Chapter 1

Introduction to the Firm

The corporation is a framework for bringing together people who want to join in a business for profit. But before we turn to corporate basics in the next chapter, we should cover the business firm. This chapter introduces you to the roles played by the key actors in any business organization – investors and managers. And we also explain the essential function of law in business firms.

We start with perhaps the most famous case of U.S. business organization law. It arose from a dispute between two co-venturers in a commercial real estate project. Although the project did not technically involve a corporation, the case raises fundamental questions about the legal relationship between investors and managers.

As you'll notice, the two people who joined together in this project had different interests and skills. One had more money to invest, the other greater expertise. Both wanted to make money from the business, but each anticipated a different role – with different prerogatives and different protections. That is not unusual. Specialization is at the core of corporate law.

Their business project, like any other, involved taking on risks. Their initial relationship allocated the risks to best serve their individual interests – and to promote their mutual interests in minimizing conflicts (selfishness) and maximizing profits. The issue before the court was whether their relationship extended to new business opportunities that arose from the initial project.

Take Note!

As you will see, even a business with just two people raises a lot of questions:
• Who should bear the key risks?
• How should they divide profits and losses?
• How should they allocate authority and responsibilities?
• How long should their business and their responsibilities last?
• How should they be able to change or end their relationship?

These questions permeate the law of corporations, and they form the building blocks of this book.

We use the case for two purposes. First, we introduce you to how risks can be allocated in a business organization. Second, we provide you an overview of

fiduciary duties in a business organization – the basic glue of corporate law. You will notice that both topics reappear throughout this book.

Meinhard v. Salmon

164 N.E. 545 (N.Y. 1928)

Cardozo, C. J.

On April 10, 1902, Louisa M. Gerry leased to the defendant Walter J. Salmon the premises known as the Hotel Bristol at the northwest corner of Forty-Second street and Fifth avenue in the city of New York. The lease was for a term of 20 years, commencing May 1, 1902, and ending April 30, 1922. The lessee undertook to change the hotel building for use as shops and offices at a cost of $200,000. Alterations and additions were to be accretions to the land.

Salmon, while in course of treaty with the lessor as to the execution of the lease, was in course of treaty with Meinhard, the plaintiff, for the necessary funds. The result was a joint venture with terms embodied in a writing. Meinhard was to pay to Salmon half of the moneys requisite to reconstruct, alter, manage, and operate the property. Salmon was to pay to Meinhard 40 per cent. of the net profits for the first five years of the lease and 50 per cent. for the years thereafter. If there were losses, each party was to bear them equally. Salmon, however, was to have sole power to 'manage, lease, underlet and operate' the building. There were to be certain pre-emptive rights for each in the contingency of death.

They were coadventures, subject to fiduciary duties akin to those of partners. As to this we are all agreed. The heavier weight of duty rested, however, upon Salmon. He was a coadventurer with Meinhard, but he was manager as well. During the early years of the enterprise, the building, reconstructed, was operated at a loss. If the relation had then ended, Meinhard as well as Salmon would have carried a heavy burden. Later the profits became large with the result that for each of the investors there came a rich return. For each the venture had its phases of fair weather and of foul. The two were in it jointly, for better or for worse.

When the lease was near its end, Elbridge T. Gerry had become the owner of the reversion. He owned much other property in the neighborhood, one lot adjoining the Bristol building on Fifth avenue and four lots on Forty-Second street. He had a plan to lease the entire tract for a long term to some one who would destroy the buildings then existing and put up another in their place. In the latter part of 1921, he submitted such a project to several capitalists and dealers. He was unable to carry it through with any of them. Then, in January, 1922, with less than four months of the lease to run, he approached the defendant Salmon. The

result was a new lease to the Midpoint Realty Company, which is owned and controlled by Salmon, a lease covering the whole tract, and involving a huge outlay. The term is to be 20 years, but successive covenants for renewal will extend it to a maximum of 80 years at the will of either party. A new building to cost $3,000,000 is to be placed upon the site. The rental, which under the Bristol lease was only $55,000, is to be from $350,000 to $475,000 for the properties so combined. Salmon personally guaranteed the performance by the lessee of the covenants of the new lease until such time as the new building had been completed and fully paid for.

Go Online!

The building project undertaken by Salmon, one of the most important in New York City in the 1920s, resulted in the "Salmon Tower." The 60-story building at 42nd Street and Fifth Avenue, across from the New York City Public Library, was for a time the second tallest building in the city. Designed by the architectural firm Shreve Lamb & Harmon (the same firm that designed the Empire State Building), it remains a landmark of the New York skyline You can go online to see a city map showing the building's location, as well as pictures of Hotel Bristol (the original building on the site) and Salmon Tower during construction and today.

The lease between Gerry and the Midpoint Realty Company was signed and delivered on January 25, 1922. Salmon had not told Meinhard anything about it. Whatever his motive may have been, he had kept the negotiations to himself. Meinhard was not informed even of the bare existence of a project. The first that he knew of it was in February, when the lease was an accomplished fact. He then made demand on the defendants that the lease be held in trust as an asset of the venture, making offer upon the trial to share the personal obligations incidental to the guaranty. The demand was followed by refusal, and later by this suit. The case is now here on an appeal by the defendants.

Joint adventurers, like copartners, owe to one another, while the enterprise continues, the duty of the finest loyalty. Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

The owner of the reversion, Mr. Gerry, had vainly striven to find a tenant who would favor his ambitious scheme of demolition and construction. Baffled

in the search, he turned to the defendant Salmon in possession of the Bristol, the keystone of the project. He figured to himself beyond a doubt that the man in possession would prove a likely customer. To the eye of an observer, Salmon held the lease as owner in his own right, for himself and no one else. In fact he held it as a fiduciary, for himself and another, sharers in a common venture. The trouble about his conduct is that he excluded his coadventurer from any chance to compete, from any chance to enjoy the opportunity for benefit that had come to him alone by virtue of his agency. This chance, if nothing more, he was under a duty to concede. The price of its denial is an extension of the trust at the option and for the benefit of the one whom he excluded.

No answer is it to say that the chance would have been of little value even if seasonably offered. Such a calculus of probabilities is beyond the science of the chancery. Salmon, the real estate operator, might have been preferred to Meinhard, the woolen merchant. On the other hand, Meinhard might have offered better terms, or reinforced his offer by alliance with the wealth of others. All these opportunities were cut away from him through another's intervention. He knew that Salmon was the manager. As the time drew near for the expiration of the lease, he would naturally assume from silence, if from nothing else, that the lessor was willing to extend it for a term of years, or at least to let it stand as a lease from year to year. At least, there was nothing in the situation to give warning to any one that while the lease was still in being, there had come to the manager an offer of extension which he had locked within his breast to be utilized by himself alone. The very fact that Salmon was in control with exclusive powers of direction charged him the more obviously with the duty of disclosure, since only through disclosure could opportunity be equalized. If he might cut off renewal by a purchase for his own benefit when four months were to pass before the lease would have an end, he might do so with equal right while there remained as many years. He might steal a march on his comrade under cover of the darkness, and then hold the captured ground. Loyalty and comradeship are not so easily abjured.

Little profit will come from a dissection of the precedents. Authority is, of course, abundant that one partner may not appropriate to his own use a renewal of a lease, though its term is to begin at the expiration of the partnership. The lease at hand with its many changes is not strictly a renewal. Even so, the standard of loyalty for those in trust relations is without the fixed divisions of a graduated scale. To say that a partner is free without restriction to buy in the reversion of the property where the business is conducted is to say in effect that he may strip the good will of its chief element of value, since good will is largely dependent upon continuity of possession. Equity refuses to confine within the bounds of classified transactions its precept of a loyalty that is undivided and unselfish. Certain it is also that there may be no abuse of special opportunities growing out of a special trust as manager or agent. A constructive trust is, then, the remedial device through which preference of self is made subordinate to loyalty to others.

We have no thought to hold that Salmon was guilty of a conscious purpose to defraud. Very likely he assumed in all good faith that with the approaching end of the venture he might ignore his coadventurer and take the extension for himself. He had given to the enterprise time and labor as well as money. He had made it a success. Meinhard, who had given money, but neither time nor labor, had already been richly paid. There might seem to be something grasping in his insistence upon more. Such recriminations are not unusual when coadventurers fall out. They are not without their force if conduct is to be judged by the common standards of competitors. That is not to say that they have pertinency here. Salmon had put himself in a position in which thought of self was to be renounced, however hard the abnegation. He was much more than a coadventurer. He was a managing coadventurer. For him and for those like him the rule of undivided loyalty is relentless and supreme. A different question would be here if there were lacking any nexus of relation between the business conducted by the manager and the opportunity brought to him as an incident of management. For this problem, as for most, there are distinctions of degree. If Salmon had received from Gerry a proposition to lease a building at a location far removed, he might have held for himself the privilege thus acquired, or so we shall assume. Here the subject-matter of the new lease was an extension and enlargement of the subject-matter of the old one.

Food for Thought

Notice that the rule (or duty) applied by Judge Cardozo is contextual. If Salmon had received information about a real estate opportunity far removed geographically or involving a non-real estate investment opportunity, Judge Cardozo suggests the result would have been different. Does it make sense for fiduciary duties to vary depending on the parties' specific relationship? Could the parties have agreed to a different rule (or set of duties) so that neither was required to share information about business opportunities, even related ones?

A question remains as to the form and extent of the equitable interest to be allotted to the plaintiff. The trust as declared has been held to attach to the lease which was in the name of the defendant corporation. We think it ought to attach at the option of the defendant Salmon to the shares of stock which were owned by him or were under his control. The difference may be important if the lessee shall wish to execute an assignment of the lease, as it ought to be free to do with the consent of the lessor. On the other hand, an equal division of the shares might lead to other hardships. It might take away from Salmon the power of control and management which under the plan of the joint venture he was to have from first to last. The number of shares to be allotted to the plaintiff should, therefore, be reduced to such an extent as may be necessary to preserve to the defendant Salmon the expected measure of dominion. To that end an extra share should be added to his half.

Andrews, J. (dissenting)

I am of the opinion that the issue here is simple. Was the transaction, in view of all the circumstances surrounding it, unfair and inequitable? I reach this conclusion for two reasons. There was no general partnership, merely a joint venture for a limited object, to end at a fixed time. The new lease, covering additional property, containing many new and unusual terms and conditions, with a possible duration of 80 years, was more nearly the purchase of the reversion than the ordinary renewal with which the authorities are concerned.

Were this a general partnership between Mr. Salmon and Mr. Meinhard, I should have little doubt as to the correctness of this result, assuming the new lease to be an offshoot of the old. Such a situation involves questions of trust and confidence to a high degree; it involves questions of good, will; many other considerations. As has been said, rarely if ever may one partner without the knowledge of the other acquire for himself the renewal of a lease held by the firm, even if the new lease is to begin after the firm is dissolved. Warning of such an intent, if he is managing partner, may not be sufficient to prevent the application of this rule.

What then was the scope of the adventure into which the two men entered? It is to be remembered that before their contract was signed Mr. Salmon had obtained the lease of the Bristol property. Very likely the matter had been earlier discussed between them. But it has been held that the written contract defines their rights and duties. Having the lease, Mr. Salmon assigns no interest in it to Mr. Meinhard. He is to manage the property. It is for him to decide what alterations shall be made and to fix the rents. But for 20 years from May 1, 1902, Salmon is to make all advances from his own funds and Meinhard is to pay him personally on demand one-half of all expenses incurred and all losses sustained 'during the full term of said lease,' and during the same period Salmon is to pay him a part of the net profits. There was no joint capital provided.

It seems to me that the venture so inaugurated had in view a limited object and was to end at a limited time. There was no intent to expand it into a far greater undertaking lasting for many years. The design was to exploit a particular lease. Doubtless in it Mr. Meinhard had an equitable interest, but in it alone. This interest terminated when the joint adventure terminated. There was no intent that for the benefit of both any advantage should be taken of the chance of renewal-that the adventure should be continued beyond that date. Mr. Salmon has done all he promised to do in return for Mr. Meinhard's undertaking when he distributed profits up to May 1, 1922.

Points for Discussion

1. What roles?

What roles do you think Meinhard and Salmon envisioned that each would play? How do their expectations about their respective roles affect the judges' views of their business relationship? Should their expectations matter?

2. What risks?

How did Meinhard and Salmon divide the risks of their business relationship? How would you have advised them to divide the risks? Would it have been possible to allocate the risks in advance, so that they could have avoided this dispute?

A. Risk Allocation in the Firm

Before turning to the court's decision on fiduciary duties, it is useful to first consider how Meinhard and Salmon allocated (and might have allocated) the business risks in their venture. You can think of Meinhard and Salmon as having a kind of "business firm." To be successful, business firms must identify and manage risk. There are different ways to manage business risk, sometimes by externalizing it and sometimes by allocating it within the firm to the parties who are willing and able to assume it. Legal rules also play a role in allocating risks.

What's That?

"Business firms" – sometimes called "business organizations" or "business enterprises" – are formed according to the interests of the parties. When many investors come together and seek common management, the usual choice is a "corporation" (with its attributes of perpetual life, centralized management, free transferability of shares, and limited liability). When the parties seek to have equal financial and management rights, a "partnership" is a common choice.

Lately, business parties can craft their firm to have the attributes that suit them best. A hybrid "limited liability company" provides the flexibility to create a firm with both corporate attributes (such as limited liability) and partnership attributes (such as non-transferable shares). The parties' agreement fixes the terms.

By the way, a "joint venture" is a "partnership" with a limited duration or scope.

1. Nature of Risk

Risk comes in different forms. And different people, or the same people in different contexts, have different attitudes about risk. How each person in a business firm views and handles risk often affects how well the venture

manages risk – and thus whether it is a success or a failure.

Two types of risk. Like all business people, Meinhard and Salmon faced two categories of business risk: non-controllable risks and controllable risks. "Non-controllable risks" are risks the parties in a business firm cannot control – like the U.S. economy, bank interest rates, and the New York City commercial leasing market. Although non-controllable risks affect different businesses differently, they cannot be completely eliminated.

Parties in a business firm also face "controllable risks," which they can control. For example, Meinhard and Salmon could decide on the kinds of tenants they would have, the quality and safety of the building materials they would use to refurbish the building, and how the project would be advertised to potential tenants. These risks also are important to the business, but unlike the non-controllable risk that the stock market might crash (or boom), the parties can control how they structure their rental agreements.

Expected returns. Some risks cannot be quantified. It would be difficult to quantify the risks of climate change or a financial meltdown. But it often is possible to determine or estimate the probabilities of uncertain events. Business firms frequently try to quantify their risks, even when they know their estimates might not be precise. By quantifying the risks associated with a particular decision, the firm can determine the "expected return," or average return, of that decision.

For example, when Meinhard originally decided to invest $100,000 in the venture with Salmon, he had a sense for what the returns might be. We might imagine there was a chance (slim perhaps) that the project would lose money – let's assume under this scenario that losses would be $12,000 a year for the full twenty years. We might estimate that the probability of this "worst-case" scenario would be 20%. There was also a more "likely" scenario (say, half of the time) that the project would produce steady profits of $20,000 a year. There was also a possible "best-case" scenario that the project would succeed beyond expectations with profits of $30,000 a year. We might assess the chances of this "best-case" scenario as 30%.

What would be Meinhard's expected return – assuming the following probabilities for the different scenarios and a 50-50 sharing of profits and losses? Meinhard would envision a 20% probability of losing $6,000, a 50% probability of earning profits of $10,000, and a 30% probability of earning profits of $15,000. Here's a simple chart to show how Meinhard might assess his expected return. Note that the expected return column reflects a weighted average of the three scenarios.

	Meinhard's share	Probability	Expected return
Worst-case scenario	($6,000)	20%	($1,200)
Likely scenario	$10,000	50%	$5,000
Best-case scenario	$15,000	30%	$4,500
		Total	**$8,300**

Now, of course, we could play with the probabilities of each of the different scenarios, or even add additional scenarios. You might try doing so in a spreadsheet, to see what effect changing different numbers has on the expected return. Overall, using the assumptions of our simplified example, Meinhard could expect a return of $8,300 per year – not bad, an 8.3% return on his investment (assuming he gets back the $100,000 initial investment at the end of the 20 years).

Take Note!

The math in this book won't get more complicated than basic arithmetic. And mathematical tools are important. For example, the concepts reflected here are useful in illustrating how investors think about risk and return. If you browse forward in this book, you'll notice that the text is not heavy on numbers or math. In fact, we use numbers only occasionally. But this simple tabular calculation anticipates our primer, later in Chapter 9, Numeracy for Corporate Lawyers, which introduces you to basic accounting and business valuation.

Risk tolerance. Notice Meinhard was willing to risk losing not only his investment, but shouldering his share of business losses. How did he view risk? We know from experience that people think differently about risk. Some people are "risk averse": they would not risk losing money. To persuade a risk averse person to invest, you would have to offer sizeable potential returns or federally-insured deposit insurance.

Other people, perhaps Meinhard, are "risk seekers": they love to bet on investments even when safer returns are available (like a bank CD paying guaranteed interest). Remember that Meinhard was a wool merchant – in fact, a very successful one. His investment in Salmon's initial project was unlikely to have ruined him, though his later multi-million dollar exposure in the expanded project actually did!

In between risk aversion and risk seeking is "risk neutrality." A risk neutral person coolly calculates probabilities and returns, and makes decisions based solely on expected returns. Such a person would be happy to take on risk anytime it will generate a benefit on average. For example, if Meinhard were risk neutral and had also been offered another investment (such as 20-year bonds offered by General Electric) with an expected return of 7.9%, he would have chosen the

Business Lingo

In addition to some math, we also will be introducing many business and finance concepts. Some of this lingo will be new to many of you. If you have no experience with these concepts, this might seem like a vocabulary course more than a law course, at least at first. Don't worry – we'll explain these concepts as they arise. Anyway, now is a good time to start. Most of you will confront these terms – in life if not in practice. And you can always go to a dictionary or Google to find a definition.

higher "expected return" project with Salmon, even though the GE Bonds carried less risk.

This discussion about risk is not merely theoretical. Appetite for risk can dramatically affect decision making, particularly when the structure the parties choose for their business relationship creates incentives to take on or avoid risk. For example, will Salmon manage the venture to attract high-rent tenants (and risk low occupancy) or low-rent tenants (and risk low, but assured returns)? The answer depends on how willing Salmon is to assume risk, which in turn depends on his risk tolerance and the incentives in the business relationship. If he is not risk averse and his compensation is in the form of profits, as it was in the case, he might go for the high-rent option. But if he is risk averse and his compensation was a fixed salary, he might prefer the safe low-rent option to make sure the project does not fail and he gets paid.

2. Methods to Manage Risk

The success of a business depends on how well it manages risk. Successful firms exploit favorable developments and minimize the effects of unfavorable ones. How well a business manages risk depends on how the parties allocate different risks, which in turn determines the incentives of the firm's participants. It is impossible for a business to avoid dealing with risk.

Insurance. One way for people to manage risk is "insurance." In purchasing insurance, a person or business pays a fee upfront, sometimes called an insurance premium, in exchange for the right to payment if a specified event occurs. Many people insure against risks in their private lives by purchasing car, fire, health or life insurance. The same type of insurance is available for many business risks. Insurance offers private parties the ability to pool risks. When you buy car insurance, you and many other people each pay an insurance premium, and if you are involved in a car accident, you receive a payment that is drawn from the pool of insurance premiums (less the sometimes very substantial cost – and haggling – associated with the insurance company).

By using insurance to pool risks, each member of the pool bears a pro rata share of the pool's total loss, which is easier to predict than the loss to any particular member. For example, Meinhard and Salmon could have purchased insurance against declines in the stock market (tied to the commercial leasing market in New York City). Business insurance is available from private insurance companies and also can be purchased in the financial markets. Today they could have bought futures contracts on an exchange in Chicago that permits parties to bet on the direction of the stock markets or even real estate markets.

Business Lingo

A "futures contract" is a standardized contract, traded on a futures exchange (like the Chicago Board of Trade, CBOT) in which parties agree to buy or sell an underlying instrument (like a pool of corporate stocks) at a certain date in the future – at a fixed price. For example, one could buy a futures contract on the Dow Jones Industrial Average (DJIA), which is an "index" (or the weighted average) of the stock prices of the 30 largest publicly-traded corporations in the United States. You also could buy a futures contract based on the price of real estate in a particular region or city.

Diversification. A second way to manage risk is through "diversification." A person or business can diversify by participating in numerous ventures, each of which involves different risks. For example, an investor in the stock market might guard against the risk of armed hostilities (or peace) by investing in both weapons suppliers and cruise ships. Although diversification will not completely eliminate the risk of loss in any given stock, it will reduce the total risk because the performance of the entire portfolio is more likely to be balanced between gains and losses. Thus the diversified portfolio will offer a more certain return than can be obtained from any particular stock.

Diversification can take many forms. For example, if the main variable affecting commercial real estate in New York City is the investment climate in the United States, a real estate investor might diversify his risk by investing in real estate ventures in other countries. In this way, if the U.S. economy falters, real estate in other economies may prosper. Likewise, such an investor could also diversify by buying commodities (like oil or timber land), foreign stocks and bonds, or Impressionist paintings, each of which involves risks that are different from, and somewhat independent of, the risks associated with the New York City commercial real estate market.

Internal risk allocation. The third way to manage risk is to "allocate" the risk. Parties in a business firm might allocate risks to the person who is most willing or best able to bear them, perhaps because he is in a better position to insure or diversify. Alternatively, a more sophisticated party with superior information might allocate risks to the person who is least likely to understand the risks.

For example, Meinhard (the capitalist) would seem to have been in a better position than Salmon (the manager) to bear the risk associated with a real estate downturn. Meinhard might have been wealthier or more sophisticated, and therefore better able to buy insurance or diversify. As it turned out, Salmon was willing to compensate Meinhard for taking on the project's risks by letting him share in profits. On the other hand, Salmon might have shifted the risk to Meinhard, because he believed Meinhard did not understand risk very well, and therefore agreed to bear it cheaply.

Risk externalization. Another (sometimes controversial) way for business firms to manage risk is to "externalize" it – that is, to move the risk to other people outside the firm. (Notice that insurance is a form of risk externalization, where insiders pay outsiders to bear firm risks.) One significant way that modern business firms externalize risk is through limited liability, which applies to corporations and other limited liability entities. The effect of limited liability is to make participants liable only up to the amount they invest in the business. Thus, outside parties that deal with the corporation must bear any loss should the corporation be unable to fulfill its obligations.

For example, if Salmon and Meinhard had incorporated their venture and their corporation had contracted to buy building supplies, the outside supplier would have had no recourse against them individually if the corporation became insolvent and was unable to pay for the supplies. For this reason, when Geary leased the expanded property to Midpoint Realty Corporation (the corporation created and owned by Salmon), he obtained personal guarantees from Salmon to assume the obligations under the lease if the corporation failed to pay.

Not all outside parties, however, are able to obtain personal guarantees from those who own and operate business firms. In particular, people who are injured by business activities (such as tort victims) often have to bear the loss themselves – or obtain their own insurance – in the event the business lacks the resources to compensate them. This problem is aggravated when businesses externalize risks on society – such as through activities that threaten the environment – where there is no mechanism to have the business or its participants take responsibility for the losses borne by everyone else. The externalization of risk is the hallmark of the modern business firm – and one of its most controversial characteristics.

3. Business Firm as Risk Allocation

Let's return to risk allocation within the firm. How might parties allocate business risks between themselves? For the sake of simplicity, let's assume there are two distinct roles the parties might play: principal and agent. We use "principal" to refer to the role of investor/owner and "agent" to refer to the role of manager/

employee. After assigning each party a role, we can consider the incentives of each party. Next we can see how different organizational choices – or allocations of risk – affect outcomes in their business venture. Then we can consider what happens if business risks are allocated to the principal, and then what happens if they are allocated to the agent. Which is preferable? Or does it depend?

Incentives of principal and agent. When a principal and agent join in a for-profit business venture, the tensions between them are inevitable. The principal will want to maximize the expected return on his investment. He will want the agent to use as much effort as possible to make the venture a success. Predictably, he will want for himself the bulk of the venture's profits. He will want the agent to put the principal's interests above the interests of others – even above the agent's own interests. He will want to know that the agent is working for him and to have the means to impose his will, if necessary.

The agent, on the other hand, will also have an interest in maximizing the expected return on his efforts, given the alternative uses of his time. He will want to be compensated munificently for his effort, even if the business does not succeed. Given human nature, he will want to expend as little effort as necessary to make the venture a success. He will want the discretion to accomplish the goals of the venture, without interference from the principal or blame should the venture fail.

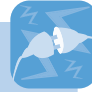
Given the divergence in their interests, the principal will understandably want to "monitor" the agent to ensure he does as expected. If he does not do as expected, the principal will want to "discipline" the agent by imposing appropriate sanctions. Even then, the agent will probably get away with some shirking. For the principal, these monitoring and disciplining efforts – and the agent's inevitable shirking – are the "agency costs" of working through a principal-agent arrangement. Despite these costs, however, both parties see potential gains from entering into the venture together. Business firms are built on the premise that participants must specialize and cooperate to accomplish their individual interests.

Matters addressed by business organization. We must remember that the parties cannot know with certainty what the future holds. The principal cannot know whether the agent will be honest, hard-working and obedient. The agent cannot know whether the principal will be steady and wise. Neither can be sure that the venture will succeed in a real world of uncertainty.

To do this, their agreement (or the rules under which they implicitly choose to operate) must address:

- the term of their relationship

- the sharing of financial rights and obligations, including profits and losses
- the discretion and responsibilities of the agent
- the supervisory powers of the principal, including access to information
- the ability of either participant to terminate their relationship



Make the Connection

The basic issues that Salmon and Meinhard must address arise in all business organizations. As you'll notice, they reflect the main topics (or modules) of this corporations casebook: the corporate form, corporate finance, corporate externalities, corporate governance, fiduciary duties, stock trading, and corporate acquisitions.

- the means by which they can change their relationship

Much of their relationship will be decided *before* the venture begins – from an *ex ante* perspective. But some terms of their relationship will be resolved only *after* the venture has begun or problems arise – from an *ex post* perspective. As we will see, business organization law (which includes corporate law) offers rules that resolve many of these issues, sometimes by mandating particular results and more often by providing standardized default terms that the parties can rewrite if they want.

Participants in a business have many choices about how to structure their relationship and allocate their risks. Contracting for the optimal structure, however, will not be costless. They will have to identify their own individual interests, as well as the interests of the other party. Among other things, they will have to decide on the term of their relationship, the allocation of gains and losses of the venture, the decision-making authority and discretion of each participant, and the circumstances in which they can exit from their relationship.

Contract or law. There are two sources of rules for parties to use in structuring their business relationship: contract and law. First, in allocating risks by contract, the parties are forced in their private agreement to address the allocation of non-controllable and controllable risks. Second, by choosing a particular legal regime, the parties accept the "off the shelf" allocation of the regime they choose. In some cases, the law will mandate the allocation of risks between the parties. But in other cases, the legal rules will permit the parties to choose among different ways to allocate risks.

Before looking at how legal rules serve to allocate risks, consider how principals and agents might allocate risks through contract. We already have discussed the allocation of non-controllable risks, such as the risk of a financial downturn

on Wall Street. The allocation of controllable risks is different, because principals and agents can affect controllable risks, by acting or not acting. For example, if the venture's success depends on Salmon actively seeking high-rent tenants, a risk to the venture is that Salmon will not make the effort. Controllable risks can be reduced by monitoring and disciplining devices that align the agent's incentives with the interests of the principal.

The difficulty in allocating risk among the parties is that the party who bears the consequences of the risk will have a greater incentive to control the risk, but the other party will not. For example, if Salmon receives a fixed salary no matter how many high-rent tenants he develops, he will have little incentive to promote the venture. This failure is called "shirking." (More generally, the danger that a person who does not bear a risk will not take steps to control that risk is referred to as "moral hazard." In general, moral hazard refers to an increase in risk when some activity is insured – the increased risk of arson when a person buys fire insurance is a common example.) To avoid the agent's self-interested shirking, the principal, who *does* bear the risk, must monitor the agent to ensure that he takes risk reducing precautions. Often it will be more efficient to place the risk on the agent and thus avoid the monitoring costs.

At the same time, however, the party who is in the best position to control risks might not be the best person to bear them. For example, if Salmon is less wealthy, less risk averse, and less able to insure or diversify, he might not want to assume the risk of low occupancy rates in the building. Who should bear the risk? Each party, perhaps justifiably, would want the other to bear it. There is a clear tension between controlling risk and bearing risk. Is there a compromise?

Allocating risks to the principal. First, let's explore the allocation of risks to the principal. Some risks are most efficiently borne by the principal – that is, the person who assumes the attributes of owner or holder of the firm's residual profits. If the principal is less risk averse than the agent, the principal will be more willing to bear the non-controllable risk of business success or failure. The agent, on the other hand, will prefer a fixed compensation. In this way, the principal accepts the uncertainty of business success or failure, and receives as compensation for this risk-taking the bulk of the returns if the business succeeds. This makes sense particularly if the principal is wealthier and has the opportunity to insure or diversify, a strategy less available to the agent.

If the agent does not bear the risks of the business, but receives a fixed compensation, there arises the controllable risk that the agent will be lazy or even corrupt. This risk of agent shirking will predictably lead the principal to want to monitor and discipline the agent. First, the principal must decide what constitutes optimal performance by the agent – an *ex ante* task. Second, having decided this,

the principal must determine whether the desired level of performance is occurring or has occurred – from an *ex post* perspective. The principal will want to minimize these agency costs.

How might the principal monitor the agent? One solution would be direct supervision where the principal both prescribes optimal standards, observes whether they are being met, and punishes the agent if not. This approach has obvious drawbacks. Deciding what the agent should do, obtaining information about whether he did it and then disciplining wayward behavior is time-consuming and costly. It would undermine the very reason that the principal hired an agent, namely to delegate decision-making authority to another. Of course, the principal could hire a supervisor. Doing that, however, would create an additional problem: Who supervises the supervisor? Maybe another supervisor, like a board of directors. But in a small business, the principal might search for another less cumbersome solution.

An alternative monitoring device might be an employment contract between the principal and agent. Such a contract could both specify the agent's duties and decision-making discretion, and prescribe sanctions (including dismissal) if the agent failed to perform those duties. It would also specify the principal's oversight and decision-making powers, and the sanctions should the agent fail to comply with his duties.

Is such a contract desirable? Although some aspects of the agent's work can be satisfactorily defined in a contract, others are more problematic. For example, in their joint venture agreement, Meinhard and Salmon specified that Salmon would be the "manager," but apparently without specifying all his tasks. This left open the question whether Salmon was obligated to bring to Meinhard's attention post-venture investment opportunities.

Because of the *ex ante* drafting difficulty, shirking might continue even with a contract. Nonetheless, a contract might still be useful if it takes an *ex post* perspective. For example, Meinhard might have insisted on the following:

> Salmon will use his best efforts as manager. Any dispute over whether Salmon has used his best efforts will be resolved by an independent arbitrator of Meinhard's choosing.

This "best efforts" clause prescribes Salmon's efforts *ex ante*. Meinhard's hope is that the clause will lead Salmon to expend the effort he would if he were the owner – that is, if he bore the controllable risks of the business. Consistent with this view of Salmon's role, the clause delegates discretion to Salmon to perform his tasks according to the actual circumstances as they arise in the building. The clause, however, makes the heroic assumption that the diligence and loyalty

implicit in "best efforts" will be clear to Salmon, and that Meinhard will be able to monitor his efforts.

To deal with the difficulties of *ex ante* specification, the clause's enforcement mechanism addresses agency costs from an *ex post* perspective. In deciding whether to enforce the clause, Meinhard might find it easier to determine whether Salmon was shirking by looking at the results of his efforts. For example, he could compare the rentals received in previous years or the occupancy rate in other office buildings. After this comparison, if the current rentals or occupancy rates were high, Meinhard could infer that Salmon used his best efforts. If low, Meinhard could then invoke his arbitration rights. Notice that this *ex post* mechanism will also have *ex ante* effects. Since Salmon cannot be sure whether Meinhard will enforce his contract rights, he has an incentive not to shirk.

Contracting, however, has its limits. For example, in their long-term venture, it was hard from Meinhard and Salmon to imagine and foresee all contingencies, such as the possibility that the Geary estate might make adjacent properties available for an expanded building project. When such contingencies arise, should the parties be able to amend their contract, under what procedures? Or should the parties be able to withdraw from the contract, on what terms? Which course will be optimal? Although contracting offers advantages in reducing controllable risks, it has its limits.

Remember also that contracting is costly. Information, negotiation and drafting costs all must be incurred – and lawyers' time is not cheap. The potential cost of enforcing contracts is high and cannot be disregarded, even if the need never actually materializes. And a contract inevitably shifts the ultimate resolution of a dispute to a third party – often a court – thereby adding new uncertainty and risk.

Allocating risks to the agent. Now let's assume an organizational model that places the risk of the agent's shirking on the agent. For example, Meinhard could have lent money to the project with fixed interest and allow Salmon to retain all the project profits. Such an arrangement would allow Meinhard to reduce his monitoring costs (though he would still want to make sure Salmon set aside enough money to repay the loan). The bulk of the monitoring would be Salmon's self-monitoring. If he works less hard, it will be because he values his non-work activities more than the fruits of his work; his reduced business profits will be counterbalanced by the value he places on those activities.

Or only some of the risk might be allocated to the agent, such as by basing the agent's compensation in part on the success (or failure) of the business. For example, Meinhard and Salmon might have agreed as follows:

> Salmon is to be paid an annual salary of $5,000. But if the project's annual net income is less than $10,000, his annual salary shall be reduced by 50 percent.

Is such a provision desirable? The project's profitability probably depends on numerous factors. Some are beyond the control of either party; and some are within their control, but unrelated to the specific problem of shirking. If shirking is Meinhard's main concern, he can tie Salmon's salary to net rentals. So if profitability depends on Salmon's efforts, the clause would create incentives for Salmon and reduces the need to monitor and discipline his performance. As a partial claimant to residual profits, Salmon would see the project from Meinhard's perspective.

Another option for the principal is to hire the agent to a long-term contract. This would then more closely align the agent's incentives with the principal's long-term interests. But this might also work against the principal. In our example, if Salmon becomes a malingerer and Meinhard cannot fire him, he will have created new agency costs. A year-to-year arrangement then would have the advantage that Salmon must prove himself with each rental cycle. A shorter term would also allow Meinhard to adapt to changing circumstances, such as unforeseen competitive pressures or the availability of MBA-trained building managers. A short-term contract puts Salmon at risk by effectively giving Meinhard the ability unilaterally to exit their arrangement, perhaps in ways that frustrate Salmon's expectations.

Finally, consider what happens if Salmon stops working for Meinhard. If he shirked for Meinhard, he might damage his reputation, reducing his value to other capitalists. Instead, Salmon will want Meinhard and others to conclude that he worked diligently for him, a signal to future owners to increase his pay and reduce their monitoring of him. Thus, reputation serves as a self-effectuating monitoring device. It is particularly useful since it does not involve any reallocation of the risks or returns of the venture.

Which allocation of risks is better? If risk is the main concern, the principal might be the better risk-bearer because of his ability to diversify and insure, or simply because he prefers risk. But under this model the principal must incur monitoring/disciplining costs to reduce the costs of agent shirking. If shirking is the main concern, the agent might be the better risk-bearer since entitlement to profits will give him incentives to maximize the venture's success. But the agent might not be willing or able to bear all the risks.

Perhaps there is a satisfactory middle ground. Suppose (as happened in the case) Meinhard and Salmon agree to divide the venture's profits 50-50, or some other mutually agreeable ratio. Even if Salmon received a fixed salary (which was

not clear from the facts of the case), he had a residual claim to project profits. Although Salmon would have some incentive to shirk, it would be minimized since any shirking would decrease his share of the profits. Meinhard would still need to monitor, but not as much. This solution, however, means that Meinhard sacrificed some of his returns from the project in the hope of reducing agency costs. It also means that some risks were allocated to Salmon, who may have been less able to bear them.

In searching for this middle ground, one dynamic affecting the parties' allocation of risk will be the specialized knowledge that the agent acquires over time while working for the principal. This was the lynchpin in the case. As Salmon became more familiar with commercial real estate management and with the 42nd Street and Fifth Avenue location, he became more valuable to Meinhard. Over time, he could have opportunistically demanded greater independence or a larger share of profits – since he would have known how hard it would be for Meinhard to replace him. But Salmon's greater specialization would have been a two-edged sword. His acquired skills and knowledge could have been primarily valuable only to Meinhard, on whom Salmon could become dependent. How should the parties allocate risk (such as the possibility of an expanded building project) as their symbiotic relationship matures? Since their contract did not resolve it, it was left to the law.

4. Role of Law in Business Firms

Thus far, our discussion of risk allocation and firm design has assumed a simplified two-person business firm. Similar allocations of risk among creditors, suppliers, employees and owners occur in more complex business firms. The business firm can be understood as a complex network of arrangements between various participants, each adding specialized inputs. Within this network, some risk allocations happen by means of contracting, but legal rules also define the relationship among the parties.

To save firm participants the costs of contracting, the law of business relationships (including agency law, partnership law and corporate law) provides the parties a set of "off the rack" rules by which they can define their relationship. These laws specify the allocation of risks, by specifying various roles and rights for the firm participants. In most situations the parties can change the rules to suit their circumstances – that is, the rules are the default unless the parties agree otherwise. Sometimes the rules are mandatory, and the parties cannot agree otherwise.

What's That?

Much of the law of business organization law, including corporate law, is a combination of default and mandatory rules. Consider the employer-employee relationship. Minimum wage rules, for example, are "mandatory" – since the parties cannot agree to a lower wage than set by law. Many other rules are "defaults," such as the "at will" employment doctrine, under which either party can terminate the employment relationship at any time, unless they agree to a specific term or other limits on termination. The at-will doctrine assumes most parties would bargain for it, making it a "majoritarian" default. Some default rules seek to anticipate what the specific parties would have bargained for – such as, the duty of agents to inform their employers of "material" employment-related information. This is a "tailored" default that tries to fit their relationship, though they always can specify otherwise. Some default rules – such as the rule that an agent can compete with his employer after the employment ends – may compel one party (here the employer) to seek an agreement otherwise, such as a non-compete clause. These are "penalty" defaults that encourage the parties to bargain and specify their relationship.

Mandatory rules assume that private bargaining (markets) is inadequate to protect weaker parties or might cause social harm. Default rules recognize the value of party autonomy, which you will discover is an underlying thesis of corporate law.

B. Fiduciary Duties

We now return to the central issue in *Meinhard v. Salmon* – what are the implicit duties of firm participants to each other? The law of business firms generally assumes that when management authority is delegated in the firm, those who run the firm have "fiduciary duties" to those who entrusted them with this authority. But to say that fiduciary duties exist only begins to frame the issue.

1. Theory for Fiduciary Duties

In a broad sense, fiduciary duties seek to protect those who delegate authority (capitalists) against the laziness, disloyalty or worse of those who exercise this authority (managers). It is inevitable that when people take on different roles in a business firm there will be conflict – one will want things done her way, the other his way. It's just human nature. But just because "friction" is inevitable does not mean the "engine" of working together should be discarded.

So how do we know specifically what are the fiduciary duties in a business firm? One answer might be that such duties exist only to the extent the parties

have specified them. That is, the parties would have to negotiate their own rules against selfishness, so the manager sees the firm from the capitalist's perspective. But this would be nearly impossible. Instead, the law steps in with its own (often vague) rules that state broadly that the fiduciary must exercise care, diligence, honesty, and loyalty with respect to the firm and its participants – even when the parties have not specified any duties of selflessness.

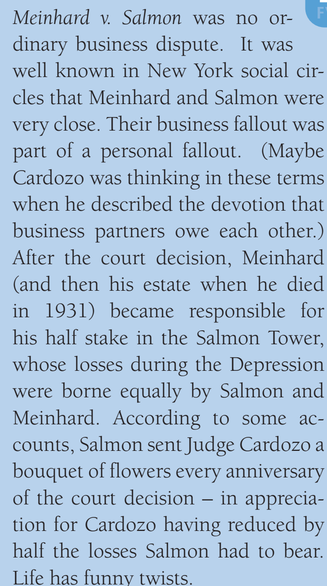
As you can see, fiduciary duties constitute the "golden rule" in business firms. Without them, it might not be feasible for people to join together in a business for profit. Sometimes, though, departures from the ideal will be hard to detect. And sometimes the law – and judges – may not be the best arbiters of what constitutes faithful or unfaithful conduct. Fiduciary duties, enforced through legal processes, cannot be the balm for everything that ails a business firm.

Not surprisingly, discussion of fiduciary duties (nebulous as they are) often evokes poetry – that is, judges just have a feeling for what's fair and good, but have trouble expressing it with clarity and specificity. Judge Cardozo's opinion in *Meinhard v. Salmon* illustrates. It is widely recognized as a stylistic masterpiece, and many lawyers and judges recall the poetic "punctilio of an honor the most sensitive."

2. Meaning of *Meinhard v. Salmon*

The case presents a fundamental issue underlying our free-market capitalist system. What protections are capitalists (Meinhard) entitled to when they delegate operational discretion to a manager (Salmon)? Judge Andrews, in dissent, takes the view that the capitalist was entitled to protections only within the context of their original agreement, which did not include any right in the capitalist to participate in post-venture business opportunities undertaken by the manager. Judge Cardozo, for the majority, takes the view that the parties' relationship existed beyond the "morals of the marketplace" and compelled the manager to make any related opportunities available to the capitalist.

FYI



Meinhard v. Salmon was no ordinary business dispute. It was well known in New York social circles that Meinhard and Salmon were very close. Their business fallout was part of a personal fallout. (Maybe Cardozo was thinking in these terms when he described the devotion that business partners owe each other.) After the court decision, Meinhard (and then his estate when he died in 1931) became responsible for his half stake in the Salmon Tower, whose losses during the Depression were borne equally by Salmon and Meinhard. According to some accounts, Salmon sent Judge Cardozo a bouquet of flowers every anniversary of the court decision – in appreciation for Cardozo having reduced by half the losses Salmon had to bear. Life has funny twists.

Points for Discussion

1. Extra-contractual nature.

There are many ways to approach *Meinhard v. Salmon*. At one level, you should notice that fiduciary duties exist beyond contractual agreements. Even Andrews agrees the result would have been different if the parties had agreed to an indefinite partnership, as opposed to a 20-year joint venture. But could Salmon have included a clause in their original agreement that he retained the option to enter into other projects involving the same real estate, without notifying or otherwise including Meinhard? That is, are fiduciary duties default terms, subject to the parties' agreement otherwise? As we will discover, the law is still struggling on this question.

2. Judge-made law.

At another level, you may have noticed the absence of any mention of partnership statutes. The law in the case is clearly judge-made. This seems quite odd given that your professor may have asked you to buy a thick (and expensive) statutory supplement for this course. What is the purpose of these statutes if the most important aspects of business organization law seem to be decided by judges, without reference to the statutes? In the end, corporate law is a wondrous mix of statutes and case law – a dialogue between legislatures and courts.

3. Gap-filling function.

At yet another level, you might ask whether the right of first refusal that Cardozo gave the capitalist Meinhard is one that the parties would have negotiated for. Was it really implicit in their relationship that Salmon would give Meinhard a chance to share in any post-venture opportunities related to their business? Meinhard contributed capital, for which he received promises of profit sharing. But did Meinhard pay also for the option to extend their business venture if a good opportunity arose? If we decided that his initial $100,000 contribution only covered his sharing of net profits, it would seem the court enforced more than the parties' expectations.

4. Utility of fiduciary duties.

Was the result in the case just? If you were inventing a capitalist system, would you impose extra-contractual fiduciary duties on managers that, as happened in this case, require sharing of outside business opportunities? Would such duties of loyalty lead to more efficient and productive business firms, and thus more skyscrapers in New York City? Would people selling their managerial talent agree to be bound by such restraints?