Family Law and Entrepreneurial Action

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In response to Benjamin Means, *The Contractual Foundation of Family-Business Law*, 75 OHIO ST. L.J. 675 (2014).

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I. INTRODUCTION

In *The Contractual Foundation of Family-Business Law*, Benjamin Means aspires to lay the groundwork for a law of family businesses.[1] Family-business law is not a "law of the horse,"[2] but governs a distinctive factual context at the intersection of two important legal forms—the family and the business organization—each of which is animated by its own set of policies and regulated by its own set of rules. This article is another fascinating contribution to Means's long-term project of rationalizing the law of family businesses. In this brief essay, I suggest that a workable family-business law along the lines suggested by Means is consistent with an overarching policy in the United States of promoting entrepreneurial action,[3] and I evaluate the proposal against this policy goal, with particular attention to Means's arguments in favor of "family-business defaults" and his concern over the potentially disruptive role of fiduciary law.

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[1] Benjamin Means, *The Contractual Foundation of Family-Business Law*, 75 OHIO ST. L.J. 675 (2014).

[2] *See* Darian M. Ibrahim & D. Gordon Smith, *Entrepreneurs on Horseback: Reflections on the Organization of Law*, 50 ARIZ. L. REV. 71, 71, 79 (2008) (arguing that "the value of creating or maintaining a field of legal study turns on the *distinctiveness* of the factual context").

[3] D. Gordon Smith & Darian M. Ibrahim, *Law and Entrepreneurial Opportunities*, 98 CORNELL L. REV. 1533, 1536 (2013).

II. FAMILY-BUSINESS LAW

Family-business law is about the internal affairs of a business organization in which "effective control of the business rests in family hands and that at least two family members be involved as owners or managers."[4] When disputes arise in family businesses, courts strive to implement the relevant policies and apply the relevant rules, but the clash of family law and business law often creates confusion. As Means observes, "Whether the issue is divorce, inheritance, or the operation of a family trust that owns business assets, family law can have a considerable influence on business law outcomes."[5] The inconsistency of outcomes that typifies the status quo "interferes with rational business planning and invites arbitrage across doctrinal categories by sophisticated parties."[6]

Means proposes to address this set of problems by extending the contractarian model of business organizations to include marital agreements, trust instruments, and inheritance contracts among participants in the business organization.[7] Placing family businesses on a contractual foundation should increase the predictability of outcomes, assuming that courts are reasonably consistent in discerning the expectations of contracting parties from explicit contracts and in applying appropriate default rules in the absence of explicit contracts. Even though "[f]amily objectives are not necessarily what a rational actor would formulate,"[8] the effect of this enhanced predictability of outcomes should be to encourage the formation of family businesses.[9]

III. ENTREPRENEURIAL ACTION

In arguing for predicable outcomes, Means is echoing the work of Max Weber,[10] Willard Hurst,[11] Douglass North,[12] Hernando de Soto,[13] Rule of Law

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[4] Means, *supra* note 1, at 690.

[5] *Id.* at 677.

[6] *Id.* at 730.

[7] *Id.* at 713.

[8] *Id.* at 678 n.14.

[9] Generally speaking, we assume that predictability mitigates the potential for opportunism, thus encouraging action. *See generally* D. Gordon Smith & Brayden G. King, *Contracts as Organizations*, 51 ARIZ. L. REV. 1, 15–19 (2009) (describing incomplete contract theory).

[10] 2 MAX WEBER, ECONOMY AND SOCIETY 641–900 (Guenther Roth & Claus Wittich eds., Ephraim Fischoff et al. trans., 1968).

[11] JAMES WILLARD HURST, LAW AND THE CONDITIONS OF FREEDOM IN THE NINETEENTH-CENTURY UNITED STATES 7 (1956).

[12] DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 3 (1990).

[13] HERNANDO DE SOTO, THE MYSTERY OF CAPITAL: WHY CAPITALISM TRIUMPHS IN THE WEST AND FAILS EVERYWHERE ELSE 5–6 (2000).

scholars,[14] Legal Origins Theory,[15] and others,[16] who contend that within a "framework of reasonably predictable consequences," private actors are "likely to cultivate boldness and energy in action."[17] Max Weber famously made the case for predictable legal outcomes as a foundation for economic development, asserting that "the increasing calculability of the functioning of the legal process . . . constituted one of the most important conditions for the existence of . . . capitalistic enterprise."[18]

Stability is not the only attribute of a legal system that encourages entrepreneurial action. Novelty is a distinguishing attribute of entrepreneurial action,[19] and novel things or novel behaviors "stretch the fabric of law."[20] Legal systems that adapt well to novelty, therefore, should have an advantage in economic development. Legal Origins Theory embraces this adaptability hypothesis,[21] holding that "legal traditions differ in their ability to evolve with changing conditions and legal traditions that adapt efficiently to minimize the gap between the contracting needs of the economy and the legal system's capabilities will foster financial development more effectively than more rigid systems."[22]

The need for stability and the need for adaptability are in tension. As noted by Andreas Engert and Gordon Smith, "the more responsive a legal system, the less people can rely on legal authority to predict how the law is going to deal with their behavior."[23] The tension between stability and adaptability can be reconciled by private ordering. Where the stability of a legal system emboldens planning, contracting parties can adjust their relationships to account for new behavioral or technological developments. Thus, a legal system that exhibits stability in positive law encourages private ordering, which is the locus of adaptability. This is consistent with Means's aspirations for contractual default rules, which "could serve as a resource for the parties, generating a set of preferred outcomes and facilitating more particular

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[14] *E.g.*, John K.M. Ohnesorge, *The Rule of Law*, 3 ANN. REV. L. & SOC. SCI. 99, 100 (2007).

[15] *See* Rafael La Porta et al., *The Economic Consequences of Legal Origins*, J. ECON. LITERATURE 285, 286 (2008).

[16] *See, e.g.*, GABRIEL KOLKO, THE TRIUMPH OF CONSERVATISM: A REINTERPRETATION OF AMERICAN HISTORY, 1900–1916, at 179 (1963); 1 WILLIAM E. NELSON, THE COMMON LAW IN COLONIAL AMERICA: THE CHESAPEAKE AND NEW ENGLAND, 1607–1660, at 3–13 (2008).

[17] HURST, *supra* note 11, at 22.

[18] WEBER, *supra* note 10, at 883.

[19] JOSEPH A. SCHUMPETER, THE THEORY OF ECONOMIC DEVELOPMENT 74–76 (Redvers Opie trans., 1934).

[20] Andreas Engert & D. Gordon Smith, *Unpacking Adaptability*, 2009 BYU L. REV. 1553, 1554.

[21] *See* La Porta et al., *supra* note 15, at 326.

[22] Thorsten Beck et al., *Law and Finance: Why Does Legal Origin Matter?*, 31 J. COMP. ECON. 653, 655 (2003) (citation omitted).

[23] Engert & Smith, *supra* note 20, at 1561.

bargaining."[24]

IV. ENTREPRENEURIAL ORGANIZATIONS

Promoting entrepreneurial action is a fundamental goal of the U.S. legal system,[25] and family businesses are an important source of entrepreneurial activity. Indeed, Means begins his article by noting, "Most U.S. businesses are family owned."[26] We could imagine various incentives to encourage the formation of family businesses, but Means has chosen to focus on issues relating to the internal affairs of the business organization. It is hard to imagine a better starting place, as the formation of firms is fundamental to the promotion of entrepreneurial action. An entrepreneurship scholar noted perceptively, "At the most general level, entrepreneurship is the creation of value through the creation of organization."[27]

Broadly speaking, governments have two strategies for facilitating or impeding the formation of firms: reducing burdens or increasing subsidies.[28] These strategies are often associated with the taxation system, but many forms of regulation impose costs on businesses, and many features of the legal system act as a form of subsidy for business transactions.[29] For example, modern legal systems facilitate the creation of firms by providing a range of off-the-shelf business forms, which offer easy access to governance rules and (usually) limited liability for the firm's owners. These business forms provide a set of default rules that can be tailored to the particular needs of the participants.

Firms are legal instruments that grease the wheels of entrepreneurial action, not only through default rules but through the flexibility enabled by fiduciary law. Constructed on a foundation laid by the law of agency,[30] which enables the entrepreneur to appoint representatives to act on the entrepreneur's behalf,[31] firms empower entrepreneurs to get more things done.[32] As the price

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[24] Means, *supra* note 1, at 679.

[25] Smith & Ibrahim, *supra* note 3, at 1536.

[26] Means, *supra* note 1, at 676.

[27] BARBARA J. BIRD, ENTREPRENEURIAL BEHAVIOR 3 (1989).

[28] André van Stel et al., *The Effect of Business Relations on Nascent and Young Business Entrepreneurship*, 28 SMALL BUS. ECON. 171, 171 (2007).

[29] *See* Smith & Ibrahim, *supra* note 3, at 1551 (observing that the "state's role [in] secur[ing] property rights and reduc[ing] the risks associated with venturing [is] . . . a form of subsidy for business transactions" (footnote omitted)).

[30] *See* ERIC W. ORTS, BUSINESS PERSONS: A LEGAL THEORY OF THE FIRM 54 (2013) ("Firms of any complexity beyond a single individual cannot exist without the law of agency.").

[31] RESTATEMENT (THIRD) OF AGENCY § 1.01 (AM. LAW INST. 2006) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act."). The law of agency is recognized by all modern legal systems. *See* W. Müller-Freienfels,

of this power, the law of agency demands that the entrepreneur be subjected to potential liabilities, including both outward looking liabilities (between the entrepreneur and third parties) and inward-looking liabilities (between the entrepreneur and another participant in the firm).[33] Thus, embedded within the entrepreneur's decision to create a firm is a (perhaps unconscious) decision to yield some control to other participants in the firm and to accept responsibility for their actions.[34] Both default rules and fiduciary law facilitate this delegation of authority.

V. DEFAULT RULES

Placing all of this in the context of a family poses special challenges for the participants. As noted by Means, "When parents and children are also coworkers, connections rooted in family life must be adjusted to meet the obligations of the workplace."[35] Typical entrepreneurs concerned about having responsibility for the actions of their representatives may expend resources to incentivize and monitor the performance of those representatives,[36] but these expenditures may seem unnecessary in family businesses, where family ties "establish a background of trust that can reduce the transaction costs of forming and operating a firm."[37]

Law of Agency, 6 AM. J. COMP. L. 165, 165 (1957) ("Agency is recognized in all modern legal systems as an indispensable part of the existing social order.").

[32] JOSEPH A. SCHUMPETER, CAPITALISM, SOCIALISM AND DEMOCRACY 132 (Routledge 5th ed. 1976) (1942) (observing that entrepreneurship "consists in getting things done"). On the benefits of agency, see Samuel Issacharoff & Daniel R. Ortiz, *Governing Through Intermediaries*, 85 VA. L. REV. 1627, 1636 (1999), observing that "[h]iring an agent simply allows us to do more."

[33] RESTATEMENT (THIRD) OF AGENCY § 1.01 cmt. c ("Agency . . . entails inward-looking consequences, operative as between the agent and the principal, as well as outward-looking consequences, operative as among the agent, the principal, and third parties with whom the agent interacts.").

[34] These are costs that are distinctive to a firm, as opposed to transactions through markets. In both firms and markets, the entrepreneur must pay for services, expend resources for supervision, and protect against self-interested behavior of the other party. The firm is distinctive from markets because the entrepreneur grants discretion over firm resources to other participants in the firm, who then become fiduciaries of the firm. *See* D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1403 (2002) [hereinafter Smith, *Critical Resource Theory*] (observing that "a fiduciary exercises discretion with respect to a critical resource belonging to the beneficiary, whereas most contracting parties exercise discretion only with respect to their own performance under the contract").

[35] Means, *supra* note 1, at 692.

[36] Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976) ("The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent." (emphasis omitted)).

[37] Means, *supra* note 1, at 709.

Of course, the law of business organizations provides additional comfort. With regard to outward-looking liabilities, all modern legal systems offer firms with limited liability, which caps financial liability at the value of the entrepreneur's investment in the firm.[38] With regard to inward-looking liabilities, we rely heavily on a robust fiduciary law to constrain participants in a firm. In the end, however, Means argues that the primary bulwark against opportunism in the family firm is contract: "because the economic concerns of business and family do not reside in separate spheres, contractual adjustments can help to clarify the parties' expectations."[39]

Means examines marital agreements,[40] trust instruments,[41] and inheritance contracts,[42] all of which may provide explicit guidance in dispute resolution. The more ambitious part of his paper, however, is the last section, which proposes the development of default rules and interpretive principles consistent with the parties' business and family relationships. His decision to promote the use of default rules seems natural, given the contractarian frame of the overall approach, but the choice of default rules represents a conscious rejection of mandatory rules that are often imposed in family-business cases currently. For Means this is pragmatic decision to elevate the expectations of the participants in the family business,[43] but it also serves to encourage entrepreneurial action.

Legal commands take the form of rules or standards.[44] The archetypal rule is a numerical speed limit, whereas the exemplary standard requires "reasonable and prudent" driving.[45] Lewis Kaplow famously described the

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[38] *See* World Bank Grp., *Entrepreneurship Dataset*, DOING BUSINESS, http://www.doingbusiness.org/data/exploretopics/entrepreneurship/ [https://perma.cc/7DN7-N5PA; https://perma.cc/J4UR-SMSS] (explaining on the "Methodology" page that the data was collected from "newly registered companies with limited liability (or its equivalent)" in 136 countries for the period 2004–2012).

[39] Means, *supra* note 1, at 710.

[40] *Id.* at 717 ("[N]o family-business plan is complete unless it takes into account possible disruptions of family relationships, including divorce.").

[41] *Id.* at 718 ("[W]hen trust law overlaps with business-organization law, the vital question is whether there is some appropriate mechanism for coordinating the parties' rights and obligations.").

[42] *Id.* at 721 ("[P]rivate ordering regarding the transfer of family wealth can establish the functional equivalent of a work-to-own employment agreement.").

[43] *Id.* at 731 ("Ultimately, the goal is to support the voluntary participation of family members in a shared venture by protecting their expectations.").

[44] The reduction of legal commands to two types is a rather recent conceptualization. *See* Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685, 1685–87 (1976) (matching "two opposed rhetorical modes for dealing with substantive issues, which I will call individualism and altruism," with "two opposed modes for dealing with questions of the form in which legal solutions to the substantive problems should be cast," namely, rules and standards).

[45] *See* Robert E. King & Cass R. Sunstein, *Doing Without Speed Limits*, 79 B.U. L. REV. 155, 155–56 (1999) (describing Montana's experience in moving from a rule to a standard).

difference between rules and standards as "the extent to which efforts to give content to the law are undertaken before or after individuals act."[46] A legal policymaker who is keen to promote entrepreneurial action should generally prefer default rules, which imply the possibility of waiver to account for tailored deviations from the normal form of organization. The superiority of this form of regulation over mandatory rules in the family-business context is clear, as mandatory rules entrench a particular vision of the interaction of family and business that undoubtedly would conflict with the preferences of many.

It has also been argued that default rules are generally preferable to standards in promoting action because rules reduce uncertainty.[47] In the case of entrepreneurial action, certainty is not necessarily a virtue, as an innovative challenge to the status quo may be expressly prohibited by the default rule, and the waiver may be difficult or expensive to obtain. But default rules probably make more sense in the family-business context, where the most salient problems do not concern innovation, but integration of the family into the business.

VI. FIDUCIARY LAW

Contracts play an important role in governing family businesses, but fiduciary relationships have a distinctive structure, relying partially on the logic of contract and partially on the logic of property.[48] This is easily seen in the context of family trusts, which often are used in the family-business context to control the family-business assets.[49] The crucial feature of family trusts—indeed, of all fiduciary relationships—is the exercise of authority by the fiduciary (trustee) over resources belonging to the beneficiaries. While the beneficiaries and fiduciary often have a contractual relationship in the form of a trust instrument, the duties imposed on the fiduciary are designed to protect the resources of the beneficiaries.[50]

Because fiduciaries exercise their discretion over the trust assets in the

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[46] Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 560 (1992) (emphasis omitted).

[47] John E. Calfee & Richard Craswell, *Some Effects of Uncertainty on Compliance with Legal Standards*, 70 VA. L. REV. 965, 966–67 (1984).

[48] *See* D. Gordon Smith, *Firms and Fiduciaries*, *in* CONTRACT, STATUS, AND FIDUCIARY LAW (Paul B. Miller & Andrew S. Gold eds., forthcoming 2016) (manuscript at 2), http://ssrn.com/abstract=2729657 [https://perma.cc/S89V-RQEP] [hereinafter Smith, *Firms and Fiduciaries*] ("[W]hile some features of fiduciary relationships are traceable to the logic of contract and some features are traceable to the logic of property, fiduciary relationships are unique hybrid institutions . . . .").

[49] Means, *supra* note 1, at 699 ("[T]he family owners might create a trust to effectuate a transition, because it is possible to allocate company stock and managerial control to one or more members of the family without depriving other family members of business profits.").

[50] *See* Smith, *Firms and Fiduciaries*, *supra* note 48.

face of incomplete trust instruments,[51] beneficiaries in fiduciary relationships are vulnerable to opportunism. The potential for opportunism in the fiduciary context—as opposed to a relationship of arm's-length contracting parties—is particularly acute because the fiduciary is authorized to exercise discretion over resources belonging to the beneficiaries, whereas "contracting parties exercise discretion only with respect to their own performance under the contract."[52] The duty of loyalty requires fiduciaries to sacrifice their own self-interest on behalf of the beneficiaries of the duty to protect those beneficiaries from opportunism by the fiduciaries.[53]

The duty of loyalty is common to all fiduciary relationships,[54] but courts tailor the duty to specific contexts. In the family trust context, the trustee has a "duty to administer the trust solely in the interest of the beneficiaries," and to "deal fairly" with the beneficiaries.[55] This duty is said to be "strict," meaning that the trustee is prohibited from engaging in transactions that involve a conflict of interest, unless, among other things, the trustee receives court authorization, the terms of the trust expressly authorize such transactions, or the beneficiaries consent to such transactions.[56] In these circumstances, "a trustee [still] violates the duty of loyalty to the beneficiaries by acting in bad faith or unfairly."[57]

Means worries about potential conflicts between the fiduciary duty of a trustee and the fiduciary duty of a business manager.[58] According to Means, "the default duty of loyalty owed by a trustee requires disgorgement of all profits, even if the dealings were fair," while a controlling shareholder "is entitled to benefit from the share ownership as long as any self-interested transactions are fair to the other shareholders."[59] Means correctly observes, "The inconsistency of fiduciary obligations becomes especially problematic when a family member is empowered as trustee to manage a family business for the benefit of other members of the family."[60]

While Means would rely on the contractual conception of the firm to clarify the trustee's role in these circumstances,[61] the fiduciary law governing

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[51] *See* D. Gordon Smith & Jordan C. Lee, *Fiduciary Discretion*, 75 OHIO ST. L.J. 609, 615–16 (2014).

[52] Smith, *Critical Resource Theory*, *supra* note 34, at 1403.

[53] *Id.* at 1407.

[54] *See* RESTATEMENT (THIRD) OF TRUSTS § 2 cmt. b (AM. LAW INST. 2003) ("Despite the differences in the legal circumstances and responsibilities of various fiduciaries, one characteristic is common to all: a person in a fiduciary relationship to another is under a duty to act for the benefit of the other as to matters within the scope of the relationship.").

[55] *Id.* § 78.

[56] *Id.* § 78 cmts. c(1), c(2) & c(3).

[57] *Id.* § 78 cmt. c(2).

[58] Means, *supra* note 1, at 700 ("In trust-controlled businesses, the law of trusts supplements and can even supersede otherwise applicable business law.").

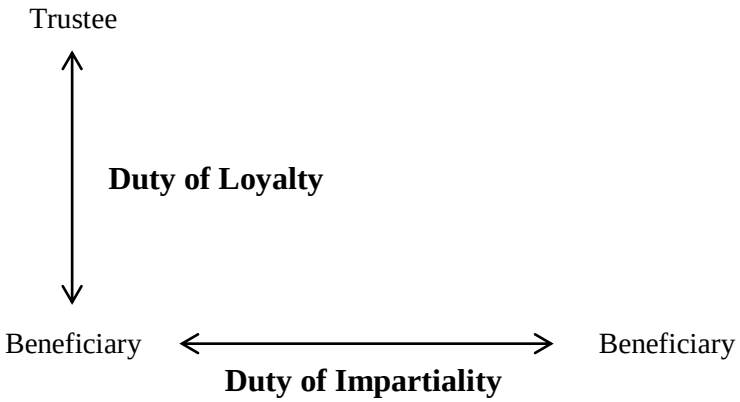
[59] *Id.* at 718.

[60] *Id.*

[61] *Id.* at 719.

trustees makes allowance for these sorts of inherent conflicts of interest. As noted in the foregoing discussion of general fiduciary principles in the trust context, notions of "fairness" infuse fiduciary law, but the trustee's duty of impartiality (mentioned briefly by Means as a limit on the "beneficiary's practical ability to challenge trust distributions"[62]) is a doctrine that seems specially designed to facilitate action. Whenever a trust has two or more beneficiaries, as is often the case in family businesses, the trustee has a duty of impartiality with regard to those beneficiaries.[63] The duty of impartiality is said to be an "extension" of the duty of loyalty,[64] but impartiality is different from the traditional duty of loyalty in an important way. As illustrated in the following diagram, the duty of loyalty regulates vertical conflicts between the trustee and the beneficiaries, while the duty of impartiality regulates horizontal conflicts between two or more beneficiaries.

Figure 1: *Duty of Loyalty and Duty of Impartiality*



The duty of impartiality applies to all of the decisions of a trustee, from the making or retention of investments to the management of trust property to the discretionary distribution of trust funds.[65] Trust beneficiaries often have competing economic interests, and when they do, the issue of impartiality is unavoidable. Impartiality does not connote strict equality among the beneficiaries, but the trustee is to act without "personal favoritism or animosity toward individual beneficiaries."[66] In balancing the competing interests of the beneficiaries, the trustee may "reasonably reflect any preferences and priorities that are discernible from the terms, purposes, and circumstances of the trust and from the nature and terms of the beneficial interests."[67]

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[62] *Id.* at 701.
[63] RESTATEMENT (THIRD) OF TRUSTS § 79 (AM. LAW INST. 2003).
[64] *Id.* § 79 cmt. b.
[65] *Id.* § 79 cmt. a.
[66] *Id.* § 79 cmt. b.
[67] *Id.* (citation omitted).

Recognizing the difficult position of the trustee with respect to the duty of impartiality, trust law allows for a "range of . . . reasonable fiduciary judgment."[68] Fiduciary duty is a "doctrine of last resort," meaning that it is "activated only when all other potentially applicable commands from constitutions, statutes, regulations, ordinances, common law decisions and contracts have been exhausted."[69] In the family trust context, "a power is discretionary except to the extent its exercise is directed by the terms of the trust or compelled by the trustee's fiduciary duties."[70] Courts review a trustee's exercise of discretion under an "abuse of discretion" standard.[71] An abuse of discretion occurs when decisions by the trustee are made in bad faith or with improper motive.[72] Evidence of such action is that a decision of the trustee is "beyond the bounds of a reasonable judgment."[73] Generally speaking, therefore, "judicial intervention is not warranted merely because the court would have differently exercised the discretion."[74]

VII. CONCLUSION

Entrepreneurial action requires organization, and the locus of organization is often the family. In his latest paper on "family-business law," Benjamin Means offers an original, challenging, and provocative new perspective on family businesses. The thesis—that "a firm includes not just business contracts, but all bargains among participants that affect the business enterprise"[75]—seems, at first glance, rather obvious, but Professor Means takes pains to explain how the contract-based nature of business relationships often is in tension with the status-based nature of families. He argues simultaneously that family businesses are deeply contractual, even though family members should not be forced "to bargain at arm's length and to rethink all aspects of their mutual relationships."[76] He ultimately concludes that our legal system should attempt to fulfill the expectations of the relevant parties in resolving disputes by developing "family-business defaults."[77] Although I endorse this proposal, I also defend the flexibility and ingenuity of fiduciary law in resolving disputes in a manner that promotes action.

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[68] *Id.*

[69] D. Gordon Smith, *Doctrines of Last Resort*, *in* REVISITING THE CONTRACTS SCHOLARSHIP OF STEWART MACAULAY 426, 427 (Jean Braucher et al. eds., 2013).

[70] RESTATEMENT (THIRD) OF TRUSTS § 87 cmt. a.

[71] *Id.* § 87.

[72] *Id.* § 87 cmt. c.

[73] *Id.*

[74] *Id.* § 87 cmt. b.

[75] Means, *supra* note 1, at 678.

[76] *Id.* at 712.

[77] *Id.* at 723–30.