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Chapter Author: Paul G. Mahoney

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Trust and Opportunism in Close Corporations

Paul G. Mahoney

A central problem for closely held corporations is the possibility of opportunistic behavior by a majority shareholder. Many closely held corporations have a 50 percent–plus shareholder and one or more owners of minority interests. The majority shareholder may use its control of the corporate machinery to appropriate wealth from the minority.

A growing literature examines how close corporation shareholders (through organizational choices) and the legal system (by providing organizational default settings and adjudicating disputes) can reduce the costs associated with majority opportunism. This paper formalizes the analysis by modeling the interaction between majority and minority shareholders as a noncooperative trust game. In the game, the majority is constrained by the possibility of nonlegal sanctions, including family or social disapproval and loss of reputation, and, as a result, a rational minority shareholder will sometimes invest despite the potential for exploitation. The strength of those sanctions is assumed to vary over time, and the minority's ex ante rational investment can therefore result in ex post appropriation.

The paper uses the trust game model to revisit a long-standing debate over the best exit rule for minority shareholders in close corporations. Corporations differ from partnerships in that, absent a contrary agreement, a shareholder can withdraw capital from the firm only pursuant to a majority vote, a rule that I call *exit by consent.* A partner, by contrast,

Paul G. Mahoney is professor of law and the Albert C. BeVier Research Professor at the University of Virginia.

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can (again absent a contrary agreement) dissolve the firm and withdraw capital at will. The ability to withdraw capital gives the minority leverage over the majority and may deter opportunism.

The limited anecdotal and survey evidence available, however, suggests that minority shareholders infrequently contract for exit rights or other organizational devices that might restrict majority opportunism, particularly in family businesses or other small closely held corporations, with which this paper will be concerned.[1] There are two schools of thought on why this is, or appears to be, so. One holds that transaction costs are to blame. Minority shareholders may be ignorant of the potential for appropriation by the majority, and the costs of becoming informed and negotiating for effective organizational constraints may be greater than the potential benefits. On this view, the default rule for close corporations should be switched to provide for easy exit or other organizational constraints as a matter of right. Thus, Hetherington and Dooley (1977) argue that close corporation shareholders should have the right to withdraw capital at will.

The alternative argument is that such minority entitlements do not merely deter majority opportunism but also create a threat of minority opportunism. The minority may use a strategically timed exit demand to threaten to impose large costs on the majority and thereby gain a larger share of the firm's cash flows. Easterbrook and Fischel (1986, 1991), therefore, argue that the failure of minority shareholders to bargain for exit rights or other organizational constraints does not reflect ignorance or large transaction costs. Instead, it reflects a judgment that, at the margin, the organizational benefits of the traditional corporate form outweigh the benefits of a more partnership-like structure. Rock and Wachter (chap. 7 in this volume) focus on asset specificity and valuation problems as a potential source of minority exploitation. O'Kelley (1992) similarly argues that the choice of exit rule involves a trade-off between majority and minority opportunism.

The present paper notes that a minority shareholder's withdrawal of capital through a buyout or dissolution takes place at a price set by, or negotiated in the shadow of, a judicial proceeding. Unless judicial valuations are systematically biased, expanded exit rights for minority shareholders will not result in minority opportunism because the minority's threat to exit is not credible so long as the majority is cooperating. Contrary to Easterbrook and Fischel's and O'Kelley's analysis, then, minority

1. The universe of closely held corporations includes some very large firms. There are also publicly traded corporations that have majority shareholders, raising analogous risks of majority opportunism. I will confine myself, however, to the problem of majority opportunism in small businesses organized as closely held corporations. As discussed in section 6.3 below, the legal solutions developed for large firms are unlikely to work for small firms without alteration.

opportunism does not explain the failure to adopt partnership-style governance unless judicial valuations are biased or the minority is risk preferring or irrational.

I therefore explore other possible explanations for the survival of exit by consent. Minority shareholders can insure against opportunism through the price they pay for the shares. This is not a complete explanation because the majority could offer a buyout right in order to reduce the variance of the minority's returns and receive a higher price from risk-averse investors. Alternatively, corporate law may do a sufficiently good job of constraining majority shareholders that minority shareholders do not find it necessary to bargain for exit rights.

The latter explanation contrasts with frequent criticisms of the courts' willingness to use dissolution or fiduciary duty actions as a form of ex post settling up when minority shareholders allege that the majority has acted unfairly. Commentators often argue that courts are not competent to determine whether the majority has upheld its bargain and that judicial intervention therefore produces costly uncertainty. Correctly understood, however, judicial intervention to uphold the parties' "reasonable expectations" is a sensible adaptation of the fiduciary principles that courts uncontroversially enforce against the managers of publicly traded companies.

Section 6.1 briefly reviews the debate between proponents of different exit rules. Section 6.2 develops the trust game model. Section 6.3 considers why, despite the predictions of the model, close corporation shareholders do not appear to bargain for exit rules and identifies legal constraints as a likely answer. Section 6.4 describes judicial intervention in close corporations and the debate over its effectiveness.

6.1 The Debate over Exit Rules

Organizational constraints may limit the majority's ability to appropriate minority returns. Minority shareholders may bargain for (or a corporate statute may provide as a default setting) supermajority voting provisions for certain transactions, proportional board representation, or similar organizational devices to reduce the majority's power to make decisions unilaterally. The literature on close corporations has focused on a particular organizational choice—exit rules—as a check on the majority. That focus is not surprising because corporate exit rules differ sharply from those of partnership.

It should be emphasized that the debate over statutory exit rules seeks to choose the optimal default rule—that is, the rule that should govern when the parties have not specified a contrary preference. The default rule matters to the extent that the costs of bargaining around the rule are

substantial. The higher those costs, the greater the likelihood that some parties will be stuck with an undesired rule, and the greater the potential social payoff from identifying the most efficient rule.

6.1.1 The Argument in Favor of Exit at Will as a Default Rule

Under standard corporate law rules, a shareholder has no right to receive a return of his investment from the corporation or other shareholders. He may sell to a third party, of course, but, if his desire to exit stems from opportunistic behavior by the majority, the purchase price will reflect that behavior and therefore provide neither recompense nor deterrence. Corporate assets are distributed to shareholders on a dissolution, but that typically occurs only pursuant to a majority vote unless a shareholder can establish the conditions for a judicial dissolution.

A general partner of a partnership, by contrast, has the right to withdraw from the partnership on demand and receive the value of his pro rata share of the partnership's assets. Like the exit-by-consent rule of corporate law, this "exit-at-will" rule is a default rule that can be altered by agreement.

Hetherington and Dooley (1977) argue that shareholders in a close corporation are in a position that closely resembles partnership and that the partnership rule of exit at will is appropriate. They propose a statutory provision that would give a close corporation shareholder the right to have his shares purchased by the corporation or the other shareholders at an agreed-on price or, failing agreement, at a judicially determined price. Although Hetherington and Dooley identify the key feature of the solution as liquidity, an equally important feature is independent valuation. A buyout rule will deter majority opportunism only if the court can be counted on to set a price that compensates for the effects of majority misbehavior.

The put right proposed by Hetherington and Dooley is not the same as the partnership exit rule because the latter provides for dissolution of the partnership rather than a sale of the partnership interest to the other partners. The effects of the two rules, however, are often the same because dissolutions of profitable partnerships typically result in the remaining partners cashing out the departing partner and continuing the business. So long as the business is worth more as a going concern than in liquidation and more in the hands of the current management than in the hands of alternative managers, we would expect a dissolution decree to result in a buyout of the dissenting shareholder or partner by the remaining shareholders or partners. Bebchuk and Chang's (1992) model of bargaining in bankruptcy (where the alternative to a negotiated solution is a liquidation) could be adapted to this situation to predict the price at which the buyout will take place.

The argument for facilitating exit by minority shareholders has influenced courts and legislatures. Although no corporate code provides for

exit at will, modern statutory provisions for judicial dissolution provide increased opportunities for minority shareholders to exit. As noted by Thompson (1993), courts have taken an increasingly broad view of their authority under these involuntary dissolution statutes. They have, for example, entertained petitions for dissolution by shareholders claiming that actions of the majority have frustrated the "reasonable expectations" of the minority. Courts have also used the threat of dissolution to encourage a buyout of the minority or have simply used their equity powers to order a buyout. These developments are not limited to the United States; as noted by Cheffins (1988), Canadian company law now includes statutory provisions that give courts substantial flexibility to define and remedy majority opportunism.

6.1.2 The Argument in Favor of Exit by Consent as a Default Rule

Easterbrook and Fischel (1986, 1991) criticize the proponents of exit at will for ignoring the risk of minority opportunism that accompanies a rule (or contract) giving minority shareholders greater exit rights. Raising cash for a buyout (through loans, sales of new shares, or sales of assets) is costly. These costs may vary over time, permitting the minority to time its exit for maximum strategic advantage. Consider, for example, a situation in which the shareholders have private information suggesting that the value of the firm's future cash flows is greater than expected but do not yet have any credible means to signal that information to potential lenders or investors. The majority may lack sufficient assets outside the firm to buy out the minority, the company's assets may be illiquid, and the information asymmetry may preclude obtaining outside financing for a buyout at an acceptable cost.

In those circumstances, the argument goes, the cost of exit at will is high, and the minority can use the threat of exit to extract a greater share of the returns than initially agreed. In general, the buyout or dissolution demand can be used opportunistically whenever the cost of replacement financing is high.

Thus, Easterbrook and Fischel argue, the choice of organizational structure reflects an inevitable trade-off between majority and minority opportunism. Devices such as buyout rights that give the minority leverage over the majority decrease the likelihood that the minority will receive less than the return to which it is entitled, but at the cost of increasing the risk that it will receive too much. The notion that minority opportunism is an inevitable cost of expanded exit rights is widely shared. O'Kelley (1992), for example, argues that the choice between partnership and close corporation organization represents a trade-off between the greater adaptability of partnership and the greater risk of minority opportunism that accompanies exit at will. Rock and Wachter (chap. 7 in this volume) argue that the problem of opportunism is acute because close corporation assets are

often project specific and have limited value in their next-best use. Dissolution, therefore, may mean the destruction of considerable potential (although unrealized) value. The "lock-in" feature of exit by consent guards against this value destruction.

Easterbrook and Fischel take the observed tendency of close corporation shareholders to accept the default rule of exit by consent as evidence that there is not enough difference between the expected cost of majority opportunism under exit by consent and minority opportunism under exit at will to justify the cost of bargaining around the default rule. They further argue that the costs of bargaining around the rule are not substantial. Majority and minority shareholders typically negotiate face to face and use lawyers to create the corporation's governing documents, and it should not, therefore, be prohibitively costly to contract around the state-supplied default rule when they prefer a different rule. These observations suggest that parties are generally satisfied with exit by consent and that legislatures and courts should leave well enough alone.

6.2 The Trust Game

The interaction between majority and minority shareholders in a close corporation can be modeled as a noncooperative trust game in which an investor (A) gives money to an entrepreneur (B). B combines A's funds with B's specialized skills to undertake a business organized as a corporation. The game begins with B offering A a specified share of the cash flows at a specified price, which A must accept or decline. To simplify the analysis, I will assume that B always offers A 49 percent of the cash-flow rights (represented by a single class of common stock). By retaining 51 percent of the stock, B controls all corporate decisions. The value of the firm under B's management is assumed to be $2r$.

If B's promise is kept, both parties receive (approximately) equal distributions, each with a present value of r. Given the price specified by B, A could invest the same amount of money elsewhere to receive a return with a present value of s. We can think of s as corresponding to the market rate of return and $2(r - s)$ as the economic rents generated by the new undertaking.

6.2.1 Interactions under the Traditional Exit-by-Consent Rule

A Model without Renegotiation

Although B promises to split the firm's cash flows equally with A, B's promise is not binding. That is, it is prohibitively expensive to define B's obligations in a way that makes cheating impossible. To do so would, among other things, require a complete specification of the salary and perquisites to be received by B in all possible states and provisions to

guard against surreptitious transfers such as payments of salary to or purchases of supplies from family members or friends, corporate reimbursement for personal expenses, and so on. The parties cannot at reasonable cost write a contract that specifies how the equal sharing principle will apply in all possible states. Moreover, I assume that A has not contracted for exit rights and, therefore, cannot withdraw capital from the firm without B's consent.

Having obtained A's money, B may renege on his promise. In the extreme, B may implement a "freezeout"—that is, pay no dividends, terminate A's employment (if any) with the firm, and use all profits to B's advantage. B cannot get rid of A involuntarily except through a merger that would be subject to judicial scrutiny for fairness if challenged by A, but, through the freezeout, B can appropriate A's entire share of the firm's cash flows.

Corporate actions that maximize the wealth transfer from A to B will likely be inconsistent with maximizing firm value. For example, if A is an employee and B fires A, B may have to hire a replacement employee who knows less about the business. By refusing to pay dividends, B may also make the company's common stock an unattractive vehicle for bonuses or other incentive payments to employees. The resulting conflict between the shareholders may deflect some of B's attention from running the business. For this reason, the game is not zero sum; B's opportunism destroys value. To capture this feature, I assume that, in a freezeout, A receives a payoff of zero and B receives a payoff of unity, where $r < 1 < 2r$.

Were B able to freeze out A without constraint, B would always do so. Knowing this, A would not invest. There are, however, extralegal constraints that make opportunism costly to B. Often, the shareholders of a close corporation are relatives or close friends, and the threat of social disapproval will constrain opportunism. B may also wish to raise capital in the future for this or other business ventures and may therefore care about reputation. These informal sanctions impose a cost, m_B, on opportunism. A diagram of the game and its payoffs appears in figure 6.1.

As thus described, the game is the familiar trust game (see, e.g., Kreps 1990; Brennan, Güth, and Kliemt 1997). After B makes an offer, A decides whether to invest (I) or not to invest (N), and B then chooses whether to reward (R) or to exploit (X). If r and m_B are taken as fixed at the beginning of play and known to both parties, the game has a straightforward equilibrium; when $r > 1 - m_B$, B will choose not to exploit, and A will therefore choose to invest (I, R); otherwise, A will not invest. Under no circumstances will A invest and B exploit.

This simple, deterministic structure makes the game unrealistic; it cannot account for the observed instances in which majority shareholders exploit minority shareholders. Nevertheless, the model demonstrates that close corporations can exist where shareholders have rational expecta-

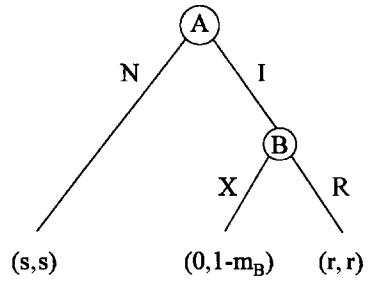

Fig. 6.1 Trust game model under exit by consent

tions, majority shareholders are unable to make binding commitments not to exploit, and minority shareholders have no exit rights.

A more realistic structure must treat r and/or m_B as random variables whose realizations are unknown at the outset of play. To introduce uncertainty but keep things reasonably simple, I will make only one of these variables, m_B, stochastic. Note that many disputes in close corporations arise precisely because m_B varies over time. Family members become estranged, friendships or marriages erode, and the strength of informal sanctions otherwise changes with time, leading to disputes and exploitative behavior. I assume the following: The density function of m_B is $f(m_B)$ on the closed interval [0, 1] and zero elsewhere, and the associated distribution function and complementary distribution function are $F(m_B)$ and $\Phi(m_B)$, respectively. The distribution is common knowledge to the parties. The firm value, $2r$, is fixed and known throughout to the parties but not verifiable by them to third parties, including the courts.

Under these assumptions, A's expected payoff from investing, V^A, is $r\Phi(1 - r)$. If $V^A < s$, A will not invest even though $r > s$. B's inability to make a credible promise to share the cash flows will therefore reduce the number of corporations created compared to an (unrealistic) baseline in which B could make a credible promise. It may also affect the type of business that is incorporated. V^A will tend to be small, all other things equal, when A and B are strangers. There will then be a tendency for closely held corporations to arise most frequently within communities linked by kinship or other bonds.

Even when the expected value of m_B is such that it is rational for A to invest, the variance in m_B and the resulting potential for opportunism reduces the parties' aggregate payoffs. When $V^A > s$, A will invest but will value the shares in the light of the expected payoff. In order to induce investment with variable m_B, B must offer a higher rate of return (i.e., sell the shares at a lower price) than he would were it possible to make a binding commitment not to behave opportunistically. Recall that s, the present value of A's next-best alternative to investing, is a function of the

price specified by B. B can make A's expected payoff from investing greater than the payoff from not investing by offering the shares at a reduced price. B's expected payoff if A invests, V^B, is

$$r\Phi(1 - r) + \int_0^{1-r}(1 - m_B)f(m_B)dm_B,$$

and the total expected payoff to the parties where A invests is

$$(1) \qquad V^A + V^B = 2r\Phi(1 - r) + \int_0^{1-r}(1 - m_B)f(m_B)dm_B.$$

It is clear by inspection that the aggregate payoff is less than $2r$. Thus, by dividing up the right to the firm's cash flows and thereby creating the possibility of opportunism, B reduces the aggregate expected value of these entitlements.

Despite its simplicity, then, the model generates two important results. The first is that, in a rational expectations framework, majority opportunism does not "oppress" the minority in the sense of producing an unexpectedly low return; the minority pays less for the shares because of the potential for majority opportunism and on average receives an adequate return on the investment. This is analogous to the familiar result from Jensen and Meckling's (1976) model of agency costs, in which the agent's compensation is reduced by the expected value of his opportunistic behavior. The second result is that the outcome of the game is not Pareto optimal because majority opportunism does not merely transfer wealth from the minority to the majority but produces lower aggregate expected payoffs.

Compare the ex post payoffs when A invests and B rewards to those when A invests and B exploits. In the former case, the aggregate payoff is $2r$. In the latter case, A gets nothing, and B gets $1 - m_B$, for an aggregate payoff of $1 - m_B$. The difference between the two, $2r - 1 + m_B$, consists of two components. The first, $(2r - 1)$, is that part of the firm's value destroyed by B's choice of inefficient corporate policies in order to freeze out A. The second component, m_B, represents B's socially wasteful investments in rent seeking (i.e., his willingness to bear the costs of social sanctions or loss of reputation). Ex ante, B receives a lower share price reflecting the expected loss of firm value and wealth transfer in the event of exploitation.

A Model with Renegotiation

Once the value of m_B is realized, both parties know whether it is in B's interest to exploit. Because B's threat to freeze out A is credible given a sufficiently low value of m_B, the parties can avoid some of the costs of a freezeout if B buys A's shares after m_B is realized. B may offer A a price of $r - \alpha$ for A's shares, which would leave B with a value of $r + \alpha - m_B$ (I assume that the parties are unable to keep B from incurring the cost m_B—

in other words, B's reputation or social interactions will suffer as a result of behaving opportunistically, whether that opportunism operates through a freezeout or a purchase of A's shares for less than their promised value). The bargain would make both parties better off because it would enable B to avoid adopting inefficient corporate policies in order to freeze out A and, as a result, increase the value of the firm by $(2r - 1)$.

A may accept B's offer or reject and make a counteroffer. The situation is a bargaining game as in Rubinstein (1982). The parties will agree on some value of α that divides between them the difference between the value of the firm absent a freezeout $(2r)$ and the value of the firm with a freezeout (unity).

With the possibility of renegotiation, there is no loss in firm value because B adopts optimal policies. B nevertheless incurs the cost m_B ex post and bears the expected private cost of opportunism to A (represented by α) in the form of a lower ex ante share price. Once again, there is no "oppression" on average so long as A makes unbiased estimates of the relevant parameters at the beginning of the game.

6.2.2 Interactions under Hetherington and Dooley's Buyout Rule

A Model without Renegotiation

Let us now assume that the relevant state's close corporation statute provides an unconditional buyout right along the lines suggested by Hetherington and Dooley (1977). That is, on request by A, B must purchase (or cause the corporation to purchase) A's shares at a negotiated price. If the parties cannot agree on the price, it will be determined by the court. I will represent the price determined by the court as ρ and assume that it is realized only at the end of the litigation, although prior to litigation the parties know its distribution. Because I am for the moment assuming no renegotiation, on a buyout demand by A, both parties receive the judicially determined payoffs.

The buyout right may enable A to behave strategically because a buyout can be costly for B. B may be liquidity constrained and therefore unable to purchase A's shares from personal resources. In order to make the purchase, B will then have to sell assets or securities of the corporation, leaving it with an inefficient mix of assets or an undesired capital structure. A change to a more debt-heavy capital structure may violate covenants with preexisting lenders or raise the cost of future credit.

To emphasize the qualitative similarity of these efficiency costs to those created when B freezes out A, I will again assume that the value of the firm decreases to unity after a strategically timed buyout demand by A. Like B in figure 6.1, A is constrained by informal sanctions that impose a cost, m_A, on opportunism. Whether A's buyout demand was prompted by B's exploitation or was opportunistic is assumed to be common knowledge

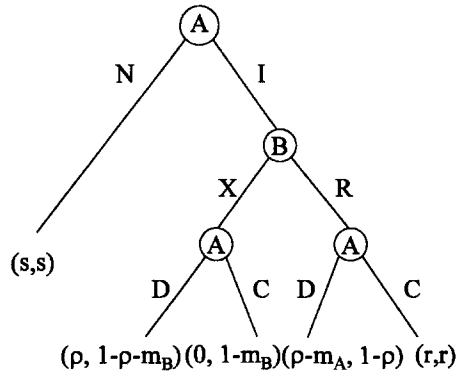

Fig. 6.2 Trust game model under exit at will

within the relevant community, with the result that A bears the cost m_A if and only if his buyout demand was opportunistic.

The resulting game is diagrammed in figure 6.2. As in the prior model, A decides whether to invest or not to invest, and B then decides whether to reward or to exploit. If B exploits, A will clearly choose to exercise the buyout right (X, D), which will reduce A's losses from exploitation. If B rewards, however, A can choose to reward as well (R, C) or to exploit by making a strategically timed buyout demand (R, D).

There is an important distinction between the games in figures 6.1 above and 6.2. In the latter, it may never be rational for A to exploit (demand a buyout) when B rewards. If the court's valuation is unbiased (i.e., if $E[\rho] = r$, where E is the expectation operator), then A's expected payoff from rewarding (r) always exceeds the expected payoff from a buyout ($E[\rho] - m_A = r - m_A$), given B's decision to reward.

A contrary result requires one of several assumptions. First, A may be risk preferring and therefore willing to gamble on the court's valuation being too high. Second, the court's valuation may be systematically biased in A's favor (i.e., $E[\rho] > r$). Third, A may be motivated by spite or otherwise irrational—that is, willing to impose large costs on B even though the expected outcome is less favorable to A than continued cooperation. I assume for the time being that one of these conditions holds so that A may choose to exploit, but in section 6.2.3, I return to the distinction between the games in figures 6.1 and 6.2.

The losses from A's opportunism are qualitatively similar to those from B's. The reduction in payoffs when B rewards and A exploits, compared to when both reward, is $2r - [(\rho - m_A) + (1 - \rho)]$, or $(2r - 1) + m_A$. Recall that, in the no-renegotiation exit-by-consent model, when A invests and B exploits through a freezeout, the difference in payoffs is $(2r - 1) + m_B$. A will pay a higher price for the shares than he would pay could he

make a credible promise never to exploit, and again the deal is "fair" in that sense.

A Model with Renegotiation

If A can make a credible threat to exploit, A might offer to avoid the court-supervised buyout and negotiate a buyout that would not significantly reduce the firm's value. For example, A might agree to accept a note rather than cash in payment for the shares in order to alleviate B's liquidity problem. As in the model of majority opportunism, renegotiation could permit A to receive a wealth transfer from B without destroying part of the value of the firm. If β is the amount of the wealth transfer, then the payoffs to A and B when B rewards and A exploits are $(r + \beta - m_A)$ and $(r - \beta)$, respectively. The result is analogous to that in section 6.2.1 above.

6.2.3 Will A Exploit?

The games diagrammed in figures 6.1 and 6.2 are similar but not identical, and the differences suggest that buyout rights do not necessarily replace majority opportunism with minority opportunism. Under exit by consent, B is constrained only by informal sanctions—B's control of the corporate machinery makes it otherwise possible to appropriate all the firm's cash flows. By contrast, the buyout made possible by an exit-at-will rule takes place in the shadow of a judicial valuation of the firm.[2] Unless that valuation is biased (putting aside the possibility that A is risk preferring or irrational), A's threat to demand a buyout is not credible when B has rewarded. As a consequence, B cannot be induced to bribe A to forgo the buyout.

In order to illustrate the point as simply as possible, I have used a one-shot game in which the strength of the informal sanctions, m_A and m_B, is exogenously determined. The sanctions could be endogenized in a repeated-game framework in which B may sell equity and A may invest multiple times, either with one another or with additional players. When either party exploits, he reveals himself to be an exploiting "type" (i.e., one subject to low informal sanctions), as in the repeated-game model of Kreps et al. (1982). Once player B is known as an exploiter, future investors will expect a lower payoff from investing, which will in turn reduce B's expected payoffs.

Depending on his discount rate, B may be willing to give up future gains for the opportunity to exploit today. Player A is once again, however, in a

2. Unlike a statutory right, a contractual buyout right might not incorporate judicial valuation, but it would have to incorporate some valuation procedure if the parties cannot reach agreement. That valuation procedure would play the role of a court's valuation in the analysis that follows.

different position because he does not experience an immediate gain in expected-value terms from exploiting. Moreover, it does not seem plausible that A's decision to exploit today could improve (rather than reduce) his future payoffs. Having been revealed as an exploiter, A will not get additional opportunities to invest, as an entrepreneur would always do better in expected-value terms to pick a new investor who might or might not be an exploiter.

The credible-threat argument on which I have relied requires unbiased judicial valuations. If judges routinely overcompensate minority shareholders, it may be rational for the minority to exploit. Easterbrook and Fischel's (1986, 1991) argument that exit at will creates a risk of minority exploitation appears to reflect an underlying assumption that judicial valuations are systematically too high. Easterbrook and Fischel focus in particular on a wrong turn taken by the courts in Massachusetts and California.[3] These courts have adopted a rigid "equal treatment" rule that entitles the minority to equal pro rata sharing (in amount, timing, and form) of all cash flows. If followed routinely, that approach would systematically overcompensate minority shareholders. In order to maximize firm value, shareholders are often willing to provide specific financial incentives for the majority shareholder-managers. Such incentives are inconsistent with equal treatment. The Massachusetts/California approach would allow minority shareholders to escape from these deals ex post, thereby creating a threat of minority exploitation.

The Massachusetts and California cases, however, may be aberrations. Courts in many states scrutinize managers of close corporations more closely than they do managers of publicly traded corporations, but these courts have generally not applied a rigid equal treatment rule.[4] While we cannot reject the possibility that courts systematically overcompensate minority shareholders and majorities consequently refuse to agree to buyout rights, for most states (including Delaware), the evidence is equally consistent with unbiased valuation.

6.3 Why Don't Shareholders Bargain for Buyout Rights?

There is no large-sample evidence on the extent to which shareholders in closely held corporations bargain for buyout rights. It is widely believed by lawyers and commentators, however, that they do so rarely (Dooley 1995). A survey of practicing lawyers found that deviations from the state-

3. See *Donahue v. Rodd Electrotype Co.*, 367 Mass. 578, 328 N.E.2d 505 (1975); *Jones v. H. F. Ahmanson & Co.*, 460 P.2d 464 (Cal. 1969).

4. See, e.g., *Toner v. Baltimore Envelope Co.*, 498 A.2d 642 (Md. 1985); *Delahoussaye v. Newhard*, 785 S.W.2d 609 (Mo. Ct. App. 1990). The Delaware Supreme Court explicitly declined to adopt an equal treatment rule in a case similar to *Donahue* (see *Nixon v. Blackwell*, 626 A.2d 1366 [Del. 1993] [en banc]).

supplied default settings are uncommon (Hochstetler and Svejda 1985). The reported judicial opinions concerning the valuation of close corporations, moreover, arise in the context of statutory dissolution proceedings, not contractual buyout rights, suggesting that the latter may be uncommon.

If buyout rights do not create a significant risk of opportunism, as I have argued, what explains minority shareholders' apparent failure to bargain for them? The most common responses are that minority shareholders fail to appreciate the danger of majority opportunism (O'Neal and Thompson 1985; Bradley 1985) or that the costs of bargaining for a buyout right are prohibitively high. Johnston (1992) demonstrates that, when the parties have private information about their proclivity to exploit, it may be difficult to bargain to the desired rule without revealing more information than the parties wish.

It would also be possible to create a model in which A and B are asymmetrically informed about the value of the firm. Under some values of the parameters representing A's and B's beliefs about firm value, exit by consent could be superior to exit at will. However, the prior literature focuses on the difficulty of verifying firm value to a court, rather than on the parties' differing beliefs about firm value, as the source of A's ability to exploit. Using the trust game model, I have shown that the inability to verify firm value to third parties is not sufficient to enable A to exploit. The following sections explore two alternative explanations for the survival of exit by consent that do not require an assumption of shareholder ignorance, private information about firm value, or high transaction costs.

6.3.1 Price Protection

In the trust game model, the minority pays a price that reflects its expected losses from majority opportunism. The exit rule would be a matter of indifference to a well-informed minority shareholder as the shareholder can pay a price that reflects the expected utility loss. When opportunism may destroy part of the firm's value, however, the majority is made worse off by the prospect of its own opportunism. The majority, therefore, has an incentive to select the most efficient rule and, therefore, to offer a buyout right if the buyout right reduces majority opportunism at an acceptable cost.

The destruction of firm value, however, can be substantially reduced by ex post renegotiation, not merely by ex ante contracting. In the model developed in section 6.2.1 above, where renegotiation is possible, the expected decrease in the parties' aggregate payoffs due to B's opportunism is

$$\int_0^{1-r} m_B f(m_B) dm_B .$$

The net loss, in other words, is the cost of social or other sanctions imposed on B multiplied by the probability that they will be incurred. To

state the obvious, B exploits only when these costs are small. Investment takes place only when $E(m_B) > 1 - r$, and exploitation occurs only when the realized value of m_B is less than $1 - r$. The expected losses from opportunism are therefore increasing in the variance of m_B. Shareholders may choose to negotiate for buyout rights (or form a partnership rather than a corporation) only when that expected variance is large.

Nevertheless, price protection cannot fully explain majority shareholders' failure routinely to offer buyout rights. A risk-averse minority would demand compensation not only for the expected reduction in wealth but also for the greater variance of outcomes produced by majority opportunism. Close corporation shareholders, who often invest a significant portion of their wealth or effort in the business, are likely risk averse with respect to their returns from the corporation. The majority could obtain a higher price by offering greater protection against opportunism and therefore lower variance of returns.

6.3.2 Fiduciary Duty Constraints

Holderness and Sheehan (chap. 5 in this volume) argue that the fiduciary duties imposed by corporate law constrain large-block shareholders in publicly traded firms from appropriating wealth from minority shareholders. They reach the conclusion by process of elimination, noting that organizational and capital market constraints do not explain the survival of the controlled public company. A similar point can be made with respect to majority shareholders in closely held corporations. The organizational devices that commentators have suggested to combat majority opportunism, such as buyout rights, do not appear to be used, yet close corporations survive as a common business form. A plausible reason is that corporate law provides sufficient constraints.

It does not follow automatically from the fact that fiduciary constraints are effective in publicly traded corporations with controlling shareholders that they would also be effective in close corporations because there are important differences between the two. Judicial intervention in publicly traded corporations is most common when there is an allegation of management self-dealing. Where there is no such allegation, the business-judgment rule shields management's business decisions from judicial scrutiny. Managers must justify self-interested transactions, by contrast, as "entirely fair" to shareholders.[5]

These constraints are looser where small close corporations are concerned because low levels of self-dealing are ubiquitous, accepted, and probably cost effective in this context. Many closely held corporations are family businesses in which family members of the controlling shareholder may be employees, suppliers, or customers of the business. The board of directors of a family business is unlikely to have an independent compen-

5. See, e.g., *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983).

sation committee. Shareholder monitoring is also more difficult in the case of a close corporation compared to a publicly traded corporation, as the latter are subject to the Securities and Exchange Commission's proxy rules, which require disclosure of self-dealing transactions and relationships.[6]

The smaller size of the classic close corporations with which I am concerned, compared to the typical publicly traded corporation, also complicates judges' attempts to police majority behavior by scrutinizing self-dealing. Consider a firm that pays its CEO/controlling shareholder a salary of $100,000 per year and has annual profits (after payment of salaries) of $200,000 per year. If the minority owns 49 percent of the stock, the directors can appropriate about a quarter of the profits that the minority would otherwise receive by raising the CEO's salary by 50 percent. Contrast this to a company that pays its controlling shareholder/CEO $1 million per year and has annual profits of $500 million. Doubling the CEO's pay would appropriate less than 1 percent of the 49 percent minority's share of profits. It is of course possible for a CEO to receive compensation measured in the tens or hundreds of millions of dollars, but amounts that large are typically tied to the performance of the company's stock, which mitigates the wealth-transfer component of the compensation.

The amounts at stake in publicly traded corporations are such that the controlling shareholder can appropriate a large fraction of minority-shareholder wealth primarily through an extraordinary transaction such as a management buyout, a cash-out merger, or a recapitalization. Not surprisingly, courts pay the closest attention to these transactions and apply a stringent fairness test. The controlling shareholder of a small close corporation, by contrast, can appropriate a significant fraction of the minority's stake through everyday transactions that courts cannot scrutinize with the same care.

This suggests that the law constrains the controlling shareholder of a typical close corporation less effectively than it does the controlling shareholder of a typical publicly traded corporation if courts apply identical forms and levels of scrutiny to each. This is not, however, what the courts have done. Instead, they have adapted the inquiries that they make to fit the close corporation context. Courts and commentators have often erred in identifying the problem—they argue that the difference between public and close corporations stems from illiquidity or the "intense relationship" between close corporation shareholders (see O'Neal and Thompson 1985), rather than the fact that large-scale appropriation in the public company context, unlike the close corporation context, usually involves an extraordinary transaction. Nevertheless, courts have developed a set of responses to majority opportunism, described in the next section, that appear to deter such appropriation.

6. See item 404 of regulation S-K, 17 C.F.R. sec. 229.404.

6.4 Judicial Scrutiny in Close Corporations

As noted above, a common setting for judicial intervention on behalf of the shareholders of a publicly traded company is a breach-of-fiduciary-duty suit challenging an extraordinary transaction such as a merger or recapitalization. In a close corporation, by contrast, the majority often has no need to rid itself of the minority in order to appropriate a large share of the minority's wealth. Thus, the most common setting for intervention is a minority shareholder's suit for dissolution of the corporation on the grounds of "oppressive" conduct by the majority.[7]

Although statutes are typically silent on what constitutes oppressive conduct and court decisions describe oppression in various ways, Haynsworth (1987) notes that many courts now ask whether conduct of the majority is inconsistent with the "reasonable expectations" of the minority. The majority and minority are assumed to have entered into the relationship with certain understandings of how the firm's cash flows would be shared, which they could not reduce to well-defined obligations for all possible states. The court's objective is to determine the parties' expectations regarding the allocation of cash flows and enforce those expectations.

Courts have also become willing to fashion equitable remedies other than the all-or-nothing remedy of dissolution. These remedies may include money damages, rescission of a transaction found to have violated the majority's fiduciary duties, or an order to pay a special dividend. Thompson (1993) details these remedial choices and notes that they have made the action for dissolution resemble a standard breach-of-fiduciary-duty action. He argues that the two distinct causes of action are gradually evolving into a single cause of action for oppression in which the substantive inquiry is whether the majority's actions are consistent with the parties' reasonable ex ante expectations and the court can apply a wide range of remedies.

The strategy is consistent with courts' behavior faced with long-term contracts in which it is prohibitively costly to specify the parties' required actions in all states. Legal scholars often call these transactions *relational contracts* (see Goetz and Scott 1981). Close corporations fit the paradigm because the parties' failure to build in specific protections against the majority appropriating wealth from the minority is plausibly a result, not of their desire to permit such appropriation, but rather of the prohibitive cost of writing a contract to achieve that result. To the extent that courts can supply implicit contract terms that are consistent with the parties' preferences, they can reduce the cost of forming close corporations.

The trend toward greater judicial intervention in close corporations has

7. See Model Act, sec. 14.30 (court may dissolve a corporation in an action by a shareholder if shareholder establishes 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").

been strongly criticized, however. Commentators argue that judicial valuation errors will ensure that these remedies do more harm than good. Ribstein (1994, 955), for example, states that judge-made or statutory "oppression" remedies "create a potential judicial 'wild card' that creates costly uncertainty." Gevurtz (1996, 288) argues in favor of greater organizational protections for minority shareholders but contends that discretionary judicial intervention is an inferior solution because it "is likely to be no more accurate than flipping a coin." Oesterle (1995, 883) argues that legislative experimentation with waivable fiduciary duties in limited-liability statutes has been driven by dissatisfaction with judicial "meddling" in close corporation governance.[8]

What commentators have described as a greater degree of intervention in close corporation governance can be better understood as an adaptation of standard fiduciary principles to the close corporation setting. In publicly traded corporations, courts have relied almost exclusively on process-based standards for evaluating the behavior of corporate directors. So long as directors follow appropriate procedures, their behavior will survive judicial scrutiny, and, absent appropriate procedures, even actions that create significant shareholder wealth can result in liability.[9] By contrast, courts have paid more attention to outcomes when close corporations are concerned. Because the managers of a small close corporation can appropriate a significant share of the minority's cash flows through day-to-day operations, courts have paid attention to the substance of those operations.

6.5 Conclusion

Legislatures, courts, and commentators have devoted considerable attention to the problem of majority opportunism in close corporations. Minority exit rights, in the form of easily available judicial dissolution or legislatively granted or contractual buyout provisions, have generated the greatest controversy. Contrary to the views of recent commentators, it is not obvious that minority shareholders could use exit rights to extort a greater share of the cash-flow rights from the majority. More generous exit rights may be unnecessary, however, as a result of the courts' ability to deter majority opportunism through statutory dissolution and "oppression" proceedings.

8. Oesterle's main point—that fiduciary duties, buyout rights, and other protections should be waivable by contract—is correct whether or not courts do a good job of identifying and remedying majority misconduct. Some parties will be able to design effective organizational mechanisms to obtain their desired outcomes, and such parties should be able to rely on self-help in preference to judicial intervention.

9. See *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985). In *Van Gorkom*, the board obtained what appeared to be a high price in a sale of the company, but the Delaware Supreme Court concluded that the board's deliberations were too hasty and found the board members liable for a breach of fiduciary duty.

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Comment

Larry Y. Dann

The study by Paul Mahoney adds to the growing body of literature that examines highly concentrated ownership in corporations. Discussion of mechanisms for resolving disputes between minority and majority shareholders in closely held, private corporations has been a topic of attention in the legal literature for at least twenty years, but, until recently, most of the attention paid in the financial economics literature to highly concentrated ownership has been confined to publicly traded corporations. Increasingly, however, financial economists are analyzing the institutional arrangements of companies in the "prepublic" stage of development. Consequently, this study, which uses a game-theoretic model to shed light on the economic and legal issues of potential opportunistic behavior by shareholders, lies at an interesting and expanding intersection of the legal and financial economics literatures.

The paper focuses specifically on so-called exit rules—arrangements by which shareholders in closely held corporations can cash out their ownership stakes. The absence of a public market for the firm's shares, and the possibility of opportunistic behavior by both minority and majority owners, makes specification of the exit rule potentially important. Debate in the legal literature has centered on the economic efficiency of the default exit rule, that is, identifying the default rule that minimizes the aggregate value loss from shareholders behaving opportunistically. By modeling shareholder opportunism in a simple setting, Mahoney sharpens the focus of the debate. The conclusion that he reaches, that the threat of minority-shareholder opportunism may have been overstated by earlier writers on the subject, and the reasons why we rarely observe contractual buyout rights for minority shareholders are examined in turn.

The model consists of one minority shareholder (A) and one majority shareholder (B). Each may be able to behave opportunistically (capture value belonging to the other) but incurs a reputational cost of doing so. In addition, the model assumes a loss in corporate value from actions taken by B to exploit A and/or from B's adjustments to opportunistic actions taken by A. Under *exit by consent* (the normal corporate rule whereby a shareholder can sell his or her shares back to the corporation only if approved by the majority of shareholders), B will find it advanta-

Larry Y. Dann is the Richard W. Lindholm Professor of Finance and Taxation in the Lundquist College of Business at the University of Oregon.

geous to expropriate value from A (via withholding dividend payments, terminating A's employment, etc.) when B's reputational cost of doing so, m_B, is low. Reputational costs will be high for B when (*a*) B's relationship with A consists of more than just co-ownership of shares (e.g., B and A are family members, friends, or members of a small community, etc.) or (*b*) B is likely to be seeking capital market resources in the future and knowledge of B's opportunism will affect his or her future capital market dealings. Under the alternative regime of *exit at will* (akin to the partnership dissolution rule, which permits any owner to demand that the business buy back the owner's claim), A might time the buyout demand to B's disadvantage (e.g., when B does not have the personal resources to buy A's claim and the cost of raising capital is high). Demanding a buyout at such a time would benefit A if either (*a*) renegotiation with B is possible such that B buys out A at a high price or (*b*) A expects a judicially determined buyout price that favors A over B. A's reputational cost of making an opportunistic buyout demand is m_A.

Under each exit-rule regime, the game is modeled both with and without the opportunity for renegotiation between B and A. This highlights two aspects of the game. One is that renegotiation between B and A allows for the possibility that the loss in corporate value from adopting non-value-maximizing policies can be avoided (although the reputational costs are still borne). Thus, ex post renegotiation limits the social loss from opportunism. The second is the apparent asymmetry of the consequences of opportunism by B versus by A. Since B controls corporate decision making, B can and will exploit A when m_B is sufficiently low. Judicial intervention does not limit B in the model since B can freeze out A (drive A's payoff to 0). For A credibly to exploit B, however, A needs help. A's threat of opportunistic behavior will be credible only if A can benefit from the behavior. This requires either the possibility of renegotiation such that A can expropriate some of the value of B's claim to the firm or, absent renegotiation, an *expected* judicial determination that favors A over B. Without either renegotiation or judicial bias, the paper correctly argues, it may never be rational for A to behave opportunistically. However, if either judicial bias favoring A over B or even the less stringent assumption of unbiased judicial intervention were an element of the exit-by-consent regime, the conditions under which B would rationally exploit A are also reduced. It appears that the consequence of allowing the existence of a judicial remedy, consistently invoked, for whether the choice of a default exit-rule regime is important depends on the costs of seeking the judicial intervention.

In section 6.3, Mahoney explains why the model treats the element of judicial intervention differently across the two exit-rule regimes. This section offers some of the best insights in the paper, especially for financial economists who (like me) are not extensively informed about the differ-

ences in legal treatment of the minority/majority-shareholder situation for closely held versus publicly traded corporations. In essence, one argument is that detection of majority-shareholder exploitation of minority shareholders (e.g., by shareholder monitoring) is more costly in closely held corporations than publicly traded ones because of the more limited reporting requirements regarding self-dealing transactions and relationships. Furthermore, since there are significant fixed costs to policing self-dealing, it is uneconomic to scrutinize judicially the small-scale valuation consequences of majority-shareholder opportunism in many closely held corporations.

Section 6.3 also explains why the model in this paper reaches a different conclusion about the threat of minority-shareholder opportunism than do such earlier writers as Easterbrook and Fischel (1986, 1991) and O'Kelley (1992). Mahoney models behavior by the minority shareholder as occurring in response to observed behavior by the majority shareholder. In contrast, he argues, the analysis underlying Easterbrook and Fischel and O'Kelley does not treat the choices made by B and A as sequential. Mahoney asserts that the natural sequence of play captured by his model is more realistic, and I tend to agree, but the point is that one important thing that we learn from the explicit modeling is the *reason* for the different conclusions being reached. Explicit specification of the form of the game envisioned sharpens the analysis.

One empirical regularity that the game does not explain is why we so infrequently observe minority shareholders obtaining, or apparently even seeking, a contractual buyout right. Mahoney posits that one explanation is that intervention by the courts has worked well as a minority-shareholder safeguard. While this conclusion is not as strong as one reached affirmatively from the analysis (instead of being arrived at by ruling out posited alternative explanations), it is nevertheless at least as plausible as any of the other alternatives mentioned. Further analysis to address this conjecture would be a valuable contribution.

Two additional questions arise from this study that, with further investigation, would advance our understanding of the extent of opportunistic behavior among shareholders in the closely held corporation. One question is how the game would change if the reputational costs of opportunism, m_B and m_A, are not known by the other player. Second, as one whose heart ultimately lies with empirical analysis, I would find it interesting (although obtaining data would be challenging) to test the empirical implication of the reputation model that we are more likely to observe exit-at-will rules or exit rights bargained for when minority shareholders do not have a personal relationship with the majority shareholder.

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