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Waiting for the Omelette to Set
Match-Specific Assets and Minority Oppression

Edward B. Rock and Michael L. Wachter

Closely held corporations (or "close corporations") form an important subset of corporations with concentrated ownership.[1] The category includes an interesting variety of enterprises, including the traditional "mom-and-pop" businesses, high-tech start-ups, and mature publicly held corporations post–leveraged buyout. More generally, close corporations are important because of their number and because even the largest publicly held corporations often started out as closely held corporations. As such, close corporations are incubators for tomorrow's publicly held corporations.

Two sets of problems have arisen repeatedly in closely held corporations but only rarely in publicly held firms. The first, now resolved, revolved around the enforceability of attempts by participants to tailor the terms set by the general corporation law. Because states historically have provided one corporation law for all corporations, participants in closely held corporations have often tried to modify the statutory structure by contract to serve their needs. These variations raised the question of the extent to

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1. Closely held corporations are typically defined as corporations for which there is no public market for shares and, sometimes, no market at all. An alternative and largely coextensive definition is corporations with few (typically fewer than twenty-five) shareholders (see, e.g., American Law Institute 1994, sec. 1.06).

which parties can contract out of the rules provided by the statute. The evolution toward greater flexibility was long and, at times, difficult, but flexibility is no longer a central issue. Today, participants in the close corporation can largely tailor its terms to their purposes.

The second set of problems, and the focus of this paper, goes under the caption *protection of minority shareholders.* To what extent should the law protect minority shareholders from "oppression" by majority shareholders, beyond what the parties have contracted for? This set of questions, unlike the first set, remains alive and controversial. It has been the subject of an enormous amount of judicial and legislative effort, much of which has been devoted to expanding the rights of minority shareholders. The questions raised, however, go to the very core of what corporations are about.

There are several repeated scenarios that raise the issue of minority oppression. Consider the following:

Case A. There is a falling out between the majority shareholder, Major, and the minority shareholder, Minor, both of whom work in the business. Major fires Minor, who then can either hold on to his shares, which pay no dividends (all distributions are through excessive salaries), or sell them back to the firm for whatever the majority shareholder is willing to offer. A variant arises when there are three equal shareholders, A, B, and C. After a falling out, A and B gang up on C and fire him, at which point he is left with shares that pay no dividends and that only the firm is willing to buy.[2]

Case B. The majority shareholder or a group of shareholders enters into a transaction with the firm in which, for example, the firm buys back a portion of the majority shareholders' shares, without making the opportunity available to the minority shareholders.[3] Easier variants of this scenario include the full range of transactions between controlling shareholders and the firm, including compensation, selling/buying property, and diversion of corporate opportunities.[4] More difficult variants include the situation in which the majority shareholder takes advantage of opportunities that are not clearly corporate opportunities, such as developing a more liquid market for shares, in which the minority shareholders would like to participate but are not offered the opportunity.[5]

2. See, e.g., *Wilkes v. Springside Nursing Home,* 353 N.E.2d 657 (Mass. 1976); and *In re Topper,* 433 N.Y.S.2d 359 (Sup. Ct. 1980).

3. Classic examples are *Donahue v. Rodd Electrotype Co.,* 328 N.E.2d 505 (Mass. 1975); and *Nixon v. Blackwell,* 626 A.2d 1366 (Del. 1993).

4. See, e.g., *Crosby v. Beam,* 548 N.E.2d 217 (Ohio 1989); and *Alaska Plastics v. Coppock,* 621 P.2d 270 (Alaska 1980).

5. *Jones v. H. F. Ahmanson & Co.,* 460 P.2d 464 (Cal. 1969).

Case C. The majority shareholder sells its majority (controlling) stake to a third party without giving the minority shareholder an opportunity to participate.

This paper addresses the question of what, if anything, the courts should do for the minority shareholders in such cases when the parties have not provided for the problem by contract.[6] Our basic answer is that the courts should not do anything except enforce the participants' contracts and vigorously prevent non pro rata distributions to shareholders. This second principle provides a guide to the expansion of minority-shareholder protection against oppression.[7]

We proceed as follows. First, we make a fundamental break with the traditional legal treatment of the problem of minority oppression by rejecting the analogy between close corporations and partnerships and the intuitions and implications that flow from it. We also show that the alternative argument that emphasizes the low agency costs of close corporations needs to be expanded to explain the Silicon Valley start-up-type close corporation. Second, we show that the close corporation form is best suited to companies that require extensive investments in match assets. In such cases, the close corporation acts as an incubator, and the lock-in is a benefit, not a cost. Low agency costs are more likely a result of the choice of form, not the reason that the form is adopted in the first instance. Third, we argue that the problem of minority oppression combines two fundamentally separate problems: the issue that, in the employment context, is raised by the doctrine of "employment at will" and the quite separate problem of controlling shareholder attempts to make non pro rata distributions of firm assets. Building on an earlier analysis of employment at will, we then show that the same norm of judicial nonintervention that governs the employment relationship solves closely similar problems in the close corporation context. This norm, combined with vigorous judicial enforcement of the rule of no non pro rata distributions, including ancillary enforcement of minority-shareholder information rights, and limitations on the ability of control shareholders to sell shares to the firm, allows the close corporation to maximize the value of its match assets. We close by drawing the implications of the analysis for a larger theory of close corporations.

6. For a very interesting and important game-theoretic analysis that arrives at many of the same points as we do, but from a different direction, see Johnston (1992). Other important treatments that overlap with ours are Easterbrook and Fischel (1991) and O'Kelley (1992).

7. There is a third problem that is not normally thought of as a close corporation problem—namely, "piercing the corporate veil." This is the issue of when a creditor can pierce the corporate veil of limited liability in order to reach the assets of the shareholders. Although formally a question that arises in both publicly held and close corporations, in fact, in the United States, at least, the issue arises only in close corporations. It is, however, beyond the scope of this paper.

7.1 Defining the Issue

There are two types of structures that fall under the heading *close corporation.* One is the traditional close corporation, often small scale and family owned. The other is what we will call the *Silicon Valley start-up.*[8] Several traits typically characterize the closely held firm: there are few shareholders, no public market for the shares, and a substantial overlap between suppliers of capital and suppliers of labor. Because of the overlap between managers and shareholders and the absence of public markets, the shareholder-managers of the close corporation are in continuous contact with each other. Because of the lack of a public market, the parties are locked in to their investments to a much greater extent than in either the partnership or the publicly traded corporation. Since the majority shareholders elect the directors and control the management of the corporation, minority shareholders are particularly vulnerable if there is a falling out with the majority.

7.1.1 Existing Positions

In a famous and influential article, John Hetherington and Michael Dooley (1977, 2) expressed the intuition that lies at the heart of the evolution of minority shareholders' remedies for oppression: that, in all important respects, "the close corporation is the functional equivalent of the partnership."[9] On their view, participants choose the corporate form over the partnership form simply in order to take advantage of limited liability. The problem with close corporation law, they argue, is that, despite this functional equivalence, shareholders cannot exit their investment with anything like the ease of partners, who always have the power to trigger a buyout by dissolving the partnership "by the express will of any partner at any time."[10] To them, the difficulty of exit is a flaw in the legal structure.

8. There is, now, a substantial literature on the structure and governance of venture capital start-ups (see Barry et al. 1990; Sahlman 1990; Gorman and Sahlman 1989; Lerner 1994, 1995; and Gompers 1995). For a more comprehensive description of the "private equity" market, see Fenn, Liang, and Prowse (1995).

9. For a classic judicial expression of the same intuition, see *Donahue v. Rodd Electrotype Co.*, 328 N.E.2d 505, 512 (Mass. 1975).

10. Uniform Partnership Act, sec. 31(2). While the dissolution may be wrongful, it will nonetheless be effective and will immediately trigger a winding up of partnership affairs, with the pro rata distribution of net proceeds. The Revised Uniform Partnership Act (1997), in effect in some states, has tried to limit the potential damage to going concerns caused by this power, but individual partners retain much of their power to dissociate from the partnership and, by doing so, to trigger a buyout regime without triggering dissolution of the partnership itself. Thus, under secs. 601 and 602, a partner may dissociate from the partnership at will, at any time, rightly or wrongly. Under sec. 602(a), partners have the power to withdraw at any time, a power that is immutable under sec. 103(b)(6) (see the comment to sec. 601). Under sec. 701, if a partner is dissociated from the partnership and the partnership continues, the partnership must buy out the dissociated partner's interest for "the amount that would have been distributable to the dissociating partner . . . if, on the date of dissociation, the assets of the partnership were sold at a price equal to the greater of the liquidation value

Their proposed solution is legislation to provide shareholders of the close corporation the same exit option that partners have.

Indeed, it is Hetherington and Dooley's intuition that lies at the heart of the evolution of minority shareholders' remedies for oppression. Although the law has not gone as far as they proposed, it has moved in that direction, driven, at least in significant measure, by an acceptance of their core claim of equivalence. Courts have been more willing to order dissolution and buyouts when convinced that the majority has engaged in oppressive conduct and have been more willing to find oppressive conduct when the minority's reasonable expectations have been violated.

A literature has also developed that explores the conditions under which oppression, that is, opportunistic behavior, is likely to occur. This literature also provides support for buyouts and other remedies for minority oppression (see, e.g., Thompson 1993; and Mahoney, chap. 6 in this volume).

Frank Easterbrook and Daniel Fischel (1991, 228–52) have provided an alternative agency-cost argument. They argue that the limited number of shareholders and the overlap of managers and shareholders naturally align the interests of the two. This occurs for a variety of reasons. First, since managers are the largest residual claimants, actions taken by them will directly affect the value of their investment. The alignment is strengthened when shareholders have a large percentage of their wealth tied up in the venture. And, since they cannot easily alienate their holdings, they will be focused on maximizing the return. Second, participants in close corporations often have familial or other personal relationships. The bond between them constrains conflicts of interest. The result of the close alignment and the familial bond is that a close corporation can have very low agency costs.

In Easterbrook and Fischel's view, companies choose the close corporate form in order to maximize the return on their low agency costs. If they wanted, they could either have adopted the partnership model, have contracted for shareholder agreements, or have adopted specific protections for minority shareholders in the articles of incorporation. Consequently, those who choose the corporate form without modification should be assumed to prize stability of operations. The implications of Easterbrook and Fischel's approach to the minority-oppression debate is clear. Providing ease of dissolution or buyouts would only serve to weaken the bonds that align the parties' interests. Consequently, controlling shareholders in close corporations should be held to the same fiduciary standards as directors in publicly traded corporations, and no additional protections should be accorded minority shareholders.[11]

or the value based on a sale of the entire business as a going concern," less any damages caused by wrongful dissolution.

11. Easterbrook and Fischel, on one side, and Hetherington and Dooley, on the other, have provided for a grand debate that has engaged not only the academic literature but also

But is Hetherington and Dooley's intuition correct? Are close corporations nothing more than "incorporated partnerships"? Do close corporations better serve the interests of the participants when exit is easy? Are Easterbrook and Fischel correct that the primary virtue of the close corporation is that it reduces agency costs and that no additional protection should be accorded minority shareholders? In order to answer these questions, we must place close corporations in a broader context, one that allows us to see that any explanation of the close corporate form must be able to explain the second type of close corporation: the Silicon Valley start-up.

7.1.2 Our Position and the Silicon Valley Start-Up

In Silicon Valley, close corporations are started when the entrepreneur has an idea for a new product or service, such as a network switch. In the initial stage, the venture attempts to develop the new product. Whether the product will be successful cannot be known since its precise form and potential revenue streams have not yet taken shape. At this stage, the company will have relatively few shareholder-managers who supply the ideas, the initial capital for the venture, or both.

In the early stages of the development of this new switch, the venture is highly dependent on these individuals either for the critical product ideas or for the financial capital. Vulnerability arises because the parties' investments are match specific. That is, the value of the investments is tied to the success of their unproved product. Were the product to be a success, the payoff to the investment would be huge. But, were the venture to be abandoned, the investment would be lost. At a conceptual level, investments in our hypothetical network switch create match assets. Match assets are those that have a value to the parties to the venture but little value to outsiders. We use the terms *match-specific assets, match assets,* and *match-specific investments* interchangeably.[12] A defining characteristic of the Silicon Valley start-up is that its key assets are specific to the match.

The intensity of match assets creates a second important characteristic of close corporations. Between the time of the initial investments in research, development, and marketing and the time at which the world can

courts faced with allegations of minority oppression. For example, to Easterbrook and Fischel, minority oppression is no more likely in the close than in the public corporation and should not be a cause of action with distinctive standards and remedies.

12. Investments in match are defined to be investments that are more valuable to the contracting parties than to a third party. We use the term *match-specific investment* in this paper in place of the more common *firm-specific training* for several reasons. First, the term *match investment* captures the broader range of activities that create a good partnership, including training and learning by doing but also including adaptations to each other's styles of interaction. In addition, the term is more general and does not restrain the investments to take place inside a firm or an industry. Finally, the term *match specific* leads one to identify the specific asset created or improved by the parties' investments.

see whether the switch will be a commercial success, it will be difficult to convince outsiders to invest in the project. Second-stage venture capitalists can be interested in the venture but, given the still unproved value of the concept, will need to be brought in as insiders. The high cost of learning and staying informed about the switch's potential value makes outside investors unwilling bidders at a price that values the match assets at the insiders' valuation. As a consequence, the company will be capital constrained with no easy access to outside financing at an appropriate valuation of the assets.

If any of the company insiders could trigger dissolution of the enterprise midstream, the forced sale of the match assets would result in substantial losses to the participants. Either the insider with the deepest pocket would buy the assets, or the assets would be sold at a low price equal to the outsiders' bid price. If critical insiders could credibly threaten dissolution, they could use the threat to extract a great share of the value of the enterprise. The resulting potential for opportunism would interfere with inducing optimal investment.[13] The problem is akin to making an omelette: between the time the eggs are broken and the time the omelette sets, the cook knows his grand plan for the omelette, but, to outsiders, the half-cooked omelette is unappetizing. Forced sales of half-developed switches and uncooked omelettes go poorly.

In our approach, low agency costs are a natural result of the choice of form but not the reason for adopting it. The close corporation will always have lower agency costs than an otherwise identical publicly owned company as a consequence of the limited number of shareholders and the overlap of shareholders and managers. But agency costs do not explain why any given firm would adopt the close corporation form. The important exception, noted by Easterbrook and Fischel, is the family business. In a family business, low agency costs already exist in the familial relationship, and the parties can thus capitalize on the relationship by adopting the close corporation form. But the Silicon Valley start-up is different. These shareholder-managers are unlikely to have preexisting family ties and hence are unlikely to bring low agency costs to the formation of the close corporation. For at least the Silicon Valley start-up, the explanation for the choice of form is an operational factor: the need to lock in parties while developing vulnerable match-specific assets. Reduced agency costs are the result rather than the cause.

The problem of match-specific investments in a context with substantial asymmetry of information characterizes many other centrally important

13. *Rent seeking*, or, more generally, *opportunism*, can be defined as the expenditure of resources or effort by one party in order to transfer resources from the other party to itself. This investment by the rent payers wastes the joint profits of the parties because it creates no new wealth. Moreover, rent seeking by one party typically causes the prospective rent payer to expend resources in order to protect its share of the joint investment.

economic relationships. The employment relationship in which an employee with match-specific training is more productive than an employee hired from the external labor market provides a classic example. That employment relationship provides a critical foundation for our analysis precisely because most or all of the shareholders of close corporations are also employees.

Focusing on match assets also shows the fundamental differences between classic partnerships and close corporations. The dissolution-at-will feature of classic partnerships means that the form will best fit enterprises in which there are few, if any, assets that are not easily sold to third parties. In such cases, the benefits of dissolution at will are clear: by providing easy exit, it prevents opportunistic rent seeking. And the costs are minimal: when there are no sunk costs, when the principal assets are easily divided or sold, dissolution at will causes little harm. Thus, for a small law firm in which partners have their own clients but wish to share office space and staff and occasionally to refer business to other lawyers in the office with greater expertise or receive referrals, the partnership form is optimal. If the firm breaks up one day, very little value is trapped. Indeed, as one would predict, small law partnerships dissolve and re-form constantly.

But, if participants can trigger dissolution at will, they will be unwilling, ex ante, to make investments in match for fear that, ex post, they will be held up. Because of this, when there are high investments in match, such as with the Silicon Valley start-up, the costs of a rule of easy dissolution explode. The traditional close corporation manifests the same features, although in a less highly articulated form. As in the Silicon Valley start-up, at the early stage of a new venture, the product or service will have no revenue but high costs. Similarly, once the initial investments of human and physical capital are made, the participants are locked in. In one respect, the traditional family-business close corporation poses an even more difficult problem of protecting match investments. Unlike the Silicon Valley start-up, the traditional close corporation often expects to remain privately held indefinitely: the nature of the products or services is often such that selling to a third party is never a live option. But traditional close corporations come in many forms, and, at least in their formative years, many often hope to develop a product or service that may eventually be successful enough to be sold to a third party.

Easy dissolution would also make it even more difficult to raise equity or debt capital than it already is. Were the firm required to retire the capital of an existing owner who sought to cash out, the cash-constrained close corporation would be forced to raise new capital in a potentially unfavorable climate. Indeed, the shareholder dissension that characterizes a minority-oppression case is likely to be highly correlated with negative events in the firm. A legal rule favoring easy exit threatens to shift the engine for raising new money into reverse, forcing capital to be retired under unfavorable conditions.

Similarly, the lock-in of the corporate form is important to creditors. In a setting of limited liability, creditors cannot be repaid from the individual wealth of the owners of a bankrupt concern. In return, and in distinction to the rules of partnership, they are protected by the existence of an entity that is difficult for the current owners to dissolve. It is only with this protection that the squabbles among those who manage the company will be of limited interest to the creditors. Nowhere is this more important than in the close corporation, whose assets are difficult to value and whose current realizable market value—at forced sale—may be considerably below its future value. In such a setting, easy dissolution or buyout increases the risk of bankruptcy, thereby reducing the credit worthiness of the company. The traditional judicial reluctance to order dissolution or a buyout of minority shareholders lowers the credit risk of close corporations and allows them to borrow at more favorable terms.

Clearly, not all close corporations will be marked by heavy investments in match. Parties can and do choose alternative corporate and noncorporate forms on the basis of very different motivations. In addition, parties sometimes make mistakes in their choice of form. In this regard, the analysis can be interpreted as defining the paradigm close corporation that is best served by the legal rules. Choose the close corporation form when heavy investments in match make restrictions on exit valuable. Choose the partnership form when exit is not costly and the parties can be given free rein to withdraw from the match.

7.2 Legal Setting

In this section, we describe the legal and nonlegal features of the close corporation. In so doing, we show how minority oppression arises and how it is constrained. This begins to set the stage for providing an answer to how the three cases noted at the outset should be resolved.

7.2.1 Core Solution: The Corporate Form

The standard, off-the-rack, corporate form provides a robust solution to the problem caused by threats of opportunistic exit. The standard form has several relevant terms. Directors are elected by a majority of the shares.[14] Dissolution requires a board resolution and a vote of the majority of the shares.[15] Individual shareholders have no general right to sell their shares back to the firm.

14. See, e.g., Delaware General Corporation Law (Del. GCL), sec. 216.
15. See, e.g., ibid., sec. 275.

The lock-in of the close corporation is created by the interaction of these terms with the absence of a public market for the shares. But the lock-in affects only the minority shareholder (Minor). The majority shareholder (Major) can dissolve the corporation through a board resolution and a vote of a majority of the shares. The individual minority shareholders have no power to trigger dissolution. Minor likewise has no right to be bought out because, under the standard corporation laws, *no* shareholder has a general right to be bought out. But, if Major dissolves the corporation, Minor will receive his pro rata share if and when the firm is dissolved.[16] In the meantime, Minor has a very limited right to be bought out by the firm, namely, the right to judicial appraisal upon a merger and, sometimes, a sale of all or substantially all the assets.[17]

In addition to the lock-in provided by the statutory form, there are additional core properties of the form provided by a combination of statute and case law. The single most important is the prohibition on non pro rata distributions during the life of the firm, combined with close scrutiny of self-dealing transactions that attempt to evade this prohibition. The restrictions on non pro rata distributions are quite clear and derive from several sources. A majority shareholder may not pay itself dividends without also paying the same per share dividend to the minority shareholders.[18] It would be clearly illegal—and easily challenged—if the majority shareholder paid itself $1.00 per share in dividends while paying minority shareholders only $0.10 per share.

Indirect means are also constrained. For example, if the majority shareholder attempts to divert assets by entering into a contract with the firm on preferential terms, the contract is subject to close judicial scrutiny, and the majority shareholder bears the burden of establishing that the transaction is "entirely fair" to the corporation, where *entirely fair* is, when possible, defined by an arm's-length market comparison. Compensation agreements are subject to the same rule.[19] Generally, in order to avoid "entire fairness" scrutiny, compensation arrangements must be authorized in advance by disinterested directors or disinterested shareholders and, even then, are subject to scrutiny by the court under a "waste" standard. Similarly, attempts by the majority shareholder to take opportunities that belong to the corporation, or to use corporate assets for its own benefit, are limited (again imperfectly) by the "corporate opportunity" and related doctrines.[20]

While no one believes that these rules eliminate non pro rata benefits of

16. See, e.g., ibid., sec. 281.
17. See, e.g., ibid., sec. 262; Revised Model Business Corporation Act (RMBCA), sec. 13.02.
18. Del. GCL, sec. 170; RMBCA, sec. 6.40.
19. ALI Principles of Corporate Governance, sec. 5.03.
20. Ibid., secs. 5.10–5.14.

control, most would agree that they do limit the magnitude of such diversion significantly. Indeed, as Clifford Holderness and Dennis Sheehan (chap. 5 in this volume) show, empirical investigation suggests that legal restraints are surprisingly effective and probably the *primary* protection for minority shareholders.

The centrality of these terms is clear: by limiting non pro rata distributions, these provisions go a long way toward making the relationship incentive compatible. So long as the majority shareholders cannot prefer themselves in distributions, minority shareholders can depend on the majority to protect their, the minority's, interests.

A second set of standard protections is equally important in facilitating and protecting the beneficial lock-in. These provisions address endgame scenarios. When, for example, the majority shareholder triggers dissolution in order to take its capital out of the enterprise, the minority shareholders share pro rata in the net proceeds.[21] Similarly, if the firm merges with another firm, shareholders receive equal shares, and minority shareholders have a right to be bought out at "fair value" whether the firm survives or disappears.[22] Under the Revised Model Business Corporation Act (RMBCA), minority shareholders are also entitled to appraisal if the firm sells all or substantially all of its assets.

Attempts by Major to circumvent these rules are constrained. If, for example, Major engineers a "squeeze-out merger" to rid itself of minority shareholders, Minor will be entitled to a judicial valuation of its shares, often with favorable procedural protections. Under Delaware law, Minor will be entitled to appraisal.[23] In addition, Minor may also be entitled to bring a breach-of-fiduciary-duty action.[24] In evaluating such a squeeze-out merger, the Delaware court will place the burden on Major to prove the entire fairness of the price.[25]

7.2.2 Majority Opportunism and the Remedy for Minority Oppression

But the very provisions that protect against opportunistic exit create the problem of opportunistic lock-in. Consider case A outlined above. When Major has a falling out with Minor and Minor is left holding a minority interest in a firm controlled by Major, the standard corporation codes do not give Minor any right to be bought out or any right to dissolve the corporation. As a result, Minor may find itself locked into an investment that pays no dividends, in which Major makes all the decisions, and from which the only exit is to sell to Major at Major's bid price.

The core protection against majority oppression is the prohibition on

21. See, e.g., Del. GCL, secs. 275, 281; RMBCA, secs. 14.02–14.05.
22. Del. GCL, secs. 251, 262; RMBCA, secs. 11.01–11.06, 13.01–13.02.
23. Del. GCL, sec. 262.
24. *Weinberger v. UOP, Inc.*, 457 A.2d 701 (Del. 1983).
25. *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997).

non pro rata distributions and the related prohibitions on self-dealing, discussed above. The doctrine of minority oppression can be understood as a supplemental judicial response to this problem. Over the last twenty-five years, in response to the perceived plight of the locked-in minority shareholder, courts and legislatures have modified the law to provide remedies to minority shareholders not available to shareholders of publicly held corporations.[26] This has been done in a variety of ways. First, legislatures in many states have broadened the circumstances in which minority shareholders may force the judicial dissolution of a corporation. In addition, legislatures have expanded the range of remedies beyond dissolution, namely, to include judicially mandated buybacks at a fair price. In most jurisdictions, shareholders can petition for dissolution on the grounds of illegality, fraud, misapplication of assets, or waste. Oppressive conduct by the majority shareholder is often listed as a basis for dissolution.[27] Similarly, frustration of shareholders' reasonable expectations is often a ground for dissolution (Thompson 1988). In other jurisdictions, shareholders' reasonable expectations are the measure of whether the majority shareholder has oppressed the minority.

Second, judges have become more willing to order dissolution or a buyout, particularly if they are convinced that majority shareholders have engaged in oppressive conduct or that shareholders' reasonable expectations have been violated.

Third, courts have made it easier, substantively and procedurally, for minority shareholders to bring suit against majority shareholders for breach of fiduciary duties. Minority shareholders have benefited from several trends. First, courts have demonstrated a tendency to make stricter the fiduciary duty owed by majority shareholders. Second, courts have shown an increased skepticism toward whether the majority has fulfilled its duties. Finally, courts have broadened the situations in which a minority shareholder can bring a (procedurally simple) direct suit in place of a (procedurally complex) derivative suit. Together, these developments have moved close corporation law toward partnership law, both with regard to the ease of dissolution and with regard to the duties owed by one shareholder to the others.

These various doctrines have proved difficult to contract out of (Oest-

26. In the following, extremely cursory summary, we follow the excellent treatment in Thompson (1993). For further details, see Thompson (1988). For even more details, see O'Neal and Thompson (1985, [1986] 1995).

27. See, e.g., RMBCA, sec. 14.30(2)(ii): "The court may dissolve a corporation . . . in a proceeding by a shareholder if it is established that . . . the directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent." Under sec. 14.34(a), when shares are closely held, "the corporation may elect, or, if it fails to elect, one or more of the shareholders may elect to purchase all shares owned by the petitioning shareholder at the fair value of the shares."

erle 1995). Because the doctrines find their foundation in either a contractual covenant of good faith or a fiduciary duty, and because contracts waiving such duties are typically void, a straightforward contractual opt-out will not be effective. Similarly, contractual attempts to divest courts of authority to dissolve the corporation are generally void. Ironically, while the overwhelming trend in close corporation law has been to permit tailoring of the standard terms by contract, the area of minority protection has stood out as an exception.

In summary, then, a cause of action has evolved for shareholder oppression or, perhaps more accurately, as Robert Thompson (1993, 708) suggests, for "shareholders' dissension." This cause of action has increased the ability of shareholders of the close corporation to turn to a third-party decision maker for relief from what that shareholder argues is oppression or unfair conduct by the controlling shareholders. Although the cause of action is still evolving and its boundaries remain obscure, these developments have increased the bargaining power of the minority, ex post, vis-à-vis the majority.

The critical question is whether such developments are likely to benefit the participants in close corporations. Our point is that the close corporation is the ideal form for enterprises with a high density of match assets because of, and not despite, its lock-in feature. Accordingly, the development of shareholder-oppression law may interfere with the efficiency of the close corporation form. To reduce this possibility, what principles should guide its evolution?

7.2.3 When Is a Legal Solution Appropriate?

The possibility of opportunistic behavior does not, itself, provide a sufficient basis for judicial or legal intervention. While the problem of opportunism is pervasive in relationships characterized by investments in match and asymmetry of information, only sometimes are such problems solved by legal intervention. To put it somewhat differently, the issue is when a non–legally enforceable norm-governed relationship serves the parties' interests better than a third-party law-governed relationship.

From this perspective, one cannot understand the role of legal intervention in the close corporation until one first understands the extent to which the relationship is already self-governed by non–legally enforceable norms enabled by the core legal form. We proceed in several steps. First, because many minority-oppression cases are employment related and the employment relationship is the best example of a relationship with match investments and asymmetric information that is almost entirely norm governed, we start with a brief summary of that analysis. Second, we apply that mode of analysis to the close corporation, examining the analogous non–legally enforceable structures that constrain opportunistic behavior. Third, we examine the fundamental legal protections that make possible that self-government. With that groundwork laid, we then turn to the appropriate judicial role in rooting out residual opportunism.

7.3 Constraints on Opportunism

7.3.1 The Employment Relationship and Investments in Match

The employment relationship and, particularly, the relationship between managers and the firm is often characterized by large investments in match.[28] These include employee investments in identifying the employer, in understanding and improving job performance, and in learning the organizational and operating structures of the company and its core competencies. The company, in turn, invests in identifying and training the employee in the factors listed above and in monitoring the employee's performance to determine the most profitable future path of joint match investments. Many of these investments are match specific and would be lost if the employee left the company.

Given the magnitude of the sunk investments in match, the threshold question is why the parties enter an ongoing relationship without adopting (legally enforceable) contract terms to protect their interests. The explanation is twofold. First, contracting over the multitude of interactions would be extremely costly in a relationship that is continuous and evolving. Second, self-enforcing but non–legally enforceable norms emerge to constrain opportunistic behavior.

The widespread but puzzling features of the employment relationship can be best understood as a remarkably robust set of self-enforcing employee protections. Consider, for example, why firms choose to discharge an employee for inferior performance rather than adopting a less severe penalty, such as reduction in wages. While this may initially seem to be in conflict with the presumed interest of the parties in maintaining the employment relationship, asymmetric information requires termination rather than a wage reduction. Because of asymmetric information, employees know their work effort, but firms do not. Firms can learn by monitoring, but constant monitoring is very costly. To save on costs, workers are infrequently monitored. The harsh penalty is driven by the low detection rate. If most shirking goes undetected, workers must be penalized an amount greater than the expected loss of any specific incident.

But this optimal deterrence explanation does not explain why the penalty for inferior performance cannot be a large salary reduction. The answer is that, if the firm could simply declare that an employee was under-

28. For a fuller analysis, see Rock and Wachter (1996) and, more generally, Wachter and Wright (1990).

performing and cut his salary, the employer would have an incentive to overstate underperformance, thereby reducing costs and increasing profits. Channeling the employer's response into discharge is thus incentive compatible. In declaring inferior performance, the company must accept the loss of the employee. The company is willing to do this if the employee's performance is indeed inferior, but not otherwise. The practice of laying off workers during a slowdown, rather than reducing wages, can be understood in a similar fashion.

From this perspective, the legal doctrine of employment at will—the doctrine according to which companies can discharge employees for good reasons, bad reasons, or no reason at all—is best understood as a rule of judicial nonintervention, not the incorporation of a substantive norm of the employment relationship.[29] Even the critics of the rule do not claim that companies often discharge workers for bad reasons or no reason. Why, when the substantive norm that governs the employment relationship seems to be no discharge without cause, would the parties prefer a legal rule that says no intervention? The answer follows from the preceding analysis.

An enforceable contract must be specified ex ante in terms that can be verified ex post by the third-party enforcer. In the employment context of continuous and evolving interactions, such a contract would invariably be incomplete. Consequently, the expectations of the parties would be difficult to establish at any given point in time. Since much of the information is asymmetrically available to one party, many of the outcomes cannot be verified by third parties.

In this context, legal enforcement of the norm of no discharge without cause would undermine the norm-based system because of the difficulties of ex post third-party verification. As a starting point, proving just cause would require that the employer engage in additional detection costs, which reduces the value of the match. In addition, the third party would have to learn enough about the internal norms of the firm to determine whether a violation of the norm was meaningful enough to constitute cause. Moreover, the presence of investments in match increases the likelihood of error when third parties enforce the norms because the valuations of those assets depend, not on market prices, but on the parties' own valuations. From the employer's perspective, just cause exists when the continuation of the match with the particular employee has negative net present value, including the reputational cost of taking too tough or too easy a stance in the face of the perceived violation.

Self-enforcing norms better serve the parties' interests. On the one hand, they allow the party with the detailed information to act on his or her knowledge at low cost. At the same time, they protect the uninformed

29. For a fuller analysis, see Rock and Wachter (1996).

party by forcing the informed party's actions into channels that make opportunistic behavior unprofitable.

In cases where norms are insufficient to deter opportunistic behavior, other, nonlegal remedies are available. The parties are involved in repetitive interactions, and the employer is also a repeat player in the competitive external labor markets. Both make it costly for an employer to act opportunistically. In the ongoing employment relationship, bad play by the employer generates retributive bad play by the employees, whether in concert or individually. This can take the form of hard-to-detect work slowdowns, bad-mouthing the employer in the public domain, or even covert vandalism and theft. Such actions cause direct losses to the employer and force an increase in monitoring, which is also costly. In the labor market for new employees, a reputation for bad play is similarly costly in the form of increased difficulty attracting or retaining the best employees. Finally, in the case of nonsupervisory employees, unionization is an effective alternative, forcing the relationship into the domain of explicit contracting with a collective-bargaining agreement.

Given these advantages, the resilience of the employment-at-will doctrine in the employment relationship is not surprising. Whenever courts encroach on the doctrine through a theory of contractual interpretation, one finds that, to the extent permitted, the parties contract around the interpretation by specifying, for example, that the terms of the employment handbook are not to be taken as legally binding. The best explanation for this resilience is that, in a relationship characterized by match investments and asymmetry of information, the parties are best served by self-enforcing rather than third-party enforced agreements. It is not that opportunistic behavior is eliminated entirely, only that the benefits of the flexible norm-governed relationship outweigh the costs of residual opportunism.

We now turn to the analogous problem in the closely held corporation.

7.3.2 Close Corporation: Nonlegal Constraints on Opportunism

As in the employment context, many of the persistent features of the close corporation provide substantial, albeit non–legally enforceable, protection against opportunities for abuse that are opened up by the form itself. In this subsection, we explore how these nonlegal constraints operate and show that the seemingly detrimental lock-in of the close corporation, supplemented by the prohibition on direct and indirect non pro rata distributions, renders the form largely incentive compatible. By locking in Major and prohibiting non pro rata payments, Major will maximize Minor's stake in seeking to maximize the value of his own stake in the firm.

This is particularly true in the case in which the close corporation is like an unfinished omelette. Like the shareholders' individual inability to trigger dissolution, the lack of a market prevents exit or opportunistic threats of exit, except under narrowly defined circumstances. Locked in together, the parties can count on each other's dedication to cooking the omelette properly. This issue is also handled, at least in the Silicon Valley start-up, by legally enforceable contracts that protect early investors through particular financing structures (Sahlman 1990; Gompers 1995). In general, then, the close corporation forces the investor into a high degree of illiquidity, an unfavorable state from a traditional investment perspective, but an illiquidity that serves the interests of the parties by locking up participants in the enterprise.

A variety of other features of the close corporation can be understood as supplementing and complementing this structure. The overlap between suppliers of capital and labor reduces information asymmetries and transaction costs. Whether in the traditional or the Silicon Valley variety, the overlap puts all the relevant players into continuing contact, providing both the entrepreneur and the capital suppliers with continuing information on their own and on the company's performance.

The result is that the operations of the close corporation are akin to the stylized employment relationship discussed above. The same types of self-enforcing norms are operational. In both cases, the participants are engaged in repetitive interactions where the parties can sanction each other for bad play and can apply the appropriate sanctions more reliably than third parties who cannot observe and monitor the behavior of the parties. In the close corporation, the ability of the participants to identify improper behavior will be much greater than the ability of any third party. Moreover, the ability of the participants to punish bad behavior will likewise be great. The disenchanted minority shareholder-manager armed with greater access to company-performance information has more leverage to sanction bad play by the employer than does the individual manager in a public corporation.

Indeed, if anything, the results found in the employment relationship are stronger in the case of the close corporation because of Easterbrook and Fischel's point on agency costs. The most difficult problem in the employment relationship is aligning the interests of the employees with those of the company. Pay for performance, particularly, stock options for senior executives, reduces the misalignment in the public company, but the device is costly to the shareholders and imperfect. In the close corporation, pay for performance is a natural result of the fact that employees are also shareholders. More generally, in the public corporation's employment relationship, senior executives and shareholders occupy mostly independent spheres. In the close corporation, the spheres overlap. The wide governance mandate of its board of directors results from the overlap of roles between capital and labor providers. The shareholder-employee is involved in the governance issues normally reserved for shareholders (in the publicly held corporation) and for employees (in the employment relationship).

The robustness of the norm protection is illustrated by the high-tech sector. The occasions for opportunistic renegotiation that arise from sequential performance are a particular problem in high-tech start-ups. Venture capitalists (VCs) worry that, after accepting early financing from the VC, the entrepreneurs will find other financing once the idea proves its worth or will quit and go to work elsewhere after the VC has invested millions of dollars. Entrepreneurs worry that the VCs will find other managers once the idea has been committed to paper and has proved its worth. These concerns, which are simply a special and detailed case of the more general problems of the close corporation, are the subject of intense contracting (and research). We illustrate by considering a few details.

The VCs protect themselves in several ways.[30] First, a surprising stylized fact of the Silicon Valley start-up is that the VCs have the right to replace the entrepreneur with a professional manager (Hellmann 1998). In addition, the terminated entrepreneur can often be forced to sell his stock back to the firm at cost, which will be well below its actual value. Finally, entrepreneurs do not automatically receive generous severance packages.

Thomas Hellmann (1998) explains why the VCs would demand such terms as a response to a holdup problem. Entrepreneurs gain private benefits of control, which lead them to stay on longer than they should. By contrast, the VCs' incentives are much better aligned with maximizing firm value, and, moreover, they are better situated to identify better professional managers. In Hellmann's model, unless the VC receives the right to displace the entrepreneur, it will not invest optimally in searching for replacement managers.

How the entrepreneurs protect themselves is equally interesting. After all, if the VC has the right to terminate the entrepreneur, which triggers a stock buyback at cost, there would seem to be an incentive to do so. The entrepreneur's protections here are entirely nonlegal, but they are substantial. Most important, VCs are repeat players in the start-up business and are likely to be constrained on a number of fronts. First, they compete to provide financing for the most promising start-ups and are thus likely to be constrained by reputational effects in their aim to maintain their position in relation to other start-up companies. In addition, the VC has to replace the entrepreneur with another person. Wrongful discharge of the CEO, even if protected from judicial second-guessing by the employment-at-will doctrine, is not a strong starting point in any recruitment process.

30. For further discussion of the provisions in this paragraph, see Fenn, Liang, and Prowse (1995, 32–33), Barry et al. (1990), Gorman and Sahlman (1989), Gompers (1995), and Lerner (1995).

Finally, the discharge will raise questions with other capital suppliers. It is a negative signal under the best of circumstances and is likely to raise the company's cost of capital. This, of course, is precisely the story we told about employment at will more generally, and the fact that employment at will governs even in a domain of such intensive contracting as the Silicon Valley high-tech sector is further support for our analysis.

That still leaves open the question of why the entrepreneur's stock position can be bought out at cost. The likely answer here, as stressed throughout the paper, is the difficulty of determining market value for a start-up company that does not trade in a public market. The contract term that sets the buyback price at cost, however, is a default setting. Here again, the VC will have a strong reputational incentive to deal fairly with the discharged entrepreneur, including paying a higher price if that can be reliably determined.

Another feature that is particularly striking is the absence of any general right to trigger dissolution or to be bought out at a pro rata share of firm value. The choice made in the high-tech sector, where contracting is most explicit, is to leave the lock-in in place and to avoid judicial valuation of hard-to-value assets, even at the cost of some residual opportunism. This is consistent with the more general reactions to the special close corporation chapters of corporation codes, promulgated by some jurisdictions in response to developments in the law and academic commentary: few firms avail themselves of the opportunity to organize under such statutes. On the contrary, close corporations seem stubbornly to adhere to organizing under the general corporation codes.

7.4 The Proper Judicial Role in the Three Cases

We have argued that the lock-in effect of the corporate form is what makes it so attractive for firms that benefit from extensive investments in match. We have argued further that there are a variety of structural features that limit the incentives and constrain the ability of the participants to act opportunistically, the principal threat to optimal match investment. In addition, the law limits significantly the non pro rata distribution of assets from the corporation and provides for pro rata treatment on dissolution and merger. Moreover, the law provides for a judicial valuation of minority shares in a sharply limited number of situations. Finally, participants are free to contract for additional or different terms, an opportunity that participants liberally use.

The remaining question is what room, if any, is there for further judicial intervention on behalf of minority shareholders? The worry is that judicial attempts to protect minority shareholders against opportunistic behavior will jeopardize the web of features and protections that makes the close corporation form so attractive and popular for firms with substantial match-specific assets.[31] In guarding further against the potential for minority oppression, do we end up increasing the potential for opportunism in the relationship by providing Minor with more chances to act opportunistically against Major?

7.4.1 Case A: Employment at Will as Minority Oppression?

Consider case A, in which Major fires Minor. Minor, the terminated minority shareholder who invested in match-specific assets related to a new network switch, had the expectation that he would share in the returns generated from the venture. We worry that Minor will not be able to share the fruit of his efforts now that he has had a falling out with fellow shareholder Major. Moreover, we worry that, having lost his job, Minor will be forced by economic necessity, and the absence of a liquid market for shares, to sell his shares at a fraction of the pro rata value of the firm. The Minors of the world, we worry, never being sure whether they will end up on the wrong end of a disagreement, will not invest optimally in match-specific assets unless their employment and investment expectations are protected.

There are two variants of case A that must be considered. First, assume that Major is the entrepreneur who supplies the ideas and has 60 percent of the stock and that Minor supplies the money and has 40 percent. What possibilities for opportunism arise in the absence of any special protection for minority shareholders? Suppose that, after Minor has invested his money and the idea is developing well, Major says, "I want an additional 10 percent of the equity, or else you will never see a dime of profit," or any number of variants that amount to the same thing. Is this a credible threat? Clearly, the answer is no. First, because of the restrictions on non pro rata distributions, if Minor does not get any dividends, neither does Major. Second, if Minor is providing more than money (management advice, industry contacts, etc.), Major may still need him. Third, the market and the need for a stream of additional capital will constrain Major's ability to threaten Minor. In these circumstances, Minor will be unwilling to put more capital into the business. Other potential investors are likely to refuse as well as soon as they learn of the incident. As long as Minor remains a material owner of the company or is known in the financial community, those in the financial community who are considering investments will undoubtedly learn of Major's opportunism. Empirical research on the

31. A weaker proposal would be to make the minority protection a default setting, from which firms could opt out. The experience of states that have special optional close corporation provisions suggests that there would be boilerplate opt-out of default settings. The widespread contracting around departures from the employment-at-will doctrine through the interpretation of employee handbooks likewise suggests that any variation would have to be mandatory to be effective.

high-tech sector confirms that the financial people are quite good at contracting for particular sorts of devices to protect against this sort of opportunism.

Consider, now, the reverse scenario: Major supplies the financial resources and holds 60 percent, while Minor is the entrepreneur who supplies the ideas and has 40 percent. Once Minor commits his idea to patentable paper, Major fires Minor. Minor has neither an employment agreement nor any shareholders' agreement that provides for a buyout right. Does Minor have a claim on our sympathies?

In this case, a threshold question is whether Minor's contribution is "one off." If it is, then Minor opens himself to opportunistic renegotiation if Minor commits the contribution before Major finishes performing. But, when the contribution really is one off, without the necessity for ongoing involvement (the scenario that gives rise to the threat of opportunism), there is an easy transactional solution: a license or sale. The person (or persons) who discovers something important but has nothing further to contribute should license or sell the idea to Major, who will then develop it. Similarly, when the capital provider has only a single investment to make and has nothing else to contribute, he should buy limited partnership shares with a VC who can then control the opportunistic Majors because of his superior knowledge and network. Of course, the onetime, would-be financier may purchase the patent or license it, only to go broke owing to his own lack of good follow-up ideas. The critical fact, however, is the following: when the contribution is, indeed, one off, there is no business reason to use the corporate form at all.

Focus, then, on the difficult cases that will involve plaintiffs who believe that they are still making contributions to the firm. If brought before a third party for resolution, Major will explain that Minor was fired because Minor has been shirking or is not suited to the current demands of his job or needs of the firm. That is, Minor is no longer making a valuable contribution. Minor will maintain that he was fired because Major wanted to take Minor's ideas for himself and capture all the gains.

This is precisely the same problem that is addressed in employment law by the employment-at-will doctrine. Sorting out the truth, here, raises precisely the difficulties of relying on a third party to resolve employment disputes. It is very difficult for the court to determine ex post what the parties' reasonable expectations were ex ante. Even if the court could determine the parties' expectations, performance is largely unobservable, so the court will be unable to determine whether the expectations have been satisfied. As in the employment context, Major and Minor know much more about who is telling the truth than a judge can ever discover. In addition, valuing the relationship-specific assets to determine whether opportunism has occurred and, if so, to set damages is, in theory and in practice, necessarily speculative. Finally, permitting Minor to sue for oppression or breach of reasonable expectations will, as in the employment context, undermine the web of self-enforcing relationships that provides the principal protection for investments in match.

Against this background, consider the classic case A case, *Wilkes v. Springside Nursing Home.*[32] Wilkes, along with three others, established a nursing home, with the work and profits apportioned more or less equally. After a falling out, the others forced Wilkes out of active participation in the management of the enterprise and cut off all corporate payments. Wilkes alleged that his termination constituted a breach of the fiduciary duties owed him by the majority shareholders. According to the court, "The severance of Wilkes from the payroll resulted not from misconduct or neglect of duties, but because of the personal desire of [the other shareholders] to prevent him from continuing to receive money from the corporation."

In holding for Wilkes, the court stated:

> 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." . . . The minority stockholder typically depends on his salary as the principal return on his investment, since the "earnings of a close corporation . . . are distributed in major part in salaries, bonuses and retirement benefits." . . . Other noneconomic interests of the minority stockholder are likewise injuriously affected by barring him from corporate office. . . . Such action severely restricts his participation in the management of the enterprise and he is relegated to enjoying those benefits incident to his status as a stockholder. . . . In sum, by terminating a minority shareholder's employment or by severing him from a position as an officer or director, the majority effectively frustrate the minority stockholder's purposes in entering on the corporate venture and also deny him an equal return on his investment.

That said, the court recognized the extent to which the controlling group needed "room to maneuver in establishing the business policy of the corporation." As a compromise, the court established a "legitimate business purpose" test: "When an asserted business purpose for their action is advanced by the majority, . . . we think it is open to minority stockholders to demonstrate that the same legitimate objective could have been achieved though an alternative course of action less harmful to the minority's interest." Because the majority had not shown a legitimate business purpose in terminating Wilkes's involvement in the firm, the court held for Wilkes.

There is, in addition, a second argument suggested that raises some additional issues. The court notes, "Other noneconomic interests of the minority stockholder are likewise injuriously affected by barring him from corporate office. . . . Such action severely restricts his participation in the

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

management of the enterprise and he is relegated to enjoying those benefits incident to his status as a stockholder." The exact thrust of the court's argument here is somewhat unclear. One reading of this claim is that there are valuable, noneconomic benefits that come with participation in the firm. To the extent that this is the argument, it simply amplifies the no-just-cause claim.

But there is a much more relevant alternative reading, namely, that terminating Wilkes's participation in the firm made it impossible for him to continue to monitor his coshareholders and that, because of the asymmetry of information that characterizes the close corporation form, this renders his continued participation as a shareholder untenable. This is an argument that differs both from the faulty employment-at-will concerns and from the non pro rata distribution concerns discussed below.

Could the other shareholders in *Wilkes* have been behaving opportunistically? Could they have terminated Wilkes's relationship with the firm in order to expropriate his investment now that he had already committed whatever special skills and knowledge he had? Absolutely. Opportunistic behavior is clearly possible in such circumstances. But that, alone, is not sufficient to justify the court's response, namely, a case-by-case analysis of termination to see whether the firm acted with "legitimate business purpose" and with no "less harmful alternative." That is the same as saying that, because opportunistic behavior is possible in the employment relationship, a court should scrutinize each termination to see if it was for just cause.[33]

Case A and *Wilkes* both present situations in which the majority shareholder or shareholders could be behaving opportunistically. But, in both cases, there are numerous nonlegal constraints on such behavior. If Major treats Minor badly, Major will have greater difficulty convincing current shareholder-employees to continue investing time, money, and effort in the enterprise and convincing prospective investors or prospective employees to join the firm on the same terms as Minor did. These are the reputation and self-help stories described earlier.

But suppose that Minor's idea or Wilkes's stake is so valuable that Major is willing to suffer whatever reputational cost it will incur by acting badly? Minor and Wilkes are still not unprotected. If Major successfully markets or develops Minor's patent or sells it, or if Springside Nursing Homes sells the nursing home to a national chain, Minor and Wilkes are still protected by the rule of no non pro rata distributions. If Major ultimately decides to liquidate or sell the firm in order to take its profits on Minor's invention, Minor will likewise receive his share. In the meantime, Minor will be in a position to make Major's life difficult with requests

33. This, of course, is precisely the argument that opponents of the employment-at-will doctrine make.

for information and threats of litigation. Finally, if these protections are insufficient and the problem is significant, future Minors always have the option of specifying additional protections by contract.

On the other side of the equation, to permit judicial scrutiny of Minor's or Wilkes's termination is to undermine the very advantages of the informal, non–legally enforceable set of protections that constitute relational "contracts." As we have argued elsewhere (Rock and Wachter 1996) in connection with the employment-at-will doctrine, the attempt to root out residual opportunism—opportunism that slips through the network of legal and nonlegal constraints—threatens to undermine the self-enforcing character of the overall relationship. Moreover, as we discuss in more detail below, the court's difficulties determining whether a discharge was for a "legitimate business purpose" are aggravated by the difficulties of valuing match assets in awarding Minor the "fair value" of his shares in a judicially mandated buyout.

The *Wilkes* case is a good example of the difficulties that courts have with the employment issues that frequently overlay close corporation cases.[34] For example, was the court correct in saying that there was no legitimate business purpose in terminating Wilkes's employment? On the one hand, we are told that there was no misconduct and that Wilkes "had always accomplished his assigned share of the duties competently." The court, however, made no attempt to determine whether Wilkes's services were still needed. Apparently, he was not replaced, suggesting overstaffing. By not appreciating the norms of the employment relationship, the court stumbled badly, inferring a right to continued employment subject only to proof of misconduct. Such a right is so at variance with employment practice anywhere that its insertion in the case undermines the logical application of the legitimate-business-purpose standard.

7.4.2 Case B: Stock Buybacks as Minority Oppression?

Consider, now, case B: Major forces the firm to buy back a portion of Major's shares (but leaving Major in control) at an entirely fair price, without giving Minor a proportionally equal opportunity to cash out. The principal variant of case B is where Major Group, the controlling shareholder group, buys back the shares of one of the control group without giving Minor a proportionally equal opportunity to cash out. In either case, does Minor have a claim on our sympathies? Here, we worry that, even if his transaction with the firm meets the entire fairness valuation standard, Major gets a benefit that Minor does not: the ability to cash out a portion of his holdings when doing so is profitable. We worry that Major's ability to "have his cake and eat it too" will undermine Minor's incen-

34. The importance of employment disputes and the employment-at-will doctrine in the close corporation setting is stressed in Johnston (1992).

tive to invest optimally in the firm by breaking the beneficial lock-in feature of the corporate form.

This is the issue in *Donahue v. Rodd Electrotype.*[35] In *Donahue,* the controlling shareholder, Dad, distributed most of his shares to his children who worked in the business. Subsequently, his sons wished that Dad would retire, and he was agreeable, but he would do so only if he could sell some of his remaining shares back to the firm (with the remainder distributed later to his sons). The firm bought back Dad's shares without offering an equal opportunity to the minority shareholders, who challenged this as a breach of fiduciary duty. After a lengthy discussion of the extent to which close corporations are really little more than incorporated partnerships, a discussion that is not only wrong but unnecessary to the decision of the case, the Supreme Judicial Court of Massachusetts held: "If the stockholder whose shares were purchased was a member of the controlling group, the controlling stockholders must cause the corporation to offer each stockholder an equal opportunity to sell a ratable number of his shares to the corporation at an identical price."

Nixon v. Blackwell likewise involved a stock-repurchase plan.[36] In *Nixon,* the firm established an ESOP (employee stock-option plan) that held company stock and provided departing shareholder-employees with the right to receive cash for their interest in the ESOP when they retired. In addition, the company established key-man insurance policies that allowed proceeds from the plan to be used to purchase stock in executives' estates. The nonemployee minority shareholders objected on the grounds that they were not provided an equal opportunity to sell their shares. The Chancery Court held that it was "inherently unfair" for the controlling shareholders to provide liquidity for themselves without providing comparable liquidity for the nonemployee shareholders.[37] The Delaware Supreme Court reversed, holding that the stock-repurchase plans served a legitimate corporate interest by maintaining an overlap between employment and ownership and that the defendants met the entire fairness standard.

Plaintiffs claimed that the preferential repurchase of shares was a breach of fiduciary duty. The claim raises the question of the extent to which preferential repurchase schemes are problematic not solely because the price is too high (a version of pure self-dealing) but because they undermine the alignment of interests between the majority and the minority shareholders that makes the form work. There are two aspects to the claim here. First, as we describe in more detail below, to the extent that a high density of match assets characterizes close corporations, it becomes very difficult for the court to determine whether the repurchase price was en-

35. *Donahue v. Rodd Electrotype Co.,* 328 N.E.2d 505 (Mass. 1975).
36. *Nixon v. Blackwell,* 626 A.2d 1366 (Del. 1993).
37. *Blackwell v. Nixon,* 1991 WL 194725 (Del. Ch. 1991).

tirely fair because there is no market benchmark. Second, even if one could value the shares, the preferential repurchase can be objectionable because it undermines the incentive-compatible lock-in that is the great attraction of the legal form. It is these aspects of the problem that lie at the heart of both *Nixon* and *Donahue* and that are not explicitly discussed in either decision. These are very different situations than those that occurred in case A: they do not raise the intrafirm employment questions that made the prior case so difficult.

But, at the same time, these cases also differ from the classic non pro rata distribution of firm assets. Here, the firm receives something of value in return for cash: shares of the firm. Normally, under the duty of loyalty, transactions between a fiduciary and the firm are not per se void or voidable. Rather, they are judged under the entire fairness standard and, if entirely fair, are valid.

The question is whether regulating such transactions is necessary to supplement the prohibition on non pro rata distributions and, if so, how to do so. The dimensions of the problems and the trade-offs among different approaches are complex. First, one needs to maintain the beneficial lock-in of participants that harnesses the self-interested efforts of the controlling shareholders in the interests of all participants. Second, one must prevent non pro rata distributions, distributions that can be made by the advantageous purchase or sale of shares. Third, one needs to maintain flexibility in the management of the firm's capital structure and compensation practices. Finally, one needs to provide for the orderly exit of participants.

There are three types of cases that must be accounted for. First, the control group may decide to buy out a minority shareholder. In such cases, there is little potential for opportunism. Second, the control group may decide to buy out a shareholder-employee who is exiting, or has exited, the firm, as in both *Donahue v. Rodd* and *Nixon v. Blackwell*. Here, the potential for opportunism is greater as the control shareholders may prefer one of their own over outside nonemployee shareholders and there may be disguised self-dealing. On the other hand, as continuing shareholder-employees, they will also bear a pro rata share of the cost. Finally, the controlling shareholder sells shares to the firm without giving up control. This is the most dangerous circumstance: the controlling shareholder has a clear incentive to receive an excessively high price while not giving up any of the private benefits of control.[38]

38. A related issue is presented by *Kahn v. Tremont Corp.*, 694 A.2d 422 (Del. 1997). In that case, Harold Simmons, the controlling shareholder of Valhi Corp. and, through Valhi, of NL Industries, was alleged to have used his control over a third corporation, Tremont, to cause Tremont to buy Valhi-owned shares of NL Industries at an excessively high price. Simmons was able to reduce his holdings in NL, without giving up control, at an allegedly excessive price, without other shareholders having an equal opportunity to cash out.

How does the law handle this range of cases? One reading of the law is to generalize *Donahue v. Rodd* into a general prohibition on the selective buyback of shares in close corporations, that is, an equal opportunity rule. This largely eliminates the opportunistic use of buybacks, but at the cost of impairing the firm's flexibility in adjusting its capital structure and compensation policies and providing exit to shareholders.

A second possibility is to generalize *Nixon v. Blackwell* into a general standard permitting selective stock repurchases whenever they are entirely fair. This preserves the firm's flexibility in compensation and in providing exit, but at the cost of diluting the beneficial lock-in.

A final possibility—which is plausible—is that *both Donahue v. Rodd* and *Nixon v. Blackwell* are correctly decided within their individual domains. *Nixon* addresses one aspect of the more complicated middle cases. Note that the Supreme Court's ruling in *Nixon* emphasized that the buyback was pursuant to a long-standing corporate policy to which the minority apparently did not object when first instituted and that the policy was adopted to benefit the corporation. Indeed, the Court viewed the policy as a form of deferred compensation that provided the firm with flexibility to adopt standard deferred-compensation packages used in other firms to encourage superior employee performance. Moreover, the court emphasized how the policy was applied in an entirely nondiscriminatory fashion among retiring employees. By contrast, the Chancery Court viewed the policy, not as a deferred-compensation practice, but as a straight financial structure issue in which members of the control group were given preference over nonemployee shareholders in cashing out.

As in case A, courts must be careful not to confuse employment-relationship issues with straightforward capital structure questions. If courts prevent firms from adopting deferred-compensation plans because of an equal opportunity rule on the exit end, close corporations will not be able to develop optimal incentive-based compensation mechanisms. In evaluating such cases, courts must look to both the compensation and the financial capital aspects of the situation, with particular attention to indicia of self-dealing.

Because of the potential for self-dealing when a control group buys out one of its own, the entire fairness rule applies. Under entire fairness, the Delaware courts look at both fair dealing and fair price. For the Delaware Supreme Court, the fact that the stock-purchase plans were adopted for legitimate corporate purposes (maintaining the overlap between ownership and control) and were provided to the shareholder-employees on a nondiscriminatory basis established fair dealing. Interestingly, the issue of whether the price paid for the shares was excessive did not come up.

In the close corporation context, both fair price and fair dealing can be problematic. Whether a repurchase plan is discriminatory depends on how the relevant group is defined. In *Nixon,* the Chancery Court found the plan discriminatory because it did not treat employee and nonemployee shareholders equally.[39] By contrast, the Delaware Supreme Court could have found it nondiscriminatory because it treated all employee shareholders equally, although, ultimately, it held that the discrimination against nonemployee shareholders was justifiable.[40] Similarly, relying on fair price is problematic when, as we discuss in more detail in the next section, the valuation problem is often intractable.

How, then, can one understand *Donahue v. Rodd* and its relation to *Nixon?* The primary difference between the two cases is that the control group in *Donahue* was a family group. One worries that the payment to Dad is disguised self-dealing, that the more Dad gets for his shares, the less the children who work in the business will have to contribute to buy him an apartment in Miami. The very family relations that Easterbrook and Fischel emphasize as important in reducing agency costs within the close corporation increase significantly the potential for self-dealing when the family group is dealing with nonfamily shareholders.

If the existence of a family relationship significantly increases the risks of self-dealing, then one can understand *Donahue v. Rodd* as consistent with *Nixon.* Reading them together, the standard in both is entire fairness, a standard not met in *Donahue* because of a (conclusive) presumption that the repurchase was not entirely fair. One can also understand the role of equal opportunity here. If adopted by the control group, it is powerful evidence that the transaction is entirely fair. In *Donahue*-type cases, offering minority shareholders an equal opportunity to exit reverses the presumption that buying back Dad's shares redounds to the sons' individual benefit by relieving them of some other financial obligation.

Appreciate, for a moment, the subtlety of the structure. While the firm is developing or producing omelettes and therefore has a reputational stake in not breaching its agreements, there are a variety of structural features that align interests, and the principal legal restriction is no non pro rata distributions. This means that the majority shareholder can refuse to pay dividends, but only at the cost of all shareholders' capital remaining trapped in the firm. This lock-in, plus the other features outlined above, provides a strong incentive for the majority shareholder to maximize firm value, thereby protecting the minority shareholders' investments as well.

But the lock-in is not absolute. As reconstructed above, the law has evolved to permit sufficient flexibility to allow the firm selectively to offer some shareholders the opportunity to cash out without offering the same opportunity to all shareholders when doing so benefits the firm. In doing so, the law distinguishes according to the potential for opportunistic be-

39. *Blackwell v. Nixon,* 1991 WL 194725 (Del. Ch. 1991), at *6.
40. *Nixon v. Blackwell,* 626 A.2d 1366, 1379 (Del. 1993).

havior by controlling shareholders. Thus, when the firm buys shares from noncontrolling shareholders, the business-judgment rule applies. When it buys shares from members of the control group who are exiting, the entire fairness standard applies, with equal opportunity being powerful evidence of entire fairness. Finally, when the firm buys back shares from a controlling shareholder or shareholding family who is remaining in the firm, the potential for self-dealing is so great that entire fairness is not satisfied absent equal opportunity.[41]

Once, however, the company enters the last period, defined by the distribution of a firm's equity capital, the norm against non pro rata distributions again protects locked-in minority shareholders. The rule of no non pro rata distribution now means that minority shareholders are able to cash out at the pro rata valuation. As the majority owner, Major gets to define when the omelette is finished and signals that fact by voiding the lock-in, either by dissolution, by merger, or by an initial public offering of stock. But, now, Minor gets to exit, either through a pro rata share of the firm equity in dissolution, or through an appraisal proceeding if the firm is merged into another firm, or by selling out to the market after a public offering of shares.

The rule against non pro rata distributions is the linchpin: it is the rule that prevents the participants from jumping out of these channels. So long as non pro rata distributions are controlled, remaining problems that arise between shareholders can be handled by analogy to employment at will: courts should not intervene in the absence of an explicit contract.

The analysis, then, largely parallels the employment-at-will account. In both cases, locking participants in to a relationship in which there are substantial investments in match is valuable because it avoids the holdup problem (threatening to leave before the omelette is done). It also forces the parties to resolve the problems themselves, avoiding defections; provides high-powered incentives to succeed; and prevents the parties from threatening to impose heavy costs (by threatening expensive litigation) as a way of renegotiating the division of the joint surplus.

In this sense, the principles applied in cases A and B are the same. In case A, Minor wants to be cashed out, at least if he cannot continue as an employee. In case B, Major wants to be cashed out, at least if he can continue in control. On our analysis, the answer is the same in both cases: neither can cash out without the other shareholders cashing out to the same degree. And, in both cases, the reason is the same: the omelette may

41. Paul Mahoney (chap. 6 in this volume) argues for minority exit at will as a default setting, using a game-theoretic model. In arriving at his conclusion, Mahoney assumes full information and, further, that, on average, courts will be correct in their valuation of closely held firms. But, when there is a high density of match assets, neither assumption will likely be correct.

not be finished yet. Major gets to decide when the omelette is finished, but, once Major declares the omelette finished, Minor shares pro rata. Meanwhile, neither gets to pull out equity.

7.4.3 Courts' Comparative Advantage: Do Cases A and B Differ?

Our analysis distinguishes sharply between case A and case B. But, say some, our distinction misses the point of what the courts are doing in these cases and, in particular, why it is important for courts to intervene in case A situations.[42] The problem, they say, is that courts cannot distinguish between market rates of compensation and excessive compensation and therefore should and do protect minority shareholders' employment in the firm as a second-best technique for protecting their investment expectations. On this view, unless you protect the expectation of employment, including the expected salary, the financial investment in the firm becomes worthless. That is, if pro rata distributions are to be defended, case A must be treated like case B in the sense of judicial intervention to protect the minority shareholder.

But this argument misses the fundamental reason that courts should not and generally do not intervene in employment cases. The argument incorrectly assumes that a court is better at distinguishing discharge for cause from minority oppression, and, when the remedy is a buyout, calculating fair value, than it is at figuring out whether payments by the firm to the majority shareholder constitute a non pro rata distribution to a shareholder. In fact, because of the presence of significant investments in match, exactly the opposite is the case, and the court is likely to be far better at policing non pro rata distributions than employment issues.

Compare the two inquiries. In case A, the court must first determine whether a termination was for cause or, more or less equivalently, for a legitimate business purpose. Having determined that a termination was unjustified, the court must then either order reinstatement or, more likely, given the bad blood between participants, order either dissolution of the corporation or a buyout of the minority shareholder at fair value. In either case, the court will have to calculate the value of the firm because, given the presence of substantial investments in match, the highest-valuing buyer in a dissolution will likely be the majority shareholder.

The first inquiry faces all the problems that have been discussed with regard to the employment-at-will doctrine. Not only is the for-cause/fair-value standard a much harder standard to apply, but it does not even eliminate the need to police non pro rata distributions. Even if an employee shareholder has been discharged for cause, so long as he is a shareholder, his financial investment in the firm must still be protected against such distributions by the majority.

42. We owe the acute articulation of this point to Robert Thompson.

The second inquiry is even worse. If we are correct that the close corporation form is most appropriate for firms with substantial investments in match, the valuation problem will be intractable: a market valuation will be unavailable (because the assets are worth much less to third parties than to the participants in the enterprise), and a cash-flow analysis will face all the information problems that make it impossible to sell the assets to third parties.

Generally, a company's assets are valued by first estimating the future discounted stream of the free cash flow that they generate and then attaching a multiple that reflects the discount rate and the risk associated with the cash flow. The estimate of free cash flow is based on several factors, including the past performance of the company in generating revenue, the performance of comparable assets in other companies, and the market outlook for the products produced by the assets. While this standard valuation methodology is adequate for established firms, it does not work well in most close corporations because the required data are not available. The company may have very limited past performance, the management may be too untested to allow reliable future predictions, and the company's products or services may be too novel to allow easy comparisons with seasoned firms. It requires time to determine whether the product ideas will work out and produce free cash flow of any given size.

Indeed, the difficulties of valuing the assets of the close corporation are, at least in the Silicon Valley context, an important explanation for why the company continues to be privately held. By the time enough information is available on likely performance to value the match assets of the close corporation, it is time for the close corporation to go public. Similarly, for firms furthest from access to a public market, the valuation problems are the greatest. Take, for example, the classic mom and pop. Where mom and pop are the enterprise, it is difficult to distinguish any ongoing market value from the value provided by the principals. The enterprise's match assets may be so tied to mom and pop that no independent valuation can be attributed to the firm's other assets. Moreover, in this case, generating additional years of performance data will not bring the firm closer to a reliable market valuation. Valuing the firm by looking at the sale value of comparable firms would also be stymied by the distinctiveness of the enterprise and the difficulty identifying comparables. Finally, when comparable companies can be found, one's confidence in the resulting valuations would be challenged by the thinness of the market.

By contrast, consider the judicial inquiry under the norm of no non pro rata distributions in case B. First, insofar as the claim is one of a failure to pay dividends, the inquiry is straightforward: as long as no one is receiving dividends, so long as the earnings are retained in the corporation, the court can defer to the discretion of the board, knowing that everyone's earnings are equally locked in.

Second, consider the manifold varieties of basic self-dealing, ranging from excessive salaries, to non pro rata dividends, to diversion of corporate opportunities, to sales to or purchases from the corporation. This is the classic domain of the duty of loyalty. The basic principle, here, is that the majority shareholder will bear the burden of establishing entire fairness, where *entire fairness* is defined with reference to an unconflicted arm's-length transaction.

Consider salaries as an example, although the analysis applies equally to other transactions with the corporation. The standard is a market standard: Are the controlling shareholders receiving more than the market wage? When, as is often the case, the controlling shareholders set their own salary, standard corporate law analysis imposes the burden of establishing entire fairness on the controlling shareholders, that is, showing that the wage is at or below the comparable market level. While plaintiffs typically fail in challenges to dividend policy or employment policy, they apparently fare substantially better in challenges to excessive compensation.[43]

Moreover, courts have already had experience in determining, in the tax context, whether close corporation salaries are excessive.[44] When there were tax advantages to paying dividends as above-market salary, the IRS scrutinized such payments on precisely this basis. As the tax preference for distributions in salary disappears, determining whether a salary meets the market test is likely to be easier because relevant benchmarks will be less distorted.

In addition, the courts have at their disposal their traditional methods of shaping the decision process by allocating burdens of proof. Thus, the courts will be more deferential to salaries that are set by independent outside directors than by the majority shareholders themselves. Interestingly, for example, the problem of diversion of profits to majority shareholders through excessive salaries seems nonexistent in the Silicon Valley high-tech context, in part at least because managers' salaries are set by, or at least in consultation with, the venture capitalists.

While judicial intervention in case A forces courts to value the firm, with the associated problems created by the high density of match-specific assets, no such difficulties bedevil case B. In the salary context, the question is whether a salary is excessive relative to market equivalents. In the context of other transactions with the firm, the issue is likewise whether

43. *Donahue* at n. 15: "Attacks on allegedly excessive salaries voted for officers and directors fare better in the courts. . . . What is 'reasonable compensation' is a question of fact. . . . The proof which establishes an excess over such 'reasonable compensation' appears easier than the proof which would establish bad faith or plain abuse of discretion." See also *Alaska Plastics v. Coppock*, 621 P.2d 270 (Alaska 1980); and *Crosby v. Beam*, 548 N.E.2d 217 (Ohio 1989).

44. See, e.g., *Alaska Plastics v. Coppock*, 621 P.2d 270 (Alaska 1980).

the terms of the transaction between the majority shareholder and the firm meet the market test. In the case of dividends, the question is only whether all shareholders receive the same amount.

Indeed, the only times the court must enter the thicket of valuing the firm are when the firm is being sold (by a merger or a sale of assets, in some jurisdictions) and the minority shareholders request appraisal or when there is a selective stock repurchase. In the case of an arm's-length merger, the shareholders have the opportunity to receive the same consideration as the majority shareholder but believe that their shares are worth more. But, in those circumstances, precisely because the firm is being sold, there is at least one measure of valuation available. Moreover, because all shareholders share equally in the proceeds of a sale or dissolution, the majority shareholder is likely to represent the interests of the minority shareholders. Major is unlikely to sell the firm unless it has reached the stage where its third-party value is beginning to approach the value to the participants.[45] As discussed earlier, selective stock repurchases present genuinely difficult issues.

The focus on preventing non pro rata distributions points the way toward incremental modifications within the existing framework to increase the level of enforcement without entering the for-cause thickets, without disturbing the employment-at-will standard, and without judicial valuation. For example, once it is clear that the issue is preventing non pro rata distributions, the courts should make it easier to challenge contracts between the controlling shareholder and the firm. Consider *Crosby v. Beam,* in which the majority shareholders entered into self-dealing contracts with the firm, including unreasonable salaries, use of corporate property, life insurance, low-interest loans, and so forth.[46] The legal issue was whether the minority shareholders must challenge the agreements through a derivative suit, which is subject to the demand requirement and in which any recovery is paid into the corporate treasury, or whether the minority shareholders could bring a direct suit. After a long discussion of how, in a close corporation, the majority shareholders owe fiduciary duties to the minority shareholders, the court held that the suit could be brought as a direct suit, with recovery going directly to the plaintiffs: "Given the foregoing, if we require a minority shareholder in a close corporation, who alleges that the majority shareholders breached their fiduciary duty to him, to institute an action pursuant to Civ. R. 23.1, then any recovery would accrue to the corporation and remain under the control of the very parties who are defendants in the litigation. Thus, a derivative remedy is not

45. A more difficult problem arises when it is the majority shareholder who is buying out the minority shares. Under these circumstances, the court has no choice but to enter the difficult problem of valuation, and, although it can and does seek to avoid the difficult valuation questions by encouraging the use of independent negotiating structures to mimic an arm's-length sale, its success in doing so is only limited.

46. *Crosby v. Beam,* 548 N.E.2d 217 (Ohio 1989).

an effective remedy because the wrongdoers would be the principal beneficiaries of the recovery. See, generally, 2 O'Neal's Close Corporations, at 120–123 section 8.11."

According to our analysis, the court got it half right. The fact that the majority is accused of engaging in a self-interested transaction with the firm is, of course, central and, in a derivative suit, would fully justify excusing demand as obviously futile and allowing the plaintiff to proceed directly to the merits of the action. But, if the guiding principle is preserving the beneficial lock-in effect of corporate form against attempts at non pro rata distributions, then the right result is that any excessive payments go back into the corporation, where they remain locked up until the majority chooses to make some sort of pro rata distribution. This is an adjustment to the procedural requirement for derivative suits in the light of the special nature of close corporations (or, perhaps, simply an application), but it is a quite different sort of adjustment than that adopted by the Ohio Supreme Court.

Along the same lines, an appreciation of the central issue will lead courts to give less deference to the board of directors in setting its own compensation or in approving asset distributions of other sorts. Finally, it makes it clear that, in the absence of some independent decision maker, the burden of proof falls on the majority shareholder to justify salaries and other payments as entirely fair.

7.4.4 Case C: Is the Sale of Control for a Premium a Non Pro Rata Distribution?

In the close corporation, we take the rule of no non pro rata distributions to have the status of a commandment. It is the principle that makes the whole thing work, that allows minority shareholders to rely on majority shareholders to manage the firm in the general shareholder interest. It is this principle that allows for optimal investment in match-specific assets. Finally, enforcing this principle frees the courts from having to enter on the impossible (and destructive) tasks of sorting out, on the one hand, whether a discharge of a minority shareholder-employee was for cause and, on the other, how much the firm is worth.

What, then, does one make of case C, in which Major sells its majority block to a third party who is unwilling to buy the minority shares on equal terms? Under U.S. corporate law, the general common law rule is that the majority shareholder may sell its holdings, and a buyer may buy its holdings, without offering the minority shareholders an opportunity to participate.[47] The principal exception is when the majority or controlling shareholder has reason to believe that the buyer will loot the corporation.[48]

47. See, e.g., *Zetlin v. Hanson Holdings,* 397 N.E.2d 387 (N.Y. 1979).
48. See, e.g., *Gerdes v. Reynolds,* 28 N.Y.S.2d 622 (Sup. Ct., Spec. Term 1941).

There are a few cases to the contrary, but this is the general rule (see, generally, Elhauge 1992). Much has been written on the efficiency of competing rules governing sales of control. We cannot enter that thicket here but must address the relation between sales of control and non pro rata distributions and, more generally, the connection between sales of control and firms with heavy match investments.

Case C seems to be an interesting and difficult mix of cases A and B: when the majority shareholder sells control, he thereby terminates his relationship with the firm while taking a larger than pro rata share of firm value. On its face, the majority shareholder's sale might seem to violate the no non pro rata distribution norm or, at the very least, the related norm governing endgames. When a majority shareholder sells its block, it gets cash at a time when the other shareholders do not. Moreover, the minority shareholders cannot even check the effect of the sale on their share of the presale equity of the firm. Finally, unlike an arm's-length merger or dissolution, in which the shareholders share on an equal basis, often with a right of appraisal, here the minority shareholders not only do not share but also have no right to appraisal. In short, we worry that the majority shareholders will sell out the minority shareholders in the process of selling control. As before, we worry about this prospect to the extent that it undermines the minority shareholders' willingness to invest in match-specific assets, thereby reducing the parties' joint surplus.

Yet the situations also seem quite different. The sale of a majority block differs from the non pro rata payment of dividends, for example, in several important respects. First, the sale of the blocks results in a change of control, while the various non pro rata distributions leave the incumbent controller in place. Second, the new controller steps into the shoes of the old controller, with all the same restrictions on non pro rata distributions, restrictions that, suggests the work of Holderness and Sheehan (chap. 5 in this volume), may be surprisingly effective. Third, to sell a majority block, one needs to find a buyer, which imposes a barrier that is not present in non pro rata distributions.

Indeed, in form at least, there is no difference between Major selling his shares to a new Major and any Minor selling its shares to a new Minor, except perhaps the amount received for the shares. There is, indeed, an active market for shares of closely held Silicon Valley start-ups, in which (sophisticated) minority shareholders sell their shares to other (sophisticated) investors pursuant to rule 144A.[49]

Why might minority shareholders, ex ante, agree to permit the majority shareholder to sell its block without an equal opportunity rule, despite the extent to which it may be in tension with the beneficial lock-in and the principle of no non pro rata distributions? This old chestnut of corporate

49. Securities Act of 1933, rule 144A ("Private Resales of Securities to Institutions"), 17 CFR, sec. 230.144A (1997).

law looks somewhat different against the backdrop of our emphasis on match investments. Take again, as given, that the close corporation is characterized by a large percentage of match assets. Moreover, assume that the lock-in of the corporate form, with exit at the close of play, is part of what renders the form incentive compatible.

The principal concern with permitting sales of a majority block is that the buyer and seller may collude to impose additional costs on third parties, here, the minority shareholders. Absent third-party effects, one can trust the buyer and seller to figure out what is best for them.[50] So long as the constraints on private benefits of control are reasonably binding, the likelihood of third-party effects is small, and one can leave it to the buyer and seller of control to negotiate terms.[51] In such cases, the seller will sell only if the buyer is better at managing the corporation than the seller, which will benefit the minority. Indeed, because of the difficulties in valuation, the buyer will likely have to be substantially better than the seller.

The key point in the close corporation context is that private benefits of control are restrained by a set of formal and informal sanctions. For example, suppose that the trapped minority believes that, through one mechanism or another, the planned sale will itself diminish the value of its investment. One remedy is to sue for a breach of the duty of loyalty. Whether or not the minority wins, such suits raise a red flag for any diligent new person thinking of becoming a controller. The reaction of the potential buyer is now threefold. First, he doubles the due diligence concerning the information provided by the majority. Presumably, the disgruntled frozen-in person might even be helpful here in supplying information. Second, the potential entrant may think twice about buying into a close corporation where the minority is disgruntled. In some circumstances, this may lead the buyer to insist on buying 100 percent. Third, the buyer may react by a standard "curse on both their houses" and choose to pull his bid entirely or to bargain hard to buy the controller's share at a cheap price. In brief, because of limited numbers, the parties can hurl mud at each other with great accuracy.

Another consideration figures in as well: the orderly exit of controllers. Sometimes, the majority shareholder gets tired of being the majority shareholder or knows that he has lost his effectiveness. Sometimes, also,

50. One might also worry that the exiting controller is selling a lemon and that the entering controller does not know that. But, even if this occurs, the minority is no worse off, just as badly off as before. Moreover, this should not be a likely event. Those who buy into an existing close corporation are, in general, likely to be highly diligent. Indeed, they are likely to be more careful than the controller who entered at the outset.

51. This is the core of Elhauge's (1992) channeling explanation for existing doctrine: the looting cases (highly liquid assets, big premium) identify those cases in which the likelihood of collusion between buyer and seller is highest; the free sale cases, by contrast, are situations in which it is difficult for buyer and seller to collude successfully, either because of the nature of the assets (illiquid) or for other reasons.

the firm is not yet ready to be sold to a third party because the omelette is not yet cooked. How do you make sure that there is someone around to play the role of majority shareholder, with all its burdens and risks? The common law answer may be the legal equivalent to the informal rule in voluntary organizations that you cannot stop chairing a committee until you find a replacement. Because the omelette is not finished, it will be very difficult to convince a third party to take over the omelette business, and it may be that the majority shareholder may have to take a substantial *discount* in order to induce a third party to take over. In such cases, the minority shareholders are beneficiaries, not because the buyer will have bribed the controller to leave, but because the controller has bribed the new controller to enter.[52]

If this is more or less right, then, so long as the prohibition on non pro rata distributions is reasonably well enforced, the incentive-compatible rule in the close corporation context is the same as in the public corporation context, namely, that, absent a shareholders' agreement to the contrary, any shareholder, majority or minority, is free to sell to whomever is willing to buy (except a looter). The buyer, majority or minority, steps into the shoes of the seller and is locked in to the same extent.

This means that, in the articulation of the pro rata principle, one must emphasize that it applies to *distributions*. On this view, the control on diversions of the cash flow does most of the work. Indeed, this may support Elhauge's (1992) argument that the laissez-faire rule is most appropriate for those situations or, more generally, those systems in which non pro rata distributions are sharply limited, while the equal opportunity rule may better fit those situations in which such distributions are badly controlled.

7.4.5 Minority Shareholders' Information Rights

In the earlier discussion, we discourage judicial intervention in cases A and C. In both cases, however, there are potential problems with respect to the minority's access to company information that, if addressed, strengthen our case. Recall the argument suggested in *Wilkes:* once Minor is terminated, the underlying asymmetry of information will make it untenable to continue as a minority shareholder. This is an important argument as we have argued that the asymmetry of information associated

52. The difficulty of valuation may enter in another way. Because the omelette is only partly cooked, it would be extremely difficult for a court to determine whether the selling majority shareholder got too much, whether he was paid a "premium" for control. This may be the reason that courts focus on preventing non pro rata distributions rather than on measuring the extent to which the majority shareholder was overpaid. But, of course, a rule preventing a majority shareholder from selling control for a premium need not involve judicial valuation: an equal opportunity rule would be as easily implemented here as it was in the *Wilkes* case.

with a high density of match-specific investments is part of what makes the close corporation form appropriate and that the overlap between shareholders and managers helps manage that asymmetry of information.

On the one hand, it may be that this untenability is optimal for the parties, under the circumstances. Both the high-tech sector and the traditional close corporation sector show that mandatory provisions that provide for the buyback of employee shares on termination of employment at either cost or book value (easily measured amounts that are often far below actual, pro rata value) are quite common.

But, as the case B cases indicate, it is not always the case that it is untenable to be a minority nonemployee shareholder. Whether, and the extent to which, such a position may be tenable depends, in part, on the extent to which the courts police the norm of non pro rata distributions. This, in turn, depends on the extent to which courts provide for and enforce minority rights to information. Like the enforcement of the norm against non pro rata distributions, enforcing minority information rights protects the beneficial characteristics of the close corporate form without dragging the courts into either adjudicating employment-at-will issues or firm valuation.

To operate effectively, however, Minor must know when Major is acting opportunistically. Minor, as either a shareholder-employee or a shareholder, has the ability to impose or threaten Major with informal sanctions. When Minor is employed, he has all the normal methods of sanction that apply to an employee. In his role as a shareholder in a closely held company, Minor also holds considerable power to impose sanctions. But, if Minor is either discharged from the company or left employed but in a nonmanagerial capacity, he is unlikely to obtain the requisite information needed to know when and how to act.

Minority shareholder information rights come from two sources: state law and federal law. Under state law, shareholders are entitled to substantial information. Delaware corporate law provides that "any stockholder, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records, and to make copies or extracts therefrom. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder."[53] As interpreted, Delaware section 220 provides minority shareholders of the close corporation substantial rights to information. First, "in the case of a close corporation, inspection rights will be liberally construed in favor of a minority stockholder" (Welch and Turezyn 1993, sec. 220.6.3, p. 466).

53. Del. GCL, sec. 220. Minority shareholders have similar information rights under the RMBCA (secs. 16.01–16.04).

Second, finding out the facts necessary to determine whether Major is engaging in self-dealing, or mismanagement, or both, is clearly a "proper purpose" under section 220 (Welch and Turezyn 1993, sec. 220.6.3, p. 466).[54]

The federal securities laws provide the second principal source of information rights for minority shareholders. Although close corporations are not subject to the periodic-disclosure obligations, section 10(b) of the Securities Exchange Act and rule 10b-5 apply fully.[55] Rule 10b-5 has proved most important in endgame scenarios. Minor, who is terminating his relationship with the firm, negotiates to sell his shares back to the firm or to the majority shareholder. At the same time, unbeknownst to Minor, Major is engaged in serious discussions with a potential acquirer of the firm or with an investment banker who wishes to take the firm public. Sometime after Minor sells his shares, the acquisition is announced, placing a value on the firm far in excess of what Minor received. Minor sues, alleging that, had he known of the merger discussions, he would not have sold his shares. In such circumstances, the courts have held that, when Major is buying out Minor, Major has a duty to disclose all material nonpublic information, including negotiations to sell the firm or take it public.[56]

This structure fits well with our previous analysis. Like the vigorous enforcement of the norm against non pro rata distributions, so, too, the enforcement of these information rights protects the incentive compatibility of the close corporation form. The state law rights to information help alleviate (although clearly not eliminate) the underlying asymmetry of information while Minor is a shareholder. Major's duty under 10b-5 to disclose material facts or abstain from buying Minor's shares protects and reinforces the endgame norm: on liquidation or merger, shareholders share equally.[57]

54. In addition, minority shareholders who are in litigation with the corporation have substantial rights to information under the civil discovery rules, whether in federal or in state court.

55. Under rule 10b-5, "It shall be unlawful for any person . . . (a) to employ any device, scheme, or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security" (17 C.F.R., sec. 240.10b-5). On the applicability of 10b-5 to close corporations, even in the sale of the entire business, see *Landreth Timber Co. v. Landreth,* 471 U.S. 681 (1985).

56. See, e.g., *Rochez v. Rhoades,* 527 F.2d 880 (3d Cir. 1975), cert. denied, 425 U.S. 993 (1976); *Thomas v. Duralite Co.,* 524 F.2d 577 (3d Cir. 1975); *Michaels v. Michaels, Michaels and Hyman-Michaels,* 767 F.2d 1185, 1194–97 (7th Cir. 1985); and *Homes v. Bateson,* 583 F.2d 542, 558 (1st Cir. 1978).

57. An additional set of issues arises when Minor is subject to a mandatory buyback provision on termination of his relationship with the corporation. The issue arises whether and when Major has a duty to disclose news that may be of significance to Minor in deciding

7.5 Conclusion

The close corporation form is ideally suited to enterprises in which there is a high density of match-specific assets. The limitations on exit, combined with the rule against non pro rata distributions, largely prevent opportunistic behavior by the majority shareholder toward the minority. By locking both into the enterprise, the majority shareholders, in maximizing their own wealth, will, to a large extent, also maximize the wealth of the minority. Indeed, many of the persistent features of close corporations can best be understood as self-enforcing mechanisms to protect the participants from misbehavior by fellow participants.

This is not to say that all enterprises that use the close corporation form make use of these attributes. An important result of this paper is that, by isolating the distinctive features of close corporations, we identify those enterprises that are best suited for the close corporation form. The enterprises that most value the lock-in are precisely those Silicon Valley start-ups with new products that need time to set. In its best use, the close corporation thus serves as an incubator for tomorrow's publicly owned corporations.

For close corporations without intensive match investments, the costs of the lock-in may well exceed the benefits. For such corporations, there are two obvious alternatives. First, they can retain the close corporation form and allow minority exit in the articles of incorporation. Alternatively, they can choose other organizational forms, such as partnership, that allow exit at will as a default. We argue against a third alternative—case-by-case adjudication based on a finding that the minority's reasonable expectations have been defeated. Gap filling in this context suffers badly because of the great likelihood of judicial error given the difficulties of first evaluating claims of defeated expectations and then, when necessary, valuing match investments.

whether to terminate his relationship with the firm (*Jordan v. Duff & Phelps,* 815 F.2d 429 [7th Cir. 1987]; *Smith v. Duff and Phelps,* 891 F.2d 1567 [11th Cir. 1990]). A related issue is whether such a mandatory buyback provision should be read to displace the employment-at-will presumption in the employment relationship. The answer has been negative (see, e.g., *Ingle v. Glamore Motor Sales, Inc.*, 73 N.Y.2d 183 [N.Y. Ct. App. 1989] [mandatory buyback provision does not get shareholder-employee any protection against at-will discharge]). Indeed, in some cases, the buyback provisions explicitly provide that "nothing herein contained shall confer on the Employee any right to be continued in the employment of the Corporation" (*Jordan v. Duff & Phelps,* 815 F.2d at 446). Finally, the question also arises whether the firm can fire an employee simply in order to trigger the mandatory buyback provision (*Gallagher v. Lambert,* 549 N.E.2d 136 [N.Y. 1989] [no breach of fiduciary duty to terminate minority shareholder triggering mandatory buyback even if firing is motivated by desire to take advantage of lower valuation]; *Knudsen v. Northwest Airlines,* 450 N.W.2d 131 [Minn. 1990] [stock-option agreement that expires when employee ceases to work for employer does not imply any covenant of good-faith termination for cause]; cf. *Jordan v. Duff & Phelps,* 815 F.2d at 439 [Easterbrook] with 815 F.2d at 446 [Posner, dissenting]). While these issues are fascinating, they are beyond the scope of this paper.

After examining the extent to which the enterprise form itself constrains opportunistic behavior by participants, we analyzed the classic problem(s) of minority oppression in the close corporation. As we understand it, minority oppression can best be understood as a combination of two separate and separable problems. The first aspect, captured in case A, is a version of precisely the same problem that, in employment law, arises under the heading *employment at will:* the situation in which Major terminates Minor's employment. Here, we showed that, by adopting the same passive stance as it does in the employment context, the law avoids threatening and undermining the self-enforcing structure in place.

The second aspect of the problem, captured in case B, is fundamentally different from employment at will and involves attempts by Major to make non pro rata distributions of company assets. Here, we showed that vigorous judicial enforcement of a prohibition on such distributions, including the vigorous protection of ancillary rights to information, is necessary to enforce norms of nonopportunism. We further showed that courts are much better at sorting out issues of this sort than they are at sorting out employment-at-will type issues because doing so does not require either relying on unverifiable factors or valuing assets that the courts cannot value.

Out of our appreciation of the beauty of the close corporation come several conclusions. First, our analysis implies that the parties themselves, rather than the courts, are best able to resolve the nasty employment issues that animate many bitter close corporation cases. Second, the analysis indicates that vigorous judicial enforcement of the sacred norm against non pro rata distributions is necessary to block the attempts of majority shareholders to profit from self-dealing transactions with the corporation. Finally, with an expanded menu of enterprise forms, there is little cost in allowing the close corporation to maintain its distinctive qualities. Firms that are not waiting for omelettes to set can choose another form that allows easy exit of capital suppliers.

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Comment Vikas Mehrotra

The organization of economic enterprises has its own rainbow coalition of followers: legal scholars, economists and historians of all hues, organization theorists, even sociologists and behaviorists, all with their own pe-

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culiar slants on the issue. The central question, however, remains common: Why do we observe the prevalence of certain forms of business organization in certain activities? In their paper, Edward Rock and Michael Wachter focus on the close corporation and its peculiarities vis-à-vis other, possibly competitive, forms of organization. What advantages are conferred by the close corporation on its main protagonists? What features of the close corporation deserve scrutiny?

The answer to the first question is made obvious by the authors' choice of title. There is an omelette in the making. The eggs and hardware have been financed by a venture capitalist (VC), and the chef is exercising her skills to prepare the omelette. There are strong incentives for both parties to remain locked in until the omelette is done since there appears to be no market for partially done omelettes. Both the VC and the chef have considerable match-specific investments in the omelette, and, therefore, an abiding interest in seeing it through to completion. This is the essence of the argument favoring the close corporate form over other alternative forms.

For example, the limited partnership, with its ease of exit and dissolution, would not suit the locked-in nature of this relationship. On sensing a particularly well-done omelette, the controlling partner can force the noncontrolling partner to relinquish a large portion of the gains from the enterprise. It does not matter, ex post, that the product of the enterprise required joint input. Ease of exit provides grounds for a credible holdup threat.

What about the open corporation? The open corporate form is characterized by diffuse ownership and easy transferability of equity shares and would require enormous resources to provide periodic updates as to the status of the omelette. These costs render the open corporate form unsuitable for ventures characterized by a high degree of information asymmetry between capital providers and managers. Moreover, it is not clear whether the open corporation, with diffuse ownership, can overcome the free-rider problem of monitoring the omelette-making process. The close corporate form overcomes both these limitations: it discourages easy dissolution and maintains the identities of the ex ante contracting parties at least until the omelette is done.

So far, this is familiar territory. Studies by Telser (1980), Klein and Leffler (1981), and Williamson (1983) have made important contributions to the literature on corporate form and self-enforcing contracts. The main, and perhaps unsurprising, message in these studies is that contracts remain self-enforcing until one of the parties finds it in its interest to quit, with the only penalty being the voiding of the contract and, naturally, all attendant future benefits. In fact, form is dictated primarily by the cost of contracting. Whereas market transactions are suitable for exchanging general purpose assets, more internalized governance is required as asset specificity and frequency of exchange increase. However, there are other determinants of self-enforcing contracts as well. In particular, as pointed out by Barzel (1982), the measurement cost of information plays a role in determining the extent of the holdup problem created when two parties lock in to a contract. This simple observation brings us to the two features related to minority protection of the close corporation—employment at will and restrictions on non pro rata distributions—highlighted by Rock and Wachter.

Obviously, providing ex ante minority protection benefits the majority (the controlling party) since, absent such protection, the minority party would either demand higher compensation or not enter into the contract at all. Rock and Wachter argue that the employment-at-will feature in the close corporation should be treated with the same passivity as is the norm in regular employee-employer relationships. They correctly point to the onerous measurement costs of untangling employee dismissal cases. The argument that malicious or arbitrary dismissals inhibit formation of VC-financed start-ups suffers from two main problems.

First, it ignores the role of reputation in curbing opportunistic behavior by the VC. Most VCs intend to hang around only until the start-up is taken public (allowing them to cash out); thus, VC wealth is the discounted value of the VC's association with all future start-ups. To wit, capturing an *unfair* share of one omelette must therefore be judged against the expected present worth of the *fair* share of all future omelettes. Second, even if such an equation is violated (owing to malice, which must be economically irrational to make the point), the courts will find it extremely costly to untangle the mess of allegations and counterallegations that frequently characterize such malice-inspired dismissals. Judicial services have their bottom lines, too.

Breach of another kind is treated differently in the view of Rock and Wachter. Non pro rata distributions transfer wealth from the minority to majority and, if left unchecked, will increase the contracting cost of start-ups. In what sense is this manner of oppression different from employment at will? After all, employment at will also confers the opportunity to transfer wealth in a way that violates ex ante rules of sharing. The arbitrary dismissal is a way to precipitate non pro rata distribution of corporate resources, insofar as the dismissed party is denied its share of the discounted worth of corporate profits. So, obviously, non pro rata distributions must refer to specific forms of denials and distributions. And herein lies the rub: how to discriminate among the various forms of non pro rata distributions?

The big contribution of this paper is that the proscription on non pro rata distributions is an outcome of the ease of documentation and presentation of evidence. To be sure, the honesty equation that cements self-enforcing contracts applies to non pro rata distributions as well. However, breaches can now be examined by the courts in a cost-efficient manner. Furthermore, whereas firing an entrepreneur-manager also relieves the VC of the entrepreneur's skills, non pro rata distributions, within limits and excluding malicious cases, need not bring the venture to a stop. Indeed, a rational VC will engage in non pro rata distributions to extract only the quasi rents from the venture, leaving just enough on the plate for the minority party to offset her external opportunities, as opposed to grabbing the entire omelette. Clearly, court intervention in these cases would raise the cost of such opportunistic behavior and lower the ex ante cost of contracting between the VC and the minority party. But, returning to the question posed in the last paragraph, what particular forms of non pro rata distributions qualify for judicial intervention?

Self-dealing transactions by the majority party with the firm are an obvious candidate that merit court-ordered protection for the simple reason that these cases are relatively simple to document. For example, cash dividends that accrue only to the majority shareholder are typically forbidden. So are interfirm transactions that are carried out at nonmarket prices. But what if the VC owns preferred shares with deferred coupons whereas the minority party owns common shares with no contractual dividends? As long as the coupon rate on the preferred shares is well specified in advance, this poses no problems. Examination of non pro rata distributions must therefore be restricted to *unanticipated* events. This point is implied throughout by the authors, but not explicitly stated.

What about transactions where the majority sells its shares to another party, without involving the minority in the sale? In my view, such transactions can easily be contracted out of at the start of the relationship. The absence of such protection does not create an unanticipated event. If, in its assessment, the minority party feels that the risk of such control changes is large, it could either ask for a negative covenant prohibiting such sales or receive a larger ex ante compensation package. The courts should not interfere with control changes for the same reasons that it *should* intervene in self-dealing transactions: the former are easy to restrict in ex ante contracts, while the set of self-dealing transactions is so large and varied that a comprehensive ex ante contract prohibiting such actions would be costly to write.

Overall, the paper makes an important contribution to our understanding of the close corporation, beginning with a clear rationale for the existence of this form of organization in certain sectors of the economy, such as the Silicon Valley start-up, and highlighting two features of minority oppression in the close corporation. The authors rightly argue that the courts maintain their passivity in employment-at-will cases and vigorously enforce non pro rata distributions of corporate resources. The arguments are built mainly on the cost of using judicial intervention to correct violations of ex ante sharing rules.

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