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ARTICLE

A CONTRACTUAL APPROACH TO SHAREHOLDER OPPRESSION LAW

*Benjamin Means**

According to standard law and economics, minority shareholders in closely held corporations must bargain against opportunism by controlling shareholders before investing. Put simply, you made your bed, now you must lie in it. Yet most courts offer a remedy for shareholder oppression, often premised on the notion that controlling shareholders owe fiduciary duties to the minority or must honor the minority's reasonable expectations. Thus, law and economics, the dominant mode of corporate law scholarship, appears irreconcilably opposed to minority shareholder protection, a defining feature of the existing law of close corporations.

This Article contends that a more nuanced theory of contract—freed from the limiting assumptions of standard law and economics—offers a persuasive justification for judicial protection of vulnerable minority shareholders. Moreover, although courts often describe the shareholder relationship in fiduciary terms, contract theory provides a more coherent explanation of current doctrine. The “contractarian” objection to shareholder protection poses a false choice between fairness and autonomy: by enforcing the implicit contractual obligations of good faith and fair dealing, courts protect minority shareholders from oppression and, at the same time, advance the values of private ordering.

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INTRODUCTION

According to standard law and economics, minority shareholders in closely held corporations must bargain for protection against opportunism by controlling shareholders before investing.¹ Close corporations, after all, contain relatively few shareholders, lowering the cost of bargaining to manageable levels.² Put simply, you made your bed, now you must lie in it.³

1. See, e.g., STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 830 (2002) (“[P]arties who want liberal dissolution rights may bargain for them . . . before investing.”); FRANK H. EASTERBROOK & DANIEL R. FISCHL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 229 (1991) (“[I]t is essential to use contractual devices to keep people in a position to receive the return on their investment.”); Paula J. Dalley, *The Misguided Doctrine of Stockholder Fiduciary Duties*, 33 *HOFSTRA L. REV.* 175, 221 (2004) (asserting that any interference by courts would “rewrite the contract and provide a windfall to the minority”); Larry E. Ribstein, *The Closely Held Firm: A View from the United States*, 19 *MELB. U. L. REV.* 950, 955 (1994) (“[J]udicially-administered remedies threaten the security of the agreements the parties have made.”); Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 *J. CORP. L.* 913, 915 (1999) (“[T]he question [is] what, if anything, the courts should do for the minority shareholders in cases where the parties have not provided for the problem by contract. Our basic answer is that courts should not do anything except enforce the participants’ contracts and vigorously prevent non pro rata distributions to shareholders.”).

2. The shareholders can all fit around a bargaining table, and “[c]orporation statutes in all states now allow shareholders substantial freedom to modify the corporate adaptive rules by unanimous contractual agreement.” Charles R. O’Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 *NW. U. L. REV.* 216, 242 (1992); see also Robert B. Thompson, *The Law’s Limits on Contracts in a Corporation*, 15 *J. CORP. L.* 377, 378 (1990) (same).

3. See Paula J. Dalley, *Shareholder (and Director) Fiduciary Duties and Shareholder Activism*, 8 *HOUS. BUS. & TAX L.J.* 301, 320–21 (2008) (arguing that just as “Enron shareholder-employees made their own beds by failing to diversify their retirement account holdings . . . [t]he same is true of ‘oppressed’ shareholders in close corporations . . . who willingly (although perhaps unwisely) chose to invest as minority shareholders”).

Yet, courts in most jurisdictions reject a narrowly contractual view of shareholder relationships and offer a remedy for shareholder oppression in closely held corporations, often premised on the notion that controlling shareholders owe fiduciary duties to the minority or must honor the minority's reasonable expectations.⁴ Thus, law and economics, the dominant mode of corporate law scholarship,⁵ appears irreconcilably opposed to minority shareholder protection, a defining feature of the existing law of close corporations.⁶

This Article contends that the “contractarian”⁷ objection to shareholder oppression doctrine is wrong for two principal reasons. First, the objection rests upon a false premise; according to standard economic theory, a rational shareholder will always bargain at arm's length for adequate protection before agreeing to invest in a closely held corporation.⁸ In reality, small business investors are not always sophisticated, founding a business is an inherently hopeful act, and fellow investors are often family members or friends. It should come as no surprise, therefore, that investors often fail to anticipate and bargain against future oppression, especially regarding problems that may not surface until later generations assume control of the business. The rational actor model of human behavior bears at most an approximate relation to reality.⁹

Second, even someone who reliably perceived and rationally pursued whatever advanced her own self-interest might fall victim to oppression as a minority shareholder. If this hypothetical, economically rational investor hoped to negotiate all points at arm's length before investing, she would soon confront the cruel reality of transaction costs. Bargaining takes time

4. See John H. Matheson & R. Kevin Maler, *A Simple Statutory Solution to Minority Oppression in the Closely Held Business*, 91 MINN. L. REV. 657 (2007) (surveying state law); Douglas K. Moll, *Reasonable Expectations v. Implied-in-Fact Contracts: Is the Shareholder Oppression Doctrine Needed?*, 42 B.C. L. REV. 989, 1002 (2001) (observing that “courts have increasingly used [reasonable expectations analysis] to determine whether oppressive conduct has taken place”). For a latecomer to the party, see *McLaughlin v. Schenck*, 220 P.3d 146, 150 (Utah 2009), which held in a case of first impression that minority shareholders are owed a fiduciary duty of “utmost good faith.”

5. See, e.g., Jon Hanson & David Yosifon, *The Situation: An Introduction to the Situational Character, Critical Realism, Power Economics, and Deep Capture*, 152 U. PA. L. REV. 129, 142 (2003) (“[T]here is no dispute that law and economics has long been, and continues to be, the dominant theoretical paradigm for understanding and assessing law and policy.”).

6. Only two states have definitively rejected special protection for minority shareholders. See *Nixon v. Blackwell*, 626 A.2d 1366, 1379–81 (Del. 1993); *Richards v. Bryan*, 879 P.2d 638, 648 (Kan. Ct. App. 1994).

7. By “contractarian,” I mean those who “view corporate law as simply a modest extension of contract law.” John C. Coffee, Jr., *The Mandatory/Enabling Balance in Corporate Law: An Essay on the Judicial Role*, 89 COLUM. L. REV. 1618, 1619 (1989).

8. See David Charny, *Hypothetical Bargains: The Normative Structure of Contract Interpretation*, 89 MICH. L. REV. 1815, 1871 (1991) (“Because it is generally feasible for the small number of shareholders in a close corporation to bargain among themselves, one view of the appropriate hypothetical bargain . . . would leave these questions to express contract.”).

9. As discussed *infra* Part III, the rational actor is a figment of abstract economic models.

and costs money; even if an investor has plenty of both, and thinks added clarity is worth the bother, there is a limit to what can be effectively dealt with ahead of time.¹⁰ Also, social relationships matter, and rational shareholders may prefer to rely on trust—without which a small business venture would never be attempted—even when explicit contractual solutions are available.¹¹

In a long-term contract rife with gaps that a party can exploit to further its own interests at the expense of the other parties to the agreement, the possibility of bad-faith opportunism¹² is ever-present and robust judicial monitoring seems not only helpful, but necessary.¹³ The serious question is thus not whether to protect minority shareholders, but how to do it. This Article contends that courts need not (and should not) apply a free-floating norm of fairness, judged after the fact, to resolve shareholder disputes. Courts that instead protect all shareholders' reasonable expectations by enforcing well-established, equitable principles of contract, including the implied covenant of good faith and fair dealing,¹⁴ facilitate private ordering. Shareholders can invest without undue fear of ex post opportunism or judicial revision of the terms of the bargain.¹⁵

10. See LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* 108 (2010) (“[C]lose corporation owners often either lacked the foresight to plan for the breakdown of their relationship, or could not easily figure out how to balance the dangers of freeze-in against the risk that a member would use a power to dissolve the corporation to oust a comember.”).

11. See, e.g., Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1805 (2001) (“The phenomenon of trust behavior suggests . . . that sometimes participants in closely held corporations may deliberately choose not to draft formal contracts, even when they could do so.”).

12. Opportunism involves more than economic self-interest. According to one scholar, a party acts opportunistically if it “behaves contrary to the other party’s understanding of their contract, but not necessarily contrary to the agreement’s explicit terms, leading to a transfer of wealth from the other party.” Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521, 521 (1981). Opportunism implies an element of bad faith. See, e.g., Michael P. Van Alstine, *The Costs of Legal Change*, 49 UCLA L. REV. 789, 834 (2002) (contending that opportunism requires “bad faith exploitation of uncertainty”); O’Kelley, *supra* note 2, at 222 (“Opportunistic actors seek to extract an advantage which would be denied them if the party with whom they deal had full information.”).

13. See Coffee, *supra* note 7, at 1620 (arguing that in “long-term contracting . . . judicial involvement is not an aberration but an integral part of such contracting”). Coffee describes judicial monitoring as a “key tradeoff” in that “we counterbalance contractual freedom with ex post judicial review.” *Id.* at 1620–21. For a related argument, see Thompson, *supra* note 2, at 394 (“A close corporation is like a long-term relational contract in which benefits for all parties necessarily depend on unstated assumptions. A fully contingent contract cannot be drafted, so some *ex post* settling up by courts is used to support these assumptions.”). This Article builds on Coffee’s and Thompson’s helpful analyses of the judicial role but resists the notion that there is a necessary tradeoff to be made. Although the covenant of good faith and fair dealing is mandatory, its purpose is to protect the parties’ bargain, not to restrict the permissible subject matter of the bargain.

14. The duty of good faith and fair dealing is implied as a mandatory term in all contracts. See RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

15. See RIBSTEIN, *supra* note 10, at 166 (“[C]ontrolling shareholders should not have fiduciary duties to noncontrolling shareholders [T]he law need only constrain opportunism by holding the controller to its express or implied contractual obligations, including the duty of good faith”). Even though Professor Ribstein takes a relatively

This Article's central contention is that a more nuanced theory of contract—freed from the limiting assumptions of standard law and economics—offers a persuasive justification for judicial protection of vulnerable minority shareholders in close corporations. Moreover, although courts often describe the shareholder relationship in fiduciary terms, contract theory provides a more coherent explanation of current doctrine. In short, the contractarian objection to shareholder protection poses a false choice between fairness and autonomy. By instead enforcing the implicit contractual obligations of good faith and fair dealing, courts can protect minority shareholders from oppression and, at the same time, advance the values of private ordering.

Part II briefly describes the problem of minority shareholder oppression in close corporations and sets forth the standard law and economics objection to judicial intervention. According to this view, shareholder relationships in a close corporation are defined by contract (including the contractual choice of business form).¹⁶ Using the familiar “nexus of contracts” theory of the firm,¹⁷ law and economics scholars advance two claims: (1) that shareholder investment decisions can best be understood via the rational actor theory of choice, which posits that people act to maximize their self-interest, however they may define it;¹⁸ and (2) that courts should enforce the parties' explicit bargain (including any background rules of corporate law) to avoid inefficient meddling with private ordering.¹⁹

Part III argues that the rational actor theory underlying the contractarian view offers a not-merely simplified but shoddy description of decisions made by close corporation shareholders, especially in family corporations. More recent behavioral economic theory, grounded in cognitive

narrow view of equitable protection, given the parties' ability to protect themselves through explicit contract, this statement of principle seems exactly right. Indeed, as discussed *infra* Part V, disagreement concerning the scope of equitable contract offers a locus for constructive engagement between law and economics and more progressive legal approaches. Instead, a lingering and calcified dispute between “contractarian” and “anti-contractarian” perspectives on corporate governance appears to have blocked progress toward a consensus concerning shareholder oppression law.

16. See EASTERBROOK & FISCHER, *supra* note 1, at 229.

17. See BAINBRIDGE, *supra* note 1, at 8 (“[T]he corporation is not a thing, but rather a web of explicit and implicit contracts establishing rights and obligations . . .”).

18. See, e.g., *id.* at 23 (“[N]eoclassical economics is premised on rational choice theory, which posits an autonomous individual who makes rational choices that maximize his satisfactions.”); AMARTYA SEN, RATIONALITY & FREEDOM 26 (2002) (“It must, however, be accepted that despite the limited reach of the self-interest approach to rationality, it is widely used not only in economics, but also in ‘rational choice’ models in politics and the increasingly important subject of ‘law and economics.’”); John Ferejohn, *Rationality and Interpretation: Parliamentary Elections in Early Stuart England*, in THE ECONOMIC APPROACH TO POLITICS 279, 281 (Kristen Renwick Monroe ed., 1991) (“[R]ational choice theorists are committed to a principle of universality: (all) agents act always to maximize their well-being as they understand it . . .”).

19. See Larry E. Ribstein, *From Efficiency to Politics in Contractual Choice of Law*, 37 GA. L. REV. 363, 395 (2003) (“As long as this choice relies on contracts between parties who are motivated to act in their own interests, bargain freely, and internalize the costs and benefits of the deal, enforcing contractual choice produces ‘Pareto’ wealth maximization.”).

psychology, helps to explain why shareholders systematically fail to do what the rational actor theory predicts.²⁰ Like the rest of us, shareholders in close corporations are imperfectly rational and tend to underestimate the likelihood of future strife.²¹

Part IV contends that a narrow focus on the terms of the shareholder bargain fails to account for transaction costs and misses the substantial benefit of social norms that encourage cooperation and trust. As law and economics scholars concede, shareholders cannot bargain in advance concerning every specific issue that might arise.²² Nor would shareholders necessarily want to tie their hands in advance.²³ The alternative contractual approach—allocating general control rights *ex ante*—causes as many problems as it solves, because minority veto and majority fiat can both be used opportunistically to extract a disproportionate share of the investment.²⁴ Moreover, some issues that might be addressed satisfactorily pre-investment may be left open on purpose; close-corporation shareholders may deliberately avoid extensive contractual negotiation to preserve the trust that makes the business form desirable in the first instance.²⁵

Part V shows that equitable principles of contract can accommodate the needs of investors committing to a long-term relationship as shareholders of a corporation. In particular, the duty of good faith and fair dealing implied in every contract gives courts an appropriate method for resolving shareholder disputes in close corporations. Contract theory, in fact, better explains existing shareholder oppression doctrine than does the imprecise invocation of fiduciary duty. Rather than settle for simplified and

20. See generally CHOICES, VALUES, AND FRAMES (Daniel Kahneman & Amos Tversky eds., Cambridge Univ. Press 2000). For an argument “that economic analysis has failed to produce an ‘economic theory’ of contract law,” see Eric Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 830 (2003). Professor Posner observes that “[t]he premises of economics push in the direction of freedom of contract . . . [a]nd yet courts do not always enforce the terms of contracts.” *Id.* at 842. Indeed, “[t]hey often refuse to enforce terms that seem . . . oppressive . . .” *Id.* Moreover, normative economic analysis relies on models that are either too simple to be useful in the real world or else too complex to provide determinate guidance. *Id.* at 880.

21. Behavioral economics supports what scholars have long observed. See, e.g., F. Hodge O’Neal, *Oppression of Minority Shareholders: Protecting Minority Rights*, 35 CLEV. ST. L. REV. 121, 124 (1987) (“Unfortunately the atmosphere of optimism and goodwill which prevails during the initial stages of a business undertaking usually obscures the possibility of future . . . conflicts . . .”).

22. See EASTERBROOK & FISCHER, *supra* note 1, at 34 (“Even when they work through all the issues they expect to arise, [venturers] are apt to miss something. All sorts of complexities will arise later.”).

23. See O’Kelley, *supra* note 2, at 225 (“[W]hile contractual specification of rights and duties may provide protection against opportunistic withdrawal, the parties may also incur significant costs from lost flexibility.”).

24. See, e.g., *id.*, at 239 (contending that rational investors will select the corporate form when they “attach greater value to the firm’s adaptability . . . and to elimination of the risk of shirking or opportunistic use of withdrawal rights by a minority shareholder than to the value of guaranteeing a minority shareholder’s right to continue as an employee, to share ratably in the firm’s profits, or to withdraw money capital”).

25. See, e.g., Blair & Stout, *supra* note 11, at 1807 (“[A]ttempts to use contracts in relationships in which trust plays a central role can prove counterproductive and promote exactly the sort of opportunistic behavior they were intended to discourage.”).

unsatisfying assumptions, contract theory incorporates asymmetries, incompleteness, and relational rather than discrete exchanges.²⁶ The law and economics refrain, “you made your bed, now you must lie in it,”²⁷ is a pithy but empty phrase.²⁸

The standard law and economics argument gains little force when recast as a choice-of-form argument based on the availability of the LLC, a newer hybrid business form that combines certain features of partnership law with the limited liability of corporation law.²⁹ If one doubts the ability of investors to bargain effectively in advance because of transaction costs, and, in many cases, family and other intimate connections, the same problems will arise in the LLC context.³⁰ Despite their differences, LLCs and close corporations both involve long-term relationships and incomplete contractual bargaining; the implied covenant of good faith and fair dealing should apply in either context to protect against opportunistic overreaching.

I. THE CONTRACTARIAN OBJECTION TO SHAREHOLDER PROTECTION

The predicament of the minority shareholder in a closely held corporation is easily stated. A corporation’s board of directors, elected by a majority of the shareholders, has the sole authority to decide whether to issue dividends and what salaries to pay managers and employees; moreover, courts traditionally refuse to second-guess business decisions made by corporate managers.³¹ Thus, using established mechanisms of corporate governance, controlling shareholders can exclude minority shareholders from any role in the corporation.³² Minority shareholders are particularly vulnerable to

26. See PATRICK BOLTON & MATHIAS DEWATRIPONT, *CONTRACT THEORY 2* (2005) (stating that “much of the existing theory of long-term or dynamic contracting was developed in the 1980s and 1990s” and that “[t]hese notions . . . complete the foundations for a full-fledged theory of the firm and organizations”).

27. See, e.g., Stephen M. Bainbridge, *Much Ado About Little? Directors’ Fiduciary Duties in the Vicinity of Insolvency*, 1 J. BUS. & TECH. L. 335, 346 (2007) (identifying in corporate law “a basic principle, captured by the colloquialism ‘you made your bed, now you have to lie in it’”).

28. If we want to take the metaphor seriously, we should observe that there are many people involved in making the bed, the bed frame cannot really be adjusted, and the people who may eventually find that the bed is uncomfortable may not even be born yet.

29. See *infra* Part V.C.

30. See Sandra K. Miller et al., *An Empirical Glimpse into Limited Liability Companies: Assessing the Need To Protect Minority Investors*, 43 AM. BUS. L.J. 609, 613 (2006) (“[M]inority LLC investors tend to be more vulnerable than their close corporation counterparts.”); Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 896 (2005) (“[T]he problem of oppression is ‘portable’ to the LLC context, as the LLC shares certain core features of the close corporation.”).

31. See BAINBRIDGE, *supra* note 1, at 242 (“[T]he business judgment rule says that courts must defer to the board of directors’ judgment absent highly unusual exceptions.”).

32. See Douglas K. Moll, *Shareholder Oppression & Reasonable Expectations: Of Change, Gifts, and Inheritances in Close Corporation Disputes*, 86 MINN. L. REV. 717, 717 (2002) (stating that “oppression doctrine combats majority shareholder efforts to exclude a minority investor from the company’s financial and participatory benefits”); D. Gordon Smith, *The Shareholder Primacy Norm*, 23 J. CORP. L. 277, 309 n.153 (1998).

these “freeze-out” techniques, because they cannot sell their shares and therefore have no other way to earn a return on their investment.³³

The standard law and economics rejoinder to the alleged problem of shareholder oppression is also easily stated. According to this view, courts should restrict their focus to the parties’ actual bargain, including the choice of business form, and should not provide any special protection to minority shareholders in close corporations.³⁴ Shareholders, majority or minority, who want a different deal have every incentive to negotiate for it and can be assumed to act rationally in their own best interests.³⁵

A. *You Get What You Bargain For*

Those who oppose minority shareholder protections argue that regardless of the sympathy that courts may feel for minority shareholders trapped in an investment gone sour,³⁶ there is no justification for the imposition of fiduciary duties on controlling shareholders.³⁷ As one scholar puts it, “Controlling stockholders’ fiduciary duties are a judicial invention stimulated by a desire to provide relief to minority stockholders who later regretted their own or their decedent’s bargains and encouraged by scholars advocating a neo-marxist view of investing.”³⁸ Like any other contract, the parties’ *ex ante* agreement should control.

The argument assumes, of course, that contract theory explains corporate law. Notably, law and economics scholars reject the traditional corporation-as-person metaphor³⁹ and contend that the corporation is better understood as a nexus of contracts among various constituencies, including shareholders, directors, officers, and employees.⁴⁰ This “contractarian

33. See F. HODGE O’NEAL & ROBERT B. THOMPSON, *OPPRESSION OF MINORITY SHAREHOLDERS AND LLC MEMBERS* § 3:1, at 3–2 (rev. 2d ed. 2005); O’Neal, *supra* note 21, at 126 (“[D]ischarge of the shareholder-employee often produces an immediate financial crisis for him.”); see also *Brooks v. Hill*, 717 So. 2d 759, 765 (Ala. 1998) (“[B]ecause of the minority shareholder’s prospect of being cut off from corporate income and privileges, the plight of a minority shareholder in a close corporation, as distinguished from both a partner in a partnership and a minority shareholder in a publicly traded corporation, is unique.”).

34. See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 STAN. L. REV. 271, 273 (1986) (“[T]here is no reason to believe that shareholders of either closely or publicly held corporations will be more or less ‘exploited.’ No *a priori* case can be made for greater legal intervention in closely or publicly held corporations.”).

35. See BAINBRIDGE, *supra* note 1, at 798 (“Investors would be foolish to agree to invest in the business, but leave planning details about the firm until the future. Instead, they should settle the critical questions in advance . . .”).

36. See *Nixon v. Blackwell*, 626 A.2d 1366, 1379 (Del. 1993) (“It is not difficult to be sympathetic, in the abstract, to a stockholder who finds himself or herself in that position.”).

37. See Dalley, *supra* note 1, at 176 (“[B]asic principles of corporate and agency law, properly understood, provide all the protection stockholders need and provide a more workable framework for evaluating stockholder behavior.”).

38. *Id.* at 222.

39. See BAINBRIDGE, *supra* note 1, at 8 (“Despite the utility of the fiction of corporate legal personhood, it is critical to remember that treating the corporation as an entity separate from the people making it up bears no relation to economic reality.”).

40. See Michael Klausner, *The Contractarian Theory of Corporate Law: A Generation Later*, 31 J. CORP. L. 779, 779–80 (2006) (“The core innovation of the theory was to conceptualize the relationship between managers and shareholders of a public company as

model [has] cemented its hold on corporate law scholarship”⁴¹ By focusing upon contract, rather than the public dimension of corporate law, the metaphor emphasizes private ordering.⁴² According to the logic of private ordering, corporation law should provide default principles for the parties to accept or modify.⁴³

To see why standard law and economics places such strong emphasis on the parties’ freedom to negotiate, it is important to understand the underlying theory of human behavior. When parties enter into a contract, they cannot know what the future will hold.⁴⁴ They must evaluate and allocate risk, including unforeseen risk.⁴⁵ Any theory of contract must explain how the parties will (or should) respond to uncertainty.⁴⁶

B. Rational Choice Theory

According to standard law and economics, the rational actor model of decisionmaking can predict a contracting party’s evaluation of contractual uncertainty.⁴⁷ A rational actor takes into account all available information and picks the best means of accomplishing her goals.⁴⁸ Thus, “[s]tandard

one of contract—a ‘corporate contract’—in which joint wealth would be maximized”); cf. REINIER KRAAKMAN ET AL., *THE ANATOMY OF CORPORATE LAW* 6 (2004) (“As an economic entity, a firm fundamentally serves as a nexus of contracts: a single contracting party that coordinates the activities of suppliers of inputs and of consumers of products and services.”).

41. Thomas W. Joo, *Contract, Property, and the Role of Metaphor in Corporations Law*, 35 U.C. DAVIS L. REV. 779, 796 (2002).

42. See BAINBRIDGE, *supra* note 1, at 8 (“Nexus of contracts theory has pervasive implications, both descriptively and normatively, for our understanding of the corporation.”); Thompson, *supra* note 2, at 378 (observing that mandatory constraints are inconsistent with the nexus of contract theory).

43. Whatever its merits as a normative claim, the characterization of corporate law rules as default settings is a highly selective one. See Melvin A. Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1461 (1989) (observing that corporations consist of rules, some determined by “contract or other forms of agreement” and “[s]ome . . . determined by law”).

44. See Melvin A. Eisenberg, *The Limits of Cognition and the Limits of Contract*, 47 STAN. L. REV. 211, 213 (1995) (“Contracts concern the future, and are therefore always made under conditions of uncertainty.”).

45. See Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089, 1090 (1981) (noting that “contract rules serve as . . . risk allocations”).

46. See *id.*

47. See Eisenberg, *supra* note 44, at 213. For a discussion of rational actor theory, see JON ELSTER, *EXPLAINING SOCIAL BEHAVIOR: MORE NUTS AND BOLTS FOR THE SOCIAL SCIENCES* 191–213 (2007). Professor Elster summarizes rational choice theory as follows: “An action is rational . . . if it meets three optimality requirements: the action must be optimal, given the beliefs; the beliefs must be as well supported as possible, given the evidence; and the evidence must result from an optimal investment in information gathering.” *Id.* at 191 (emphasis omitted).

48. See Jennifer Arlen, Comment, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1767 (1998) (noting law and economics “assumption that individuals choose rationally” and without any systematic biases); see also Eisenberg, *supra* note 44, at 213. As Professor Eisenberg explains, the rational actor theory assumes:

that individual decisionmakers can compute (subjective) probability estimates of uncertain future events; that they perceive accurately the dollar cost or outcome of the uncertain outcomes; that they know their own attitudes toward risk; that they

economics assumes . . . that we are cognitively unhindered in weighing the ramifications of each potential choice.”⁴⁹ To be rational, one must act upon adequate information to maximize one’s own perceived utility unencumbered by relationships with other people and free of any other cognitive biases or limitations.⁵⁰

Although rational actor theory is sometimes understood to require relentless selfishness, it applies to means, not ends, and can accommodate socially-motivated preferences for charity as easily as a self-interested desire for personal gain.⁵¹ Rational choice theory takes all preferences as given, so long as they are internally consistent.⁵² Thus, even if law and economics tends to assume self-interested behavior, economic analysis can accommodate the fact that human beings are social animals and not motivated exclusively by self-interest.⁵³ The mechanism for doing so—

combine this information about probabilities, monetary values of outcomes, and attitudes toward risk to calculate the expected utilities of alternative courses of action and choose that action that maximizes their expected utility.

Id. (quoting Thomas S. Ulen, *Cognitive Imperfections and the Economic Analysis of Law*, 12 *HAMLIN L. REV.* 385, 386 (1989)).

49. DAN ARIELY, *PREDICTABLY IRRATIONAL* 239 (2008). Professor Ariely observes, “even if we make a wrong decision from time to time, the standard economics perspective suggests that we will quickly learn . . . either on our own or with the help of ‘market forces.’” *Id.*

50. See GARY S. BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* 14 (1976) (contending that individuals “maximize their utility from a stable set of preferences and accumulate an optimal amount of information and other inputs in a variety of markets”). The rational choice vision can be described as a kind of modern stoicism:

This is the ideal of the disengaged self, capable of objectifying not only the surrounding world but also his own emotions and inclinations, fears and compulsions, and achieving thereby a kind of distance and self-possession which allows him to act ‘rationally’ . . . Reason is no longer defined in terms of a vision of order in the cosmos, but rather is defined procedurally, in terms of instrumental efficacy, or maximization of the value sought, or self-consistency.

CHARLES TAYLOR, *SOURCES OF THE SELF: THE MAKING OF THE MODERN IDENTITY* 21 (1989).

51. On a stricter view of neoclassical economics, an individual values “payoffs to other individuals only insofar as these influence his own payoff.” Ernst Fehr & Herbert Gintis, *Human Motivation and Social Cooperation: Experimental and Analytical Foundations*, 33 *ANN. REV. SOC.* 43, 45 (2007) (stating that “experimental evidence . . . rejects the selfishness assumption routinely made in economics”); see also Blair & Stout, *supra* note 11, at 1808 (criticizing law and economics by citing “extensive empirical evidence” that “most people shift readily from purely self-interested to other-regarding modes of behavior depending on . . . social context”).

52. Rational choice theory accommodates plainly irrational desires. See, e.g., SEN, *supra* note 18, at 39 (pointing out that if someone decides to cut off his toes, rational choice theory would decide whether or not he is rational by examining whether he has selected a sharp enough knife). But the rational actor theory does not purport to be a full account of human reason. For instance, many people drive because they “have an irrational fear of flying.” Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 *STAN. L. REV.* 1551, 1554 (1998). They “want above all to avoid being killed; yet they choose the more dangerous mode anyway.” *Id.* Posner asserts, however, that “[a] preference can be taken as a given, and economic analysis proceed as usual, even if the preference is irrational.” *Id.* Although irrationally afraid of airplanes, nervous flyers still respond to changes in ticket price when choosing whether to drive or fly. *Id.* at 1559 n.16.

53. Although some economists continue to assume that individuals act to maximize self-interest, “[t]he discrepancy between the traditional theory and experimental results has driven several economists to develop a theory of ‘social preferences’ that incorporates

describing other-oriented motives in terms of the actor's own personal utility—is ungainly but perhaps serviceable.

However, if we cannot look behind the preference to address whether or not it is rational—as might be possible if we could evaluate preferences against a narrow conception of self-interest—then we cannot know whether a vulnerable minority shareholder has behaved irrationally. Without substantive constraints on rational choice, we can always construct a preference that the contractual arrangement serves. This creates two related difficulties.

First, if we identify individuals' preferences by working backward from their choices, then the rational actor model is tautological.⁵⁴ The definition of rationality excludes unsuitable governance arrangements.⁵⁵ As the Delaware Supreme Court has stated, “The tools of good corporate practice are designed to give a purchasing minority stockholder the opportunity to bargain for protection before parting with consideration.”⁵⁶ Because rational minority shareholders would take reasonable steps to protect the value of their investment, the controlling shareholders' conduct, if within the bounds of the agreement, is not oppression. On this view, courts should not interfere with voluntary agreements to provide benefits unavailable through negotiation.⁵⁷

Second, because rational choice theory takes all preferences as a given, law and economics scholars cannot claim that corporate law rules are well designed to serve wealth-maximizing goals in the close corporation context. This inherent limitation is easy to overlook. Judge Frank H. Easterbrook and Professor Daniel R. Fischel, for example, note that there are a variety of business forms available and conclude that “[a]t the margin the problems must be equally severe, the mechanisms equally effective—were it otherwise, investors would transfer their money from one form [of

preferences for other-regarding behavior” Mizuho Shinada & Toshio Yamagishi, *Bringing Back Leviathan into Social Dilemmas*, in *NEW ISSUES AND PARADIGMS IN RESEARCH ON SOCIAL DILEMMAS* 93, 94 (A. Biel et al. eds., 2008). For a recent critique of economic theories that focus upon self-interested choice, see Ronald J. Colombo, *Exposing the Myth of Homo Economicus*, 32 *HARV. J.L. & PUB. POL'Y* 737 (2009) (reviewing *MORAL MARKETS: THE CRITICAL ROLE OF VALUES IN THE ECONOMY* (Paul J. Zak ed., 2008)).

54. See ELSTER, *supra* note 47, at 54 (“Trying to explain [a] choice by its . . . consequences is a form of ‘rational-choice functionalism’ . . . that sheds no light on the meaning of the behavior.”); Ferejohn, *supra* note 18, at 281 (“Rational choice theory . . . constructs explanations by ‘reconstructing’ patterns of meanings and understandings (preferences and beliefs) in such a way that agents’ actions can be seen as maximal, given their beliefs.”).

55. See Melvin A. Eisenberg, *Why There Is No Law of Relational Contracts*, 94 *Nw. U. L. REV.* 805, 808 (2000) (“[I]f actors always act rationally in their own self-interest, then, in the absence of fraud, duress, or the like, all bargains must be fair.”).

56. *Nixon v. Blackwell*, 626 A.2d 1366, 1380 (Del. 1993). In that regard, well-advised shareholders ought to consider the feasibility of buy-sell agreements and long-term employment agreements to supplement the basic corporate documents.

57. Dalley, *supra* note 1, at 221 (“Where a controlling stockholder bargains for control, the courts should not rewrite the contract and provide a windfall to the minority.”); see *Nixon*, 626 A.2d at 1380 (“It would do violence to normal corporate practice and our corporation law to fashion an ad hoc ruling which would result in a court-imposed stockholder buy-out for which the parties had not contracted.”).

ownership] to the other until the marginal equality condition was satisfied.”⁵⁸ But this is true only if shareholders invest across business forms solely to maximize expected profits. To the extent participation in a closely held corporation reflects other values—for instance, the desire to participate with friends and family in a shared venture—then we can no longer assume that the different business forms will produce similar financial returns and that their governance problems are equivalent.⁵⁹

The central problem with the contractarian objection to shareholder protection is not that it values rationality—we all want to be rational—but that it ignores the reasons why real-world bargaining among corporate investors often bears little resemblance to the simplified assumptions of standard law and economics. The next part uses the insights of behavioral economics to explain why rational actor theory fails to describe shareholder relationships in close corporations.

II. THE PERSISTENCE OF IRRATIONAL CHOICE

It is no secret that minority shareholders in close corporations tend not to bargain for adequate protection, a problem that has been evident for decades.⁶⁰ Equally well-understood is that the statutory model of the corporation was designed with the public corporation in mind.⁶¹ Yet the rational actor theory cannot account for uncorrected flaws in the corporate model.⁶² After all, a perfectly rational minority shareholder would always negotiate for adequate protection, demand a discount commensurate with the risk of loss through majority opportunism, or decline to invest. Unless

58. EASTERBROOK & FISCHER, *supra* note 1, at 231.

59. See Benjamin Means, *A Voice-Based Framework for Evaluating Claims of Minority Shareholder Oppression in the Close Corporation*, 97 GEO. L.J. 1207, 1234 (2009) (“[P]articipating in a close corporation may represent a fundamental life choice, a commitment to work together with family or friends to build a business consistent with their values.”); Susan Clark Muntean, *Analyzing the Dearth in Family Enterprise Research, in DEVELOPMENTS AND FUTURE RESEARCH IN FAMILY BUSINESS* 3, 6 (Phillip H. Phan & John E. Butler eds., 2008) (“Rational-legal models of the firm typically are silent on the role trust and altruism flowing from family ties and networks play[s] in decision making and choice of organizational structure.”).

60. See, e.g., Moll, *supra* note 30, at 907 (“[C]lose corporation shareholders typically fail to engage in advance planning and fail to contract for protection from dissension.”); O’Kelley, *supra* note 2, at 243 (“Available evidence suggests that relatively few closely held corporations adopt such contractual devices.”); O’Neal, *supra* note 21, at 124 (“Important arrangements among participants in small business enterprises are often oral and sometimes nothing more than vague understandings, never even definitely stated orally.”).

61. See Harwell Wells, *The Rise of the Close Corporation and the Making of Corporation Law*, 5 BERKELEY BUS. L.J. 263, 265–66 (2008); see also ROBERT CHARLES CLARK, *CORPORATE LAW* 762 (1986) (“[C]entralization of management . . . has proven most troublesome in the close corporation context.”). Professor Clark observes that “the standard model . . . makes good economic sense for public corporations” but works less well for close corporations as “the shareholders will also expect to be actively engaged in helping to form and implement the corporation’s business decisions, and they will want to be compensated as officers or employees.” *Id.*

62. See Posner, *supra* note 20, at 865 (“The economic scholarship on contract law purports to assume that individuals are rational in the sense of neoclassical economics. Their preferences obey certain consistency requirements, and their cognitive capacity is infinite.”).

the close corporation form offered an equal return on investment at the margin, a rational investor would say no.⁶³

This part contends that the rational choice assumptions of standard law and economics are unhelpful as a way of understanding the predicament of the minority shareholder or the doctrinal responses that have evolved.⁶⁴ Behavioral economics offers a more compelling account of minority shareholders in close corporations. Admittedly, integrating empirical observation and cognitive psychology complicates the picture of human behavior and does not lend itself to grand synthesis, but the law should value accuracy over elegance.

A. Behavioral Economic Evidence

Behavioral economics starts from the premise that “economics [would] make a lot more sense if it were based on how people actually behave, instead of how they should behave.”⁶⁵ By empirically testing assumptions about rationality, behavioral economists have demonstrated what common sense had long suggested—people are not as rational as the rational actor model assumes and depart systematically from its formal requirements.⁶⁶ Thus, “[o]ur irrational behaviors are neither random nor senseless—they are systematic and predictable.”⁶⁷

For example, although it is not economically rational, owners tend to think their possessions are worth more than non-owners do (the “endowment effect”) and have a strong aversion to loss.⁶⁸ In one study, Duke University students who had entered a lottery for basketball tickets subsequently assigned a different dollar value to the tickets, depending on whether they won or lost the lottery, even though the value of the experience of attending basketball games should have remained the same.⁶⁹ Experimenters found that “the students who did not own a ticket were

63. See EASTERBROOK & FISCHER, *supra* note 1, at 231 (“Because the world contains so many different investment vehicles, none will offer distinctively better chances of return when people can select and shift among them.”).

64. See Posner, *supra* note 20, at 865 (“If individuals were rational, with no cognitive limits, and if transaction costs were zero, the role of contract law would be simple and uninteresting.”).

65. ARIELY, *supra* note 49, at 239; see also ELSTER, *supra* note 47, at 67 (“To understand how people act and interact, we first have to understand how their minds work.”).

66. ARIELY, *supra* note 49, at 239 (defining behavioral economics as “an emerging field focused on the (quite intuitive) idea that people do not always behave rationally and that they often make mistakes in their decisions”); Jon Hanson & Douglas A. Kysar, *Taking Behavioralism Seriously: The Problem of Market Manipulation*, 74 N.Y.U. L. REV. 630, 633 (1999) (“For the past few decades, cognitive psychologists and behavioral researchers have been steadily uncovering evidence that human decisionmaking processes are prone to nonrational, yet systematic, tendencies.”).

67. ARIELY, *supra* note 49, at 239 (“We all make the same types of mistakes over and over, because of the basic wiring of our brains. So wouldn’t it make sense to modify standard economics and move away from naive psychology, which often fails the tests of reason, introspection, and—most important—empirical scrutiny?”).

68. *Id.* at 129.

69. *Id.* at 133 (“From a rational perspective, both the ticket holders and the non-ticket holders should have thought of the game in exactly the same way.”).

willing to pay around \$170 for one.”⁷⁰ But “[t]hose who owned a ticket. . . demanded about \$2,400 for it.”⁷¹ More than 100 students were contacted; not one student “was willing to sell a ticket at a price that someone else was willing to pay.”⁷²

The behavioral economics literature is vast, but the point is simple: we are not always effective at perceiving and advancing our own self-interest.⁷³ (A moment’s introspection should suffice to confirm the truth of this statement). If shareholders in close corporations are subject to the same predictable cognitive biases, then the law and economics objection to shareholder protection rests upon false assumptions. The objection clings to a narrow and implausible conception of rational choice, despite empirical evidence that human decisionmaking departs considerably from the formal model, in predictable, systematic fashion.⁷⁴

Behavioral economics has clear implications for our understanding of close corporation shareholders.⁷⁵ Although a rational actor would not overestimate the value of family bonds or fail to give appropriate weight to all possible future outcomes, close corporation shareholders, as humans, are susceptible to systematic cognitive errors.

1. Disposition Bias

As shown by the fact that “[n]early ninety percent of drivers believe they drive better than average,” it is clear “that as a systematic matter, people are unrealistically optimistic.”⁷⁶ Perhaps more relevant to the launching of a

70. *Id.* at 132.

71. *Id.*

72. *Id.*

73. See RICHARD H. THALER & CASS R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS* 9 (Penguin Books 2009) (2008) (“The false assumption is that almost all people, almost all of the time, make choices that are in their best interest or at the very least are better than the choices that would be made by someone else. . . . [T]his assumption is false—indeed, obviously false.”).

74. Some law and economics scholars admit that the rational choice model does not capture actual decisionmaking, that shareholders are only “boundedly rational,” and that shareholders may even be subject to the predictable biases identified in the behavioral economics literature. For a discussion, see BAINBRIDGE, *supra* note 1, at 23–26. However, it is not enough to posit that law and economics is akin “to Newtonian physics” and that corporate rules are simple falling objects for which more sophisticated models are unnecessary. *Id.* at 26. The concession that people are not rational in the formal economic sense leaves no adequate explanatory mechanism. See ELSTER, *supra* note 47, at 26 (contending that rational choice theorists cannot rely on the analogy to “Newton’s theory” because “[t]here is no general nonintentional mechanism that can simulate or mimic rationality”) (emphasis omitted). Professor Bainbridge may nevertheless be right that standard “economics adequately explains the behavior of large masses of people engaged in exchange.” BAINBRIDGE, *supra* note 1, at 26. Perhaps market forces supply the mechanism in those circumstances. *Cf.* ELSTER, *supra* note 47, at 26 (acknowledging possibility that “[s]ome kind of social analog to natural selection” might substitute for rationality “at least roughly”). As discussed *infra* Part III.C, however, markets do not correct for irrational choice in close corporations.

75. See Eisenberg, *supra* note 43, at 1465 (“[P]roblems of systematic error apply with special force to bargains concerning closely held corporations.”).

76. Eisenberg, *supra* note 44, at 216.

business venture are surveys of individuals who are about to get married, showing that while “respondents correctly estimated that fifty percent of American couples will eventually divorce” they “estimated that their own chance of divorce was zero.”⁷⁷

Thus, disposition bias may cause investors to overvalue the likely success of a venture and to underestimate the risk of conflict.⁷⁸ Even if potential investors understood, as a general matter, that business ventures fail and that family relationships falter, they might not apply that insight to their own situation. Moreover, although a rational actor would gather the optimal amount of information before making a final decision, optimism may cause investors to look for information that reinforces their existing belief.⁷⁹

2. Cognitive Bounds

Shareholders may also fail to protect themselves against the possibility of oppression because they cannot process information perfectly, as the rational choice model requires. This discrepancy between the ideal and the actual is sometimes called “bounded rationality.”⁸⁰ For example, minority shareholders may “give too little weight to future benefits and costs as compared to present benefits and costs.”⁸¹ Similarly, shareholders may misjudge the risk of low-probability, unpleasant outcomes.⁸² Even when

77. See *id.* at 217 (citing Lynn A. Baker & Robert E. Emery, *When Every Relationship Is Above Average: Perceptions and Expectations of Divorce at the Time of Marriage*, 17 *LAW & HUM. BEHAV.* 439, 443 (1993)).

78. See *id.* (“[W]hen people rate their chances for personal and professional success, most unrealistically believe that their chances are better than average.”); Sean Hannon Williams, *Sticky Expectations: Responses to Persistent Over-Optimism in Marriage, Employment Contracts, and Credit Card Use*, 84 *NOTRE DAME L. REV.* 733, 733 (2009) (“Most people underestimate the likelihood that they will experience negative events and overestimate the likelihood that the law will protect them if those events occur.”).

79. See ELSTER, *supra* note 47, at 158 (“The agent initially forms an emotion-induced bias, and the urgency of emotion then prevents her from gathering the information that might have corrected the bias.”).

80. See William J. Carney, *The Theory of the Firm: Investor Coordination Costs, Control Premiums and Capital Structure*, 65 *WASH. U. L.Q.* 1, 59–60 (1987) (“Investors in closely held enterprises are likely to be subject to conditions of bounded rationality, under which they either fail to perceive the complete set of problems that may occur later, or underestimate the probability of their occurrence.”); D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 *ARIZ. L. REV.* 1, 17 (2009) (defining “bounded rationality” as “a somewhat malleable term that includes an inability to negotiate future plans because parties ‘have to find a common language to describe states of the world and actions with respect to which prior experience may not provide much of a guide.’” (citation omitted)).

81. Eisenberg, *supra* note 44, at 222 (contending that, as a consequence of their “faulty telescopic faculty” people systematically misjudge their future preferences) (internal quotation marks omitted); see also ELSTER, *supra* note 47, at 224 (defining the “inability to project” as “the lack of ability to imagine what oneself or others would have reasons to believe, or incentives to do, in future situations that depend one’s present choice”).

82. See Eisenberg, *supra* note 44, at 223 (“Related to actors’ faulty telescopic faculties is the systematic underestimation of risks.”). Professor Eisenberg cites “empirical evidence . . . that people often not only underestimate but ignore low-probability risks.” *Id.* On the other hand, people may dramatically overestimate unlikely events that are “available” (like

they modify default rules, shareholders may do so in ways that fail rationally to advance their own interests.

For example, in *Demoulas v. Demoulas Super Markets, Inc.*,⁸³ two brothers (and their respective families) had equal control over the profitable Demoulas supermarket chain.⁸⁴ When one of the brothers died, the surviving brother assumed full control of the business.⁸⁵ He later used that power to squeeze out his brother's family, reserving most of the benefits of ownership for himself.⁸⁶ It apparently had not occurred to the brothers to take steps to prevent the surviving brother from misappropriating the value of the business.⁸⁷ Quite the opposite, they had entered into a voting trust agreement that gave unchecked authority to the surviving brother, expecting that each would take care of the family of the predeceased.⁸⁸

The implications of behavioral economics research for law remain unsettled,⁸⁹ but for our purposes, it suffices that shareholders in close corporations are unlikely to behave like *homo economicus*. Unless we take the brute force view that "eventually they'll learn," a contract theory based on a false description of human behavior is just not terribly useful.⁹⁰

B. Contesting the Implications of Irrational Choice

Law and economics scholars may respond to the findings of behavioral economics by contending that markets and lawyers will correct for any serious departures from rational choice on the part of individual investors, that behavioral economics lacks theoretical coherence and offers no clear lessons, and that, even assuming human beings do not always measure up to an economist's vision of rationality, corporate law should remain oriented

terrorism) while paying insufficient attention to more likely but less salient risks—like flu and dehydration. *See id.* at 223–24.

83. 677 N.E.2d 159 (Mass. 1997).

84. *Id.* at 165. The business was established by their parents as "a neighborhood food store" in 1917. *Id.*

85. *Id.* at 165–66 (describing operation of voting trust agreement that vested sole voting power in the hands of the surviving brother).

86. *Id.* at 166.

87. This may also be an example of "disposition bias."

88. Through the voting trust agreement, the parties not only failed to consider the possibility of oppression, but actually sought to eliminate legal protections they otherwise would have enjoyed. *Id.* at 171 (describing restrictions on shareholder litigation built into the trust agreement). Of course, trust agreements impose specific fiduciary responsibilities; arguably, the parties bolstered their fiduciary obligations contractually, using trust law to supplant corporate law protections. Although permitting the plaintiffs to sue for breach of the trust agreement may have best honored the terms of the contract, the court found the shareholder litigation restriction void as against public policy. *Id.* at 172.

89. *See generally* Arlen, *supra* note 48.

90. *See* Eisenberg, *supra* note 55, at 810–11 ("[E]xpected-utility (rational-actor) theory emerged from a logical analysis of games of chance rather than from a psychological analysis of risk and value. The theory was conceived as a normative model of an idealized decision maker, not as a description of the behavior of real people.") (quoting Amos Tversky & Daniel Kahneman, *Rational Choice and the Framing of Decisions*, 59 J. BUS. S251, at S251 (Supp. 1986)).

toward rational behavior. These objections, however, are speculative and undermined by the available evidence.

Although markets are sometimes offered as a corrective for individual cognitive errors, they seem unlikely to play that role in a close corporation:

Any plausible theory of effective market discipline in corporate law generally rests on some combination of the following: an efficient capital marketplace that prices both good and bad corporate governance with reasonable precision; compensation of key insiders using stock or options, so as to better align the interests of managers and investors; the emerging power of institutional investors who can actually threaten to exercise their voting rights; and a reasonably active market for corporate control.⁹¹

Unlike a public corporation, where the stock price will, in theory, impound all available information, even though individual investors may lack the information or the ability to process it, close corporation stock does not trade actively.⁹² Because the market is illiquid, there is no established market price for close corporation stock and no market for corporate control.⁹³ Other markets may be useful—for instance, the employment market that indicates the salary a shareholder could command by working for a different business—yet those markers provide only rough guidance and have little bearing on the problem of oppression.⁹⁴ Also, close corporation shareholders often have investment goals that are more complex than simple profit maximization.⁹⁵

Alternatively, because business investment decisions are not often made lightly and may involve the assistance of counsel, we might insist upon rational behavior from participants in a business venture, even though we

91. Donald C. Langevoort, *Private Litigation to Enforce Fiduciary Duties in Mutual Funds: Derivative Suits, Disinterested Directors and the Ideology of Investor Sovereignty*, 83 WASH. U. L.Q. 1017, 1031 (2005).

92. Douglas K. Moll, *Shareholder Oppression in Close Corporations: The Unanswered Question of Perspective*, 53 VAND. L. REV. 749, 759 (2000) (“By definition . . . there is no ready market for the stock of a close corporation.”).

93. Although the divergence of interest of managers and investors is less serious in close corporations, because investors typically run the corporation directly, that alignment of interest does not reduce the incentive of controlling shareholders to take a disproportionate share of corporate profits. See Michael Carney, *Corporate Governance and Competitive Advantage in Family-Controlled Firms*, 29 ENTREPRENEURSHIP THEORY & PRAC. 249, 250 (2005).

94. See EASTERBROOK & FISCHER, *supra* note 1, at 233 (“There can be no presumption that those who have invested equal amounts are entitled to equal salaries as managers.”).

95. See, e.g., Bill Vlasic, *Family Loyalty Anchors Ford in Risky Times*, N.Y. TIMES, June 23, 2009, at A1.

Ford is still losing money—\$1.4 billion in the first quarter alone—and its cash reserves are shrinking as auto sales have dried up for the entire industry. Even so, Ford family members said they could not envision any situation that would cause them to sell out.

“If this were just a financial investment, the family probably would have been out of it years ago,” Bill Ford said. “This is very much an emotional commitment.” Although Ford Motor Company is publicly traded, the descendants of its founder, Henry Ford, are the controlling shareholders.

Id.

would make allowances for human frailty elsewhere.⁹⁶ However, “many close corporation participants are ill-advised or unsophisticated and so may not anticipate” dissension.⁹⁷ Lawyers may not be involved or, because of cost concerns, have only a peripheral role.⁹⁸ Further, even excellent lawyers cannot anticipate all future events, and the fundamental tension between preserving flexibility and constraining opportunism will remain.

For some law and economics scholars, the questionable choice to put all one’s eggs in a single basket must nevertheless be consistent with rational choice.⁹⁹ The argument is tautological because it assumes what is at issue: whether a concentrated investment decision will be made carefully. Indeed, if anything, the decision to tie up a substantial percentage of one’s wealth in a close corporation may itself be evidence of a departure from economic rationality.¹⁰⁰ Even though some shareholders are quite sophisticated—venture capital firms, for instance, approximate the rational-actor model when making investment decisions and bargain for control rights in exquisite detail—the law’s basic structure should protect unsophisticated investors who are unlikely to protect themselves.¹⁰¹ Indeed, the ranks of the relatively unsophisticated often include business entrepreneurs who seek venture-capital financing.¹⁰²

96. See EASTERBROOK & FISCHER, *supra* note 1, at 237 (“The attorney is a specialist provider of information; questions that never occur to the parties have been addressed and solved long ago by others, and attorneys transmit this accumulated expertise.”).

97. Charny, *supra* note 8, at 1872.

98. See O’Neal, *supra* note 21, at 124 (“[E]ven if the participants foresee the possibility of future dissension, they are reluctant to call in and pay the costs of legal counsel to provide against contingencies.”). Not all lawyers have the requisite expertise to help close corporation shareholders negotiate appropriate, tailored provisions. See Judd F. Sneirson, *Soft Paternalism for Close Corporations: Helping Shareholders Help Themselves*, 2008 WIS. L. REV. 899, 916 n.92 (“[S]ome attorneys who do not specialize in business planning may not appreciate the need for [minority shareholder] protections or be able to professionally draft them.”). A lawyer who advises all participants may fail to protect the interests of each participant. Moreover, as sales of self-incorporation books indicate, many corporations are formed without legal advice. See *id.* at 916–17.

99. See EASTERBROOK & FISCHER, *supra* note 1, at 237 (“Investors in close corporations often put a great deal of their wealth at stake, and the lack of diversification (compared with investors in publicly held firms) induces them to take care.”).

100. See Robert A. Ragazzo, *Toward a Delaware Common Law of Closely Held Corporations*, 77 WASH. U. L.Q. 1099, 1109 (1999) (“Holding stock in a closely held corporation, viewed purely as an investment decision, seems almost irrational from an economic perspective.”).

101. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 93 (1989) (“[I]f the majority is more likely to contract around the minority’s preferred default rule (than the minority is to contract around the majority’s rule), then choosing the minority’s default may lead to a larger set of efficient contracts.”). Admittedly, the choice of more protective default rules “involves imposing costs of drafting opt-out agreements on some transactors to protect other transactors who would not have the sophistication or good judgment to insist by contract on the protections that they automatically receive under a more protective regime.” Charny, *supra* note 8, at 1872. However, venture capital firms can reuse previously drafted agreements, thereby reducing the cost.

102. See Jesse M. Fried & Mira Ganor, *Agency Costs of Venture Capitalist Control in Startups*, 81 N.Y.U. L. REV. 967, 975 (2006) (“[W]e doubt that many entrepreneurs are well advised and fully informed when contracting with VCs”); Manuel A. Utset, *Reciprocal*

Nor does it follow that bargained-for protections indicate, by negative implication, that other protections must not have been considered valuable.¹⁰³ Even when the parties do negotiate, certain issues will be easier to anticipate and address, and their relative simplicity bears no obvious relation to their importance. For instance, in many cases “[v]oice matters to minority shareholders not only as a procedural protection, but often as, in itself, a central benefit of the investment.”¹⁰⁴ Yet the closest analogue—a long-term employment agreement—does not fully capture the minority’s interest in having a voice in the business and raises other problems for the controlling shareholders. As one commentator observes, “[I]nvestors in a near-the-margin closely held corporation would be unlikely to grant minority investors a contractually fixed right to continued employment and to a predetermined share of profits.”¹⁰⁵ By contrast, restraints on share alienability designed to limit ownership to agreed members may not be considered critical, yet such restraints are relatively simple to conceive and implement.

Even conceding that irrationality impacts decisionmaking and is not reliably cured by other market forces or by lawyers, some may object that a list of departures from rationality falls short of a theory of behavior.¹⁰⁶ It takes a theory to beat a theory.¹⁰⁷ But behavioral economics demonstrates that cognitive errors are systematic, not random, and bases its observations on a theory of mind. Whether behavioral economics counts as an

Fairness, Strategic Behavior & Venture Survival: A Theory of Venture Capital-Financed Firms, 2002 WIS. L. REV. 45, 100 (“[T]he manner by which an entrepreneur collects and interprets facts about the contractual context, as well as the way that she uses these facts to construct her beliefs and plans, will be affected in significant ways by the tendency of entrepreneurs to be over-optimistic.”).

103. See EASTERBROOK & FISCHER, *supra* note 1, at 238 (rejecting “ignorance” explanation for exclusion of shareholder protections by reference to commonly-included provisions such as “restraints on alienation” of shares).

104. Means, *supra* note 59, at 1213.

105. O’Kelley, *supra* note 2, at 244. The problem with such guarantees is that they “undermine the adaptability of the team and create a risk of minority opportunism in the form of shirking, two problems that efficiency-minded joint owners . . . seek to avoid by choosing corporate form instead of partnership form.” *Id.*

106. See ELSTER, *supra* note 47, at 7 (“In itself, irrationality is just a negative or residual idea, everything that is not rational. For the idea to have any explanatory purchase, we need to appeal to specific forms of irrationality with specific implications for behavior.”); Arlen, *supra* note 48, at 1768 (“[E]ven when people are not rational, behavioral analysis of law cannot necessarily provide an alternative framework for developing normative policy prescriptions because it does not yet have a coherent, robust, tractable model of human behavior which can serve as a basis for such recommendations.”); Adam Benforado & Jon Hanson, *Legal Academic Backlash: The Response of Legal Theorists to Situationist Insights*, 57 EMORY L.J. 1087, 1119 (2008) (“As soon as behavioralism began to gain some traction, many conventional legal economists denigrated the new approach for lacking a single, simple theory that could generate at-the-ready testable behavioral predictions.”).

107. See Posner, *supra* note 20, at 867 (“[One reason that] [e]conomists reject bounded rationality arguments . . . is methodological: They cannot agree on a standard, mathematically tractable formulation of bounded rationality.”). As Posner comments, “This might be a good reason for economists, but it is a bad reason for lawyers.” *Id.*

independent theory because it builds upon and does not wholly reject traditional economic analysis, the evidence cannot simply be ignored.¹⁰⁸

The objection that behavioral economics is too ad hoc to count as theory is further undermined by the tendency of standard law and economics to treat its own assumptions as non-falsifiable.¹⁰⁹ For instance, one commentator dismisses the problem that people fail to plan for their future needs and instead over-indulge current consumption preferences (“hyperbolic discounting”) by postulating that human identity over time is not continuous.¹¹⁰ The present “self” choosing is not the same as the future “self” experiencing the consequences; the present “self” may rationally ignore the interests of that future person, who is a stranger, remote in time and space.¹¹¹ Although the “‘multiple selves’ approach” is convenient (and could even be true), its after-the-fact interpolation diminishes the integrity of rational-choice theory and its pretension to scientific explanation.¹¹² Moreover, if this is what rational choice means, why would we defer to it? To the extent people cannot order their affairs into the future, a society that intends to preserve itself over time must make up for that deficiency.¹¹³

However, a skeptic might also observe that behavioral economics sometimes fails to generate clear predictions.¹¹⁴ If there are multiple cognitive biases, and if those biases sometimes point in different directions, then who can say what role any particular bias may have on behavior?¹¹⁵ Thus, behavioral economics cannot generate determinate answers to most questions. But we do not need to separate each causal factor to understand

108. See William W. Bratton, *The Economic Structure of the Post-Contractual Corporation*, 87 Nw. U. L. REV. 180, 185 (1992) (“The assertion ‘it takes a theory to beat a theory’ is not strictly correct. A theory indeed may beat a theory. Nothing, however, beats a theory like a practice, and reference to practice makes the pure contractual corporation untenable.”).

109. See, e.g., Posner, *supra* note 52, at 1558–59 (asserting superior predictive power of simpler rational-choice model); *id.* at 1560 (“If a theory cannot be falsified, neither it nor its predictions can be validated . . .”).

110. See *id.* at 1555 (“All the selves are rational but they have inconsistent preferences.”).

111. See *id.*

112. This problem also arises when rational choice theorists contend that any supposedly unselfish motivation for choice can be redescribed in terms of the personal utility gained by acting charitably or out of a sense of moral duty. See SEN, *supra* note 18, at 28 (critiquing “complex instrumentality” arguments). It may be true that other-directed conduct serves hedonistic goals, but the assertion that it must do so is impossible to falsify and gives rational choice the ability to swallow any motive.

113. For an interesting argument that contractual commitments extend human identity over time, see JED RUBENFELD, *FREEDOM AND TIME: A THEORY OF CONSTITUTIONAL SELF-GOVERNMENT* (2001).

114. Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 STAN. L. REV. 1471, 1487 (1998) (“A possible objection to our approach is that conventional economics has the advantage of simplicity and parsimony. At least—the objection goes—it provides a theory.”). As the authors concede, “a behavioral perspective offers a more complicated and unruly picture of human behavior, and perhaps that picture will make prediction more difficult, precisely because behavior is more complicated and unruly.” *Id.*

115. See Arlen, *supra* note 48, at 1768; see also ELSTER, *supra* note 47, at 46 (“In general, the social sciences are not very good at explaining how causes interact to produce a joint effect.”). Thus, “[t]he existence of an interaction effect may be subject to the same kind of indeterminacy that we find in mechanisms more generally.” *Id.* at 47.

that, collectively, they push shareholders away from the negotiation that the rational choice model predicts. The multiplicity of causation counsels modesty in our efforts to explain human behavior and only reinforces the need to move past the stylized, rational choice model.¹¹⁶

Still another version of the objection to behavioral economics might argue that if irrationality is part of being human, courts will be as prone to error as shareholders.¹¹⁷ Cognitive errors, however, depend on the actor's situation, and a court will not be subject to the emotional attachments and over-optimism that may lead to a sub-optimal amount of bargaining in close corporations.¹¹⁸ To the contrary, we might worry that judges will succumb to "hindsight bias," treating an event as highly probable or inevitable simply because it actually happened.¹¹⁹ If the eventual dispute appears to have been inevitable, then a court may conclude that the minority shareholder ought to have anticipated it. In any event, it is not enough to claim that judges are imperfect—law and economics scholars must offer some reason to prefer non-ideal contracting to non-ideal judging, a burden they have not met.

Nor does it derail the argument to acknowledge that majority shareholders, who have more invested and more to lose, are also subject to cognitive limitations.¹²⁰ The point is not that a cunning majority dupes a guileless minority into investing without adequate protection—although information disparities and disparate power may sometimes produce that result. Rather, shareholder oppression is a problem because the majority may later be tempted to act opportunistically or, in the event of family or corporate dissension, may wish to punish the minority. When informal, cooperative dynamics falter, corporate law gives the majority the ability to get its way without the need for any substantial minority input, let alone support.

Finally, there is the normative case for rational choice. Despite our many failings, we "want to be rational" and "do not take pride in our lapses from rationality."¹²¹ The behavioral economic critique demonstrates the flaws of rational choice as a predictive theory but "does not, in itself, provide

116. See Hanson & Yosifon, *supra* note 5, at 191 ("It is the *economists* who resist seeing or taking seriously what others are revealing, through the scientific method, about what moves us. And they are doing so based on a theory that has been falsified (or is non-falsifiable) and, which, therefore, is based, at bottom, on an evidence-blind intuition or faith.").

117. See, e.g., Thompson, *supra* note 2, at 391 (noting that in some situations "[i]t may be easier to anticipate, and therefore incorporate into price or otherwise bargain around, the selfish conduct of fiduciaries than to anticipate the conduct of judges and the monitoring and error costs associated with judicial decisions").

118. See Coffee, *supra* note 7, at 1622 ("From its *ex post* perspective, a court can more easily determine if opportunistic advantage has been taken of the minority.").

119. See generally Jeffrey J. Rachlinski, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. CHI. L. REV. 571 (1998).

120. There may well be circumstances where enforcement of the literal terms of an agreement—for instance, opportunistic use by the minority of a buy-sell provision—produce inequitable results for majority shareholders.

121. ELSTER, *supra* note 47, at 164.

grounds for questioning the formulation of rationality.”¹²² However, a more capacious definition of rationality is possible; rather than reduce rationality to the maximization of self-interest, we might, for example, characterize it as the “discipline of subjecting one’s choices—of actions as well as objectives, values and priorities—to reasoned scrutiny.”¹²³ This definition could include within the ambit of rationality socially motivated reasons for choice and choices dictated by a sense of moral duty.¹²⁴ In the close corporation context, those additional considerations might involve a sense of family obligation, honesty, and fairness.¹²⁵

C. *The Limits of Institutional Design*

An advantage of the behavioral economic perspective is that it encourages creative solutions to enable human beings to act in accordance with their own self-interest and to overcome their cognitive limitations.¹²⁶ For example, recognizing that “[a]ctors systematically give too little weight to future benefits and costs as compared to present benefits and costs,”¹²⁷

122. SEN, *supra* note 18, at 29.

123. *Id.* at 4; see also Roger G. Noll & Barry R. Weingast, *Rational Actor Theory, Social Norms, and Policy Implementation: Applications to Administrative Processes and Bureaucratic Culture*, in THE ECONOMIC APPROACH TO POLITICS 237, 237 (Kristen Renwick Monroe ed., 1991) (“The principal alternative [to rational actor theory], the communitarian approach, argues that behavior is driven primarily by commonly shared values . . . which are internal to a society and which have value and meaning . . . within the social context in which behavior takes place.”). Although socially motivated reasons for choice might be described in self-interested terms—for instance, the self-satisfaction one feels after a charitable donation—choice cannot be reduced to those terms without serious loss of meaning. SEN, *supra* note 18, at 26 (“[T]he point is that these broader values are not ruled out on the ground that they lack reason and would be irrational to entertain (unless justified by some underlying complex instrumental connection that makes them selfishly beneficial).”).

124. See SEN, *supra* note 18, at 28 (contending that rational choice theory “has denied room for some important motivations and certain reasons for choice, including some concerns that Adam Smith had seen as parts of standard ‘moral sentiments’ and Immanuel Kant had included among the demands of rationality in social living (in the form of ‘categorical imperatives’).”); see also ELSTER, *supra* note 47, at 227 (“Acting on the categorical imperative is . . . irrational. Rationality tells me to choose as a function of what will happen if I do A rather than B.”). Consequently, to be rational, choices “have to be reinterpreted . . . within the format of intelligent pursuit of self-interest” and “[t]his has given the explanatory role of [rational choice theory] an almost forensic quality, focusing on the detection of hidden instrumentality . . .” SEN, *supra*, at 28. Professor Sen concludes caustically: “[t]hings, it is darkly hinted, are not what they seem (or at least seemed to simple-minded observers like Smith or Kant).” *Id.* at 29.

125. I do not mean to suggest that courts *should* enforce altruistic behavior under the guise of rationality, only that the meaning of rationality need not be artificially constricted so that anything that does not maximize an individual’s self-interest cannot count as rational. The normative desirability of reason should not weigh for or against protection of minority shareholders.

126. See ELSTER, *supra* note 47, at 232 (“If we understand our propensity to make mistakes, we can and do take precautions to make us less likely to make them again, or at least limit the damage if we do.”); THALER & SUNSTEIN, *supra* note 73, at 11–13 (describing goal of choice architecture: “Choosers are human, so designers should make life as easy as possible.”).

127. Eisenberg, *supra* note 44, at 222.

we might automatically enroll employees in a retirement savings plan while allowing them to opt out.¹²⁸ Employees would remain free to decide according to their own preferences, but would receive a “nudge” in what (for the vast majority of people) is the right direction. Because such proposals second-guess individuals’ own choices while leaving them free to make the final decision, Professors Cass Sunstein and Richard Thaler use the label “libertarian-paternalism” to acknowledge the seeming contradiction.¹²⁹ Recently, some scholars have applied these insights to close corporation law.¹³⁰

However, solving the problem of shareholder oppression requires more than a “nudge” for three principal reasons. First, unless there is a clear right answer, we cannot choose helpful default settings. Unlike the obvious and near-universal benefits of tax-deferred savings plans, a rational investment in a close corporation will depend upon the specific circumstances. For instance, some minority shareholders might benefit from mandatory distribution of profits as dividends in order to prevent freeze outs, while others—if they contemplated working for the business—might prefer to negotiate long-term employment contracts with specified salaries.¹³¹ The two strategies could be combined; alternatively, a rational shareholder might prefer to leave corporate managers with maximum flexibility. Since multiple approaches are appropriate in different contexts, what would we “nudge” people to do?¹³²

Second, even if we concluded that certain default rules would benefit minority shareholders, we would have to measure that benefit against potential costs. For instance, a rule requiring the distribution of dividends

128. See THALER & SUNSTEIN, *supra* note 73, at 12.

129. See *id.*, at 4–5.

130. See, e.g., Michael K. Molitor, *Eat Your Vegetables (Or at Least Understand Why You Should): Can Better Warning and Education of Prospective Minority Owners Reduce Oppression in Closely Held Businesses?*, 14 *FORDHAM J. CORP. & FIN. L.* 491, 496 (2009) (contending “that statutes governing both corporations and LLCs should require all owners to read several warnings about the dangers of a lack of advance planning before starting a business . . . [and] that ‘form’ agreements and provisions protecting minority interests should be widely available, either as freely available standard ‘template’ agreements or . . . default provisions in statutes”); Sneirson, *supra* note 98, at 901–02 (“By redesigning state incorporation forms to so ‘nudge’ parties to protect themselves against later minority-shareholder oppression . . . secretaries of state and others can . . . encourage those likely to need such protection to elect it, while allowing more sophisticated incorporators to easily and cheaply opt out.”).

131. See, e.g., *Wilkes v. Springside Nursing Home, Inc.*, 353 N.E. 2d 657, 662 (Mass. 1976) (“A guaranty of employment with the corporation may have been one of the ‘basic reason[s] why a minority owner has invested capital in the firm.’” (quoting Symposium, *The Close Corporation*, 52 *NW. U. L. REV.* 345, 392 (1957))).

132. Professor Sneirson suggests that do-it-yourself manuals should also advise incorporators to enter “shareholder agreements that guarantee the original investors seats on the company’s board, employment with the company, and dividends (perhaps according to a formula).” Sneirson, *supra* note 98, at 928. He is right to counsel that self-help books on incorporation should include discussion of shareholder oppression issues, but it is unclear whether his specific recommendations would improve corporate governance in most close corporations. Mandatory board and employment rules limit a corporation’s flexibility, and dividend requirements limit the ability to commit substantial resources to the business and create a risk of shirking. There are tradeoffs involved, and the optimal mix will vary.

could later hamstring the corporation's ability to reinvest funds, or, in adverse business environments, to retain extra operating capital.¹³³ Additionally, even if advantageous in the abstract, a default rule might need too much tailoring to accomplish its purpose. For instance, if we reasoned that in a world without transaction costs most rational investors would bargain for a right to sell their stock, we might decide to create a default right of exit.¹³⁴ However, one-size-fits-all exit provisions¹³⁵ may only encourage opportunism. If the accompanying valuation mechanism is set too low, it creates an incentive for controlling shareholders to freeze out minority shareholders and force a buy out.¹³⁶ If the valuation is too high or the method of valuation is itself particularly burdensome, the right of exit could encourage minority shareholder opportunism.¹³⁷

Third, it might be objected that even useful default settings cannot substitute for mandatory rules, and that the Sunstein and Thaler model could undermine existing shareholder protections.¹³⁸ For instance, Professor Judd Sneirson uses the model to propose heightened duties owed among shareholders as a default setting, leaving the parties free to reject those responsibilities.¹³⁹ Although the argument presumes that

133. Of course, such issues can be addressed through detailed negotiation and, for some corporations, the benefits of mandatory distribution will outweigh the costs. *See, e.g.*, *Galler v. Galler*, 203 N.E.2d 577 (Ill. 1964) (enforcing shareholder agreement that conditioned payment of annual dividends, inter alia, on maintenance of \$500,000 surplus). The point is that, when any number of policies are equally plausible and highly context dependent, it will be difficult for a benevolent lawmaker, armed with the latest behavioral economic research, to establish a useful default setting.

134. *See, e.g.*, Dalley, *supra* note 1, at 198 (observing without endorsement that "the law might contain default rules similar to those selected by sophisticated investors"); Matheson & Maler, *supra* note 4, at 691.

135. *See Means, supra* note 59, at 1252–54.

136. For example, in *Pedro v. Pedro*, 489 N.W.2d 798 (Minn. Ct. App. 1992), three brothers were shareholders in a close corporation and entered into a stock retirement agreement (SRA) intended to guide the purchase of one shareholder's stock by the others if that shareholder wanted to leave the business or else upon his death. The SRA valued each share of stock at only "75% of net book value at the end of the preceding calendar year," *id.* at 800, and this low valuation may have motivated two of the brothers to fire the third. *See id.* The purchase price dictated by the SRA was \$563,417.67 lower than the fair market value later awarded by the court after finding that the two brothers had acted oppressively. *Id.* at 802.

137. *See O'Kelley, supra* note 2, at 226 (noting that a strong exit right "exposes team members to the risk of loss from opportunistic threats to withdraw").

138. Under existing law, parties may "bargain over structural and distributional rules," but they cannot waive fiduciary duties. *See Eisenberg, supra* note 43, at 1469.

139. Sneirson contends that "[w]ith a few simple changes, states' (typically) one-page incorporation forms can be made to encourage protection for those minority shareholders most likely to need it without imposing on those shareholders and businesses most likely not to need it." Sneirson, *supra* note 98, at 901. Incorporators would have to "opt out if they do not want to owe one another heightened . . . fiduciary duties." *Id.* at 919–20. For a related argument that courts should enforce fiduciary norms as default terms, see Charny, *supra* note 8, at 1872:

Occasions for opportunistic distribution of gains from the enterprise arise in an enormous array of situations that may be difficult to anticipate via contract terms. Given the complexity of the requisite provisions, it would seem to be substantially

shareholders systematically depart from rational choice—which is why they need a “nudge”—it does not explain how the default rule would reduce the likelihood of cognitive error.¹⁴⁰ Unless some level of protection is mandatory, trusting and optimistic shareholders may be induced to abandon it at the outset of the venture.¹⁴¹ On the other hand, courts routinely enforce unwise contractual bargains, and an explicit decision to waive certain protections is not an oversight; it is a specific choice.¹⁴²

In sum, we can perhaps ameliorate—but cannot hope to solve—the problem of shareholder oppression by changing default rules. The next part further establishes the need for a strong judicial monitoring role to remedy shareholder oppression by explaining why, even if shareholders were entirely rational in a formal, economic sense, it would be unrealistic to expect them to bargain in advance for protection against all variants of opportunism.

III. ACCOUNTING FOR INCOMPLETE BARGAINS AND SOCIAL NORMS

The contractarian objection to shareholder oppression doctrine posits that rational shareholders bargain for necessary protections before investing in a

cheaper to imply a strong set of background duties and permit individual transactors to draft opt out provisions.

140. Cf. Eisenberg, *supra* note 43, at 1469 (“[B]argains to relax materially the fiduciary rules set by law would likely be systematically underinformed even over the short term.”). Thus, “[a]ny such waiver would therefore inevitably permit unanticipated opportunistic behavior.” *Id.* at 1470.

141. See Bernard S. Black, *Is Corporate Law Trivial? A Political and Economic Analysis*, 84 NW. U. L. REV. 542, 572 (1990) (“[G]iving close corporations the power to dispense with the duty of loyalty would be troublesome.”). Although Professor Black favors enabling rules that parties can modify, he acknowledges that “[t]he casebooks are full of situations where . . . trust proved to be misplaced” in close corporations. *Id.* Consequently, “a fully enabling regime may be inefficient.” *Id.* at 573. Absent mandatory protection, the “instances of abuse will likely increase.” *Id.* at 572. Similarly, Professor Coffee contends that some fiduciary norms should be mandatory and that any permitted “departures from the default rules of fiduciary duty must be sufficiently specific and bounded to permit the departure to be accurately priced.” Coffee, *supra* note 7, at 1624.

142. Courts, of course, may demand clear evidence that a choice to waive fiduciary protection has been made. Recent Delaware case law suggests that courts will not lightly find a waiver. Under Delaware’s LLC law, as amended in 2004, LLC members may choose to eliminate all fiduciary duties. DEL. CODE ANN. tit. 6, § 18-1101 (2005). For such a waiver to be enforceable, however, the Delaware courts have required that it be unmistakably clear. See, e.g., *Bay Ctr. Apartments Owner, LLC v. Emery Bay PKI, LLC*, No. 3658, 2009 WL 1124451, at *9 (Del. Ch. Apr. 20, 2009) (“[T]he interpretive scales also tip in favor of preserving fiduciary duties under the rule that the drafters of chartering documents must make their intent to eliminate fiduciary duties plain and unambiguous.”) (citations omitted). To the extent that honoring the parties’ decision to waive fiduciary duties leads to wealth-reducing outcomes, then autonomy and welfare conflict, and law and economics scholars have to justify why we should care about rational choice. However, as discussed *infra* Part V, this Article contends that the covenant of good faith and fair dealing implied in every contract gives courts a powerful tool for addressing shareholder oppression disputes consistent with a robust view of private ordering. In addition, courts can reject bargains that are unconscionable. See Seana Valentine Shiffrin, *Paternalism, Unconscionability Doctrine, and Accommodation*, 29 PHIL. & PUB. AFF. 205, 221–23 (2000) (arguing that the doctrine of unconscionability does not require paternalism, because the enforcement of contracts involves community standards that are not within the power of the parties to alter).

close corporation.¹⁴³ Yet, even if we made the heroic assumption that shareholders are rational actors and immune to cognitive biases, transaction costs would prevent complete bargaining.¹⁴⁴ Therefore, according to law and economics scholars, investors save time and money by selecting the form of business organization that supplies the most suitable general terms. Those terms then become part of the contractual bargain,¹⁴⁵ while unsuitable ones are jettisoned or modified.¹⁴⁶ In a shareholder dispute, then, courts should treat the background rules of corporate law as part of the parties' agreement.¹⁴⁷ If courts must supplement the bargain, they should aim to supply for the parties what they "would have bargained for had they anticipated the problems and been able to transact costlessly in advance."¹⁴⁸

This part contends that the standard law and economics response to incomplete bargaining is inadequate, because it attaches too little importance to courts as gap-filling mechanisms. First, background corporate law rules govern all types of corporations and may be unsuitable for close corporations.¹⁴⁹ Also, a business form may be selected for tax planning purposes or other reasons unrelated to governance.¹⁵⁰ Because transaction costs apply to the modification of default rules as well as to drafting contracts *ab initio*, we cannot simply assume that the parties will be able to afford the cost of bargaining around problematic default rules.

Second, because corporate governance rules allocate the right to make future decisions to the board of directors, which is elected by a majority of

143. See Thompson, *supra* note 2, at 392 ("A close corporation provides more direct opportunity for specific private ordering because there exists no large-numbers problem that can lead to free rider questions or rational apathy.")

144. See, e.g., Charny, *supra* note 8, at 1819 ("In almost all transactions, it would be extremely costly to draft a contract that purported explicitly to address the obligations of the parties for all conceivable future contingencies."); Goetz & Scott, *supra* note 45, at 1090 (same); Posner, *supra* note 20, at 833 ("A theoretically complete contract would describe all the possible contingencies, but transaction costs—including the cost of negotiating and writing down the terms—and foreseeing low-probability events, render all contracts incomplete.")

145. See, e.g., Larry E. Ribstein, *Why Corporations?*, 1 BERKELEY BUS. L.J. 183 (2004).

146. See Goetz & Scott, *supra* note 45, at 1090 ("If the basic risk allocation provided by a legal rule fails to suit the purposes of particular parties, then bargainers are free to negotiate an alternative allocation of risks.")

147. See O'Kelley, *supra* note 2, at 216 ("If consensus is not possible, then the close corporation contract's gap-filling processes will come into play."). O'Kelley states that "[t]he close corporation contract assigns primary gap-filling authority to majority shareholders . . ." *Id.* This authority includes the ability to "discharge a minority shareholder from the corporation's employ" as well as "policies concerning payment of dividends, redemption of shares, or compensation of shareholder-employees." *Id.* at 216 n.2. The contract leaves only "secondary, discretionary gap-filling authority to courts." *Id.* at 216.

148. EASTERBROOK & FISCHER, *supra* note 1, at 34.

149. See, e.g., DOUGLAS K. MOLL & ROBERT A. RAGAZZO, *THE LAW OF CLOSELY HELD CORPORATIONS* 1-1 (2009) ("[S]hareholders in closely held corporations often expect to run their businesses in ways that differ dramatically from traditional corporation norms—norms that are generally designed to serve the needs of publicly held corporations.")

150. LLCs are an increasingly popular choice of form because firms can readily "adopt corporate-type terms such as free transferability, perpetual life, and centralized management without subjecting themselves to the corporate double tax . . ." RIBSTEIN, *supra* note 10, at 131.

the shares eligible to vote, even a matter entirely outside the contemplation of the parties at the time of investment would not fall into a contractual gap. This adaptive capacity is a virtue of corporate law but seems to leave little room for courts to protect minority shareholders from oppression at the hands of the majority. If courts adopted the narrow view of their role that law and economics scholars advocate, rational parties would be forced to mistrust corporate law's sensible, if rough, control rules and add layers of costly negotiation.¹⁵¹

Third, trust and social bonds are hallmarks of the closely held business, and rational shareholders may choose not to bargain at arm's length when doing so could endanger the social norms that drive the business.¹⁵² Judicial monitoring, in short, deserves to be a primary—not merely secondary—response to the problem of transaction costs.

A. *Transaction Costs and Gap Filling*

Corporations have an unlimited lifespan, and shareholders cannot practicably bargain for a fully specified, long-term contract.¹⁵³ Thus, economically rational investors will often prefer to live with an incomplete bargain, addressing problems later, if and when they arise.¹⁵⁴ To the extent the parties rationally choose to leave some questions unanswered, however, the gap-filling mechanisms they select (or that the law supplies) become an important part of their agreement.¹⁵⁵

151. See Charny, *supra* note 8, at 1820 (“Correlatively, once the parties know that the law will supply the term, they take that into account when calculating the benefits of drafting an express term. Parties will not incur the costs of specifying the term if they suspect that courts will supply the appropriate term in any event.”); Coffee, *supra* note 7, at 1621 (“In drafting the corporate contract, lawyers rely less on the model form provided by legislature than on their expectation that courts will prevent either side from taking ‘opportunistic’ advantage of the other.”).

152. See ARIELY, *supra* note 49, at 78–83 (observing that some businesses have sought to foster social, rather than purely market relationships with their employees and, even, with their customers). Ariely contends that “[i]f corporations started thinking in terms of social norms, they would realize that these norms build loyalty and—more important—make people want to extend themselves to the degree that corporations need today: to be flexible, concerned, and willing to pitch in.” *Id.* at 83. As Ariely concludes, “That’s what a social relationship delivers.” *Id.* Whether it is rational for close corporation shareholders to rely on social norms instead of arm’s-length negotiation depends in part on whether courts can be expected to take an active role in monitoring disputes.

153. See BOLTON & DEWATRIPONT, *supra* note 26, at 36 (“[M]ost long-term contracts in practice are incomplete, in that they do not deal explicitly with all possible contingencies and leave many decisions . . . to be determined later.”) (emphasis omitted).

154. See O’Kelley, *supra* note 2, at 216 (“Viewed contractually, the typical closely held corporation is mostly gaps.”); see generally Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 *ECONOMETRICA* 755 (1988).

155. See Oliver E. Williamson, *Transaction Cost Economics*, in *FOUNDATIONS OF CORPORATE LAW* 12, 13 (Roberta Romano ed., 1993) (“Although it is instructive and a great analytical convenience to assume that agents have the capacity to engage in comprehensive *ex ante* contracting . . . the condition of bounded rationality precludes this.”). Consequently, “[t]he study of structures that facilitate gap filling, dispute resolution, adaptation, and the like . . . become part of the problem of economic organization.” *Id.*

According to law and economics scholars, rational investors meet the problem of incomplete bargaining first and foremost by adopting the form of business organization that best suits their needs.¹⁵⁶ There are, after all, partnerships, limited partnerships, corporations, and LLCs, each with different governance rules.¹⁵⁷ Distinct business forms reduce transaction costs by providing sets of coherent principles against which any further explicit bargaining can take place.¹⁵⁸ In particular, different forms of business organization allocate the right to make decisions in the future.¹⁵⁹ By incorporating, investors give majority shareholders substantially unfettered discretion to decide questions that have not been negotiated *ex ante*.¹⁶⁰ Finally, and solely as a residual matter, law and economics scholars contend that the role of efficiency-minded courts is to supply the contract terms that economically rational parties would have chosen under conditions of frictionless bargaining.¹⁶¹

Unfortunately, choice-of-form analysis does not solve the problem of incomplete bargaining. Unless we assume that a perfect choice exists for each prospective business, the most we can conclude is that the form selected by investors was, all things considered, better than the alternatives.¹⁶² Any choice may have significant drawbacks, and

156. *See, e.g.*, Ribstein, *supra* note 145. For a seminal work on transaction-cost economics and the theory of the firm, see R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937), reprinted in RONALD H. COASE, *THE FIRM THE MARKET AND THE LAW* 33 (1988).

157. For instance, partnership law provides a default rule for equal participation in decisionmaking, regardless of the relative amounts contributed to the enterprise. *See* UNIFORM PARTNERSHIP ACT §§ 202(a), 401(f) & (j) (1997). Investors may also choose to be governed by the laws of any jurisdiction, regardless of where they intend to operate the business.

158. *See, e.g.*, RIBSTEIN, *supra* note 10, at 2 (“[F]irms may lack the resources to deal expertly with multidimensional long-term contracting problems. The availability of sets of default rules that fill the contracting gaps can be critical to these firms’ success.”).

159. *See* Posner, *supra* note 20, at 858 (noting that economic models of incomplete contracts “predict that contracts will contain descriptions not of ‘physical’ contingencies but of the bargaining procedures that parties must follow at the time of performance”).

160. *See* BAINBRIDGE, *supra* note 1, at 242. Of course, to the extent a particular jurisdiction offers a statutory or common law remedy for oppression, even if that provision is inconsistent with other corporate law rules, the thorough-going contractarian must concede that it is appropriate to apply that remedy, since the parties could have chosen to incorporate elsewhere. *See generally* Ribstein, *supra* note 19.

161. *See, e.g.*, EASTERBROOK & FISCHER, *supra* note 1, at 34 (“Corporate law—and in particular the fiduciary principle enforced by courts—fills in the blanks . . . with the terms that people would have bargained for had they anticipated the problems and been able to transact costlessly in advance.”); Coffee, *supra* note 7, at 1622 (“Under this approach, the parties will be deemed *ex post* to have consented *ex ante* to the term that would have been most rational for them to specify; in short, rationality implies consent.”); Juliet P. Kostritsky, *Taxonomy for Justifying Legal Intervention in an Imperfect World: What To Do When Parties Have Not Achieved Bargains or Have Drafted Incomplete Contracts*, 2004 *WIS. L. REV.* 323, 342 (noting that the theory of transaction-cost economics holds that “courts should supply default rules that mimic what ‘similarly situated’ parties would have consented to absent transaction costs”).

162. *See* O’Kelley, *supra* note 2, at 218–19 (contending that logical choice-of-form decisions, at least for decisions based on internal governance needs, can be arrayed along a continuum from sole proprietorships to corporations depending on the need for adaptability and concerns about opportunism). Indeed, one scholar contends that “the close corporation

transaction costs limit the parties' ability to rectify problems to the extent that the parties are even aware of them.¹⁶³ Thus, ordinary corporate law rules may not resemble what the parties would actually have negotiated for themselves.¹⁶⁴ Indeed, substantial contrary evidence may exist concerning what the parties intended.¹⁶⁵

Nor will courts uphold the parties' bargain by imposing the economically rational terms that hypothetical investors might have wanted. First, the choice-of-form theory leaves little room for judicial gap filling of any kind; unmodified default rules are taken to embody the parties' preferences.¹⁶⁶ Second, even if the court identifies gaps in the explicit bargain, inserting hypothetical terms based on economic theory may not reflect the parties' actual understanding of their relationship.¹⁶⁷ In fact, the assumption "that rational parties would agree ex ante on whatever provision maximized value, even if the resulting gains were to be unequally distributed," is highly implausible.¹⁶⁸ As Professor John Coffee explains, "Nothing that we know about the real world suggests that individuals are actually so risk neutral as to behave in a fashion that is indifferent to the distribution of gains and losses."¹⁶⁹ Moreover, in a close corporation, shareholders "typically invest their human capital along with their financial capital" so that "corporate decisions will affect the shareholders' wealth other than through the value of the stock (which is difficult to determine in any event)."¹⁷⁰ Consequently, we have little reason to expect shareholders to "agree that the corporation should maximize firm value without regard to risk or to the value of the shareholders' other assets."¹⁷¹

Although the hypothetical contract approach purports to advance the parties' own autonomy interests by helping them to avoid economically

was an evolutionary dead end because the corporate form could not be a satisfactory vehicle for closely held firms." RIBSTEIN, *supra* note 10, at 102.

163. See BECKER, *supra* note 50, at 7 ("The assumption that information is often seriously incomplete because it is costly to acquire is used in the economic approach to explain the same kind of behavior that is explained by irrational and volatile behavior . . . in other discussions.").

164. See George S. Geis, *Economics as Context for Contract Law*, 75 U. CHI. L. REV. 569, 597–98 (2008).

165. For example, in one fairly typical case the evidence indicated that, despite the background rule of at-will employment, the plaintiff "utilized his own funds . . . not simply as an investment, but to provide employment and a future for himself." *In re Dissolution of Wiedy's Furniture Clearance Ctr. Co.*, 487 N.Y.S.2d 901, 903 (App. Div. 1985).

166. See Coffee, *supra* note 7, at 1625 (observing that the hypothetical contract gap-filling methodology requires "an omitted term" and yet, because corporate law establishes a "governance mechanism," "the corporate contract may appear complete on its face"). In the context of shareholder oppression, the default governance mechanism—majority rule—is precisely the problem.

167. See Bratton, *supra* note 108, at 192 ("Hypothetical contract is a welfare norm asserted by an academic. It is not a transactional artifact.").

168. See Coffee, *supra* note 7, at 1623.

169. *Id.* A court that focused only on overall wealth maximization "would ignore important issues of distributive fairness." *Id.*

170. Ronald J. Gilson, *Separation and the Function of Corporation Law*, 2 BERKELEY BUS. L.J. 141, 149 (2005).

171. *Id.*

irrational outcomes,¹⁷² it actually gets no closer to the parties' real bargain than does the blanket imposition of fiduciary duties drawn from partnership law. In assuming either that close corporation shareholders embrace partnership norms of behavior or instead that shareholders are driven to maximize wealth, a court is applying an "untailored" rule most people would supposedly choose, according to one or another theory, rather than seeking the "tailored" rule that the parties involved in the dispute would actually have wanted.¹⁷³ We have no solid empirical basis for concluding that one approach better captures the preferences of close corporation shareholders than the other.

As discussed *infra* in Part V, courts should instead seek to enforce the parties' actual expectations, using equitable contract principles to evaluate available evidence concerning the parties' bargain.¹⁷⁴ Encouragingly, this seems to be the approach many courts follow, even when they describe the relevant duties in fiduciary terms.¹⁷⁵ These courts' analyses begin with the corporation's articles of incorporation, by-laws, and any supplemental written shareholder agreements but encompass all material evidence of the parties' understood bargain.¹⁷⁶ The question of intent "is no trivial matter, as a great virtue of contract law lies in its flexibility and in the freedom of parties to make their own private laws."¹⁷⁷ Moreover, courts can potentially reduce overall transaction costs by deterring opportunism, thus

172. Cf. JEAN-JACQUES ROUSSEAU, *THE SOCIAL CONTRACT* 27 (G.D.H. Cole trans., Prometheus Books 1988) (1761) (arguing that liberty is not diminished by the social contract, even though "whoever refuses to obey the general will shall be compelled to do so"). According to Rousseau, "This means nothing less than that he will be forced to be free . . ." *Id.* Although a man loses "his natural liberty" through the social contract, he acquires "moral liberty, which alone makes him truly master of himself; for the mere impulse of appetite is slavery, while obedience to a law which we prescribe to ourselves is liberty." *Id.* at 27–28. Economic rationality might be viewed as such a law. The relationship of rationality and freedom is deeply contested. See generally SEN, *supra* note 18. For sharp criticism of Rousseau's position, see generally ISAIAH BERLIN, *Two Concepts of Liberty*, in LIBERTY 166 (Henry Hardy ed., 2002).

173. See BAINBRIDGE, *supra* note 1, at 30 (distinguishing majoritarian default rules from tailored default rules); Ayres & Gertner, *supra* note 101, at 91 (same).

174. Professor Coffee argues that default rules should be established to force greater actual bargaining. See Coffee, *supra* note 7, at 1623 ("The rationale for such a 'coercive' default rule is that it forces those possessing private information to disclose it to the market—and hence results in more accurate pricing."). While Coffee is right to observe that "hypothetical bargaining is inferior to actual bargaining," see *id.*, penalty default rules may be difficult to impose in close corporations, where shareholders often fail to bargain even when it would be economically rational to do so.

175. See, e.g., McLaughlin v. Schenck, 220 P.3d 146 (Utah 2009) (holding that termination of shareholder employee did not violate the majority's fiduciary duty, because the employee's stock holdings "were not inextricably tied to his employment; they were a separate investment in the company"); Merola v. Exergen Corp., 668 N.E.2d 351, 354 (Mass. 1996) (holding that, despite strong fiduciary duties, "there was no evidence that . . . stockholders had expectations of continuing employment because they purchased stock").

176. See MOLL & RAGAZZO, *supra* note 149, § 7.01[D], at 7-68 to 7-70 (identifying key factors).

177. Geis, *supra* note 164, at 597–98 (observing that, in addition to efficiency justifications, intent is considered "fundamental to most philosophical arguments for upholding promises").

encouraging small corporate ventures that might be stifled if the participants were forced to engage in expensive, protracted negotiations beforehand.¹⁷⁸

B. *The Power of Social Norms*

In addition to transaction costs that render the notion of complete contracting fictional, courts should also account for the bargain-limiting but socially beneficial phenomenon of interpersonal trust.¹⁷⁹ If we believe that our fellow investors will treat us fairly regardless of whether they have a clearly defined legal obligation to do so, it may seem unnecessary to bargain carefully against future opportunism.¹⁸⁰ Trust facilitates business relationships. In a sense, social norms represent the sunny side of non-rational choice.¹⁸¹

When participants in a business enterprise feel personally invested, moreover, they show more loyalty and the willingness “to extend themselves to the degree that corporations need today: to be flexible, concerned, and willing to pitch in.”¹⁸² If “[t]hat’s what a social relationship delivers,”¹⁸³ then courts should be cautious about enforcing the logic of market transactions to such an extent that all considerations of trust among the parties become irrelevant.

Even when market norms work adequately as motivation, they may be less efficient than social norms: “Money, as it turns out, is very often the most expensive way to motivate people.”¹⁸⁴ As one commentator observes, “It’s remarkable how much work companies (particularly start-ups) can get out of people when social norms (such as the excitement of building something together) are stronger than market norms (such as salaries stepping up with each promotion).”¹⁸⁵ This is not to suggest that a close

178. See Coffee, *supra* note 7, at 1624 (“[I]n the absence of certain judicially administered mandatory terms, such as a duty of good faith, the costs of contracting would be vastly increased, uncertainty would reign and litigation would become more likely.”); O’Kelley, *supra* note 2, at 247 (“[R]ational investors might predict that courts will exercise their equitable gap-filling powers to provide optimal governance rules to the parties *ex post*, thereby making *ex ante* contracting unnecessary.”).

179. EASTERBROOK & FISCHER, *supra* note 1, at 229 (“The bond between parents and children, for example, constrains conflicts of interest.”). Trust can substitute for more expensive contracting but “[i]t is . . . no accident that some of the famous cases dealing with closely held corporations involve situations where these informal bonds have broken down as a result of death, divorce, or retirement of the patriarch.” *Id.* at 229–30.

180. Elinor Ostrom, *Collective Action and the Evolution of Social Norms*, 14 J. ECON. PERSP. 137, 139 (2000) (“A substantial gap exists between the theoretical prediction that self-interested individuals will have extreme difficulty in coordinating collective action and the reality that such cooperative behavior is widespread, although far from inevitable.”).

181. See Blair & Stout, *supra* note 11, at 1760 (“Trust . . . can provide a motivation for players in a social dilemma to choose the optimal, cooperative outcome over the individually rational but suboptimal solution.”).

182. ARIELY, *supra* note 49, at 83.

183. *Id.*

184. *Id.* at 86; EASTERBROOK & FISCHER, *supra* note 1, at 229 (observing that “familial or other personal relations” typical of close corporations “reduce[] agency problems”).

185. ARIELY, *supra* note 49, at 83.

corporation is or should be a non-market institution but simply a reminder that “[s]ocial norms are not only cheaper, but often more effective as well.”¹⁸⁶

If we value social norms, requiring shareholders to bargain for protection at their peril is not a recipe for preserving those norms.¹⁸⁷ Indeed, in a business context, “to trust someone is to lower one’s guard, to refrain from taking precautions against an interaction partner, even when the other, because of opportunism or incompetence, could act in a way that might seem to justify precautions.”¹⁸⁸ Under standard economic analysis, trust is irrational, and yet personal relationships among shareholders are critical to the success of the enterprise, lowering the cost of doing business.¹⁸⁹

By relying on trust rather than bargained-for protection, shareholders may even seek “to induce trustworthiness.”¹⁹⁰ Assuming certain protections are feasible and not ruled out by transaction costs, a minority shareholder might nevertheless choose to do without those protections so that the other participants would understand that the relationship is one founded on trust.¹⁹¹ Experimental results indicate that this strategy works best when the other party is aware “that one has refrained from taking precautions that one might have taken.”¹⁹² This may in part explain why dissension occurs so often in the second or third generation, long after the founders have retired; trust may not be as transferable as stock.¹⁹³

186. *Id.* at 86. For an argument that trust may be valuable because untrustworthy people assume others are like them and will therefore avoid closely held businesses, see Blair & Stout, *supra* note 11, at 1804. Of course, even if this is true, the next generation of owners will not benefit. *See id.* (contending that conflict “can be explained as a consequence of the fact that while the original founders of a closely held firm are subject to selective pressures that favor trust . . . their heirs and successors are not”).

187. See Thompson, *supra* note 2, at 395 (“Too much emphasis on the possible failure of the business is inconsistent with the positive effort necessary to establish the enterprise . . .”); *see also* Blair & Stout, *supra* note 11, at 1806 (“Suppose a potential business partner shows up armed with a lawyer and a ten-page contract loaded with fine print. What does that behavior suggest?”).

188. ELSTER, *supra* note 47, at 344 (emphasis omitted).

189. See Krishnan S. Chittur, *Resolving Close Corporation Conflicts: A Fresh Approach*, 10 HARV. J.L. & PUB. POL’Y 129, 130–31 (1987) (stating that investors “incorporate with minimal fanfare, expecting that any subsequently discovered problem will be resolved amicably and reasonably”); *see also* MANFRED F.R. KETS DE VRIES & RANDEL S. CARLOCK WITH ELIZABETH FLORENT-TREACY, FAMILY BUSINESS ON THE COUCH: A PSYCHOLOGICAL PERSPECTIVE 55 (2007):

Many successful family businesses see such trust as a core organizational value, and design flexible organization structures to exploit it. Conversely, publicly-traded firms with short management tenures, especially at the top, often build structures that assume *distrust*, and design defensive controls to protect against self-serving behavior and conflicts of interest.

190. ELSTER, *supra* note 47, at 346 (emphasis omitted) (further observing that “[t]he idea of taking precautions might be incompatible with the agent’s emotional attitude toward the other person”).

191. See Blair & Stout, *supra* note 11, at 1805 (“The phenomenon of trust behavior suggests . . . that sometimes participants in closely held corporations may deliberately choose not to draft formal contracts, even when they could do so.”).

192. ELSTER, *supra* note 47, at 350.

193. Blair & Stout, *supra* note 11, at 1804–05. The implications are debatable. Perhaps the minority shareholder who consciously adopts a trust strategy should have no legal

The social norm of trust operates in a “relational construct” and “cannot be explained in terms of simple economic rationality.”¹⁹⁴ For standard law and economics, reliance on social norms makes sense only when transaction costs bar any other option.¹⁹⁵ For instance, if the parties thought that a court would be likely to misconstrue their bargain in the minority’s favor, and if it were difficult for the majority to price this risk, the parties might prefer to live with the possibility of opportunism.¹⁹⁶ Even so, the minority would eschew judicial protection only where private ordering and other market or reputational constraints offered a reasonable substitute.¹⁹⁷

Although irrational from the perspective of standard law and economics, trust can have powerful benefits. Consider, for instance, the classic prisoner’s dilemma, in which two prisoners are isolated, and each prisoner is given the choice of implicating the other prisoner or staying silent.¹⁹⁸ The best coordinated decision would be to remain silent, but self-interest indicates that each prisoner should point the finger and hope that the other prisoner is foolish enough to stay silent:

If the prisoners pursue their own individual self-interest “rationally,” they will end up with the worst possible outcome for both of them. But they also can trust each other enough to accept the risk of retreating from their own immediate interest in favor of a common solution that will benefit

recourse if it works out poorly. Indeed, if we assume participants understand the law, background legal protection would seem to undermine the deliberate vulnerability that can encourage trustworthiness. Or we might draw a more modest conclusion: since conspicuous displays of trust can have a positive impact, and since intimate groups live on trust, we should hesitate before holding close corporation shareholders to the requirements of pure market rationality.

194. Michel Crozier, *The Relational Boundaries of Rationality*, in *THE ECONOMIC APPROACH TO POLITICS* 306, 308 (Kristen Renwick Monroe ed., 1991). We learn to trust each other over time, as when business participants have a pre-existing relationship. *Id.* at 307 (“I trust John because over time I built a relationship that is strong enough for each of us to know the other will live up to his word.”).

195. Yet law and economics scholars have recognized that social relationships can reduce agency costs. *See* EASTERBROOK & FISCHER, *supra* note 1, at 229 (“Participants in closely held corporations frequently have familial or other personal relations in addition to their business dealings. The continuous and nonpecuniary nature of these relationships reduces agency problems.”).

196. *See* *Jordan v. Duff & Phelps, Inc.*, 815 F.2d 429, 448 (7th Cir. 1987) (Posner, J., dissenting). Of course, this assumes that the risk of opportunism can be valued more accurately than the risk of judicial error, a dubious assumption. *See* Thompson, *supra* note 2, at 402 (“[I]t seems unlikely that the parties would have agreed that, upon the occurrence of any disagreement, the majority shareholders would have the right to exclude the minority. That right could not have been effectively priced by the minority at the beginning . . .”).

197. *See* Thompson, *supra* note 2, at 402 (arguing in favor of mandatory rule that waiver of fiduciary protections is irrational because “there are no other alternative checks” on majority opportunism).

198. *See* Peter Kollock, *Social Dilemmas: The Anatomy of Cooperation*, 24 *ANN. REV. SOC.* 183, 186 (1998) (“What defines the Prisoner’s Dilemma is the relative value of the four outcomes. The best possible outcome is defecting while one’s partner cooperates The next best outcome is mutual cooperation . . . followed by mutual defection . . . , with the worst outcome being the case in which one cooperates while one’s partner defects . . .”).

each of them. The key variable in that case is trust. If there is no possibility of communication, trust does not make any sense rationally.¹⁹⁹

In addition to its instrumental value in overcoming problems of collective irrationality, trust is also an attitude toward life. The standard law and economics perspective leaves out the nonconsequential motivations that individuals may have for their behavior.²⁰⁰ Although “[m]uch of economic behavior is purely consequentialist,”²⁰¹ investing a substantial proportion of one’s time and wealth in a close corporation may be about means as well as ends.²⁰² If close corporation shareholders intend to make money but also wish to participate with friends and family in a meaningful business venture, a rational choice account of the investment decision will be incomplete and misleading.²⁰³

To summarize, even if law and economics scholars were right to assume that investors approximate the rational choice model when selecting the corporate form and in negotiating their rights before investing, there would still be a substantial role for judicial monitoring. Shareholder oppression doctrine reduces the need for expensive ex ante bargaining, allowing the participants to proceed with an incomplete agreement. Finally, by reducing the need for hardnosed bargaining, laws that protect shareholders from opportunism facilitate an atmosphere of trust.

IV. WHY CONTRACT THEORY JUSTIFIES SHAREHOLDER PROTECTION

This part contends that contract theory, properly understood, offers the best rationale for minority shareholder protection in close corporations. Importantly, the “you made your bed” version of contract invoked by law and economics does not actually exist—and for good reason.²⁰⁴ Since at

199. Crozier, *supra* note 194, at 307. Of course, close corporations lack the formal structure of the prisoners’ dilemma because coordination is possible—indeed, the contractarian objection emphasizes that shareholders ought to negotiate before investing. The point is simply that, to the extent that a corporation can operate more efficiently if the parties have a high degree of trust in one another, individually rational self-protection at each stage of a corporation’s operation could lead to the collectively undesirable result of a hobbled corporate enterprise.

200. ELSTER, *supra* note 47, at 81 (stating that “motivations may be consequentialist or nonconsequentialist, that is, oriented either toward the outcome of action or toward the action itself”).

201. *Id.* (“When people put aside money for their old age or stockbrokers buy and sell shares, they attach no intrinsic value—positive or negative—to these actions themselves; they care only about the outcomes.”).

202. By contrast, standard economic analysis assumes in every situation that “[r]ational individuals invest their . . . capital with a view to maximizing the value of such resources.” O’Kelley, *supra* note 2, at 220.

203. Arguably, the shareholders’ goals can be described in consequential terms, even if they are non-monetary, but this still understates the extent to which social norms motivate behavior. See ELSTER, *supra* note 47, at 83 (describing social norms as “a further special case of nonconsequentialist behavior”).

204. Some law and economics scholars argue that contract law should shed its equitable trappings, but that is a much broader discussion. It will suffice to observe here that the contractarian critique of shareholder oppression doctrine is inconsistent with modern contract law. For general criticism of the proposed revival of formalism in contract analysis,

least the nineteenth century merger of law and equity, courts have placed equitable limits on the substance of contract²⁰⁵ and have taken a substantial ex post role in interpreting contract terms: “judicial determination of the contractual obligation serves as a fallback mechanism for vindicating the parties’ intent whenever a court determines that the formal contract terms fall seriously short of achieving the parties’ purposes.”²⁰⁶

Part V.A contends that the close corporation bargain creates a long-term relationship that may be broader and more nuanced than the terms that have been reduced to writing.²⁰⁷ Part V.B argues that contract law’s implied covenant of good faith and fair dealing explains shareholder oppression doctrine more convincingly than the fiduciary approach courts often claim to follow. Part V.C shows that recent innovations in LLC law do not reduce the need for equitable oversight of investor bargains, either in the close corporation or the LLC context.

A. *The Close Corporation as Relational Contract*

In a “relational contract,” the parties intend to formalize a relationship rather than commit to a discrete transaction.²⁰⁸ Thus, “[a] contract is

see Shawn J. Bayern, *Rational Ignorance, Rational Closed-Mindedness, and Modern Economic Formalism in Contract Law*, 97 CALIF. L. REV. 943 (2009).

205. For instance, courts refuse to enforce liquidated damages provisions that provide for recovery exceeding actual damages. Jody S. Kraus & Robert E. Scott, *Contract Design and the Structure of Contractual Intent*, 84 N.Y.U. L. REV. 1023, 1043–44 (2009) (describing “the penalty doctrine” and other equitable limitations to common law contract doctrine, including “equitable exceptions to the parol evidence rule” and a “part-performance exception to the Statute of Frauds”).

206. *Id.* at 1025. Professors Kraus and Scott dislike this “judicial insurance policy against formal contract terms” because they contend that sophisticated parties may prefer to limit the scope of judicial interpretation, and enforcing the parties’ “ends” can interfere with the enforcement of their selected “means.” *Id.* at 1025–27 (“Sometimes the only way to maintain fidelity to the parties’ contractual intent is to enforce the formal contract terms to which they agreed, even when doing so defeats their contractual ends.”). Assuming that some parties make a rational tradeoff between litigation costs and opportunism, however, it blinkers reality to assume that all “firms organized in corporate form with five or more employees” count as “sophisticated economic actors.” *Id.* at 1026 n.6 (citing Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 545 (2003)). Also, because controlling shareholders can usually protect themselves without the assistance of a court, the risk of opportunism falls disproportionately on the minority shareholders. Before we assume that close corporation shareholders may have intended their “means” to trump their “ends,” we should recall that they are situated differently: controlling shareholders would receive most of the benefits of the tradeoff and minority shareholders would bear most of the costs.

207. *See, e.g., In re Topper*, 433 N.Y.S.2d 359, 365 (Sup. Ct. 1980) (observing that in close corporations “[t]he parties’ full understanding may not even be in writing but may have to be construed from their actions”).

208. For foundational work in relational contract theory, see Ian R. Macneil, *Contracts: Adjustments of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854 (1978); *see also* Eisenberg, *supra* note 55, at 816 (defining the relational contract concept: “What is especially striking about the numerous efforts to define relational contracts . . . is that a straightforward definition . . . is readily at hand. The obvious definition of a relational contract is a contract that involves not merely an exchange, but also a relationship, between the contracting parties.”). Professor Eisenberg contends that what is needed, however, is not a special doctrine of relational

relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations.”²⁰⁹ Indeed, even though the parties to a relational contract may anticipate certain issues, they will often be unable to resolve those issues in advance.²¹⁰ Typically, relational contracts involve long-term arrangements, “but temporal extension per se is not the defining characteristic.”²¹¹

Close corporations are quintessential relational contracts.²¹² The founding shareholders negotiate a long-term, open-ended relationship with each other for the general purpose of operating a profitable business. Moreover, shareholder relations are often bolstered by preexisting business or family connections.²¹³ No matter how cogent their business plan, the parties will need to remain involved and flexible, because the needs of the business will evolve over time.²¹⁴ Some potential problems cannot be solved in advance without creating new ones. For instance, even if the parties anticipate the possibility of shareholder dissension, specific contract provisions cannot supplant the role of good faith; the minority might opportunistically exploit strong exit rights or veto powers. Yet without those rights, the majority can use its control to disadvantage the minority.²¹⁵

Although few law and economics scholars would deny that close corporation governance is “relational,” the law and economics model leaves no room for an evolving, flexible bargain governed more by good faith than by specific contract terms.²¹⁶ Rather, law and economics theory builds upon a vision of contract “as ‘nothing more than a sale with a time lag . . . distributing risk.’”²¹⁷ In a discrete exchange, the parties owe no

contract but a greater appreciation of relational aspects that impact the interpretation of any contract. *See id.* at 817.

209. Goetz & Scott, *supra* note 45, at 1091.

210. *See id.* (“[D]efinitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance.”). Thus, relational contract theory “borders closely on the field of transaction-cost economics.” Coffee, *supra* note 7, at 1619 n.5.

211. Goetz & Scott, *supra* note 45, at 1091.

212. Moll, *supra* note 32, at 756 (“[T]he investment bargains entered into by close corporation shareholders reflect the characteristics of relational contracts.”).

213. *See, e.g.*, Ian R. Macneil, *The Many Futures of Contract*, 47 S. CAL. L. REV. 691, 751 (1974) (observing that “the creation of a new joint enterprise, such as a business partnership or close corporation, is normally preceded by other business relations giving rise to a willingness to go into a deeper relation”).

214. Moll, note 32, at 756 (“[T]he very nature of employment and management bargains requires the ongoing personal involvement of the parties.”).

215. As I have previously argued, the possibility of shareholder oppression is a seemingly unavoidable consequence of the informal, efficient operation of a close corporation. *See Means, supra* note 59, at 1209. Courts have sought to provide ex post relief to minority shareholders where appropriate without undermining the ex ante flexibility that makes the close corporation form attractive. *See id.*

216. As discussed *supra* Part IV, standard law and economics assumes that rational investors will address contractual incompleteness through the choice of business form and selective tailoring of default rules.

217. Ian R. Macneil, *Economic Analysis of Contractual Relations: Its Shortfalls and the Need for a “Rich Classificatory Apparatus”*, 75 NW. U. L. REV. 1018, 1020 (1981) (citation omitted); Joo, *supra* note 41, at 805 (“In corporations theory, though not in contract theory,

duties prior to contract, and all duties are specified in the contract.²¹⁸ By presupposing an arm's-length bargain, standard law and economics misses much of what matters in corporate governance arrangements.²¹⁹ Consequently, viewing corporate governance through the lens of standard law and economics contract theory produces a distorted and incomplete picture. Because a corporate venture is a relationship more than it is a discrete bargain, courts properly turn to equitable principles when necessary to honor the parties' intent and to prevent opportunistic abuse of the contractual relationship.²²⁰

To be clear, the argument advanced here is not that relational contract constitutes a distinct legal category or that special rules of contract interpretation should apply. Rather, relational contract theory suggests an approach to the interpretation of all contracts, focusing on matters that receive little or no attention under standard economic analysis.²²¹ In particular, as discussed in the next two sections, a relational contract approach helps us to see why agreements governing shareholder relationships are highly vulnerable to opportunistic exploitation and to identify equitable aspects of contract theory that explain and justify the judicial protection of the parties' reasonable expectations.

1. Shareholder Oppression as Opportunism

A literal bargain of any complexity can be exploited opportunistically—think of all the tales involving genies, lamps, and wishes gone awry—and equitable considerations inform every contractual relationship.²²² Indeed, the careful judicial response to the problem of minority shareholder oppression in close corporations can be understood as an application of equitable contracting principles.²²³ The implied covenant of good faith and

the battle over the terrain of 'contract' is essentially over. The free-market . . . connotations of CONTRACT . . . have taken firm root . . .").

218. Macneil, *supra* note 217, at 1019.

219. For instance, in a close corporation, shareholders are unlikely to draft a new contract to reflect every alteration of the business relationship. *See* Moll, *supra* note 32, at 760 ("Under the relational theory, the parties expect that the terms of their relationship will evolve. There is no need for formalities to validate new practices in order to make those practices part of the contract.") (citation omitted).

220. *See* JOHN D. CALAMARI & JOSEPH M. PERILLO, *THE LAW OF CONTRACTS* § 3.13, at 155–56 (4th ed. 1998).

221. To the extent all contracts are more relational than they are discrete, the norms of relational contracting may entirely occupy the field. *See* Eisenberg, *supra* note 55, at 817 (arguing that no legally significant distinction between relational and discrete contracts is possible, and that separate legal rules are unnecessary because "relational contracts and contracts are virtually one and the same"). If this is a slippery slope, the end result seems desirable.

222. *See, e.g.,* Kraus & Scott, *supra* note 205, at 1025 ("Honoring the contractual intent of the parties is the central objective of contract law.").

223. *See* Eisenberg, *supra* note 55, at 809–10 ("Because the objective of contract law should be to further the interests of the contracting parties, the rules of contract law must often be formulated so that their application will turn on the particular circumstances of the parties' transactions and, in certain cases, on the parties' subjective intentions.").

fair dealing fills in gaps in the parties' agreement and limits their ability to exploit control provisions in unforeseen circumstances.²²⁴

The covenant can be stated plainly: if the literal terms of a contract allow one party to do something that the other party clearly would not have countenanced if consulted in advance, then the conduct at issue is bad-faith opportunism.²²⁵ For instance, a majority's argument that the default rules of corporate law give it the power to decide all questions concerning dividends and employment should not, without more, dispose of a specific shareholder oppression claim brought by a minority shareholder who has been denied any financial return on her investment. Minority shareholder oppression, therefore, can be understood as nothing more than a special case of the opportunistic conduct courts police in all contracts.²²⁶

Even staunch defenders of the bargain-for-it-if-you-want-it approach to shareholder rights in close corporations acknowledge that "[t]he problem of distinguishing legitimate exercise of contract rights from opportunistic behavior is pervasive in the law of contracts."²²⁷ This admission matters because it shows that contract analysis requires more than a parsing of written terms. Courts can view shareholder disputes in contractual terms without any overlay of fiduciary duty and still protect minority shareholders from abusive overreaching by the majority.

224. For an argument emphasizing a need for constraints on contracting, see Thompson, *supra* note 2, at 394 ("A close corporation is like a long-term relational contract in which benefits for all parties necessarily depend on unstated assumptions. A fully contingent contract cannot be drafted, so some *ex post* settling up by courts is used to support these assumptions."). Professor Thompson contends that mandatory rules are necessary "[t]o the extent that corporate law is the intersection of a variety of relational contracts which reflect expectations that cannot be specified in distinct transactions." *Id.* at 387. Thus, he concludes that "[t]here are times when law does not and should not yield to private ordering, either because of third party effects or because of distrust of the bargain between the parties." *Id.* at 379.

225. See, e.g., *Katz v. Oak Indus., Inc.*, 508 A.2d 873, 880 (Del. Ch. 1986). Professor Ribstein adds that opportunistic conduct takes "selfish advantage" of "the literal terms of the contract" and "gaps or costs of the legal system." RIBSTEIN, *supra* note 10, at 17. For further definitions of "opportunism," see *supra* note 12.

226. See MOLL & RAGAZZO, *supra* note 149, § 7.01[E], at 7-131 (stating that the "tension between (1) enforcing a contract as written, and (2) construing a contract to prohibit opportunistic conduct, is present in a number of oppression disputes."). To the extent some law and economics scholars have acknowledged the complexity of shareholder bargains and intermittent need for judicial monitoring, the relational-contract theory provides a context for those concessions. See, e.g., Bratton, *supra* note 108, at 192 (contending that even in the canonical work of the contractarian movement, Judge Easterbrook and Professor Fischel "avoid modeling internal relationships in the discrete transactional terms that prevail in neoclassical microeconomic analyses of corporate arrangements" and instead implicitly adopt "the relational contract paradigm").

227. See EASTERBROOK & FISCHEL, *supra* note 1, at 248 n.29. Under an earlier, more formalistic model of contract, objective intent ruled and considerations of good faith would have been irrelevant. See Smith & King, *supra* note 80, at 5-7 (contrasting classical and neoclassical contract theory). Both versions of contract law "rely heavily on a stylized image of exchange involving two roughly equal parties." *Id.* at 7.

Judicial gap filling has its limits, of course, because litigation costs money and time, and courts cannot always ascertain the parties' intent.²²⁸ Whether a party is enjoying the benefit of its bargain or behaving opportunistically may not always be clear. Consequently, there may be many cases where minority shareholders decide that litigation is not feasible or where no recourse will be available. Nevertheless, an imperfect remedy for minority shareholders is better than none at all.²²⁹

2. Reasonable Expectations in a Relational Contract

As a descriptive account, the relational contract perspective, unlike the standard law and economics alternative, offers a coherent explanation of shareholder oppression doctrine.²³⁰ In a growing number of jurisdictions, courts evaluate claims of oppression by asking whether the majority has deprived the minority of the objectively reasonable expectations that motivated its investment.²³¹ In other words, has the majority abused its control so as to deprive the minority of the benefit of its bargain?

Conduct that is contrary to the reasonable expectations of the parties will also run afoul of the implied covenant of good faith and fair dealing implied in every contract. This has an important practical consequence: rather than

228. For instance, courts must decide whether silence on a point reflects an intention to exclude or simply a lack of attention: "A missing term likely means that the parties did not want it, but it *could* mean that they were ignorant . . ." EASTERBROOK & FISCHER, *supra* note 1, at 238. It may also be difficult to see how the parties intended their negotiated provisions to interact with background rules of law. See Larry Ribstein, *Contracting for Termination of an LLC*, IDEOBLOG (Dec. 22, 2009, 5:29 AM), <http://busmovie.typepad.com/ideoblog/2009/12/contracting-for-termination-of-an-llc.html>.

The problem with the [oppression] remedy is that it may be hard to square with the contract. After all, the whole reason for the remedy is that the contract does *not* provide for exit, yet the court is providing one. One might say that the parties in effect adopted the statutory default rules, including the oppression remedy. But it still may not be clear how the parties wanted those defaults to fit with their agreement.

Id. (citation omitted).

229. If law and economics scholars could show that the overall cost of judicial involvement in close corporation business disputes outweighs its benefits, then perhaps "penalty default" rules that force minority shareholders to bargain at their peril would be appropriate. See Ayres & Gertner, *supra* note 101, at 93 ("If it is costly for the courts to determine what the parties would have wanted, it may be efficient to choose a default rule that induces the parties to contract explicitly."). As discussed *supra* Part II, however, close corporation shareholders systematically fail to bargain in advance to protect their interests. A penalty default approach would have harsh consequences for existing shareholders and only a hazy, speculative impact on future parties.

230. Cf. Posner, *supra* note 20, at 863 (stating that, given the inability of economic models to predict behavior, "we are left with a sterile normative defense of freedom of contract"). In particular, "the premise of full rationality does not seem right, for it predicts contractual structures that bear little resemblance to the contracts designed by real parties." *Id.* Thus contracts may be incomplete both because of "the cost of negotiating and writing" the agreement and because of "cognitive limits of the parties, which include the inability to foresee future events and maybe something more." *Id.* at 866.

231. See Matheson & Maler, *supra* note 4, at 679. Admittedly, we may have difficulty determining what is objectively reasonable when some but not all aspects of the agreement have been reduced to writing.

arguing across a seemingly unbridgeable chasm between those who would offer special protections for minority shareholders and those who would not, we can focus instead on the meaning of “good faith” and other well-accepted equitable contract principles.²³² However we may choose to define good faith, the use of contract interpretation principles to inform reasonable expectations analysis rebuts the contractarian objection that those who would protect minority shareholders are simply making it up as they go along.²³³

Thus, the equation of oppression doctrine and equitable contract analysis clarifies that while the reasonable expectations standard requires courts to exercise judgment—based on careful analysis of the parties’ overall relationship—it does not invite courts to create a different set of rights and obligations for the parties than those they intended to assume. A minority shareholder’s expectations reflect the parties’ objective intentions both at the time of investment and as the relationship has evolved over time.²³⁴ Equitable contract analysis permits courts to recognize and enforce the parties’ “true” bargain, even if it lacks the definiteness that contract law doctrine might require in the context of a discrete exchange.²³⁵ Some flexibility is critical if courts are to identify and redress oppression; at the same time, it is fundamental to contract law that a court “may not substitute its own notions of fairness for the terms of the agreement reached by the parties.”²³⁶

Another advantage of equitable contract theory is that it helps explain why minority investors should not be permitted to insist upon their “expectations” without also holding up their end of the bargain. As some commentators have observed, reasonable expectations analysis can mislead courts into believing that only minority expectations count.²³⁷ For example,

232. See Coffee, *supra* note 7, at 1654–55 (discussing various definitions and concluding that “it may be easier to define ‘bad faith’ than ‘good faith’”).

233. See, e.g., Ribstein, *supra* note 1, at 955 (describing shareholder oppression remedies as a “wild card” that creates costly uncertainty for parties to closely held firms”). In previous work, I have expressed concern that “reasonable expectations” analysis, without some guiding principle, may be circular. See Means, *supra* note 59, at 1227. However, the problem of circularity can be alleviated by offering “a deeper theory of shareholder rights and obligations.” *Id.* Contract theory is useful in this respect.

234. To the extent some jurisdictions may exclude post-investment expectations, they should reconsider that stance. See Moll, *supra* note 32, at 720 (“A strict time of investment standard . . . seems to ignore the possibility that post-investment expectations may arise.”).

235. Professor Douglas Moll is right to observe that “[a]lthough both oppression precedents and contract precedents base their decisions on breached ‘agreements’ and ‘understandings’ between the parties, it is clear that different meanings are ascribed to these terms.” Moll, *supra* note 4, at 1066. Professor Moll concludes, however, that “it is fair to assert that oppression law is doing what contract law should be doing if contract law took a broader perspective when identifying and enforcing bargains.” *Id.* at 1073. As described in this Article, a relational theory of contract takes that “broader perspective.”

236. See *Lola Cars Int’l Ltd. v. Krohn Racing, LLC*, Nos. 4479, 4886, 2009 WL 4052681, at *8 (Del. Ch. Nov. 12, 2009).

237. See Robert C. Art, *Shareholder Rights and Remedies in Close Corporations: Oppression, Fiduciary Duties, and Reasonable Expectations*, 28 J. CORP. L. 371, 398 (2003) (contending that “the focus on the minority’s expectations rather than on the majority’s duties tends to subvert the principle of majority rule in corporate governance and to penalize

in a case where a minority shareholder (who was also an employee) had assaulted another employee and damaged a customer's personal property, a court found that terminating the shareholder's employment somehow violated his reasonable expectations.²³⁸ In another case, a court found in favor of the minority shareholder and stated baldly that "[w]hether the controlling shareholders discharged petitioner for cause or in their good business judgment is irrelevant."²³⁹ If courts used equitable contract principles to define "reasonable expectations," the difference between a shareholder's conditional expectation of employment and rights owed by virtue of shareholder status would be clear.²⁴⁰ Under contract analysis, employment is not an absolute right; unclean hands should bar equitable relief.²⁴¹ Put differently, it is not reasonable to expect continued employment when egregious cause exists for termination.

Some might object that contract theory cannot explain shareholder oppression doctrine because of the time inconsistency of shareholder investment. Indeed, the corporation may include "shareholders who have made no investment" and "who receive their shares as gifts or inheritances."²⁴² For those shareholders, there is no bargained-for investment decision. Moreover, even if some change to the previous shareholder relationship were contemplated, "a modification under contract law requires additional consideration to be enforceable."²⁴³ If equitable contract analysis covered only first generation investors and offered no insight into reasonable expectations among close corporation shareholders who invested or inherited shares anytime after formation, contract theory would fail to account for the judicial protection of minority shareholders.

However, the rights of post-founding investors and even those who take their shares as a gift or an inheritance can be clarified by analysis of the parties' understood bargain. First, it is worth underscoring that reasonable

conduct of the majority even when justified"); Moll, *supra* note 92, at 806-07 (identifying a "pure minority perspective" that ignores evidence of "[a] minority shareholder's misconduct or incompetence in his job" if the plaintiff can show that there was a "basic understanding of employment").

238. See *Pooley v. Mankato Iron & Metal, Inc.*, 513 N.W.2d 834, 838 (Minn. Ct. App. 1994); see also *Leslie v. Boston Software Collaborative, Inc.*, No. 010268BLS, 2002 WL 532605, at *8 (Mass. Super. Ct. Feb. 12, 2002) (finding that plaintiff "was hardly a model employee" but that his termination was not justified because, "as a founder and a nearly one-third minority shareholder, he was entitled to the utmost good faith and fair dealing"). The plaintiff's termination followed an e-mail message interpreted by the defendants as a threat of violence. *Id.* at *4.

239. *In re Topper*, 433 N.Y.S.2d 359, 362 (Sup. Ct. 1980). For further criticism of this decision, see Art, *supra* note 237, at 396-97; Moll, *supra* note 92, at 767-69.

240. Cf. Art, *supra* note 237, at 417-18 (assuming flaws in reasonable expectations approach and contending that courts should instead use fiduciary analysis to identify oppression).

241. See E. ALLAN FARNSWORTH, 3 FARNSWORTH ON CONTRACTS § 12.4, at 164-65 (3d ed. 2004) (listing "equity's colorful maxims" embodying the equitable restrictions, including "one who comes into equity must come with clean hands").

242. Moll, *supra* note 32, at 720.

243. *Id.* at 751-52 (citing JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS § 5-14, at 262 (3d ed. 1987)).

expectations analysis does not give courts an open-ended license to meddle in a corporation's internal affairs in order to produce a "fairer" result; non-investing minority shareholders cannot claim an entitlement to valuable rights they never bargained for and that are not conveyed by shareholder status alone. For instance, the fact that an original shareholder worked for the business does not guarantee employment for his heirs, who may be incompetent, disinterested, or both. Thus, the lack of remedy available for some types of claims may be a virtue of the contractual approach.²⁴⁴

Second, because contributions to small corporate enterprises are often "team specific," meaning that resources committed to the business cannot be moved elsewhere without substantial loss of value,²⁴⁵ it would seem plausible to treat those contributions over time as the equivalent of other forms of bargained-for consideration. For instance, if a second generation shareholder spent her entire adult life working for the corporation, and profits were distributed substantially through salary, the fact that she did not pay for her shares initially should not preclude an argument that she had a reasonable expectation of continued employment based on an understood bargain among the shareholders without which she would not have contributed her labor. The issue should be whether the evidence supports her claim despite the lack of an explicit employment agreement, not whether contract law permits her to make the argument.²⁴⁶

Finally, although contract theory illuminates shareholder oppression law, corporations are only metaphorically contractual.²⁴⁷ If specific contract law doctrines make no sense in the context of close corporations, they should be jettisoned. Moreover, the centrality of contract values to shareholder oppression analysis does not negate the existence of other important values.²⁴⁸ For instance, there may be circumstances in which legitimate and important business purposes should take priority over the minority's otherwise reasonable expectations. Likewise, there may be cases where the majority has abused its control as part of a scheme to freeze out the minority, even though the minority had no enforceable expectation concerning the particular matter at issue. On the whole, though, equitable

244. See, e.g., *Whitehorn v. Whitehorn Farms, Inc.*, 195 P.3d 836, 842 (Mont. 2008) (holding that plaintiff shareholder had no reasonable expectation of dividends because he received his shares as a gift, and the corporation had no history of paying dividends).

245. See Blair & Stout, *supra* note 11, at 1755 (noting that "contracting difficulties can discourage investment in team production, especially when invested resources become 'team specific,' so that team members cannot walk away from the project without losing some of the value of their investment").

246. Professor Moll discusses an analogous case where a shareholder investor does not expect employment at the time capital is contributed—unlike his fellow investors—but that expectation alters in the first months of the venture. As Professor Moll points out, it would seem anomalous to allow the other shareholders to terminate his employment years later, despite the "near-equivalence of the minority shareholders' situations." Moll, *supra* note 32, at 719.

247. See Joo, *supra* note 41, at 805.

248. For further discussion of value pluralism and shareholder oppression law, see Benjamin Means, *The Vacuity of Wilkes*, 32 W. NEW ENG. L. REV. (forthcoming 2011) (draft on file with author).

contract theory sets forth appropriate contours for shareholder oppression law.

B. A Modest Role for Fiduciary Duties

Some commentators contend not just that contract analysis has limits but also that it is an unhelpful way of framing the corporate relationship. These commentators assert that strong fiduciary duties, akin to those owed by partners—which go further than the basic loyalty and care provisions applicable to corporate managers—are needed in order to protect minority shareholders from oppression at the hands of controlling shareholders.²⁴⁹ On this view, no plausible interpretation of the parties' actual bargain can substitute for mandatory duties that enforce an appropriate code of conduct.²⁵⁰

Yet, the objection to contractual analysis assumes a narrow version of contract based on a classical model of discrete exchange.²⁵¹ If contract analysis had no ability to respond to the problems posed by relational contract and required us to reject all judicial monitoring of the parties' relationship as "neo-Marxist" meddling,²⁵² then we would have a clear choice to make between contract and fiduciary duty analysis.²⁵³ However, if contract law is understood to include a strong obligation of good faith and fair dealing, and if courts can use that obligation to fill gaps in the parties'

249. See, e.g., Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization Through Alphabet Soup to Contract as Deity*, 14 *FORDHAM J. CORP. & FIN. L.* 445, 470 (2009) ("In short, to rely on the contractual duty of good faith as a substitute for fiduciary duty is akin to replacing heavy cream with skim milk."); Sandra K. Miller, *The Role of the Court in Balancing Contractual Freedom with the Need for Mandatory Constraints on Opportunistic and Abusive Conduct in the LLC*, 152 *U. PA. L. REV.* 1609 (2004) (contending that fiduciary obligations are the key to preventing freeze outs in LLCs and that contractual duty of good faith is not an adequate substitute).

250. See Kleinberger, *supra* note 249, at 469 ("History suggests that contractual good faith and fiduciary duty are not functional equivalents; they developed independently to serve different values."). Professor Kleinberger contends that "[p]roperly understood, the contractual duty is ancillary and subservient to the contractual arrangements." *Id.* Thus, good faith's "function is to allow the contract to mean what it says; it is therefore of no use to police misconduct that is outside the contract." *Id.* at 469–70. However, what is within the scope of the parties' agreement is itself subject to interpretation, so the distinction between contractual and extra-contractual duties may be less crisp than Professor Kleinberger's argument seems to assume.

251. See, e.g., Reza Dibadj, *The Misguided Transformation of Loyalty Into Contract*, 41 *TULSA L. REV.* 451, 452 (2006) (arguing in context of unincorporated business associations against "trying to replace an established duty of loyalty with weak and nebulous notions of good faith"). Professor Dibadj contends that good faith analysis "deploys outworn economic concepts reminiscent of the neoclassical Chicago School . . . based on facile assumptions applied in a static manner." *Id.* Professor Dibadj rejects the possibility of a more "sophisticated contract theory" and does not consider the relational-contract approach recommended here. *Id.* at 463–64.

252. See Dalley, *supra* note 1, at 222.

253. This assumes, of course, that we could agree on the meaning of fiduciary duty. See, e.g., Deborah A. DeMott, *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 1988 *DUKE L.J.* 879, 879 ("Fiduciary obligation is one of the most elusive concepts in Anglo-American law."); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 *VAND. L. REV.* 1399, 1400 (2002) ("Fiduciary law is messy.")

contract consistent with the parties' reasonable expectations, then fiduciary duties can be confined for the most part to the traditional duty of loyalty owed by directors and controlling shareholders in all corporations.²⁵⁴

Once we recognize that contract analysis has an equitable component, “[f]iduciary and good faith duties may be difficult to distinguish in practice.”²⁵⁵ This is especially true for a contract governing a long-term relationship, because so much depends on good faith performance by the parties in situations that cannot be fully anticipated in advance. Taken seriously, the duty of good faith gives courts ample ability to regulate shareholder relationships. One court explained, in the context of a limited partnership:

If in each contract the parties had to expressly describe and prohibit every artifice by which the parties could potentially deprive each other of the fruits of their agreement, then contracts would soon become as long as the tax code, as difficult to interpret, and (like the tax code) still contain innumerable loopholes available to a party that wished to avoid the spirit of its bargain.²⁵⁶

The court concluded that it is preferable “to treat a contract for what it is—an exchange of solemn promises—and enforce the objectively reasonable expectations of the parties.”²⁵⁷

In fact, a relational contract model may sometimes afford minority shareholders *greater* protection than would a fiduciary alternative. For instance, “[w]hen directors consider a dividend policy, they are not

254. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). In exercising control, shareholder directors are subject to “usual fiduciary duties in acting on behalf of the corporation.” Dalley, *supra* note 1, at 212. Some may object that a move away from a stronger conception of fiduciary duty represents “a significant dilution of fiduciary duty as an aspirational precept to guide the conduct of corporate power holders in favor of rules protecting Holmes’s ‘bad man’ from unintentionally incurring liability.” Lawrence E. Mitchell, *The Death of Fiduciary Duty in Close Corporations*, 138 U. PA. L. REV. 1675, 1681–82 (1990) (quoting Justice Oliver Wendell Holmes, Jr., *The Path of the Law*, 10 HARV. L. REV. 457, 461 (1897)). However, this gives too little attention to the duty of good faith. Whether or not good faith is an “aspirational” concept, it precludes parties from acting opportunistically while also recognizing the fact that parties need to know what the law requires in order to comply with it.

255. LARRY E. RIBSTEIN & JEFFREY M. LIPSHAW, *UNINCORPORATED BUSINESS ENTITIES* 219 (4th ed. 2009).

256. *Or. RSA No. 6, Inc. v. Castle Rock Cellular of Or. Ltd. P’ship*, 840 F. Supp. 770, 776 (D. Or. 1993), *aff’d in part and rev’d in part*, 76 F.3d 1003 (9th Cir. 1996); see also Eisenberg, *supra* note 43, at 1465 (“Because of the difficulty of predicting and planning for future events and their impact on a business enterprise, an opportunistic shareholder who controls one or more aspects of a closely held corporation will often find ways to exploit bargained-out structural and distributional rules that seemed both fair and complete at the time of the bargain.”).

257. *Castle Rock Cellular*, 840 F. Supp. at 776. As the Chief Justice of the Delaware Supreme Court recently argued in the context of LLC law, courts are perfectly capable of enforcing the parties’ true bargain and curbing opportunism through a contractual analysis. See Myron T. Steele, *Freedom of Contract and Default Contractual Duties in Delaware Limited Partnerships and Limited Liability Companies*, 46 AM. BUS. L.J. 221, 232 (2009) (“[A]ny ‘bad acting’ will be ferreted out by the parties’ bargain and the implied covenant of good faith and fair dealing.”).

‘interested’ because their interest is no different from that of the other stockholders, even if some or all of the directors have personal situations that lead them to prefer one policy over another.”²⁵⁸ Because the minority shareholders cannot allege a violation of the duty of loyalty, the managers’ decision will be protected by the business judgment rule, and there will be no recourse for the minority. To the extent that the parties’ investment bargain included a particular policy with respect to dividends, however, a shareholder could conceivably establish a contract-based claim.²⁵⁹ Moreover, there is no question that relational contract duties are owed to the contracting parties. With respect to fiduciary duty, “it is not clear whether the duty is owed to the other stockholders directly or whether it is owed to the corporation and only derivatively benefits the minority stockholder.”²⁶⁰

In a recent decision involving alleged breaches of fiduciary duty in a close corporation, Delaware Chancellor William Chandler remarked upon the absence of any claims for breach of contract.²⁶¹ The minority shareholder, eBay, had bargained for certain protections (including cumulative voting, which guaranteed it the ability to elect one member of the three-person board of directors) in connection with its investment in craigslist.²⁶² When it became clear that the parties’ longer-term goals were not aligned, eBay exercised its contractual rights to launch a competing venture.²⁶³ Craigslist’s controlling shareholder responded by taking steps to ensure, among other things, that eBay would no longer be able to elect a representative to craigslist’s board of directors.²⁶⁴ eBay argued that the controlling shareholders had breached their fiduciary duty, and Chancellor Chandler observed that

[t]hroughout this dispute, I have repeatedly read and listened to what look and sound like breach of contract arguments, which eBay uses not to prove [that the controlling shareholders] breached a contract, but rather to prove [that they] breached their fiduciary duties. This has been an odd

258. Dalley, *supra* note 1, at 217; *see also* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720–21 (Del. 1971) (distinguishing dividend policy established by controlling shareholder that included minority shareholders and was therefore protected by the business judgment rule and dealings with subsidiary that allegedly transferred assets to another subsidiary wholly owned by the controlling shareholder, thus excluding the minority from a proportional share of the return).

259. This is not to say that the evidence would often support a claim, but only that the business judgment rule would not effectively bar it.

260. Dalley, *supra* note 1, at 179.

261. eBay Domestic Holdings, Inc. v. Newmark, No. 3705, 2010 WL 3516473, at *18 (Del. Ch. Sept. 9, 2010).

262. *Id.* at *5. Pursuant to the parties’ agreement, craigslist enacted a “new charter [that] provides for a three-person board of directors to be elected under a cumulative voting regime. The mechanics of cumulative voting ensured that eBay could use its 28.4% stake in craigslist to unilaterally elect one of the three members to the craigslist board.” *Id.*

263. *Id.* at *6 (“[T]he Shareholders’ Agreement does expressly and unequivocally permit eBay to compete but guarantees certain consequences should eBay do so.”). Loss of cumulative voting rights is not one of the specified consequences, however. *See id.*

264. *Id.* at *12 (noting that the controlling shareholders sought to identify “capital structure or corporate governance changes that . . . would make it impossible for eBay to place a director on the board and would limit eBay’s ability to purchase additional craigslist shares”).

exercise, and I admit I am puzzled by eBay's decision not to bring a breach of contract claim or, more promising perhaps, a claim for breach of the implied covenant, considering eBay expended significant effort arguing that the 2008 Board Actions violated both the technical provisions and the spirit of the [Stock Purchase Agreement] and the Shareholders' Agreement.²⁶⁵

Ultimately, craigslist's controlling shareholders succeeded in blocking eBay's ability to appoint a board member by amending craigslist's charter to create a staggered board. For eBay's cumulative-voting right to matter, all three members of the board must stand for election at the same time. By altering the voting rules such that only one director would be elected each year, the controlling shareholders ensured that eBay would never have the voting power to elect a director. Arguably, this maneuver was not in good faith, given the parties' explicit contractual bargain. But eBay did not allege any contractual violation, and so the court did not formally resolve the issue.²⁶⁶

Admittedly, fiduciary duties borrowed from partnership law could be applied expansively to require the operating majority to exercise control in the interest of the minority.²⁶⁷ This would address the problem of minority shareholder oppression quite effectively but would also defeat the purpose of acquiring control and contradict the basic majoritarian premise of corporate law.²⁶⁸ As the Chief Judge of the Delaware Supreme Court has observed, "The danger in applying default fiduciary duties is that, rather than determining the ex ante intent of the parties as contemplated by their agreement, a court might be wooed by plaintiffs' fiduciary duty claims and accept their proposal to apply an ex post fiduciary duty analysis."²⁶⁹ If applied expansively, a fiduciary norm of selflessness would conflict with a shareholder's basic right of "selfish ownership."²⁷⁰

265. *Id.* at *18.

266. It should be noted, however, that the court expressed considerable skepticism about the merits of such an argument, since eBay's right to compete caused its bargained-for protections to elapse, and one of these protections was "the contractual right . . . to consent to any charter amendment that would 'adversely affect [] [eBay].'" *Id.* at *26. The court opined that "the Staggered Board Amendments cannot be inequitable because they were exactly the sort of consequence eBay accepted would occur if eBay decided to compete with craigslist." *Id.*

267. *See* *Walta v. Gallegos Law Firm, P.C.*, 40 P.3d 449, 457 (N.M. Ct. App. 2001) ("[R]ecognizing the fiduciary nature of a relationship does not give it content in any given context."). If one wanted to apply a strong version of fiduciary duty, there is in traditional fiduciary law a normative requirement of "selflessness" that goes far beyond the requirements imposed upon parties to an ordinary contract. *See* *Coffee*, *supra* note 7, at 1658 ("The traditional fiduciary ethic insists that the fiduciary act selflessly."). Thus, "a contracting party may seek to advance his own interests in good faith while a fiduciary may not . . ." *Id.*

268. Also, fiduciary duty analysis could inhibit the parties' ability to create a bargain that suits their particular needs. *See* *Coffee*, *supra* note 7, at 1625 ("The problem with traditional fiduciary theory is its hostility to all forms of contractual innovation."). Equitable contract analysis works with the parties' bargain.

269. *Steele*, *supra* note 257, at 236.

270. *Brodie v. Jordan*, 857 N.E.2d 1076, 1080 (Mass. 2006) (noting tension and holding that courts should strike a "proper balance between the majority's 'concede[d] . . . rights to

In our efforts to remedy minority shareholder oppression, we should remember also that the default rules of partnership law create different but not necessarily lesser dangers of opportunism:

Partnership form . . . exposes majority partners to two risks: the risk that a minority partner will extort unfair changes in team rules by opportunistically threatening to dissolve the partnership and the risk that a minority partner will shirk, content in the belief that the majority will be unwilling to expel her for fear that a court might label the resulting dissolution wrongful.²⁷¹

Strong fiduciary principles that impede majority control expose corporations to attempts by minority investors to rewrite the rules in their own favor.²⁷² Also, fiduciary standards, if interpreted too broadly, may stand in the way of the parties' actual bargain.²⁷³ Accordingly, the argument that close corporations should be treated as if they were partnerships is unpersuasive.²⁷⁴ General corporate fiduciary duties imposed on corporate managers and on controlling shareholders to prevent theft of corporate opportunities and other property of the business offer important protection to minority investors, but equitable contract theory provides surer footing for shareholder oppression law.

C. LLCs and the Choice-of-Form Objection

The relatively recent LLC form of business organization offers substantial advantages for privately owned businesses.²⁷⁵ No longer must investors choose between the management and exit rights of partnership law on the one hand and the limited liability of the corporate form on the other; the LLC provides the attractive aspects of both on a default basis.²⁷⁶ Also, for investors concerned about unclear fiduciary norms, the LLC's more explicitly contract-oriented format may be preferable.²⁷⁷

what has been termed 'selfish ownership,' and the minority's reasonable expectations of benefit from its shares.") (internal citation omitted).

271. O'Kelley, *supra* note 2, at 238.

272. For an application of fiduciary duty to a minority shareholder who wielded veto power, see *Smith v. Atlantic Props., Inc.*, 422 N.E.2d 798 (Mass. 1981).

273. See Goetz & Scott, *supra* note 45, at 1127 ("Rather than deriving its justification from the terms of the contract itself, [the fiduciary obligation] is imposed as a condition of the relationship, irrespective of efforts by individual bargainers to negotiate an alternative standard.").

274. It may be that the strong notion of selfless conduct lacks coherence, even in the partnership context, except perhaps as an articulation of norms of fair dealing. See RIBSTEIN, *supra* note 10, at 171 (arguing that appropriate results in partnership disputes can be achieved through "a marginal constraint on selfish conduct" without also imposing "a broad prohibition on self-gain").

275. See Miller, *supra* note 249, at 1609–10 (noting that "entrepreneurs have an unparalleled range of choices for structuring LLC relationships, and LLC participants have access to the twin benefits of corporate limited liability and flow-through partnership tax status.").

276. See RIBSTEIN, *supra* note 10, at 119.

277. See Miller, *supra* note 249, at 1610 (citing Dale A. Oesterle, *Subcurrents in LLC Statutes: Limiting the Discretion of State Courts to Restructure the Internal Affairs of Small Business*, 66 U. COLO. L. REV. 881, 881 (1995); Donald J. Weidner, *Three Policy Decisions*

Accordingly, one scholar contends that the close corporation form was “a misbegotten compromise”²⁷⁸ and has proved to be an “evolutionary dead end.”²⁷⁹

It is not clear, however, that the LLC is a panacea for shareholder oppression. First, if the relationships among investors cause minority shareholders to underestimate the possibility of future oppression, the same departure from rational behavior will be exhibited when investors choose the business form. Moving the problem does not answer it.²⁸⁰ Also, although the LLC form offers significant flexibility, investors must bargain for governance terms, and their difficulty in creating an operating agreement that deals appropriately with all possibilities is substantially identical to the problem close corporation shareholders face in negotiating articles of incorporation, by-laws, and shareholder agreements.²⁸¹ Moreover, in response to estate and gift tax rules that provide a lower valuation for tax purposes only if the children’s shares are not liquid, most LLC statutes have been amended to eliminate default exit rights.²⁸² Thus, minority investors who choose an LLC are locked in by the default rules and vulnerable to mistreatment by the majority, just as they would be in a close corporation.²⁸³

As recent LLC caselaw illustrates, courts must either apply the equitable principles evolved over long centuries of experience in the English and United States courts or else accept serious injustice in individual cases when the terms of the literal agreement depart in obvious ways from the parties’ intent. For instance, in *VGS, Inc. v. Castiel*,²⁸⁴ a founding member lost control of his LLC, despite having bargained for the right to appoint

Animate Revision of Uniform Partnership Act, 46 BUS. LAW. 427, 428 (1991)). Although the LLC statutes contain default terms, and some, unlike Delaware, include mandatory fiduciary duties, “[t]he statutes typically assume that the individual owners will develop their own LLC operating agreements that define their respective rights, responsibilities, and remedies.” *Id.* at 1610–11.

278. RIBSTEIN, *supra* note 10, at 252.

279. *Id.* at 102.

280. See Miller, *supra* note 249, at 1612 (finding that “classic ‘squeeze-out techniques,’ which have a long history in the close corporation setting of the past fifty years, are now surfacing in the context of the LLC”).

281. For an argument that courts should apply a full panoply of contract principles, including unconscionability, when parties waive fiduciary obligations in an LLC agreement, see Larry A. DiMatteo, *Policing Limited Liability Companies Under Contract Law*, 46 AM. BUS. L.J. 279 (2009). The approach Professor DiMatteo recommends contrasts with this Article’s approach because it seems designed to limit the parties’ ability to tailor their bargain. See *id.* at 287 (identifying ways courts could apply dissolution statutes to create exit rights where appropriate, “[e]ven where the operating agreement contains a ‘no-exit’ provision”). Although courts might in rare cases refuse to enforce the parties’ intended bargain, my focus here is on the use of equitable contract provisions to fill gaps in the parties’ agreement, furthering their actual intent.

282. See RIBSTEIN, *supra* note 10, at 179–80.

283. *Id.* at 180 (“Removal of buyout rights from LLCs has the perverse secondary effect of forcing lawmakers to provide a backup exit right. Therefore, judicial dissolution, which had brought so much unpredictability to close corporations, now haunts the LLCs that replaced them.”).

284. No. C.A. 17995, 2000 WL 1277372 (Del. Ch. Aug. 31, 2000).

two of the three members of the Board of Managers.²⁸⁵ The independent member of the Board, who held a minority interest in the LLC, convinced the appointed member to defect and to effectuate a merger of the LLC into a corporation, relegating the original member to a minority position.²⁸⁶

The founding member's ouster violated none of the literal terms of the parties' bargain. The Delaware Court of Chancery observed that while the founding member would certainly have removed the faithless member of the Board, if given notice of the proposed merger, "the LLC Act, read literally, does not require notice . . ." ²⁸⁷ Yet the court further reasoned that the purpose of the statute was to enable "LLC managers to take quick, efficient action in situations where a minority of managers could not block or adversely affect the course set by the majority even if they were notified . . ." ²⁸⁸ That purpose was not advanced because the founding member "had the power to prevent any Board decision with which he disagreed." ²⁸⁹ The court rescinded the merger, relying on "a classic maxim of equity—'equity looks to the intent rather than to the form.'" ²⁹⁰ Thus, while there are substantial differences between LLCs and close corporations, the contractual duty of good faith and fair dealing establishes common ground.²⁹¹

Finally, whether or not oppression analysis applies in the LLC context, the new choice of business form should not undermine existing protection of shareholders in close corporations. To the extent the LLC form gives greater weight to the explicit terms of the parties' bargain, as embodied in the operating agreement,²⁹² the distinct treatment only means that investors who choose the corporate form (and who could have chosen LLC form)

285. Ironically, this bargained-for protection left him more exposed than he would have been had he relied on "the statutorily sanctioned mechanism of approval by members owning a majority of the LLC's equity interests." *Id.* at *4. If the court chose to apply a formalistic contract interpretation, the express decision to reject the default protection would be presumed deliberate and informed, and the court would have no reason to consider evidence of overall intent.

286. *See id.* at *2. The founding member of the LLC was also excluded from the board of directors of the newly-formed corporation. *See id.*

287. *Id.* at *4.

288. *Id.*

289. *Id.* at *1.

290. *Id.* at *4 (citations omitted). The court's interpretation of the LLC Act (which formed the basis of the parties' bargain) gave priority to considerations of equity. Thus, the analysis was contractual in the modern rather than formal economic sense. The court also described its holding in terms of the "duty of loyalty" members owe to the LLC and one another and to a general obligation of "good faith." *Id.* The connection the court intends to draw between these fiduciary obligations and the equitable interpretation of contract is not entirely clear. For further discussion, see Mark J. Loewenstein, *The Diverging Meaning of Good Faith*, 34 DEL. J. CORP. L. 433, 450 (2009) (arguing that *Castiel* is best understood as an example of contractual good faith analysis).

291. *See, e.g.,* Adlerstein v. Wertheimer, No. Civ.A. 19101, 2002 WL 205684, at *8 (Del. Ch. Jan. 25, 2002) (evaluating adequacy of notice to close corporation shareholder and observing that plaintiff's "more persuasive . . . arguments are predicated largely on . . . VGS, Inc. v. Castiel").

292. *See, e.g.,* Sutherland v. Sutherland, No. 2399, 2009 WL 857468, at *4 (Del. Ch. Mar. 23, 2009) (distinguishing freedom of contract in LLC from more limited freedom in corporate context).

may be presumed to have chosen the existing protections available in most jurisdictions for minority shareholders.²⁹³

In sum, because the duty of good faith and fair dealing is an implied term in all contracts and opportunistic conduct is likely to be similar in LLCs and close corporations, courts should apply substantially the same oppression analysis in either context. However, if courts take a narrow and literalistic approach to the interpretation of LLC agreements, that novel approach stands in sharp contrast both with courts' longstanding willingness to protect minority shareholders from oppression and the equitable principles built into modern contract law more generally.

CONCLUSION

As a matter of methodology, contrasting views of contract theory contribute to the corporate governance debate by treating the framework for analysis as part of the discussion rather than a condition for it.²⁹⁴ Commentators will continue to disagree about the appropriate scope of minority shareholder protection, but it would be a marked improvement if they seemed to be partaking in the same discussion.²⁹⁵ In broader context, Professor Stephen Bainbridge has gone so far as to conclude that “[a]s a matter of intellectual interest, the debate over the contractual nature of the firm is over” and “[c]ontractarians and noncontractarians no longer have much of interest to say to one another; indeed, they barely speak the same language.”²⁹⁶ As this Article has shown, though, we need not simply agree to disagree; the language of contract is itself a useful locus of debate.

A contractual approach to close corporation law does not require courts to abandon minority shareholders to the explicit terms of their bargain, regardless of whether those terms are consistent with the parties' reasonable expectations. If the corporation is a contract, it is a relational contract intended to endure over time and not a discrete, bargained-for exchange. Indeed, judicial protection of vulnerable minority shareholders conflicts

293. See RIBSTEIN, *supra* note 10, at 253 (“Small firms may prefer the comfort of corporate restrictions on opting out of fiduciary duty and mandatory remedies for majority shareholder oppression.”).

294. Cf. JOHN SEARLE, MIND, LANGUAGE, AND SOCIETY 32 (1998) (noting that certain propositions cannot meaningfully be debated, because any discussion presupposes their existence). For instance, “you can’t . . . settle the issue about the existence of the real world, because any such settling presupposes the existence of the real world.” *Id.* Thus, “realism is not a theory at all but the framework within which it is possible to have theories.” *Id.* By contrast, we can and should choose intelligently among the available frameworks for understanding shareholder relationships in close corporations. The standard law and economics framework may cause certain choices to appear inevitable once applied, but the framework itself can be challenged.

295. In many respects, the terms of the debate over shareholder remedies have remained unchanged since the earliest exchange of views. Compare EASTERBROOK & FISCHER, *supra* note 1 (defending the standard law and economics perspective), with J.A.C. HETHERINGTON & MICHAEL P. DOOLEY, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1 (1977) (supporting minority shareholder oppression remedies, including a right of exit).

296. BAINBRIDGE, *supra* note 1, at 31.

with private ordering only if we assume the artificially rational world of standard economics. But shareholders live in the real world, not in the pages of a game theory treatise, and the ties of family and friendship, the social norms of business, and the constraints imposed by transaction costs all impact the likelihood that the parties will negotiate adequate protections against possible future discord.