward. Because partners all generally have some say in the operation of the business and some control over firm assets and the surplus (profit),⁵⁵ potential conflicts of interest and opportunistic behavior pose a persistent threat to the stability of a partnership.⁵⁶ It can be very costly for partners to monitor each other to detect such opportunistic behavior. Indeed, too much monitoring is inimical to the very idea of a partnership and would neces-

51. Epstein, *supra* note 14, at 968.

52. *Id.* at 973-74.

53. *Id.* at 975-76.

54. For a comprehensive discussion of the partnership at will, with both detailed statutory analysis and proposals and a lucid policy analysis of the costs and benefits of dissolution at will, see Larry E. Ribstein, *A Statutory Approach to Partner Dissociation*, 65 WASH. U. L.Q. 357 (1987).

55. See 1 ALAN R. BROMBERG & LARRY E. RIBSTEIN, *BROMBERG AND RIBSTEIN ON PARTNERSHIP*, § 2.07 (1988).

56. Epstein, *supra* note 14, at 959-60.

sarily eat up all the gains such a venture can generate. The ability to withdraw from and dissolve a partnership at will⁵⁷ then serves as a very effective and credible alternative to costly monitoring. Large-scale opportunism dissipates most of the gains from cooperation and means that the exploited partner has little to lose from invoking his dissolution right, making this sanction credible.⁵⁸ On this view, withdrawal at will serves to stabilize the partnership after formation, which best serves the interests of the parties at the time of formation.⁵⁹

C. Lender Liability

The most recent application of the Perfect-Markets argument (at least of which I am aware) is Professor Daniel Fischel's criticism of the recent judicial trend toward implying a broad fiduciary duty of good faith to limit explicitly conferred lender discretion in lender-borrower contracts.⁶⁰ Professor Fischel's discussion centers on two of the best-known lender liability cases, *State National Bank v. Farah Manufacturing Co.*,⁶¹ and *K.M.C. Co. v. Irving Trust Co.*⁶² In *Farah*, a loan covenant prohibited certain management changes without the consent of the lender, but the Texas Court of Appeals affirmed a jury award of nineteen million dollars for bad-faith exercise of this explicit contractual discretion. Similarly, in *K.M.C.*, explicit covenants gave the lender sole discretion to continue to lend and the ability to call outstanding amounts as immediately due and payable,⁶³ but the Sixth Circuit affirmed a \$7.5 million jury award based on the lender's bad faith failure to give notice before refusing to advance additional funds.⁶⁴

The Perfect-Markets analysis views covenants giving vast discretion to the lender as an optimal device to discipline borrower opportunism, a simple and administratively inexpensive alternative to costly ongoing

57. Withdrawal is of course not necessarily equivalent to either dissociation—termination of the partner's legal relationship with the firm—or dissolution of the firm. See Ribstein, *supra* note 54, at 364-70.

58. Epstein, *supra* note 14, at 962.

59. *Id.*

60. Fischel, *supra* note 14. Recently, in *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351 (7th Cir. 1990), Judge Easterbrook explicitly rejected the approach to good faith in lender liability taken in *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985), on reasoning very similar to Professor Fischel's.

61. 678 S.W.2d 661 (Tex. Ct. App. 1984).

62. 757 F.2d 752 (6th Cir. 1985).

63. *Id.* at 759; see also Fischel, *supra* note 14, at 136.

64. 757 F.2d at 760; see also Fischel, *supra* note 14, at 132.

monitoring.⁶⁵ The insight that any covenant operates bilaterally, however, implies that lenders might well use their discretion opportunistically, to obtain "a benefit not contemplated by the initial agreement."⁶⁶ However, following Professor Epstein's lead at this point, Fischel argues that because lenders are typically large, repeat players, market reputation will deter them from engaging in opportunistic, bad-faith behavior; a bad reputation will cause borrowers to substitute away on the margin and go to some other source of credit.⁶⁷ But like Epstein, Fischel recognizes that some lender-borrower relationships may become highly specialized, as when the lender comes to know a great deal about the borrower and its business. This knowledge would be very costly or even impossible for other lenders to acquire.⁶⁸ The lender may learn about special needs, such as time immediacy of the borrower, and can use this knowledge essentially to extort renegotiation of the terms.⁶⁹

Unlike Epstein, however, Fischel concedes that "[w]hether the increased risk of lender misbehavior created by loan covenants imposes costs that outweigh the benefits from limiting debtor misbehavior cannot be resolved at a theoretical level."⁷⁰ But where theory fails, Coasean empiricism succeeds: if covenants giving the lender vast discretion are present, "the parties must have concluded at the time of initial agreement that the gains from deterring debtor misbehavior outweighed the costs from increasing the probability of lender misbehavior."⁷¹ In other words, if there were mutual gains from limiting lender discretion with something like a broad fiduciary duty of good faith, the parties would have put such a limitation in their contract; the parties' failure to agree explicitly to such a term is a strong presumption against its efficiency. Moreover, even if the parties would have liked to include something like a broadened duty of good faith, but could not rationally do so because of

65. Fischel, *supra* note 14, at 135-37.

66. *Id.* at 138.

67. *Id.*

68. *Id.* at 139.

69. *Id.* Judge Easterbrook also recognized this point recently when arguing, in *Kham & Nate's Shoes No. 2, Inc. v. First Bank*, 908 F.2d 1351, 1357 (7th Cir. 1990), that "[b]ank did not break a promise at a time Debtor was especially vulnerable, then use the costs and delay of obtaining legal enforcement of the contract as levers to a better deal." And yet in the same opinion, Easterbrook seemed to ignore the informational advantages existing lenders enjoyed at the time of renegotiation when he asserted that "[i]f more credit would have enabled Debtor to flourish, then other lenders should have been willing to supply it." *Id.* at 1358.

70. Fischel, *supra* note 14, at 140.

71. *Id.*

the costs of negotiating and enforcing such an agreement, there still remains the problem of distinguishing in an uncertain ex post adversary proceeding opportunistic from nonopportunistic behavior.⁷²

II. AN ALTERNATIVE MODEL: ASYMMETRIC INFORMATION AND IMPERFECT FIDUCIARY PROTECTION

A. *A Stylized Story*

Consider an entrepreneur who will become the majority stockholder in a new business enterprise. The majority-stockholder entrepreneur has financial capital and has discovered a valuable new business opportunity that will, for a time at least, yield positive rents. The entrepreneur wishes to take on a skilled manager to operate the business.⁷³ To better motivate the manager, she requires that he become a minority stockholder.⁷⁴

The manager knows that it is possible that the entrepreneur will become so active and skilled in the new business that she no longer needs the manager's services. The manager knows that under a number of other eventualities, the entrepreneur would desire to see the manager depart—ill will may develop between the two, policy differences could

72. *Id.* at 141.

73. Throughout this Article, I assume that entrepreneurs and managers are distinct—individuals are specialized and differ in entrepreneurial and managerial skill. For an article making a similar assumption, see Thomas J. Holmes & James A. Schmitz, Jr., *A Theory of Entrepreneurship and Its Application to the Study of Business Transfers*, 98 J. POL. ECON. 265 (1990). Note that individuals may be identically endowed, and nonetheless have an incentive to become specialized in different kinds of skills. See Sherwin Rosen, *Specialization and Human Capital*, 1 J. LAB. ECON. 43 (1983).

74. It may be, and in fact is generally to be expected, that the optimal compensation package for risk-averse managers will consist of a fixed payment plus a performance-contingent component. See Bengt Holmström, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979); Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 BELL J. ECON. 55 (1979); Kenneth J. Arrow, *The Economics of Agency*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 37 (John W. Pratt & Richard J. Zeckhauser eds., 1985). My formal treatment of this problem, Johnston, *supra* note 7, assumes that the manager is risk neutral. With risk neutrality on both sides of such a principal-agent relationship, the optimal contract (concerned therefore only with incentives) would give the manager the entire return *from his effort*. That is, even with risk neutrality, the optimal contract obviously does not give the manager 100% of ex post firm value, no matter how ex post value compares to ex ante value. Rather, the optimal contract would give the manager 100% of the increase in value due to managerial effort and strictly less than 100% of ex post firm value whenever ultimate firm value is a function both of the entrepreneur's contributions and the manager's effort. This distinction is an aspect of the crucial and more general distinction between *asset ownership* and *return ownership*. As explained in OLIVER HART, *Incomplete Contracts and the Theory of the Firm*, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION AND DEVELOPMENT 138, 143 (1991), the extent of one's monetary interest in a firm's performance is distinct from the extent of one's ownership interest in a firm.

arise, or the entrepreneur simply may decide to keep all the surplus from cooperation to herself. Such opportunistic behavior—behavior that essentially unilaterally alters the agreed-upon formula for sharing the surplus from cooperation⁷⁵—is especially likely to occur when large amounts of surplus are to be divided, that is, when this particular venture generates returns that are higher than the market return.⁷⁶ If completely unprotected against such behavior, however, the manager will be reluctant to commit to this particular business. In particular, he will lower the level of his relationship-specific investments: investments whose returns depend upon the relationship's continuation,⁷⁷ but that may in large part account for the special success of this venture. For example, the manager might be faced with a choice between recruiting and training a sales force that eventually, several years hence, will yield higher revenues and focusing on short-term sales by making them himself. The short-term option boosts the manager's own reputation as a salesman and maximizes *his* current market value; the long-term option generates few direct benefits for the manager, but maximizes the *firm's* present value.

Realizing this, a well (but not necessarily perfectly) informed entrepreneur will find it in her interest to offer the manager some protection against opportunistic or exploitive behavior.⁷⁸ The entrepreneur faces several tradeoffs in deciding what kind of contractual protection to offer the manager. A term contract, for example, gives the manager security against discharge, but also may weaken his incentives.⁷⁹ A promise promptly to disclose future plans to merge or sell the company to a larger firm at a premium over book value might, by ensuring that the manager can share in such gains, better motivate the manager, but it could also

75. For a classic and early definition of opportunism along these lines, see Oliver E. Williamson et al., *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. ECON. 250, 258-59 (1975) ("Opportunism is an effort to realize individual gains through a lack of candor or honesty in transactions."). See generally OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 47-49, 64-67 (1985).

76. This point is made in Sanford Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 692 (1986).

77. I have taken this succinct description of firm specificity from Vincent R. Crawford, *Relationship-Specific Investment*, 105 Q.J. ECON. 561 (1990).

78. Note that in my model, fiduciary protection raises the level of firm-specific investment by a good manager simply because it increases the manager's expected return from such investment. I am not relying here on the kind of job security/job performance relationship recently criticized as without empirical foundation by Mayer G. Freed & Daniel D. Polsby, *Just Cause for Termination Rules and Economic Efficiency*, 38 EMORY L.J. 1097, 1131-34 (1989).

79. For an elaboration on this point, see Shleifer & Summers, *supra* note 21.

enable the manager to thwart such a deal if he felt it posed a threat to his continued employment.⁸⁰

The mere existence of tradeoffs of this sort, however, is not sufficient reason for courts to supplement the parties' agreed-upon contractual protections with *ex post* fiduciary duties. The parties may have imperfect information, and bargaining may be costly, but at least at the formation stage of the new business venture they have both common and conflicting goals. The manager wants protections to maximize his expected gain from the venture, but he is limited in pushing for a bigger share of the pie by his recognition that if he is too aggressive, he will not be part of the venture at all. *Ex post* fiduciary duties, however, are typically sought by a disgruntled manager after cooperation has ended. The court adjudicates a pure conflict situation in which the parties tell inconsistent stories about expectations formed years prior to the litigation. It seems inevitable that courts will often err in determining, *ex post*, what the parties would have wanted *ex ante*.⁸¹

The Perfect-Markets (and Imperfect-Courts) analysis essentially stops at this point. But this, I contend, is precisely when the analysis becomes most interesting and subtle. All we have done up to this point is to show that terms agreed upon *ex ante*, through private bargaining, are likely to reflect the true economics of a deal much better than are terms a court implies *ex post*. We have not seriously examined the *strategic* limitations on the kind of terms that parties in our situation can agree to *ex ante*.

B. *A Contract-Proposal Game*⁸²

Suppose there are two types of manager and two types of entrepreneur.

80. This is essentially the same problem that shareholders in a publicly held corporation face in deciding whether to allow managers the discretion to defend against hostile takeovers. For interesting and competing views on this subject, compare David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987) (advocating manager discretion to defend) with Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161 (1981) (arguing against manager discretion to defend).

81. For a discussion of some of the reasons courts are not well able to formulate rules governing behavior in the public corporation—reasons that apply equally to behavior in the partnership or close corporation—see Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 56-58 (1990).

82. The model in this section was inspired, in a general way, by Partha Dasgupta, *Trust as a Commodity*, in *TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS* 49 (Diego Gambetta ed., 1988). For other models of how information can be revealed, to strategic disadvantage, in bargaining around legal default rules, see Ayres & Gertner, *supra* note 7, and Johnston, *supra* note

Some members of each set are opportunistic (or, for ease of reference, bad), and some are nonopportunistic (or, for ease of reference, trustworthy, or good). An opportunistic entrepreneur will take a greater share of the firm value than the parties have agreed upon by diverting some firm assets to her own use and by effectively lowering the share that goes to the manager.⁸³ An opportunistic manager will exploit expansive fiduciary duties imposed on the majority-shareholder entrepreneur by failing to invest in firm-specific skills and by then bringing baseless claims of oppression when he is fired for his failure to make these very investments; the untrustworthy manager will use an expansive and uncertain fiduciary duty standard to extort a greater-than-agreed-upon portion of firm profits from the entrepreneur. Note that by baseless, I mean a claim that in fact is not well founded. Because the court is imperfectly informed, it may find for the complaining shareholder even if his claim is unfounded. Therefore, opportunistic managers can bring baseless, albeit successful, claims against both trustworthy and untrustworthy entrepreneurs. (Even if the manager succeeded in detecting all actual opportunism by an opportunistic entrepreneur, he could further extract rents with baseless, but sometimes successful, actions claiming that his own firing was also in breach of the majority shareholder's fiduciary duty).⁸⁴

7. For articles that point to information revelation and adverse selection as one of several problems that may inhibit bargaining and justify mandatory terms governing the publicly held corporation, see Jeffrey N. Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549, 1569-73 (1989); John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618 (1989) [hereinafter *Judicial Role*]; John C. Coffee, Jr., *No Exit?: Opting Out, The Contractual Theory of the Corporation, and the Special Case of Remedies*, 53 BROOK. L. REV. 919 (1988) [hereinafter *No Exit*]. For a similar argument justifying mandatory sharing rules in bankruptcy, see Mark J. Roe, *Commentary on On the Nature of Bankruptcy: Bankruptcy, Priority, and Economics*, 75 VA. L. REV. 219 (1989). Coffee and Gordon's arguments have been forcefully criticized by Butler & Ribstein, *supra* note 81, at 36-53. As I noted in the introduction, I have not attempted here explicitly to model bargaining around default rules governing directors' fiduciary duties in a publicly traded corporation, but I do remark in the concluding section on the potential relevance of my analysis here to this related bargaining problem.

83. This depiction of entrepreneurial opportunism follows along the lines of Grossman & Hart, *supra* note 76, at 693-95, who build their model on the assumption that the owner of an asset has the residual rights of control, that is, "the right to control all aspects of the asset that have not been explicitly given away by contract." *Id.* at 695. In a small cooperative venture, such opportunism is an inherent possibility. Indeed, Bernard Williams has defined cooperation in such terms: "Two agents *cooperate* when they engage in a joint venture for the outcome of which the actions of each are necessary, and where a necessary action by at least one of them is not under the immediate control of the other." Bernard Williams, *Formal Structures and Social Reality*, in *TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS*, *supra* note 82, at 3, 7.

84. I am grateful to Gillian Hadfield for recognizing the importance to my results of this decidedly nonpositivist analysis of baseless breach-of-fiduciary claims. Cf. Avery Katz, *The Effect of*

By contrast, a trustworthy manager does not take advantage of fiduciary duties to rip off the firm, but instead increases his investment in firm-specific assets, and the firm's profits, because fiduciary duties that protect him against majority exploitation increase the return from his investment. A trustworthy majority shareholder does not behave opportunistically, but expansive fiduciary duties better protect the manager against the probability that the majority will turn out to be opportunistic.

In this model, both information and timing are critical. Figure 1 displays both the sequence of actions taken and the information available to actors at different stages in the game. Briefly summarized, the parties, who have already agreed to form the venture, pass through three stages. First, they bargain either to expand the level of fiduciary duty protection beyond the default level set by the courts or accept that level, a bargaining process characterized by a single proposal which is accepted or rejected. Second, the manager decides whether to make a firm-specific investment and the entrepreneur decides whether to divert firm assets. Finally, relations either break down (as the bad manager is discovered and fired and then sues for bad faith termination, and/or the bad entrepreneur is discovered and sued for breach of its fiduciary obligations) or, if both are trustworthy, they continue to cooperate. Several important results depend upon this structure of play, its timing, and the information conveyed at each stage.

Formation Stage	Operation Stage	Final Stage: End or Continue
Entrepreneur Proposes/Does Not Propose Expanded Fiduciary Duties	Manager Invests/Does Not Invest; Entrepreneur Diverts Assets/Does Not Divert	Bad manager or Bad Entrepreneur Discovered and Sued; Firm Ends or Continues

Figure 1

The Sequential Structure of the Game

Note first that, during the initial operation phase following firm formation, the entrepreneur has an opportunity to rip off firm assets (and lower the total value of the firm), while at the same time the manager

Frivolous Lawsuits on the Settlement of Litigation, 10 INT'L REV. L. & ECON. 3, 7 (1990) (interpreting validity of plaintiff's claim in positivistic terms, "so that the validity of the plaintiff's claim depends solely on the court's expected reaction to his information.").

decides whether to invest. These actions, however, are taken *before* the manager (if bad) has an opportunity to exploit fiduciary duties by bringing a bad-faith lawsuit. This is plausible, for, regardless of entrepreneurial type, it is only after the bad manager is revealed as such and fired that he can bring a breach of fiduciary duty claim that is itself in bad faith.⁸⁵ (A claim against a bad entrepreneur alleging entrepreneurial opportunism of course will not be in bad faith but will be an accurate claim.) Note also that it is important that the manager's investment is a firm-specific cost and has little value in alternative uses; were the investment (say, in skills and training) of general value outside the enterprise, it would not be vulnerable to entrepreneurial opportunism.⁸⁶ Observe finally, however, that the manager may have learned the entrepreneur's type (through the information the first-stage proposal revealed) before the manager decides how much to invest in firm-specific training.⁸⁷

1. *Failure to Opt in Due to Redistributive Effects Under Imperfect Information*

Relative to the status quo level of fiduciary protection for the minority-shareholder manager, expanding such protection (i.e., by including a term that forbids termination of the manager's employment except for cause) has two effects: it increases good managers' firm-specific investments and facilitates bad managers' opportunistic ripoffs through base-

85. Johnston, *supra* note 29, rationalizes firing the bad manager in a model with two periods of firm operation: it may be cheaper for the entrepreneur to fire the bad manager and take her chances hiring a new manager (despite the lawsuit a bad manager will file) than to retain the bad manager for another period.

86. This definition of firm or transaction-specific costs is set out, and applied, in the pathbreaking article by Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 AMER. ECON. REV. 519, 522 (1983). In the context of the publicly traded corporation, Jonathan R. Macey, *Externalities, Firm-Specific Capital Investments, and the Legal Treatment of Fundamental Corporate Changes*, 1989 DUKE L.J. 173, 190, has perceptively noted that the timing of firm-specific investments (and their recovery) is critical. But he fails to see the difficulty of contracting ex ante to protect such investments, even when their value and timing is known. *Id.* at 191. ("Because managers should fully understand the increase in firm value that comes as a result of their investments, as well as the importance of the timing of those investments, they should be able to extract ex ante promises from their firms to compensate them for the investments they make.")

87. When the proposal (or non-proposal) identified the entrepreneur as opportunistic, the manager has in a certain sense not been exploited by opportunistic behavior because he perfectly expected the entrepreneur to take a greater share of the firm's value than the parties actually explicitly agreed to. And yet such a defense would not be legally cognizable.

less breach of fiduciary duty suits. If there is a positive probability that a manager is good, the total expected surplus from cooperation must be higher when the expansive term is included than when it is not because the term stimulates increased firm-specific investments by good managers. Despite this unambiguous efficiency, neither sort of entrepreneur will agree to include such a term if the probability that the manager is bad is sufficiently high. Because bad managers do not make investments that are sensitive to the level of fiduciary protection or this term in particular, inclusion of the term simply allows a bad manager to appropriate more of the fixed cooperative surplus to himself. Thus, including the term causes entrepreneurs to lose relative to bad managers, and potentially to gain relative to good managers. If the probability of a good manager is small enough, the expected gain from contracts with good managers must be less than the expected loss on contracts with bad managers, and it cannot be in the interest of entrepreneurs to include such a term.⁸⁸

To make this argument more concrete, consider some stylized facts drawn from a number of important recent cases.⁸⁹ A minority-shareholder manager has an option to purchase shares in the corporation at a favorable price. A broad fiduciary duty might include a term that would prevent the majority shareholder from firing the minority shareholder merely to prevent her from exercising her option to purchase. Without such a term, a good minority shareholder will reduce her firm-specific investments because of the probability that the majority may fire her and prevent her from realizing the increase in firm value produced by exercising her investment option. But a bad minority shareholder would exploit such a term and claim that she had been fired solely to prevent her from exercising the option, when in fact she had been fired for failing to make an adequate commitment to the firm. Given the inaccuracy of the legal process, such a claim might actually succeed. If the probability of such a bad manager is high enough, the majority shareholder would not agree to include a term of this sort in the contract, notwithstanding the efficiency

88. It follows by a simple continuity argument that the result would be unchanged even if bad managers slightly increased investment in response to the inclusion of a fiduciary duty. Provided that fiduciary duty allows such a manager to divert more than the surplus due to increased investment that the duty stimulates, an entrepreneur still would be worse off with fiduciary duties with a bad manager than without them.

89. The cases include: *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567 (11th Cir. 1990); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987); *Knudsen v. Northwest Airlines*, 450 N.W.2d 131 (Minn. 1990); *Gallagher v. Lambert*, 549 N.E.2d 136 (N.Y. 1989).

gained because the term increases investment by good managers but does not affect investments by bad managers.

2. *Failure to Opt in Due to Information Revelation in Contract Proposal and Acceptance*

When the legal default rule does not imply expansive fiduciary duty protection, and the parties initially have imperfect information as to each other's type, a proposal to broaden the scope of the fiduciary duty may reveal whether the proposing party is an opportunistic or trustworthy sort. Such information revelation, in turn, for strategic reasons might make it disadvantageous to make the proposal. In the language of game theory, the initial, pooling equilibrium might well be stable with respect to opt-in proposals.⁹⁰

To see how an initial pooling equilibrium with narrow fiduciary duties might be stable despite the efficiency of more expansive fiduciary protection, suppose that expanding fiduciary protection cuts entrepreneurial opportunism only slightly, while greatly facilitating managerial opportunism. If entrepreneurial opportunism is only cut a little, good managers' firm-specific investments will not increase by much when entrepreneurial fiduciary duties are broadened (unless the proposal to include them is made such that the manager greatly increases his post-proposal probability that the entrepreneur is good).⁹¹ But if expanded fiduciary duties greatly facilitate managerial opportunism, and if the probability of a bad manager is sufficiently high, the good entrepreneur would not opt in to fiduciary duties, even if the good manager attached a post-proposal probability of one to the entrepreneur being good and greatly increased

90. Stable, that is, in the sense of In-Koo Cho & David Kreps, *Signaling Games and Stable Equilibria*, 102 Q.J. ECON. 179 (1987).

91. By referring to probabilities with which different sorts of entrepreneurs might make opt-in proposals, I allow for mixed-proposal strategies—that is, randomizations over the pure strategies of either proposing or not proposing. For a lucid introduction to the notion of mixed and other probabilistic strategies, see ERIC RASMUSEN, *GAMES AND INFORMATION: AN INTRODUCTION TO GAME THEORY* (1989). The practical significance of mixed strategies has been questioned. See, e.g., Alan Schwartz, *The Myth that Promises Prefer Supracompensatory Remedies: An Analysis of Contracting for Damage Measures*, 100 YALE L.J. 369, 401 (1990). There are, however, a number of ways to explain and rationalize mixed strategies. See generally DREW FUDENBERG & JEAN TIROLE, *GAME THEORY* 230-37 (1991). In the law and economics context, see Jason Johnston, *Strategy and Constraint: An Introduction to the Game Theoretic Analysis of Legal Rules and Institutions* (work in progress, 1992). To assure the generality of the theoretical analysis in Johnston, *supra* note 29, I have allowed for the possibility that entrepreneurs play mixed strategies in the proposal game.

its firm-specific investment.⁹² The good entrepreneur simply would have too great an expected loss on contracts with bad managers (as in the previous section).

But note now that the bad entrepreneur always loses less from managerial opportunism than does the good entrepreneur, because the bad entrepreneur can always divert a portion of the cooperative surplus *before* the bad manager acts to bring a bad-faith lawsuit. Despite this relatively smaller loss on contracts with bad managers, however, the bad entrepreneur cannot be better off opting out when he is the only type to do so (or, whenever the managers think he is the only type to do so). Since the broadened fiduciary duty cuts entrepreneurial opportunism only slightly (by assumption), and since *the proposal to broaden the duty reveals the entrepreneur to be an opportunist*, the good manager may not increase investment at all relative to its initial level under the pooling status quo. The good manager will of course accept the proposal if it reveals the entrepreneur to be bad (because if expanding the fiduciary duty is at all effective, the good manager is better off with expanded protection than without, given that the entrepreneur is known to be bad). But because of the effect of the revelation of its type, the bad entrepreneur would be no better off with expanded fiduciary duties in a match with a good manager and would be strictly worse off with fiduciary duties in a match with a bad manager; therefore, the bad entrepreneur would not wish to make the proposal to expand the scope of its fiduciary duty.⁹³ Since, as already argued, the good entrepreneur also would not wish to propose expanding protection, neither sort of entrepreneur will opt to expand the level of protection, despite the efficiency of such an expansion relative to the default level the law provides.

To return to the example of the minority-shareholder manager with a stock option package, we may think of expanded fiduciary duty protection as a kind of hostage the manager holds. A good manager will only

92. This is particularly likely to be true when entrepreneurs and managers are risk averse, because then the entrepreneur at some point realizes very small marginal increases in expected utility from increased managerial investment.

93. Let g, b , represent entrepreneurial type and m be the message "include fiduciary duties." Then, the initial pooling equilibrium is stable with respect to such a message in the intuitive sense of Cho & Kreps, *supra* note 90, because: 1) there does not exist any set of manager beliefs, $P(g|m)$, under which the good entrepreneur is better off sending the message than in the initial equilibrium; and 2) if, consistent with 1), the manager inferred $P(b|m) = 1$, the bad entrepreneur would be worse off than in the initial equilibrium. Also, because both manager types are (at least weakly) better off with fiduciary duties than without, managers cannot signal with the proposal. See Johnston, *supra* note 29.

keep the hostage (bring a claim) if the entrepreneur is an opportunist and thus the hostage should be kept. A bad manager will always keep the hostage. A bad entrepreneur gives a lower-value hostage than does the good entrepreneur—the value of the hostage is a fraction of what remains of firm surplus after entrepreneurial opportunism. It may be, however, that *only* bad entrepreneurs offer the hostage, and if managers know this, it may be also that the hostage no longer serves its purpose.⁹⁴ Return to the facts of the stock-option story. If there are many bad managers, and if the only kind of entrepreneur likely to agree to a term constraining her from discharging the manager has little to lose because she will have already appropriated the benefits of a good manager's firm-specific investments, good managers will not significantly increase investment in response to the inclusion of the term, and no entrepreneur will propose it.

This gloomy story is only one possible outcome. Especially if managerial opportunism is neither sufficiently serious nor likely, either or both types of entrepreneur may propose an expansion in the level of fiduciary protection beyond the default. Moreover, if expanding fiduciary duties greatly decreases entrepreneurial opportunism, such opportunism is quite likely; and if the expanded fiduciary duty is difficult to abuse, then it may be that only good or trustworthy entrepreneurs propose the expansion, and a rather natural equilibrium in which the good entrepreneurs signal their type by proposing expanded legal protection for the minority manager may result. Other, more nonintuitive equilibria (including equilibria in which only bad entrepreneurs propose the expansion) are also possible.⁹⁵ As a general, working conclusion on the feasibility of private bargaining efficiently to broaden the scope of fiduciary protection beyond the default, however, my model suggests the following: Such bargaining—"opting in" for short—is likely to occur *unless* the probability of managerial opportunism (abuse of the expanded protection) is very high and a serious drain on firm value when it occurs.⁹⁶

94. This story is related to Williamson's observation that when the party that offers the hostage cannot tell whether the other party has made the investment called for, hostages cannot assure that the efficient level of investment will be taken. See Williamson, *supra* note 86, at 527.

95. For an explication of these equilibria, see Johnston, *supra* note 29.

96. For a more formal proof of this assertion, see *id.*

3. *The Efficiency of Fiduciary Duties Under Alternative Assumptions Regarding Entrepreneurial Firm-Specific Commitment and Asset Ownership*

This general conclusion emerges within the context of a rather specialized model of an asymmetric manager-entrepreneur relationship in which the entrepreneur makes no firm-specific investment. In this subsection, I focus on those assumptions that define the asymmetric manager-entrepreneur relationship discussed thus far. Both the efficiency of expansive fiduciary duties and strategic incentives in opting to expand fiduciary protection beyond the legally implied default level are somewhat different when entrepreneurs as well as managers may make firm-specific investments and when both parties exercise control and make relationship-specific investments of human capital (an enterprise I refer to as a symmetric two-person partnership, although without implication for the actual organizational form).

a. *Firm-Specific Investment by Entrepreneurs and the Efficiency of Fiduciary Duties*

Rather than assume that both good and bad entrepreneurs make a fixed investment in the venture, we might assume instead that good entrepreneurs make greater firm-specific investments than do bad entrepreneurs, and that they optimally vary the level of such investments with the probability of managerial opportunism. We still retain the distinction, however, between entrepreneurs and managers: only entrepreneurs have residual rights of control in firm assets. Under these general assumptions, imperfect fiduciary duty protection, which opportunistic minority-shareholder managers can abuse, may reduce firm-specific investment by good entrepreneurs. This weakens the efficiency of expansive fiduciary duty protection. Such protection can still be efficient, however, provided that the probability of managerial opportunism and the loss from such opportunism is small relative to the probability and magnitude of entrepreneurial opportunism, and that managerial investment is more important to total surplus and more sensitive to the risks of opportunism than is entrepreneurial investment.

As for strategic incentives in opting into more expansive fiduciary duties than the law otherwise provides, the main effect of variable entrepreneurial investment is to reduce a good entrepreneur's incentive to opt in. That is, the exploitation of the fiduciary duty by a bad manager

harms a good entrepreneur both directly—through the possibility of a reduced share of surplus—and indirectly, by lowering the entrepreneur's own incentive to make firm-specific investments and hence lowering the surplus. A good entrepreneur may now opt into a more expansive duty only if she is the only type of entrepreneur to do so, so she can get the biggest possible benefit from managerial investment. Since the incentives for bad entrepreneurs to bargain into more expansive fiduciary protection remain the same as in our previous analysis, allowing for variable firm-specific investment by good entrepreneurs generally lowers both the likelihood that expansive fiduciary duties are efficient and the likelihood that the parties will bargain into more expansive fiduciary duties if they are more efficient than the default protections the courts provide.

This presents something of a dilemma for the choice of a legal default rule governing the expansiveness of fiduciary duty protection in close corporations. Expansive fiduciary duty protection is less likely to be efficient when some entrepreneurs make a rational, good-faith decision regarding their degree of variable firm-specific commitment to a venture than when entrepreneurs do not make firm-specific investments. But for the same reasons, it is less likely that trustworthy entrepreneurs will bargain into expansive fiduciary protection even if it is efficient, as they suffer a double loss, in a sense, compared to the bad entrepreneur's single, direct loss. Courts choosing default-level protection subject to this trade-off could begin by recalling that a bad entrepreneur's incentive to opt into an efficient fiduciary duty is unaffected by the effect of managerial exploitation of that duty on good entrepreneurs' investment. And there are conditions under which bad entrepreneurs will propose an expansion in fiduciary protection, even if they are the only sort of entrepreneur to do so (and therefore reveal their, or bad, type by so doing): somewhat nonintuitively, this is possible when entrepreneurial opportunism is a significant disincentive to managerial firm-specific investment, when more expansive fiduciary protections greatly increase managerial firm-specific investment, and when managerial firm-specific investment is very important to overall firm performance.⁹⁷

If these conditions are present, courts could set a relatively narrow default level of fiduciary protection and rely on private bargaining to effect efficient expansions beyond this level. Conversely, if it seems that entrepreneurial firm-specific investment may be the most important com-

97. This assertion is demonstrated more formally in Johnston, *supra* note 29.

ponent of firm performance and that fiduciary duties are easily exploited by untrustworthy managers, of which there is a high proportion in the overall population, it is unlikely that expansive fiduciary protection would be efficient; again, the narrow default would be appropriate. Only if entrepreneurial firm-specific investment is either nonexistent or relatively unimportant, or if expansive fiduciary protection is very difficult for opportunistic managers to exploit, should courts opt for a very expansive default level of fiduciary protection.

4. Fiduciary Duties and Symmetric Partnerships

By a symmetric partnership, I mean a two-agent venture in which both agents have legal control over the firm's business and both make firm-specific investments of human capital. In such a venture, an imperfect fiduciary duty protects a good venturer from direct abuse of the other's control position, but at the same time facilitates a new sort of abuse—of the duty itself—by the other venturer. Thus, the case for the efficiency of fiduciary duties is weaker in symmetric partnerships than in either asymmetric manager-entrepreneur firms with variable entrepreneurial investment or in asymmetric manager-entrepreneur firms with fixed entrepreneurial investment. Like the minority-shareholder manager, an untrustworthy partner can exploit an imperfect fiduciary duty by claiming that he was terminated (the partnership dissolved) in breach of the fiduciary duty; but like the majority-shareholder entrepreneur, the partner can exploit the imperfectness of the fiduciary duty by diverting firm assets to his own use. Both of these actions reduce the incentive for a trustworthy partner to make firm-specific investments. Thus, efficient expansive fiduciary duties in this setting must directly reduce the full extent of both sorts of opportunism. The settings considered earlier were asymmetric and required less for fiduciary duty protection to be efficient: if controlling entrepreneurs do not make firm-specific investments, the untrustworthy manager's ability to claim that he was terminated in breach of the fiduciary duty does not affect efficiency. Even if such claims do affect efficiency by lowering the good entrepreneur's incentive to make firm-specific investments, the good entrepreneur's exclusive control position ensures that he faces only one sort of abuse due to imperfect legal protection, bad-faith lawsuits claiming breach of fiduciary duties, rather than two such bad-faith lawsuits and erroneously unpunished real breaches of the fiduciary duty by his partner. Thus, symmetry between the participants in a venture in terms of both control over assets and the

need for variable firm-specific investments tends to weaken greatly the efficiency of expansive and imperfect fiduciary protections.

This result is disturbing, for it seems to imply the inefficiency of the law's general attitude, which is to imply very expansive default fiduciary protection in legal partnerships.⁹⁸ But this implication ignores both the differences between legal and economic distinctions and the specific informational assumptions upon which my model is grounded. The implication of the law's inefficiency is true only on my assumption that the parties have imperfect information regarding each other's type, while the law may well suppose that this assumption holds sometimes (with corporations) but not others (with partnerships). Enterprises corresponding to my notion of a symmetric partnership traditionally have been organized as partnerships, because the partnership default rules have always provided (as have close corporation rules only in the last few decades) for shared ownership and control and joint participation in business decisions.⁹⁹ It may be that such enterprises usually are characterized not by imperfect information regarding the trustworthiness of the participants, but (probabilistically) by degenerate beliefs in the certainty of trustworthiness. Were this very different informational world present, the expansiveness of fiduciary protection would be essentially irrelevant to formation and investment decisions, and the law's adoption of very broad fiduciary duties simply would be a shorthand for what the parties actually believed and expected.¹⁰⁰

To the extent, however, that the law's apparent assumption regarding the informational characteristics of partnership negotiations is overly optimistic, in that partners often form ventures with little information regarding each other's trustworthiness, a contraction in the scope of partnership fiduciary duties likely would be efficient. This is especially likely if the blurring of organizational forms due to modern close corporation statutes has led to the adoption of partnership status for reasons (e.g., tax) that have little or nothing to do with how well the parties know and trust each other. Moreover, for the same reasons that expansive fiduciary protection is unlikely to be efficient in symmetric partnerships formed under imperfect information, the parties' incentives to opt into a

98. The classic statement of the general partner's strict fiduciary duty remains *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928) (Cardozo, J.).

99. Ian Ayres, *Judging Close Corporations In the Age of Statutes*, 70 WASH. U. L.Q. 365 (1992).

100. That is, to use Robert Scott's very helpful distinction, expansive partnership fiduciary duties would be subjective default rules, rather than objective default rules. See Scott, *supra* note 10.

broadened fiduciary duty in such a venture are likely to mirror the efficiency of such broadening perfectly. In this setting, the efficiency of an expansive duty implies that it must have cut total opportunism, which implies that a good partner would happily propose such an expansion.

The strategic issues highlighted by my analysis in this subsection thus suggest that the law's traditional preference for expansive partnership fiduciary duties may be inefficient. And yet, the broader analysis of a range of enterprise types that I have presented suggests the need for a menu of differing default levels of fiduciary protection. As summarized in Figure 2 below, my results may well indicate a functional, rather than formal, distinction among default levels of fiduciary protection in different enterprises. The degree of symmetry in asset ownership and the ability to make important sunk investments may be an important determinant of the efficient scope of fiduciary protection provided by the legal default rule. These results, depicted in Figure 2, may be summarized as follows:

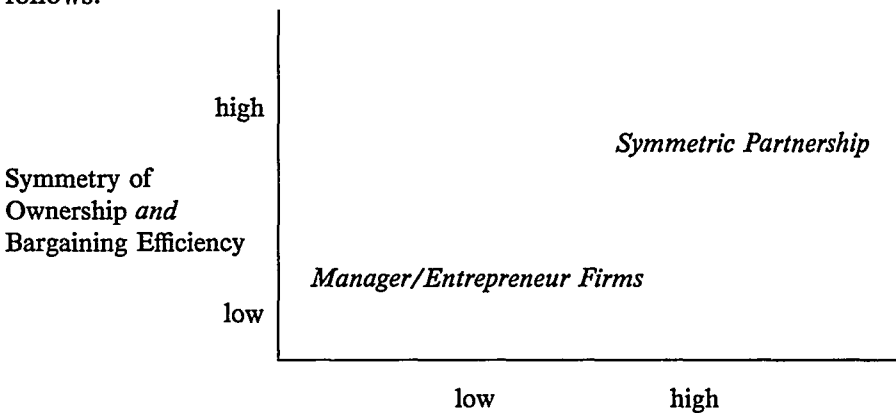


Figure 2

Symmetry of Sunk-Investment Capability and Likely Inefficiency of Expansive Fiduciary Duty

(1) Symmetry in ownership and sunk-investment capability suggests the inefficiency of expansive fiduciary duties and the likely ability of the parties to bargain for increased protection if such an increase is efficient.

(2) Asymmetry in ownership and in investment capability dictates an only slightly more complicated inquiry into the likelihood and severity of managerial opportunism; a low probability or likelihood of such opportunism suggests that the courts again should set the default level of protection at a fairly narrow level, because there will be few strategic

impediments facing the parties in bargaining for increased protection if such an increase is efficient.

(3) Asymmetry in ownership and symmetry in sunk-investment capability creates the most complex problem for courts in choosing efficient default rules; although expansive protection is not likely to be efficient if managerial opportunism is likely and severe, it could be efficient if managerial investment were extremely sensitive to expansions in fiduciary protection and important to firm value and if entrepreneurial firm-specific investment is relatively unimportant. Even if efficient, the parties could bargain for expansions beyond a low default level of protection only if expanding fiduciary protection does not greatly discipline majority-shareholder opportunism.

III. TOWARD A POSITIVE THEORY OF THE IMPLIED FIDUCIARY DUTY

The admittedly rather austere analysis of the previous section suggests but does not address the need for a positive theory that explains how and when strategic impediments to bargaining make it optimal for courts to imply expansive fiduciary duties rather than to rely solely on explicit contractual protections that the parties included. While my main purpose here is not to develop such a theory, this Section sketches how such a theory might be built around variations in some of my maintained assumptions. Many of these variations are central assumptions in the Perfect-Markets analysis of the implied fiduciary duty, and I have therefore organized this section to compare the variations' implications for my theory with their role in the Perfect-Markets analysis.

A. Opportunism as a Fixed Characteristic

I have assumed that the population frequency of opportunistic types is exogenously determined and, in particular, is invariant with respect to the legal rule on implied fiduciary duties. In recent path-breaking work, Robert Frank has shown that a stable mix of honest and opportunistic people can arise either because it is costly to scrutinize people to determine whether they really are honest (as their outward emotions might indicate) or because it is costly to determine a person's reputation for honesty. If it is costly to scrutinize a person for the physical signs of sincerity, no one would bear scrutiny costs and the probability of opportunism would increase; similarly, no one would gather information as to

reputation in a population in which everyone was honest, and the amount of dishonesty would increase.¹⁰¹ The generality of Frank's theory can justify my assumption that the law's attitude about fiduciary duties in cooperative relationships does not affect the population mix of opportunists and trustworthy types: if the situations I discuss are but a small fraction of a person's total network of relationships, honesty will be a trait determined outside the set I consider.¹⁰²

Still, for some persons, it might be that the rewards and costs of opportunism determined by the law on fiduciary duties are an important determinant of the overall costs and benefits of opportunism. My analysis reveals that these rewards and costs are a function of not only the direct effect of the fiduciary duty, but also its indirect effect as private information may be revealed in the process of bargaining into or out of the fiduciary duty. The direct effect of the fiduciary duty varies both with the structure of the relationship and with the efficiency of the fiduciary duty. In asymmetric minority-majority situations, the fiduciary duty, even if efficient, encourages managerial opportunism and discourages entrepreneurial opportunism. In symmetric partnerships, an efficient fiduciary duty discourages opportunism by lowering the return on such behavior, but an inefficient fiduciary duty has precisely the opposite effect. Consideration of the direct effect of fiduciary duties on the return to opportunistic behavior thus tends to alter the earlier implication that fiduciary duties ought not be implied in symmetric partnerships, and instead implies that the law is consistent with efficiency.

More significant than these direct effects, however, may be the indirect effect that bargaining around the legal default rule on fiduciary duties may have on the information available to parties when they form cooperative ventures. Indeed, such an effect may be the strongest argument for not implying a fiduciary duty. As I argued above, bargaining around the initial default rule on fiduciary duties can induce the revelation that a party is a good or trustworthy type only if the initial default rule does not imply fiduciary duties. Moreover, by assuming that the parties either contract with the default or with the proposed modification, my model, if

101. ROBERT H. FRANK, *PASSIONS WITHIN REASON: THE STRATEGIC ROLE OF THE EMOTIONS* 92 (1988).

102. There is, moreover, recent survey evidence indicating both that dishonesty consistently pays in business because reputation and retaliation are very ineffective sanctions for such behavior, and, at that same time, that most businesspeople attempt to be honest, primarily to conform to social and ethical standards. See Amar Bhidé & Howard H. Stevenson, *Why Be Honest if Honesty Doesn't Pay*, HARV. BUS. REV., Sept.-Oct. 1990, at 121.

anything, understates this effect. In a model of competitive matching, in which potential co-venturers shop for the best match, a good entrepreneur or partner may avoid a bad manager or partner entirely by making an opt in or opt out proposal; that is, in a matching markets model,¹⁰³ the benefits from such revelation may be realized with probability one, rather than with the ex ante probability that the manager or partner is good. By forcing the parties to bargain for expansive fiduciary duties, the law may play an important role in destabilizing cooperative ventures that should be destabilized and stabilizing desirable matches.¹⁰⁴

Both the modification game I have modelled and this matching markets context, however, assume that the parties are well enough informed to bargain to opt into fiduciary duties and sophisticated enough to appreciate that information may be revealed through such an opt-in process. If this assumption does not hold—as, for example, in many common general partnerships—the information-revelation rationale for giving the parties only that fiduciary-duty-type protection for which they bargained falls away. Hence, to the extent that the law treats common or unsophisticated general partnerships differently than more sophisticated partnerships or close corporations, it is consistent with this positive implication of the (expanded) model.

B. *The Role of Reputation*

Reputation plays a crucial role in the Perfect-Markets analysis of the fiduciary duty of good faith, a role elaborated most fully by Professor Epstein.¹⁰⁵ As applied to our stylized story, the reputational argument would imply that the manager has little to fear even without fiduciary duty protection, because the entrepreneur will lose other key employees

103. For a comprehensive discussion of matching markets, see ALVIN ROTH & MARILDA SOTOMAYOR, *TWO SIDED MATCHING: A STUDY IN GAME-THEORETIC MODELLING AND ANALYSIS* (1990).

104. By not implying a fiduciary duty, the law can therefore discourage the formation of what Annette Baier has called “morally corrupt” trusting relations and encourage the formation of morally sound relations. Annette Baier, *Trust and Antitrust*, 96 *ETHICS* 231, 255 (1986). In her terms, “to the extent that what the truster relies on for the continuance of the trust relation is something which, once realized by the truster, is likely to lead to (increased) abuse of trust, and eventually to destabilization and destruction of that relation, the trust is morally corrupt.” *Id.* In our setting, the law can force the revelation of opportunistic types. Once revealed, opportunists can no longer take advantage of the relative ignorance of the possibly trustworthy party on the other side, but are forced into destructive relations with other opportunists.

105. See Epstein, *supra* note 14. For a more general analysis of how reputation—a nonlegal sanction—interacts with legal sanctions, see Charny, *supra* note 24.

if she behaves in bad faith. Conversely, because resumes and references are so unreliable, managers are not effectively disciplined by reputation; a manager who fudges and fabricates a story to tell to the court about majority shareholder exploitation is not stigmatized as a problem employee or vexatious litigant. The same holds for lenders and borrowers; lenders are disciplined, as borrowers respond to lender bad faith by shifting business to other lenders, but borrowers are free to abuse fiduciary duty protection without paying a market penalty.¹⁰⁶

In constructing my alternative model—the contract proposal game—I have assumed that actors have very imperfect information and know only the relative proportion of opportunistic and trustworthy types in the relevant pool of either managers or entrepreneurs. The Perfect-Markets analysis of the effect of reputation diverges, quite obviously, from this assumption. But, more importantly, the Perfect-Markets analysis also misconstrues both the general equilibrium effect of reputation and the efficiency implications of this (misconstrued) effect. The Perfect-Markets analysis might be relying on an asymmetric reputational effect in which minority-shareholder managers have perfect information that the entrepreneur is good. Unless it is costless for managers to get information about entrepreneurial reputation, however, there cannot be an equilibrium in which all entrepreneurs are good.¹⁰⁷ There may be cases in which information as to reputation is costless and perfect—in contracting, for example, with a family member—but the Perfect-Markets analysis is clearly intended to be much broader than this.

The Perfect-Markets analysis might instead be relying on an asymmetric reputational effect in which there is a positive probability that the majority-shareholder entrepreneur is an opportunist, but will never behave in an opportunistic fashion because the future cost of being identified as such (higher wage demands by future managers, departures, and the like) is too great. But there cannot be an equilibrium in which there is a positive probability that a party is an opportunist (or will behave opportunistically) but in which no one ever behaves opportunistically.

Hence, if there is a positive cost to determining reputation, then there must be a positive probability that the entrepreneur (or lender) will behave opportunistically. If the cost of determining reputation is low, then this may be a very small probability. In this way, then, we can incorpo-

106. See Fischel, *supra* note 14.

107. See FRANK, *supra* note 101, at 71-95.

rate reputational effects within my general model. A small probability of entrepreneurial opportunism implies, within this model, that fiduciary duties may be inefficient if managerial opportunism is likely and if entrepreneurial firm-specific investments are very important and sensitive to managerial opportunism.

But for managerial opportunism to be very likely, it must be that the entrepreneur has high costs of determining managerial reputation, and that these costs are higher than the manager's cost of determining entrepreneurial reputation. The issue, therefore, becomes an empirical one involving the comparative costs to employees and employers of determining reputation. There seems to be little reason to expect such empirical evidence to bear out the Perfect-Markets assumption. When seeking employment, managers normally must produce references and other background information. While it may be possible for a manager to conceal relatively minor past opportunistic acts from potential employers, important and profitable opportunism often will have ended in messy litigation, which is very difficult if not impossible to conceal: it would be easy for the entrepreneur to detect such past opportunism. It would not appear to be as easy for a manager to gain information about a potential majority-shareholder-entrepreneur employer: present employees may be hesitant to speak frankly, and former employees may be difficult if not impossible to locate (unless the entrepreneur provides access to them, in which case the credibility problem is identical to that arising with managerial references).

Even an admission that the manager and entrepreneur have equal costs of determining each other's reputation almost certainly fails to imply that the probability of managerial opportunism is higher and its seriousness greater than the probability and seriousness of entrepreneurial opportunism. The entrepreneur's control position means that the entrepreneur benefits more from opportunism than does the manager. Because the entrepreneur often will be more diversified—engaged in a number of ventures—she generally also should be less risk averse than the manager and therefore more willing to risk losses incurred by creating a bad reputation. For these reasons, it seems likely that entrepreneurial opportunism is both more serious and more likely than managerial opportunism, which implies that even an imperfect, exploitable fiduciary duty may be efficient.

My analysis, however, does not mean that courts should imply a fiduciary duty; indeed, a low probability of opportunism, and the potential

for decently protective ex post fiduciary protection suggests that courts might simply enforce whatever fiduciary like protection for which the parties explicitly contracted. There is a case for narrow, limited default fiduciary protection, but not for the general inefficiency of an expansive fiduciary duty.

C. Relationship-Specific Investment and Marginal Analysis of Cooperative Ventures

Underlying the Perfect-Markets reliance on asymmetric reputational effects is the assumption of strong marginal substitution effects in response to entrepreneurial opportunism. My argument, however, assumes an entrepreneur-manager (or lender-borrower, partner-partner) relationship that generates supra-competitive rents or profits in excess of those that could be earned elsewhere, rents that flow from the manager's sunk, relationship-specific investment. In such relationships, inter-firm marginal effects—opting for a different relationship if the terms of the default are not good enough—are unlikely to be present (at least over a wide range of alternative contractual arrangements).¹⁰⁸ But this is not to say that large, firm-specific investments are somehow undesirable merely because they create rents over which the parties will bargain. Rather, the issue is whether private bargaining will create appropriate rewards to such investment, investment that by definition increases both returns and vulnerability to opportunism.

This, at least, is the way my model poses the issue. In Professor Epstein's theory, however, relationship-specific investment, which should be characterized as a good, is instead profoundly problematic. His argument may be summarized as follows:

1) Employment at will raises the specter of opportunistic discharge in relationships that involve large investments in firm-specific human capital, relationships that generate returns to both employees and employers above those they could get elsewhere; but,

2) The specter of opportunism is illusory, because workers will substitute away from the firm "on the margin" in response to employer opportunism; and,

3) The employer will have difficulty replacing them because there is such poor information about employees; but,

4) In any event, contracts at will help to reduce the size of the surplus

108. See Epstein, *supra* note 14, at 973-77.

arising from firm-specific investments.¹⁰⁹

There are two difficulties with Epstein's argument. First, point two is inconsistent with everything else in the story: if workers are not easy to replace because employers cannot verify worker skill and reputation, there will not be any margin. Discrete, indivisible, heterogeneous and firm-specialized employees do not have anywhere to go, so there will not be automatic worker substitution away from opportunistic employers. The second problem with Epstein's story is its treatment of firm-specific investments. Point four treats these as bad, as creating bilateral monopolies that employment at will helps eliminate by essentially destabilizing all employment relations. However, point one treats such investments, more or less, as a social good. Epstein seems to be saying that employment at will is desirable *because* firm-specific investments lessen the risk of opportunism, but even better because it eliminates market frictions by eliminating the incentive to become specialized in a particular relationship.

IV. SOME TENTATIVE DOCTRINAL IMPLICATIONS

A. *Fiduciary Obligations in Partnerships*

My model suggests, somewhat surprisingly, that a broad fiduciary duty is least likely to be efficient—most risky for courts to imply—in the symmetric partnership, a general, terminable-at-will partnership in which both (or all) partners contribute both capital and labor and have roughly equal shares of profits. My analysis also indicates, however, that the parties in such a relationship will face few strategic impediments to opting into fiduciary-like protection if it is indeed efficient.

There are, of course, scores of cases standing for the general proposition that partners owe a very strong fiduciary duty of good faith to each other.¹¹⁰ My model obviously contradicts and does not explain this rule of partnership law. However, my model assumes extremely rational parties whose bargains account for the incentives that the duty of good faith creates. Partnership law does not make this assumption; it in fact assumes precisely the opposite: because the legal partnership relation can arise simply by virtue of the general way the parties have done business (without, that is, any express agreement),¹¹¹ many general partners do

109. *See id.* at 955-77.

110. *See, e.g., Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928).

111. 1 BROMBERG & RIBSTEIN, *supra* note 55, §§ 2.01-2.02.

not bargain at all over the legal details of firm formation and certainly do not bargain with an acute awareness of the incentive effects of the implied duty of good faith. If this assumption is warranted, efficiency has nothing to say about the implication of the duty of good faith. Parties completely unaware of legal rules cannot be affected by them, and the rules can be chosen to satisfy ex post perceptions of fairness without affecting ex ante incentives.

If, however, some general partners do bargain over firm formation with sophisticated legal representation and a sophisticated awareness of the possibilities for opportunistic behavior inherent both in the partnership structure and the implied duty of good faith, then the law does matter, and my model applies. It suggests that judges should be very reluctant to supplement partnership agreements with additional, implied protection against opportunism under the good-faith rubric. In contrast to vague rhetorical statements about the partner's duty of good faith, courts have decided whether to provide additional protection largely in conformity with what my model would predict to be efficient.

To see this, consider two very well-known cases, *Page v. Page*,¹¹² and *Nicholes v. Hunt*,¹¹³ both involving terminable-at-will partnerships. These cases are well known precisely because they are members of a rare species: partnership cases in which courts were willing to imply fiduciary limitations on the decision to terminate an at-will partnership.¹¹⁴ Neither of these cases, moreover, fits the indistinguishable-partner paradigm. This fact supports my theory, which says that expansive fiduciary duties more likely would be efficient in an asymmetric partnership. However, when we run the theory through the facts in *Page* and *Nicholes*, we find both cases to be, at the least, troubling.

In *Page*, Justice Traynor of the California Supreme Court created an implied agreement between two general partners that neither would terminate the partnership simply to exclude the other from partnership business opportunities.¹¹⁵ This implied agreement made it necessary for the jury to decide whether a partner had "acted in bad faith and violated his fiduciary duties by attempting to appropriate to his own use the new

112. 359 P.2d 41 (Cal. 1961).

113. 541 P.2d 820 (Or. 1975).

114. Dissolution at will is a right that may protect against exploitation, but yet be exploited, just as fiduciary protection against exploitation may both protect and be exploited. For an excellent discussion of the costs and benefits of allowing the parties to dissolve at will, free of fiduciary duty constraints, see Ribstein, *supra* note 54.

115. 359 P.2d at 45.

prosperity"¹¹⁶ of a laundry business he had operated with his brother on a terminable-at-will basis.

The stronger partner in *Page* terminated the partnership shortly after a large military base was built nearby and just when the partnership appeared to be on the brink of profitability after suffering years of losses.¹¹⁷ The "stronger" partner was stronger in that he both managed and was most familiar with the business and was its major creditor.¹¹⁸ The brothers apparently had been in several other similar partnerships with each other in the past.¹¹⁹

Professor Robert Hillman criticizes Justice Traynor's creation of a duty not to terminate an at-will partnership "wrongfully." Hillman says that judicial implication of such a duty creates uncertainty regarding the consequences of partnership dissolution that will unduly stabilize partnerships, and that such a result is especially troubling because "[t]he weaker partner in *Page* could have bargained for a definite term, but he did not. Fairness under such circumstances does not require the stronger partner to continue to carry the weaker partner indefinitely."¹²⁰ My model supports Hillman's ultimate conclusion, but explains what he assumes: 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. According to the model, the first question to ask is whether the protective term would increase firm-specific investment by the weak partner. This happens when the weaker partner does not have very good information about the strong partner, and would not invest as much without the term. In *Page*, neither of these conditions was met. The weaker partner apparently made little or no relationship-specific investment in human capital. Moreover, the weaker partner had been in several similar ventures with his brother, and not only had good information about his partner, but had actually agreed on at least one prior occasion to a written term providing that profits were to be retained "until all obligations were paid."¹²¹

116. *Id.*

117. *Id.* at 44.

118. *Id.* at 42, 44.

119. *Id.* at 42.

120. Robert W. Hillman, *The Dissatisfied Participant in the Solvent Business Venture: A Consideration of the Relative Permanence of Partnerships and Close Corporations*, 67 MINN. L. REV. 1, 33 (1982).

121. 359 P.2d at 43.

Page is thus a very easy case, under my analysis, because it is quite clear that there was no strategic impediment to explicit inclusion of the kind of protective term requested by the weaker party. A better test of the theory is provided by *Nicholes v. Hunt*,¹²² in which the Oregon Supreme Court found that the stronger partner had not acted in bad faith in dissolving a terminable-at-will partnership. The stronger partner in *Nicholes* used special equipment he had designed and operated a business that produced lead shot for shotgun shells.¹²³ The weaker partner made an equal capital contribution and was also to work full time for the new partnership.¹²⁴ The stronger partner introduced evidence that he had dissolved the partnership because the weaker partner failed to devote his full time to the business and failed to follow the stronger partner's "major decisions."¹²⁵

The theoretical issue *Nicholes* poses is whether the court should have even bothered to consider whether the dissolution was in good faith. The partners in *Nicholes* were not indistinguishable, for although they made equal capital contributions and were both supposed to work full time for the partnership, the stronger partner had developed the business opportunity and had know how and equipment that allowed him to continue the business after dissolution.¹²⁶ There obviously would have been a risk for the strong partner in including a term that provided for fiduciary-like protection, a term, for example, providing for dissolution only "for cause." The risk was in fact realized: the weak partner used the term to hold up the strong partner and extort what he had not truly earned. If we assume, however, that the strong partner dissolved the partnership primarily to form a new venture with someone who would be more committed to the business, the weaker partner would be extorting only some fraction in the increase in firm value that the strong partner would realize by replacing a shirker with a more involved and committed partner. Protection of this sort would not, that is, allow the weaker partner to extort a large fraction of firm value. By my theory, it follows from this that the parties could have bargained for such protection if in fact they had viewed it as a way to increase the weaker partner's commitment to the

122. 541 P.2d 820 (Or. 1975).

123. *Id.* at 822.

124. *Id.*

125. *Id.* at 824.

126. For a similar case, see *Cude v. Couch*, 588 S.W.2d 554 (Tenn. 1977) (dissolving partner in laundromat business owned premises leased to the business and refused to lease them to his former partner or any other successor). See also Ribstein, *supra* note 54, at 384.

venture. There would have been no strategic impediment to including such a term, because both trustworthy and devious strong partners would have wanted to include such a term and the proposal to include it would therefore not have revealed the strong partner to be an opportunist.

B. Involuntary Dissolution of Close Corporations for Violation of the Minority's Reasonable Expectations

In most states, a minority shareholder can obtain involuntary judicial dissolution of the corporation on the ground of majority shareholder "oppression."¹²⁷ In some states, including New York, "oppression" has been interpreted to encompass "violation of the minority shareholder's reasonable expectations" of continued participation in the business as an employee and/or continued receipt of a share of firm profits.¹²⁸ The first New York decision taking this view, *In re Topper*,¹²⁹ is indicative of the general type of case in which New York courts have granted dissolution on the ground that the minority's reasonable expectations were violated.¹³⁰ In contrast to the partnership cases just discussed, my theoretical account of the strategic feasibility of contracting for expansions in fiduciary protection argues that the court may have been correct to imply a "reasonable expectations" standard into the close corporation contract.

The minority shareholder in *Topper* was a pharmacist who quit a job he had held for twenty-five years in Miami and invested his life savings in a new pharmacy business in New York.¹³¹ There was no dispute that the

127. See Thompson, *supra* note 33, at 206.

128. See generally *id.* In New York, BUS. CORP. LAW § 1104a(a)(1) (Consol. 1991) provides that a minority shareholder owning at least 20% of all outstanding shares of stock in the corporation can seek dissolution of the corporation on the ground that the majority shareholders behaved oppressively toward the minority. In *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173 (N.Y. 1984), the New York Court of Appeals upheld the lower courts' view that "oppression" constitutes, *inter alia*, conduct that substantially defeats the 'reasonable expectations' of minority shareholders in committing their capital to the particular enterprise. . . . A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment.

Id. at 1179.

129. 433 N.Y.S.2d 359 (Sup. Ct. 1980).

130. See, e.g., *In re Weidy's Furniture Clearance Ctr. Co.*, 487 N.Y.S.2d 901 (App. Div. 1985); *Mardikos v. Arger*, 457 N.Y.S.2d 371 (Sup. Ct. 1982); *In re Taines*, 444 N.Y.S.2d 540 (Sup. Ct. 1981).

131. 433 N.Y.S.2d at 362.

minority-shareholder pharmacist had in fact been the most active member of the business until he was abruptly discharged as an employee, removed as an officer and co-signatory on corporate accounts, and locked out of the corporation's offices.¹³² The court held that the minority shareholder could obtain involuntary dissolution of the corporation if he could show that the majority shareholders had violated the original understanding between the parties regarding the role the minority shareholder was expected to play in the business.¹³³

On the view taken by Judge Easterbrook and Professor Fischel,¹³⁴ *Topper* is an unfortunate precedent, for it subjects majority shareholders to the threat that disgruntled minority shareholders will initiate the bad-faith lawsuits seeking dissolution under the vague, open-ended "reasonable expectations" standard. Such lawsuits are a credible way to extort firm profits from the majority because dissolution is such a drastic remedy, often entailing the loss of significant going-concern value.¹³⁵

By my theory, however, the harshness of the remedy available to minority shareholders may argue in favor of the "reasonable expectations" test. The number of cases decided since *Topper* in which a minority-shareholder employee has uprooted himself and made a significant, sunk investment in a new business only to see the majority attempt to eliminate him from the business suggests that protection under the "reasonable expectations" test might indeed decrease the risk minority shareholders face and therefore increase their firm-specific investments.¹³⁶ If there is a significant probability that a minority shareholder will use the test oppressively, however, and if, as assumed, the dissolution (or buyout) remedy usually will be very costly to the majority, it often will be difficult for the parties to bargain something equivalent to the "reasonable expectations" test into the firm-formation contract. Even if such a clause might be, on balance, desirable, it would be odd for a ma-

132. *Id.*

133. *Id.* at 366.

134. See Easterbrook & Fischel, *supra* note 14, at 288.

135. See *id.* at 287. In New York, Bus. CORP. LAW § 1118 (Consol. 1991) explicitly authorizes courts to order buyout of the minority's shares as an alternative to dissolution of the corporation, and, in an attempt to lessen the likelihood that the minority would use the statutory remedy as an oppressive tool, New York courts have often ordered either a buyout of the minority's shares or, in the alternative, dissolution. See, e.g., *In re Kemp & Beatley, Inc.*, 473 N.E.2d 1173, 1181 (N.Y. 1984); *In re Taines*, 444 N.Y.S.2d 540 (Sup. Ct. 1981) (staying dissolution pending a determination that the corporation could show that it was financially able to buy out the minority).

136. See, e.g., *In re Imperatore*, 512 N.Y.S.2d 904 (App. Div. 1987); *In re Taines*, 444 N.Y.S.2d 540 (Sup. Ct. 1981).

jority-shareholder entrepreneur (the sort involved in *Topper*) to propose or agree to it if the legal status quo gave the minority no such protection.¹³⁷ Given the risk that it would be abused, the protective clause might well be preferred only by majority shareholders who are confident that they can rip off the minority in less detectable, and perhaps even more harmful, ways than ousting him outright from the venture, who are indeed confident that they can make life so miserable for the minority that he will actually *want* to leave the firm. Or, put somewhat differently, the prospect of forced dissolution will not be terribly threatening to a majority shareholder anticipating a program of looting and spending, a majority shareholder who does not anticipate that there will be much going-concern value at risk at the time of dissolution, and indeed who has no intention of ever creating going-concern value.

Thus, if courts literally did nothing to prevent the frustration of the minority's reasonable expectations, the parties might be unable contractually to enable the courts to do so, and the end result would be a highly insecure world in which participation as a minority-shareholder employee in a close corporation would be worthwhile only if one is not really committed to the business.

C. *Termination of At-Will Employee Shareholders to Activate Stock Repurchase Plans*

Another, apparently increasingly common corporate situation involves an at-will executive employee who purchases stock in the corporation subject to a shareholders' agreement requiring the corporation to repurchase the stock at book value (or some other agreed-upon valuation formula) if the employment is terminated.¹³⁸ Sometimes the executive decides to quit, but is not told by the majority about events that will greatly increase the value of his shares.¹³⁹ In other, more egregious instances, the employee is fired solely to prevent him from holding onto his shares long enough to realize an increase in their value.¹⁴⁰ The kind of

137. By "no such protection" I mean a zero probability that a court would grant dissolution on this ground.

138. See, e.g., *Smith v. Duff & Phelps, Inc.*, 891 F.2d 1567 (11th Cir. 1990); *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429 (7th Cir. 1987); *Villada v. Merrill, Lynch, Pierce, Fenner & Smith, Inc.*, 460 F. Supp. 1149 (S.D.N.Y. 1978); *Knudsen v. Northwest Airlines*, 450 N.W.2d 131 (Minn. 1990) (stock option agreement terminated with cessation of employment); *Gallagher v. Lambert*, 549 N.E.2d 136 (N.Y. 1989); *Ingle v. Glamore Motor Sales, Inc.*, 535 N.E.2d 1311 (N.Y. 1989).

139. See *Jordan*, 815 F.2d at 432-33; *Villada*, 460 F. Supp. at 1150.

140. See *Ingle*, 535 N.E.2d at 1314; *Gallagher*, 549 N.E.2d at 137.

fiduciary duty protection sought therefore varies from case to case. A quitting employee needs the court to impose an affirmative duty of disclosure on the majority;¹⁴¹ the opportunistically terminated employee only needs the court to prohibit the majority from terminating him solely to prevent an appreciation in the value of his shares.¹⁴²

According to my model, in deciding whether to protect the minority-shareholder executive with an implied fiduciary duty, a court should ask whether the duty would generally increase an executive's commitment to a particular business, and whether, even if it would, the parties could have bargained to include such a duty. It does not seem difficult to conclude that an implicit promise to disclose information regarding anticipated changes in share value and to refrain from terminating an employee just to prevent him from participating in positive changes will increase an employee's commitment to the venture. After all, making an executive a shareholder seeks to tie the executive's return to the success of the business, to improve and sharpen his incentives.¹⁴³ Majority-shareholder opportunism cuts the executive's benefit from stock ownership by capping his return: if things go very well, the executive might get cut out; if they go badly, he shares in the misery. Unless executives have a great deal of information about the majority-shareholder employer, the specter of opportunistic discharge and repurchase cuts the expected return from stock ownership and cuts the executive's optimal level of investment in firm-specific human capital. By disciplining majority-shareholder opportunism, the courts can make stock ownership a much more effective incentive device, benefiting nonopportunistic, trustworthy majority shareholders by increasing executive commitment.¹⁴⁴

This inquiry into incentive effects is, however, only the first stage in deciding whether to imply fiduciary duty protection. The next step requires the court to ask whether the risk of opportunistic minority-share-

141. See *Jordan*, 815 F.2d at 434 (finding such a duty under Rule 10b-5).

142. See *Ingle*, 535 N.E.2d at 1314 (finding no such obligation implicit in the employment relation); *Gallagher*, 549 N.E.2d at 138 (finding no such obligation implicit in the shareholder relation).

143. See *Holmström*, *supra* note 74; *Shavell*, *supra* note 74; *Arrow*, *supra* note 74.

144. Both a duty to disclose and a duty to refrain from avowedly opportunistic discharge and repurchase have desirable incentive effects. A case like *Jordan v. Duff & Phelps*, in which the employee decided to quit and take another job, may seem at first to have less to do with incentives than does a case like *Gallagher v. Lambert*, in which the employee was fired just to prevent him from realizing a stock appreciation. But without a right to have stock-price information disclosed to him prior to quitting, an employee will rationally expect a lower return from owning stock, since he will be making poorly informed quit/stay decisions, and thus his optimal level of firm-specific investment will be lower.

holder abuse of the fiduciary duty is so high that only opportunistic majority shareholders would explicitly agree to it. If this is so, then there is a strong case for judicial implication because there were probably large strategic obstacles in private bargaining.

The opportunistic risk that inheres in a contractual duty to disclose events that materially affect share value is, as Judge Posner put it, that the corporation will be stuck with a "viper in its nest, a disgruntled employee remaining only in the hope of appreciation of his stock."¹⁴⁵ The opportunistic risk in a prohibition against terminating employees solely to deprive them of a share in stock appreciation is that employees who are terminated for poor performance will claim they were terminated for the impermissible exploitative reason. But neither type of opportunism would seem to pose a serious risk for the corporation. Termination of an employee at will for poor performance will not often occur precisely when stock appreciation is imminent. Some employees may hang around just to share in upcoming good fortune, but these individuals will be atypical, unless most employees happen to be thinking of leaving just around the time the good fortune is disclosed.

For these reasons, the particular kind of fiduciary protection at issue in these cases is not likely to have high costs of opportunistic abuse. In my model, this argues against having judges write such protective terms into contracts. It argues that there is no great strategic impediment precluding the parties from explicitly agreeing to a protective term. Such a term could provide that the minority-shareholder executive could not be discharged within a certain period prior to a merger or restructuring that would have the effect of significantly increasing the value of the executive's stock. The period could be long enough to preclude the majority from simply delaying the value-increasing event and short enough to prevent it from becoming an incentive-weakening employment guarantee. Or, like a golden parachute, a term could provide that the executive may be dismissed, but must be paid a fraction of any gain in stock value realized within a certain period after his dismissal.¹⁴⁶

145. *Jordan*, 815 F.2d at 450 (quoting the majority opinion).

146. Golden parachutes do not typically make the departing manager's payment contingent upon subsequent increases in stock value, and indeed may be designed in part to lessen the manager's incentive opportunistically to oppose socially desirable changes in control, even as they may also discipline against opportunistic, rent-shifting takeovers.

V. CONCLUSION

As I noted earlier,¹⁴⁷ my analysis of strategic incentives in opting into and out of fiduciary duties has been tailored to a particular set of cases. I have not addressed the kind of case in which the academic debate over implied fiduciary duties has been perhaps most vigorous of late: the fiduciary duties of directors in a large, diffusely held public corporation. Coasean contractual theorists have, however, argued that even in this context, fiduciary duties should generally be waivable, and ought not be broadly implied.¹⁴⁸ Against this position, a number of theorists have recently attempted to make a case for mandatory fiduciary duties of one sort or another.¹⁴⁹

In indicating how my analysis might apply to this issue, it is useful to note first that there are a large number of instances in which the shareholders of a publicly traded corporation have in fact voted to opt out of some aspect of the directors' fiduciary duty obligation.¹⁵⁰ This phenomenon can be explained within the framework of my model; indeed, that framework suggests that there may be circumstances under which it is not efficient to impose a fiduciary duty of due care on the directors of a publicly traded corporation. Shareholders of a publicly traded corporation can, in principle, vote to change the composition of the board; the market, moreover, votes on board decisions through changes in the market price of the corporation's stock, and such changes can both signal the need and provide an incentive for control changes. Finally, strong reputational effects at the top management level may transmit directly to management compensation. All of these effects tend to diminish the marginal efficiency gain from fiduciary duty discipline relative to the situ-

147. See *supra* note 82.

148. For a general discussion of the Coasean contractual approach to these issues, see Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416 (1989); for an application, arguing that the widespread but only partial adoption of corporate-charter antitakeover amendments indicates that for some corporations mechanisms other than the market for corporate control exist to discipline directors, so that such amendments ought to be allowed, see Barry D. Baysinger & Henry N. Butler, *Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation*, 71 VA. L. REV. 1257 (1985); and for a succinct statement of the position that courts should not override private agreements and make fiduciary duties mandatory even when the parties have tried to opt out of them, see Butler & Ribstein, *supra* note 81, at 30.

149. See Coffee, *No Exit*, *supra* note 82; Coffee, *Judicial Role*, *supra* note 82; Gordon, *supra* note 82; Lucien A. Bebchuck, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820 (1989).

150. For Delaware corporations, the authorization for waivers of the directors' duty of care is provided by DEL. CODE ANN. tit. 8, § 102(b)(7) (1991).

ations with which I have been concerned. In short, there are many non-legal sanctions for detectable, significant managerial misbehavior so that managers may exercise in fact far less control and have far less room to behave opportunistically than does the majority-shareholder entrepreneur or partner in my model. At the same time, there is an enormous potential cost from opportunistic lawsuits by shareholders claiming that the directors breached their fiduciary duties.¹⁵¹ Together, the high cost of opportunistic lawsuits and the presence of strong extra-legal sanctions tend to suggest that fiduciary duties often may be inefficient within the context of the publicly traded corporation.

Within the context of my model of strategic bargaining, this implies, most importantly, that opt-out proposals need not convey information about managerial type: both good and bad managers may prefer to be without the fiduciary duty of care. If there is then only a small efficiency loss from giving bad managers this additional leeway, and eliminating the duty greatly reduces the cost of opportunistic shareholder lawsuits, then (provided that most shareholders do not bring such lawsuits) a majority of shareholders would accept the proposal to opt out of the managerial fiduciary duty of care.

This same argument, however, might apply with equal force to the duty of loyalty,¹⁵² suggesting that, unless it is very costly to contract into such a duty, it might be optimal to imply no fiduciary duties and to leave the shareholders to whatever explicit protection they achieve in the charter. This rather extreme proposal follows from a set of assumptions that are of course far from uncontroversial: for example, that the shareholders of a large publicly held corporation can overcome collective action problems and effectively bargain with the board to include fiduciary limitations on the board's discretion. Even with these assumptions, however, my model suggests a reason for distinguishing between the duty of care and the duty of loyalty, a reason courts should imply the latter but not the former: allegations that an act of self-dealing or similar overt diversion of funds to the directors' own use breached the duty of loyalty usually should be more difficult to prove than allegations of a breach of the duty of care. Because courts are more accurate in determining gross dishonesty than gross negligence, opportunistic shareholder lawsuits alleg-

151. For similar arguments, see Baysinger & Butler, *supra* note 148 and Butler & Ribstein, *supra* note 81.

152. On the duty of loyalty, see Harold Marsh, Jr., *Are Directors Trustees?: Conflict of Interest and Corporate Morality*, 22 *BUS. LAW.* 35 (1966).

ing that the duty of loyalty was violated are likely to be much less frequent and costly than opportunistic shareholder lawsuits alleging a violation of the duty of care. For this reason, implying the duty of loyalty may be efficient even when implying the duty of care is not.

This analysis of opting into and out of the directors' fiduciary duties is not complete, but it does suggest a possible further application of the model I have developed here. Strategic incentives in opting out of the directors' fiduciary duties figure importantly in two prominent arguments for mandatory corporate rules.¹⁵³ In future work, I shall therefore extend my analysis to that problem.

153. Professors Gordon and Coffee have elaborated mandatory-term theories that rely, in different ways, on problems of strategic information revelation. Professor Gordon develops an "Innovation Hypothesis," which says that shareholders may infer—apparently incorrectly—that only bad managers would want to opt out of the fiduciary duty of care, a harmful inference that the state can prevent with a statute that explicitly authorizes such optouts. Gordon, *supra* note 82, at 1569-73. Professor Coffee generally would have courts imply fiduciary duties whenever corporate contracts or statutes are arguably vague, see Coffee, *Judicial Role*, *supra* note 82, at 1685, but would allow transaction-specific opt out provisions, on the theory that the market can better assess the moral-hazard cost of such provisions (and reflect it in share price) than of more general opt-out provisions. For criticism of Coffee's transaction-specificity requirement, see Butler & Ribstein, *supra* note 81, at 37-39. And for an interesting, more general argument that mandatory rules in corporate law in fact no longer exist, see Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis*, 84 Nw. U. L. REV. 542 (1990).