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# The Contractual Foundation of Family-Business Law

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# The Contractual Foundation of Family-Business Law

BENJAMIN MEANS\*

*Most U.S. businesses are family owned, and yet the law governing business organizations does not account adequately for family relationships. Nor have legal scholars paid sufficient attention to family businesses. Instead, legal scholars operate within a contractarian model of business organization law, which holds that a firm is comprised of a nexus of contracts among economically rational actors. Intimate relationships appear irrelevant except insofar as they affect contractual choices. Indeed, strictly speaking, there is no such thing as family-business law.*

*This Article lays the foundation for a law of family business by expanding the contractarian model: a firm includes not just business contracts, but all bargains among participants that affect the business enterprise. The payoff for including family considerations is twofold. First, when family obligations introduce uncertainty, such as when co-owners of a business divorce, contract offers an explanatory resource for resolving disputes consistent with the parties' expectations. Second, a contractual conception of the firm can guide the establishment of appropriate default rules for the interpretation and enforcement of family-business bargains.*

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## I. INTRODUCTION

Most U.S. businesses are family owned,<sup>1</sup> and yet the law governing business organizations does not account adequately for family relationships.<sup>2</sup> Nor have legal scholars paid sufficient attention to family businesses.<sup>3</sup> Instead, legal scholars operate within a contractarian model of business organization law, which holds that a firm is comprised of a nexus of contracts among

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<sup>1</sup> See DWIGHT DRAKE, *BUSINESS PLANNING: CLOSELY HELD ENTERPRISES* 274 (2d ed. 2008) (“Family dominated businesses comprise more than 80 percent of U.S. enterprises, employ more than 50 percent of the nation’s workforce, and account for the bulk . . . of America’s gross domestic product.”); Joseph H. Astrachan & Melissa Carey Shanker, *Family Businesses’ Contribution to the U.S. Economy: A Closer Look*, 16 *FAM. BUS. REV.* 211, 217–18 (2003) (“No matter what criteria are used, family businesses represent a substantial portion of the U.S. economy and have a massive impact on the economy as a whole.”). This Article defines family business broadly to include businesses in which effective control rests in family hands and at least two family members are involved as owners or managers. For further analysis, see *infra* Part III.A.

<sup>2</sup> First, “[a]s a legal matter, the corporation is an entity wholly separate from the people who own it and work for it.” STEPHEN M. BAINBRIDGE, *CORPORATION LAW AND ECONOMICS* 7 (2002). Further, shareholders are presumed to seek their own economic advantage. See Charles R. O’Kelley, Jr., *Filling Gaps in the Close Corporation Contract: A Transaction Cost Analysis*, 87 *NW. U. L. REV.* 216, 220 (1992) (“Rational individuals invest their human and money capital with a view to maximizing the value of such resources.”); GARY S. BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* 14 (1976).

<sup>3</sup> See Eric A. Chiappinelli, *Stories from Camp Automotive: Communicating the Importance of Family Dynamics to Corporate Law Students*, 34 *GA. L. REV.* 699, 710 (2000) (observing that “corporate law casebooks are astonishingly devoid of any systematic consideration of family dynamics”). In a recent article, I explored the underlying values that often motivate family-business owners. See Benjamin Means, *Nonmarket Values in Family Businesses*, 54 *WM. & MARY L. REV.* 1185, 1195 (2013); see also Steven H. Hobbs & Fay Wilson Hobbs, *Family Businesses and the Business of Families: A Consideration of the Role of the Lawyer*, 4 *TEX. WESLEYAN L. REV.* 153, 158 (1998) (identifying distinctive social and cultural dimensions of family businesses). This Article examines the legal implications of family relationships, making a more direct case for the salience of family-business law.

economically rational actors.<sup>4</sup> Intimate relationships appear irrelevant except insofar as they affect contractual choices.<sup>5</sup> Indeed, strictly speaking, there is no such thing as family-business law.<sup>6</sup>

Nevertheless, family relationships have a habit of intruding on business matters. For instance, if a married couple owns a corporation, either spouse can petition for divorce, triggering an equitable division of assets overseen by a family court judge who is not bound by the existing allocation of stock between the spouses. In a “no-fault” divorce proceeding, it is irrelevant whether the petitioning spouse could have sought corporate dissolution by alleging shareholder oppression, let alone demonstrated an ownership stake that would have provided the spouse standing to assert such a claim.<sup>7</sup> Whether the issue is divorce, inheritance, or the operation of a family trust that owns business assets, family law can have a considerable influence on business law outcomes.<sup>8</sup>

Further, the supposed irrelevance of family relationships does not follow from the premise that business organizations are defined by contract. A central purpose of contracting is to empower individuals to order their own affairs.<sup>9</sup> In a family business, the members’ relationships are multifaceted in ways that impact business-planning choices. Through private ordering, family-business

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<sup>4</sup> See BAINBRIDGE, *supra* note 2, at 26 (“[I]t is fair to say that the economic theory of the firm is now the dominant paradigm in corporate law.”) (citing William T. Allen, *Contracts and Communities in Corporation Law*, 50 WASH. & LEE L. REV. 1395, 1399 (1993)); Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 311 (1976) (arguing that the firm is “a framework of contractual relations”).

<sup>5</sup> See FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 229 (1991) (noting that “[t]he continuous and nonpecuniary nature of these relationships reduces agency problems”).

<sup>6</sup> Perhaps because family business disputes often fall within the equitable jurisdiction of family court, the bulk of legal scholarship concerning family businesses does not engage broader theories of corporate law and is produced by practitioners in the context of continuing legal education programs. See, e.g., William M. Long & Scott A. Sissel, *Divorce and the Family Business—What are the Options?*, 9 BUS. ENTITIES 30, 30 (2007); John J. Scroggin, *Factor Estate Planning Considerations into Divorce Arrangements*, 70 PRAC. TAX STRATEGIES 23, 23 (2003); Myron E. Sildon, *Dealing with Divorce and Non-Traditional Relationships in the Family Business*, A.L.I.-A.B.A. EST. PLAN. COURSE MATERIALS J., Feb. 2010, at 39.

<sup>7</sup> A petition for corporate dissolution, by contrast, is more akin to a divorce based on fault. See John H. Matheson & R. Kevin Maler, *A Simple Statutory Solution to Minority Oppression in the Closely Held Business*, 91 MINN. L. REV. 657, 691 (2007) (“[B]ecause there is no concept of no-fault divorce (or even irreconcilable differences) for business dissolutions, the mud of mistreatment allegations must be slung, and litigants (and courts) must muddle through the quagmire.”).

<sup>8</sup> For purposes of the argument advanced in this Article, estate planning falls within the broad domain of family law because it concerns the transfer of family wealth across generations.

<sup>9</sup> Henry N. Butler, *The Contractual Theory of the Corporation*, 11 GEO. MASON L. REV. 99, 100 (1989) (“[F]reedom of contract requires that parties to the ‘nexus of contracts’ must be allowed to structure their relations as they desire.”).

members can manage the intersections of business law and family law. For instance, because families involve the transfer of resources across generations, family businesses are often structured to achieve estate planning and related tax objectives; trusts, wills, and other testamentary documents may be as constitutive of the business as articles of incorporation, bylaws, and shareholder agreements.<sup>10</sup> Likewise, because divorce can seriously disrupt a family business, married couples may use nuptial agreements to specify whether business assets count for purposes of equitable division in the event of divorce.<sup>11</sup>

This Article lays the foundation for a law of family business by expanding the contractarian model: a firm includes not just business contracts, but all bargains among participants that affect the business enterprise. Like businesses, families are a locus of economic activity and members must negotiate questions of production, distribution, and exchange.<sup>12</sup> In a family business, therefore, the background economic concerns of family life are central, not ancillary, to the structure of the business and the parties' mutual expectations.<sup>13</sup> As extensions of family life, family businesses are defined by broader economic goals and more intimate associations.

The payoff for placing family considerations within the contractual conception of the firm is twofold. First, when family obligations introduce uncertainty, such as when co-owners of a business divorce, contract offers an explanatory resource for resolving disputes consistent with the parties' expectations.<sup>14</sup> Family members' agreements regarding business and family

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<sup>10</sup> See *infra* Part III.C.

<sup>11</sup> See UNIF. PREMARITAL & MARITAL AGREEMENTS ACT § 9(c), 9C U.L.A. 22–23 (2012).

<sup>12</sup> See VIVIANA A. ZELIZER, *THE PURCHASE OF INTIMACY* 241 (2005) (“Many households . . . build commercial activity directly into their daily operations.”). Professor Zelizer contends that “commercial relationships do not simply transect and influence household relationships; they *become* household relationships.” *Id.*; see also Jill Elaine Hasday, *Intimacy and Economic Exchange*, 119 HARV. L. REV. 491, 493 (2005) (arguing that “[e]conomic exchange is not foreign to intimate relations, either as a matter of first principles or as a positive matter of legal regulation”).

<sup>13</sup> Families are regulated by law but subject to further contractual agreements among members. See Elizabeth S. Scott & Robert E. Scott, *Marriage as Relational Contract*, 84 VA. L. REV. 1225, 1229 (1998) (“Like relational contracts in commercial contexts, a marital contract contemplates a long-term commitment to pursue shared goals, the fulfillment of which will enhance the joint welfare of the parties.”); Jana B. Singer, *The Privatization of Family Law*, 1992 WIS. L. REV. 1443, 1444 (contending that private ordering has increasingly “supplanted state-imposed rules and structures for governing family-related behavior”); see also Marjorie Maguire Shultz, *Contractual Ordering of Marriage: A New Model for State Policy*, 70 CALIF. L. REV. 204, 208 (1982).

<sup>14</sup> Family objectives are not necessarily what a rational actor would formulate and appreciating them may “force us to reckon with the role of far less rational emotions—particularly, love—in guiding the familial structures . . .” Ariela R. Dubler, *All Unhappy Families: Tales of Old Age, Rational Actors, and the Disordered Life*, 126 HARV. L. REV.

matters interrelate and should not be read in isolation.<sup>15</sup> For example, if corporate assets are at issue in a divorce, the enforceability of a prenuptial agreement specifying what counts as marital property may be as crucial to the business as any shareholder agreement.

Second, a contractual conception of the firm can guide the establishment of appropriate default rules for the interpretation and enforcement of family-business bargains. Contract is more than just a tool for interpreting and synthesizing explicit bargains in particular cases. Honoring the parties' intentions can be difficult because the communal aspects of family life color individual choices and the self-interest attributed to a rational actor does not always provide a reliable guide to intentions.<sup>16</sup> Moreover, family members may not have addressed key issues in advance because actual bargaining can undermine trust.<sup>17</sup> Properly informed, contract law could serve as a resource for the parties, generating a set of preferred outcomes and facilitating more particular bargaining.<sup>18</sup> By overlaying simultaneously relevant business and family considerations, a contractual approach makes it possible to appreciate what is at stake in a family business.

This Article proceeds as follows. Part II traces the emergence of the nexus-of-contracts theory of the economic firm, emphasizing that the nature of the firm depends upon the contracts that bind its participants. Part III shows that family businesses have distinctive characteristics, both because family values influence business choices, and because the laws governing divorce, inheritance, and trusts can produce results at odds with what business organization laws would otherwise dictate. Part IV argues that contracts encompass the parties' business and family obligations and, therefore, can account for the distinctive characteristics of family businesses. Part V contends

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2289, 2292 (2013) (reviewing HENDRIK HARTOG, *SOMEDAY ALL THIS WILL BE YOURS: A HISTORY OF INHERITANCE AND OLD AGE* (2012)).

<sup>15</sup> See G. Mitu Gulati et al., *Connected Contracts*, 47 *UCLA L. REV.* 887, 894 (2000) (arguing for a conception of "connected contracts" in which the boundaries of a firm are constantly undermined by "a fluid, nonlinear, nonhierarchical set of interactions and interrelationships").

<sup>16</sup> See DAVID BORK, *FAMILY BUSINESS, RISKY BUSINESS: HOW TO MAKE IT WORK* 26 (1986) (arguing that "what is going on in the individual [is] inseparable from the family network of relationships in which the individual is embedded [and from] the emotional processes in that system . . ."); see generally Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 *YALE L.J.* 87, 91–93 (1989) (exploring the role of courts in defining contractual obligations in the absence of explicit terms based on assumptions regarding the parties' intentions).

<sup>17</sup> See Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 *U. PA. L. REV.* 1735, 1805–06 (2001) (noting that parties may avoid explicit bargains in order to preserve trust).

<sup>18</sup> See Adam J. Hirsch, *Default Rules in Inheritance Law: A Problem in Search of Its Context*, 73 *FORDHAM L. REV.* 1031, 1045 n.52 (2004) ("The tendency of parties to accede to default rules in order to avoid the cost of contracting around them renders them 'sticky[.]'") (citing Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 *STAN. L. REV.* 1591, 1598 (1999)).

that conceptualizing family businesses in terms of a contractual nexus would also guide the design of default rules and interpretive principles sensitive to the parties' business and family expectations.

## II. THE NEXUS OF CONTRACTS: A REVIEW

Most business law scholars accept some version of the proposition that a "corporation is not a thing, but rather a web of explicit and implicit contracts establishing rights and obligations . . ." <sup>19</sup> As Part II.A shows, economists first developed the nexus-of-contract theory to explain how rational actors use firms to avoid transaction costs that can inhibit market exchanges. <sup>20</sup> Part II.B describes the nexus theory's rapid, if selective, acceptance by legal academics. Centrally, this Part contends that the conception of the firm as a set of contractual arrangements provides no a priori reason for excluding family bargains.

### A. *An Economic Theory of the Firm*

In order to understand the nature of firms and their boundaries, it may help to begin with a more basic question: *why* are there firms? <sup>21</sup> Firms acquire capital, use that capital to produce goods or services, and seek to sell those goods and services for more than the cost of production. <sup>22</sup> Until relatively recently, most economists took firms for granted, treating them as little more

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<sup>19</sup> BAINBRIDGE, *supra* note 2, at 8; *see also* Allen, *supra* note 4, at 1400 ("[T]he corporation is seen as the market writ small, a web of ongoing contracts (explicit or implicit) between various real persons."). Even critics of the nexus framework concede that many aspects of corporate governance are (and should be) modifiable. *See* Melvin Aron Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1461 (1989). More recently, one legal scholar has advanced an alternative, institutional argument that "firms have a social ontological existence because they are artificial fictions that are legally reinforced in the real world." ERIC W. ORTS, *BUSINESS PERSONS: A LEGAL THEORY OF THE FIRM* 16 (2013). However, while the theory treats firms as more than the sum of their contractual arrangements, it gives significant weight to the "bottom-up authority of participants." *Id.*

<sup>20</sup> Note that "[i]n economics, the concept comparable to the corporation is that of the firm . . ." Gulati et al., *supra* note 15, at 890.

<sup>21</sup> "If the competitive equilibrium of the neoclassical model actually [existed], there would be no need for other economic organizations." PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION AND MANAGEMENT* 73 (1992).

<sup>22</sup> *See* DENNIS W. CARLTON & JEFFREY M. PERLOFF, *MODERN INDUSTRIAL ORGANIZATION* 14 (1st ed. 1990) ("A firm allocates resources that it has purchased in order to produce and sell valued product; it earns the difference between what it receives as revenue and what it spends for the resources."); George S. Geis, *The Space Between Markets and Hierarchies*, 95 VA. L. REV. 99, 106 (2009) ("Every company . . . accepts capital inputs . . . and uses this cash to purchase physical or intangible assets . . . . The company then deploys these assets against a business model in the pursuit of incremental value.").

than a “black box” that transforms inputs into outputs.<sup>23</sup> Yet, as long as individuals can contract with one another to exchange goods and services at mutually agreed prices in an undistorted market, no further organizing mechanism is needed.<sup>24</sup>

Centrally planned allocations of resources are more expensive and, therefore, less efficient as a means of coordinating economic activity.<sup>25</sup> For instance, when a business decides to make items in-house rather than buying them from an external source, the lack of competitive pressure may lead to a decline in quality.<sup>26</sup> Other costs arise as firm owners compensate for the absence of a reliable market check of value, including the need to monitor the performance of employee agents,<sup>27</sup> and the sheer cost of creating and maintaining the hierarchical structure of the firm.<sup>28</sup> The problem, then, is to explain the phenomenon of firms without rejecting either the price mechanism as a means of allocating scarce societal resources or the assumption that individuals will rationally pursue the course of action best calculated to maximize their wealth.<sup>29</sup>

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<sup>23</sup> See R.H. Coase, *The Nature of the Firm*, 4 *ECONOMICA* 386, 389 (1937) (noting a “gap in economic theory between the assumption . . . that resources are allocated by means of the price mechanism and the assumption . . . that this allocation is dependent on the entrepreneur[.]”).

<sup>24</sup> *Id.* at 387 (“An economist thinks of the economic system as being co-ordinated by the price mechanism . . .”). Although some economists argue that firms became necessary as the complexity and scale of industry required a greater division of labor, Coase points out that the price mechanism applies with equal force regardless of the level of complexity. *Id.* at 398 (“It is perhaps the main achievement of economic science that it has shown that there is no reason to suppose that specialisation must lead to chaos.”); see also Butler, *supra* note 9, at 103 (“In theory, all possible gains from specialization could be realized through market coordination in the absence of transaction costs . . .”).

<sup>25</sup> See, e.g., F.A. Hayek, *The Use of Knowledge in Society*, 35 *AM. ECON. REV.* 519, 524 (1945) (arguing that market prices contain information and send signals that lead to more rapid and accurate allocations of resources than could be replicated by even the wisest central planner).

<sup>26</sup> See Geis, *supra* note 22, at 107 (“Essentially, the argument is that sourcing any given activity internally shields production from the pressures of the marketplace . . .”); Coase, *supra* note 23, at 389 (“[T]he distinguishing mark of the firm is the suppression of the price mechanism.”).

<sup>27</sup> See Geis, *supra* note 22, at 112 (“[A]gency costs offer another reason to avoid centralizing economic activity within a firm.”).

<sup>28</sup> See *id.* at 108 (noting that “[a]nyone who has tried to navigate the shoals of a large corporate bureaucracy” will understand the costs of coordinating internal activity); KENNETH J. ARROW, *THE LIMITS OF ORGANIZATION* 25 (1974) (noting that a firm’s “internal organization is . . . hierarchical and bureaucratic”).

<sup>29</sup> See Coase, *supra* note 23, at 390 (“Our task is to attempt to discover why a firm emerges at all in a specialised exchange economy.”). One could avoid the horns of the dilemma by offering instead a political rationale for firms, focused on the power of the managerial class, or some other consideration, rather than expecting market efficiency. MILGROM & ROBERTS, *supra* note 21, at 73 (“Political organizations might still arise as people attempt to capture larger shares of the benefits of joint production or to bring more



As a corrective lens, it turns out that a single additional concept—transaction cost—makes possible a straightforward, economic explanation for the existence of firms. In work for which he later received the Nobel Prize in Economics, Ronald Coase hypothesized that organizing production through firms is sometimes cheaper than relying upon open-market contracts.<sup>30</sup> That is because, in the real world, the contracts that govern performance must be negotiated, written, monitored, and, if necessary, enforced.<sup>31</sup> In longer-term relationships that do not involve a discrete exchange of goods and services, it becomes quite difficult to negotiate all issues satisfactorily and there remains a considerable risk that market actors will exploit power and information disparities to their advantage.<sup>32</sup> When transaction costs are significant, rational market actors may decline to enter into trades that would generate value for all participants.

For rational actors, the goal is to minimize *all* costs. Therefore, if transaction costs burden market transactions, it may be cheaper to organize production within a firm instead.<sup>33</sup> A crucial implication of Coase's work is that the solution to contract problems that can make markets inefficient is, well, contracts.<sup>34</sup> For example, an entrepreneur can use employment contracts to establish a right to direct the manner in which work is performed.<sup>35</sup> Although the relationship between employer and employee is hierarchical,<sup>36</sup> it is defined by the employment contract; the employer has “no power of fiat, no authority,

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concern for equity into the system, but organizations aimed at improving economic efficiency would be unnecessary.”).

<sup>30</sup> Coase, *supra* note 23, at 390 (“The main reason why it is profitable to establish a firm would seem to be that there is a cost of using the price mechanism.”).

<sup>31</sup> *Id.* at 390–91.

<sup>32</sup> Geis, *supra* note 22, at 110 (noting that transaction-cost theories of the firm “share[] the common insight that aggregating production into one legal entity can protect against the hold-up problem inherent with relation-specific assets”). An asset is relationship-specific if it would command a much lower price, once developed, if sold elsewhere. The danger is that the purchaser will exploit its advantage, capturing most of the value of the exchange. *See id.* at 108–09. Long-term contracts can address the problem. *See* Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 *YALE L.J.* 541, 559–62 (2003). It is difficult, however, to anticipate “every variety of opportunistic renegotiation.” Geis, *supra* note 22, at 109.

<sup>33</sup> *See* Butler, *supra* note 9, at 103 (“[O]nce transactions costs are added, the least costly, or most efficient, form of coordination of certain economic activities may be through the firm.”).

<sup>34</sup> *Cf.* *The Simpsons, Homer vs. The Eighteenth Amendment* (Fox Network television broadcast, Mar. 16, 1997), available at <https://youtube.com/watch?v=PdFoAr5QdwA> (“To alcohol! The cause of—and solution to—all of life’s problems.”).

<sup>35</sup> This form of contracting may be cheaper, from a transaction-cost perspective, because the owner “does not have to make a series of contracts with the factors with whom he is co-operating within the firm . . . .” Coase, *supra* note 23, at 391.

<sup>36</sup> *See, e.g.*, R.H. Coase, *The Problem of Social Cost*, 3 *J.L. & ECON.* 1, 16 (1960) (“Within the firm individual bargains between the various cooperating factors of production are eliminated and for a market transaction is substituted an administrative decision.”).

no disciplinary” power beyond what would be available through “ordinary market contracting.”<sup>37</sup> According to this view, the firm is just a label that stands for the set of contracts that organize economic production.<sup>38</sup>

Because the firm is the aggregate of a set of contractual relationships, its boundaries are loosely defined. Contracts exist inside and outside the firm and pertain to the same economic substance—the development and sale of goods and services. Thus, whether a particular contractual relationship falls within or crosses over the boundaries of the firm requires functional analysis.<sup>39</sup> There is no categorical difference.<sup>40</sup> What we see when we open up the black box is identical to what we find outside the black box: contracts among various parties organizing the factors of production.<sup>41</sup>

Moreover, economic firms share much in common with other types of organizations. In each case, laws provide a core structure of mostly default principles around which voluntary relationships concatenate:

It is important to recognize that most organizations are simply *legal fictions which serve as a nexus for a set of contracting relationships among individuals*. This includes firms, non-profit institutions such as universities,

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<sup>37</sup> Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777, 777 (1972). Alchian and Demsetz argue that firms arise when production can be done most efficiently through a team effort, in which individual contributions are difficult to separate and, thus, costly to coordinate through open-market contracts. *Id.* at 779. For a related theory of corporate law, see Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 250–51 (1999).

<sup>38</sup> Jensen & Meckling, *supra* note 4, at 311 (“The private corporation or firm is simply one form of legal fiction which serves as a nexus for contracting relationships . . .”). According to the nexus theory, “[c]ontractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc.” *Id.* at 310.

<sup>39</sup> *Id.* at 311 (“Viewed this way, it makes little or no sense to try to distinguish those things which are ‘inside’ the firm (or any other organization) from those things that are ‘outside’ of it. There is in a very real sense only a multitude of complex relationships (i.e., contracts) between the legal fiction (the firm) and the owners of labor, material and capital inputs and the consumers of output.”).

<sup>40</sup> For instance, the various arrangements among firms can include joint operations, shared marketing, subcontracting, and other complex relational ties. See Geis, *supra* note 22, at 101–02 (describing hybrid outsourcing arrangements); G.B. Richardson, *The Organisation of Industry*, 82 ECON. J. 883, 884 (1972), reprinted in *THE THEORY OF THE FIRM: CRITICAL PERSPECTIVES ON BUSINESS AND MANAGEMENT* 16 (Nicolai J. Foss ed., 2000) (“So complex and ramified are these arrangements, indeed, that the skills of a genealogist rather than an economist might often seem appropriate for their disentanglement.”).

<sup>41</sup> See, e.g., JAMES P. WOMACK ET AL., *THE MACHINE THAT CHANGED THE WORLD* 58 (1990) (“[T]he make-or-buy decisions that occasioned so much debate in mass-production firms struck [managers] at Toyota as largely irrelevant, as they began to consider obtaining components for cars and trucks. The real question was how the assembler and the suppliers could work smoothly together to reduce costs and improve quality, whatever formal, legal relationship they might have.”).

hospitals and foundations, mutual organizations such as mutual savings banks and insurance companies and co-operatives, some private clubs, and even governmental bodies such as cities, states, and the Federal government, government enterprises such as TVA, the Post Office, transit systems, etc.<sup>42</sup>

As Jensen and Meckling recognized, the pressures that motivate cooperation within firms are not unique, nor are the governance choices found in firms radically distinct from those employed in other ventures calculated to achieve shared purposes.<sup>43</sup>

Finally, the nexus-of-contracts conception of the firm includes agreements that may fail to contain the basic legal elements of a contract, namely offer, acceptance, and consideration.<sup>44</sup> Economic contracts include, more broadly, “compacts among people, who recognize their mutual interests and agree to modify their behavior in ways that are mutually beneficial.”<sup>45</sup> Such agreements are considered contractual in this broader sense “regardless of whether they have the legal status of contracts.”<sup>46</sup> By focusing on the functional role of contract, rather than the formal indicia that lawyers use to separate enforceable from unenforceable agreements, economists can extend contractual analysis to explain the structure of a wide variety of voluntary human associations.<sup>47</sup>

### B. *Corporate Law's Economic Structure*

Before the advent of law and economics, the prevailing theory of corporate law characterized the corporation as a legal person authorized and defined by the state, operated by private individuals only as a concession from the state, and subject to extensive regulation.<sup>48</sup> Although deemed a legal person, the

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<sup>42</sup> Jensen & Meckling, *supra* note 4, at 310.

<sup>43</sup> *See id.*; *see also* Saul Levmore, *Competition and Cooperation*, 97 MICH. L. REV. 216, 219–20 (1998) (suggesting a possible analogy between the boundaries of cooperation in a family and a firm).

<sup>44</sup> *See* RESTATEMENT (SECOND) OF CONTRACTS § 17(1) (1981) (stating that “the formation of a contract requires a bargain in which there is a manifestation of mutual assent to the exchange and a consideration”).

<sup>45</sup> MILGROM & ROBERTS, *supra* note 21, at 127; *see also* John H. Langbein, *The Contractarian Basis of the Law of Trusts*, 105 YALE L.J. 625, 629 (1995) (“The bedrock elements of contract are consensual formation and consensual terms.”).

<sup>46</sup> MILGROM & ROBERTS, *supra* note 21, at 127.

<sup>47</sup> *See* JON ELSTER, EXPLAINING SOCIAL BEHAVIOR: MORE NUTS AND BOLTS FOR THE SOCIAL SCIENCES 20 (2007) (stating that one measure of the credibility of a social science hypothesis is whether it has “excess explanatory power” with “implications that are novel, counterintuitive, and as different from the original explanandum as possible”).

<sup>48</sup> Butler, *supra* note 9, at 100 (noting that “[t]he entity theory of the corporation supports state intervention”). On the other hand, “[t]he contractual theory of the corporation is in stark contrast to the legal concept of the corporation as an entity created by the state.” *Id.*

metaphysical characteristics of the corporation remained uncertain.<sup>49</sup> In a famous article, Professor Felix Cohen ridiculed “as transcendental nonsense” the notion that one could, for example, sensibly ask where a corporation is located.<sup>50</sup> A jurisprudence that takes such “supernatural” concepts seriously becomes an empty, “autonomous system of legal concepts, rules, and arguments.”<sup>51</sup> Corporate law, Cohen argued, does not stand apart from “ethics and . . . such positive sciences as economics or psychology.”<sup>52</sup>

Whatever the limitations of the underlying corporation-as-person metaphor, most corporate law scholarship focused on practical concerns regarding the managerial power resulting from the separation of ownership and control in large public corporations.<sup>53</sup> Deeper reflections on the nature of the corporation, let alone theories of economic firms in general, were an afterthought until, borrowing from Jensen and Meckling’s work in economics,<sup>54</sup> legal academics in the late 1970s and early 1980s reframed the debate in corporate law.<sup>55</sup> The

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<sup>49</sup> See William W. Bratton, Jr., *The New Economic Theory of the Firm: Critical Perspectives from History*, 41 STAN. L. REV. 1471, 1482, 1489 (1989).

<sup>50</sup> See Felix S. Cohen, *Transcendental Nonsense and the Functional Approach*, 35 COLUM. L. REV. 809, 810 (1935) (“Clearly the question of *where a corporation is*, when it incorporates in one state and has agents transacting corporate business in another state, is not a question that can be answered by empirical observation.” Rather, continued Cohen, it is “a question identical in metaphysical status with the question scholastic theologians are supposed to have argued at great length, ‘How many angels can stand on the point of a needle?’”)

<sup>51</sup> Cohen, *supra* note 50, at 821. Cohen argued that scholars should replace the “ghost-world of supernatural legal entities” with “legal concepts as patterns of judicial behavior, behavior which affects human lives for better or worse and is therefore subject to moral criticism.” *Id.* at 828–29.

<sup>52</sup> *Id.* at 821. However, a rejection of formalist conceptions of corporate law does not require acceptance of the legal realist project or, more broadly, the claim that law is a branch of social science. See, e.g., Joseph Vining, *The Resilience of Law*, in LAW AND DEMOCRACY IN THE EMPIRE OF FORCE 151, 154–55 (H. Jefferson Powell & James Boyd White eds., 2009) (objecting that the influence of social science on law has often been reductive, offering unwarranted simplicity and failing to account for law’s authoritative dimension). According to Professor Vining, “authority and therefore . . . law[ ] runs straight up to a *transcendent* dimension of the universe.” *Id.* at 167 (emphasis added).

<sup>53</sup> See Bratton, *supra* note 49, at 1486; see also ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 119 (1932).

<sup>54</sup> See, e.g., Reinier H. Kraakman, *Corporate Liability Strategies and the Costs of Legal Controls*, 93 YALE L.J. 857, 862 (1984); Kenneth E. Scott, *Corporation Law and the American Law Institute Corporate Governance Project*, 35 STAN. L. REV. 927, 930 (1983); Robert Hessen, *A New Concept of Corporations: A Contractual and Private Property Model*, 30 HASTINGS L.J. 1327, 1330 (1979).

<sup>55</sup> See, e.g., Lucian Arye Bebchuk, *Limiting Contractual Freedom in Corporate Law: The Desirable Constraints on Charter Amendments*, 102 HARV. L. REV. 1820, 1820–21 (1989); Frank H. Easterbrook & Daniel R. Fischel, *Corporate Control Transactions*, 91 YALE L.J. 698, 701 (1982); Daniel R. Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259, 1261–62 (1982); Ronald J. Gilson, *Evaluating Dual Class Common Stock: The Relevance of Substitutes*, 73 VA. L. REV. 807, 808–11 (1987).

signature work encapsulating the law and economics contribution remains Frank H. Easterbrook's and Daniel R. Fischel's *The Economic Structure of Corporate Law*.<sup>56</sup>

According to the economic account of corporate law, a firm "is a legal fiction that serves as a nexus for a set of contractual relationships among individual factors of production."<sup>57</sup> The background rules are also contractual, because, whether or not bargained for explicitly, "[a]ll the terms in corporate governance are contractual in the sense that they are fully priced in transactions among the interested parties."<sup>58</sup> In this regard, the parties' choice of business entity form is part of the contract.<sup>59</sup> If there are provisions that most investors would want, it is more efficient to provide those terms in advance through a standard form, while permitting those with more idiosyncratic needs to modify the agreement.<sup>60</sup> The resulting legal structure of the firm, including the centralization of management, represents "the cost-saving devices of transacting parties."<sup>61</sup>

The new corporate law theory's debt to transaction-cost economics should be apparent.<sup>62</sup> However, as translated into legal academic discourse, the economic theory of firms usually addresses a more specific quandary—the nature of the business corporation—a subset of economic firms.<sup>63</sup> Also, unlike

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<sup>56</sup> EASTERBROOK & FISCHEL, *supra* note 5. For a survey of contemporary work in corporate law and economics, see generally RESEARCH HANDBOOK ON THE ECONOMICS OF CORPORATE LAW (Claire A. Hill & Brett H. McDonnell eds., 2012).

<sup>57</sup> Bratton, *supra* note 49, at 1471; see Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1418 (1989); Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1, 10 (1983).

<sup>58</sup> EASTERBROOK & FISCHEL, *supra* note 5, at 17. Thus, "the firms that pick the wrong terms will fail in competition with other firms competing for capital. It is unimportant that they may not be 'negotiated' . . ." *Id.*

<sup>59</sup> See Butler, *supra* note 9, at 105 ("The theory of the firm helps explain not only why certain activities are organized through firms rather than markets, but also the particular type of firm organization utilized under different circumstances."). According to Easterbrook and Fischel, "corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting." EASTERBROOK & FISCHEL, *supra* note 5, at 34.

<sup>60</sup> EASTERBROOK & FISCHEL, *supra* note 5, at 34 (arguing that corporate law, in its ideal form, "supplements but never displaces actual bargains, save in situations of third-party effects").

<sup>61</sup> Bratton, *supra* note 49, at 1482.

<sup>62</sup> See *id.* at 1471 ("Law and economics writers restated corporate law in the new theory's terms and successfully reoriented legal discourse on corporations." (footnote omitted)). A more detailed account would further distinguish agency theory, transaction-cost economics, and property-rights theory, see, e.g., Robert B. Thompson & D. Gordon Smith, *Toward a New Theory of the Shareholder Role: "Sacred Space" in Corporate Takeovers*, 80 TEX. L. REV. 261, 264–71 (2001), but this Article's claims do not require exploration of each permutation of the Coaseian insight.

<sup>63</sup> See Bratton, *supra* note 49, at 1471 n.1 ("Economic theories of the firm concern all producing units, no matter how organized. Legal theories of the firm, in contrast, tend to focus on the corporation."). Contemporary analysis would include the LLC and perhaps

their economist forerunners, legal academics have not necessarily accepted that the boundaries of a firm depend upon the content of its contracts and, ultimately, are arbitrary.<sup>64</sup>

Despite those departures from the economist's version of the nexus theory, its implications for corporate law have been liberating. As one scholar summarizes,

The nexus-of-contracts approach . . . produces three important and related insights about corporate law. The first is that shareholders' rights and duties are (or should be) defined by contract. The second is that corporate law should be "enabling" rather than mandatory. The third is that no particular set of outcomes is best for all firms. Rather, each firm must find the specific set of contractual obligations that best suits its shareholders.<sup>65</sup>

To the extent family members who co-own a business have distinctive expectations, it would seem to follow that contracts would allow them to conform the firm to those expectations. Part III offers an affirmative argument to that effect.

At this stage, though, it will suffice to underscore two points. First, the contractual framework envisions that firms should be designed to suit the needs of shareholders, rather than the other way around. Second, the distinctions between internal, corporate contracts and other contractual arrangements that advance the firm's business are not always amenable to categorical line drawing.<sup>66</sup> Accordingly, there is no justification for excluding family

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other types of unincorporated business entities. See LARRY E. RIBSTEIN, *THE RISE OF THE UNINCORPORATION* 178–79 (2010).

<sup>64</sup> See Robert H. Sitkoff, *An Agency Costs Theory of Trust Law*, 89 CORNELL L. REV. 621, 671–72 (2004) (characterizing as "contractarian nihilism" the logic "that leads to the conclusion that organizations have no boundaries"). From a legal standpoint, it is the entity status of the firm that enables it to hold property separately from its owners. *Id.* at 632–33 (arguing that "[a]sset partitioning . . . represents an important difference between organizational forms and simple contractual arrangements") (citing George G. Triantis, *Organizations as Internal Capital Markets: The Legal Boundaries of Firms, Collateral, and Trusts in Commercial and Charitable Enterprises*, 117 HARV. L. REV. 1102, 1104–06 (2004)). However, if the focus is instead on the internal, contractual governance of the firm, then it may not be relevant whether in their external function firms also have a "proprietary or in rem dimension that complements their internal contractarian or in personam features." *Id.* at 633.

<sup>65</sup> Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Nonshareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1269 (1999).

<sup>66</sup> See Oliver E. Williamson, *Intellectual Foundations: The Need for a Broader View*, 33 J. LEGAL EDUC. 210, 214 (1983) (noting the absence of a sharp distinction given the shared use of contract to organize relations). For instance, in one case, a corporation abandoned a contemplated merger when too many shareholders indicated that they would dissent from the transaction and seek to have their shares appraised; instead, the corporation entered into a series of long-term supply contracts with its former merger partner designed to achieve the same substantive result but without giving shareholders a voice in the matter.

arrangements by fiat—to rely on formal, doctrinal distinctions between business law and family law is to traffic in the kind of legal formalism that law and economics means to replace.

It is beyond the scope of this Article to address the ultimate success of the nexus of contracts as a theory of corporate law.<sup>67</sup> Arguably, the economic turn in corporate law scholarship replaces the self-referential, enclosed universe of formalistic jurisprudence with an equally self-referential and enclosed universe based on a simplified economic model of human behavior.<sup>68</sup> However, whatever its limitations, the economic framework has been enormously influential, both in its conceptual clarity and its far-reaching normative implications.<sup>69</sup>

This Article proceeds, therefore, on the assumption that contract offers a useful way of thinking about the formation and governance of business entities. An argument for legal rules focused on the distinctive characteristics of family-owned businesses could be advanced as well under alternative conceptions of business organizations that emphasize their political and social dimensions,<sup>70</sup>

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*See* Good v. Lackawanna Leather Co., 233 A.2d 201, 204–05 (N.J. Super. Ct. Ch. Div. 1967).

<sup>67</sup> In earlier work, I criticized strong versions of contractarian reasoning to the extent that they fail to recognize the vulnerable status of minority investors in closely held firms who are often unable to protect themselves via contract. *See, e.g.*, Benjamin Means, *A Contractual Approach to Shareholder Oppression Law*, 79 *FORDHAM L. REV.* 1161, 1163–64 (2010) [hereinafter Means, *A Contractual Approach*]; Benjamin Means, *A Voice-Based Framework for Evaluating Claims of Minority Shareholder Oppression in the Close Corporation*, 97 *GEO. L.J.* 1207, 1214–15 (2009) [hereinafter Means, *A Voice-Based Framework*]. Others have been more pointed in their criticisms of the nexus framework. *See* Grant M. Hayden & Matthew T. Bodie, *The Uncorporation and the Unraveling of “Nexus of Contracts” Theory*, 109 *MICH. L. REV.* 1127, 1127 (2011) (reviewing RIBSTEIN, *supra* note 63).

<sup>68</sup> *See, e.g.*, Vining, *supra* note 52, at 159 (arguing that the law and economics conception of the corporation is impoverished because it assumes that the only purpose of a corporation is long-term profit maximization for shareholders). Taking a different tact, Professor Pierre Schlag argues that “the concept of transaction costs does not have the sort of theoretical intelligibility and operational applicability necessary to make the market-based transaction cost approach plausible.” Pierre Schlag, *The Problem of Transaction Costs*, 62 *S. CAL. L. REV.* 1661, 1664 (1989); *see* Pierre Schlag, *Cannibal Moves: An Essay on the Metamorphoses of the Legal Distinction*, 40 *STAN. L. REV.* 929, 967–70 (1988); *see also* Means, *A Contractual Approach*, *supra* note 67, at 1171–72.

<sup>69</sup> *See* Michael Klausner, *Corporations, Corporate Law, and Networks of Contracts*, 81 *VA. L. REV.* 757, 760 (1995) (summarizing descriptive and normative claims relating to the nexus of contracts). Professor Klausner contends, in particular, that the standard contractarian account should appreciate that “corporate contracts” interrelate. *Id.* at 761.

<sup>70</sup> *See, e.g.*, Brian M. McCall, *The Corporation as Imperfect Society*, 36 *DEL. J. CORP. L.* 509, 528 (2011) (arguing “that the corporate form is, and throughout its history has been understood to be, an imperfect community”).

identify team-specific commitments made by a variety of stakeholders,<sup>71</sup> or otherwise take a broader view of the role of businesses in society.<sup>72</sup> Indeed, the significance of family business might be easier to defend under some of these alternative views. As the next Part shows, however, any conception of the family-owned firm that ignores family law will misapprehend the parties' actual obligations in a wide set of circumstances.

### III. FAMILY LAW'S INFLUENCE

In family businesses, the implications of family law are inescapable. This Part argues that family law's influence runs through the essential questions of business organization law: who the members are, what obligations they owe to one another, and how the assets of the firm will be controlled and distributed. Part III.A offers a general definition of family business and contends that difficulties of application in particular cases only underscore the importance of identifying central, recurring issues. Part III.B shows how family law and business law principles overlap in businesses co-owned by married couples, especially when business assets must be divided. Part III.C identifies conflicting business and family governance rules and fiduciary obligations that arise when family ownership is intermediated through trusts. Finally, Part III.D explores the extent to which family business entities may be driven by tax considerations, including opportunities for income splitting among family members and for reducing estate taxes. Taken together, these examples set up Part IV's argument for a contractual approach to family businesses by demonstrating that family businesses already contain family law and business law elements but lack a general framework for integrating those elements when they conflict.

#### A. *Defining the Inquiry*

In order to evaluate the significance of family law for family businesses, logic would suggest that we must first clarify the meaning of family business—thereby providing a stable referent for analysis.<sup>73</sup> To this end, we might begin

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<sup>71</sup> See Blair & Stout, *supra* note 37, at 250; LYNN STOUT, *THE SHAREHOLDER VALUE MYTH: HOW PUTTING SHAREHOLDERS FIRST HARMS INVESTORS, CORPORATIONS, AND THE PUBLIC* 74 (2012).

<sup>72</sup> See, e.g., Susan S. Kuo & Benjamin Means, *Corporate Social Responsibility After Disaster*, 89 WASH. U. L. REV. 973, 975–76 (2012); Ian B. Lee, *Citizenship and the Corporation*, 34 LAW & SOC. INQUIRY 129, 129 (2009); Ronald Chen & Jon Hanson, *The Illusion of Law: The Legitimizing Schemas of Modern Policy and Corporate Law*, 103 MICH. L. REV. 1, 64–65 (2004); Yoshiro Miwa, *Corporate Social Responsibility: Dangerous and Harmful, Though Maybe Not Irrelevant*, 84 CORNELL L. REV. 1227, 1227–30 (1999); Peter Nobel, *Social Responsibility of Corporations*, 84 CORNELL L. REV. 1255, 1255 (1999).

<sup>73</sup> See ELSTER, *supra* note 47, at 15 (emphasizing that the first, and “easily overlooked” step in social science explanation is “to establish that the fact *is* a fact”).



with a simple requirement that effective control of the business rests in family hands and that at least two family members be involved as owners or managers.<sup>74</sup> In finance and management literature, other definitions variously require an intention to maintain family ownership over time,<sup>75</sup> the involvement of more than a single generation of family owners, or high-level managerial involvement.<sup>76</sup>

However, any broad definition involves simplification and may be difficult to apply in particular cases. For instance, what is the proper characterization of a business formed by a married couple that divorces but continues to work together?<sup>77</sup> Or surviving spouses who share no connection other than the sibling bond of their deceased partners? Or a business founded by unrelated individuals whose children later fall in love and marry? In these cases, and others that might be imagined, family connections exist but are difficult to define.<sup>78</sup> It is even possible to create a family relationship to satisfy a business requirement, rather than the other way around.<sup>79</sup>

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<sup>74</sup> See Danny Miller & Isabelle Le Breton-Miller, *Challenge Versus Advantage in Family Business*, STRATEGIC ORG., Feb. 2003, at 127 (stating requirement that “a family has enough ownership to determine the composition of the board, where the CEO and at least one other top executive is a family member, and where the intent is to pass the firm on to the next generation”); see also Means, *supra* note 3, at 1205.

<sup>75</sup> Miller & Le Breton-Miller, *supra* note 74, at 127.

<sup>76</sup> *Id.*

<sup>77</sup> See Long & Sissel, *supra* note 6, at 35 (“Often the only thing divorcing spouses can agree on is that the family business should not be sold at the time of the divorce.”). Joint ownership may persist “if the business would not currently generate an acceptable purchase price, where the spouses would not retain their positions with the company after sale, where opening a competing business is not practical, or where the spouses’ children rely on their current employment with the family business.” *Id.*

<sup>78</sup> Professor Susan Kuo deserves thanks for posing a few of these hypothetical challenges.

<sup>79</sup> See Vikas Mehrotra et al., *Adoptive Expectations: Rising Sons in Japanese Family Firms*, 108 J. FIN. ECON. 840, 841 (2013) (examining “two unique practices of Japanese business families: marriages arranged to inject talent into business families and adoptions of promising adults as principal heirs”). In a recent novel, one author described a historical antecedent of the contemporary phenomenon:

“To speak with sincerity,” says Ogawa, “my blood ancestors is not here: I was borned at Tosa Domain, on Shikoku, which is big island”—Ogawa points east—“that way, to father of low retainer of Lord Yamanouchi of Tosa. Lord gave my schooling and sent me in Nagasaki for learn Dutch under Ogawa Mimasaku’s house to make bridge between his Tosa and Dejima. But then old Lord Yamanouchi died. His son has no interest in Dutch studies. So I was ‘marooned,’ you say? But then Ogawa Mimasaku’s two sons died in cholera, ten years ago. Much, much death in city that year. So Ogawa Mimasaku adopted me, to continue family name . . . I had new name, new life, new father, new mother, new ancestors.”

Also, differences in business scale may require further diversification of the family-business model. For example, in a small, family-owned entity, the external consequences of a business dispute may be limited to the family relationships among owners.<sup>80</sup> In larger organizations, destabilizing family disputes affect hundreds of employees and may even have civic implications. To cite one case in point, the Los Angeles Dodgers organization was thrown into turmoil when the owner's divorce created uncertainty about who would gain control of the team, while the sheer cost of the divorce allegedly siphoned away funds needed to sustain operations.<sup>81</sup> A more detailed typology could also distinguish vertical and horizontal family ties, designate the generation of family ownership, and account for other significant ethnic or religious affiliations.<sup>82</sup>

In sum, any single definition of family business will struggle to account for a wide variety of family and business contexts. Even worse, the leading indication of whether a business should qualify as a family business for purposes of this Article's analysis may be whether family law affects it. (From an internal perspective, the equivalent proposition would be that a family business is just a business in which the participants believe that they are in a family business).<sup>83</sup> As a formal matter, this borders on tautology: A is B whenever B is A.

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<sup>80</sup> See, e.g., *Meiselman v. Meiselman*, 307 S.E.2d 551 (N.C. 1983) (involving a dispute over ownership of family-owned close corporations).

<sup>81</sup> When the Dodgers' owner, Frank McCourt, sought refuge in a bankruptcy proceeding, the Commissioner of Major League Baseball filed papers indicating the possibility of terminating the franchise. See Lester Munson, *The 'Death Penalty' and the Dodgers*, ESPN (Sept. 30, 2011), [http://espn.go.com/espn/commentary/story/\\_/page/munson-110930/mlb-shows-powerful-hand-dodgers-dispute](http://espn.go.com/espn/commentary/story/_/page/munson-110930/mlb-shows-powerful-hand-dodgers-dispute), archived at <http://perma.cc/U95D-RMUJ> ("Paying his personal expenses with Dodgers money, baseball says, prevents McCourt from 'acquiring new players,' meeting 'future payroll obligations' and 'improving the Dodgers fan experience.'"). The Dodgers case is also discussed *infra* Parts III.B.2, IV.C.1.

<sup>82</sup> See, e.g., *Hobby Lobby Stores, Inc. v. Sebelius*, 723 F.3d 1114, 1120 (10th Cir. 2013), cert. granted 134 S. Ct. 678 (2013) (asserting corporation's right to free exercise of religion based upon the family owners' religious beliefs); *Conestoga Wood Specialties Corp. v. Sec'y of U.S. Dep't of Health & Human Servs.*, 724 F.3d 377, 380 (3d Cir. 2013), cert. granted 134 S. Ct. 678 (2013) (same); see also Matthew I. Hall & Benjamin Means, *The Prudential Third-Party Standing of Family-Owned Corporations*, 162 U. PA. L. REV. ONLINE 151, 154-55 (2014), <http://www.pennlawreview.com/online/162-U-Pa-L-Rev-Online-151.pdf> (identifying distinctive aspects of family ownership).

<sup>83</sup> See Means, *supra* note 3, at 1206 ("[F]or purposes of this Article's focus on family business governance, what matters is not so much a formal definition of family but whether the business participants understand themselves to be members of a family."). As one scholar observes, "[a] century ago, 'family' was culturally confined to persons related by marriage and blood; today, family is defined by relations of affinity, love, and commitment." William N. Eskridge, Jr., *Family Law Pluralism: The Guided-Choice Regime of Menus, Default Rules, and Override Rules*, 100 GEO. L.J. 1881, 1883 (2012).

Two responses are in order. First, the utility of a contractual approach to coordinating relationships does not presuppose perfect distinctions between legal categories, so long as the parties are able to anticipate legal obligations and adjust those obligations through contract. It is of no practical import to the parties whether they, or their legal advisors, could establish two boxes— one for family businesses and one for non-family businesses— and reliably assign businesses to one of the two boxes.<sup>84</sup> Indeed, aspects of family law might be dealt with contractually in firms that are not, by any stretch, family businesses. For instance, a hedge fund could require its partners to have premarital agreements in place to protect the business from the consequences of divorce.<sup>85</sup> In other words, the lack of a fully specified “family business” category may reinforce the importance of contractual flexibility.

Second, the difficulties in determining, on a case-by-case basis, how to categorize businesses are no impediment to the study of recurring challenges involving the combination of business and family interests.<sup>86</sup> Perhaps most significant, “[f]amily businesses present distinctive challenges because they combine the values and expectations of the workplace with more intimate family bonds.”<sup>87</sup> When parents and children are also coworkers, connections rooted in family life must be adjusted to meet the obligations of the workplace.<sup>88</sup> Thus, operating a family business can be difficult because it destabilizes the social roles that help individuals “categorize themselves and others as a means of ordering the social environment and locating themselves and others within it.”<sup>89</sup> For instance, family business participants must decide whether to prioritize family obligations—by employing family members or

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<sup>84</sup> See Pierre Schlag, *The Aesthetics of American Law*, 115 HARV. L. REV. 1047, 1055 (2002) (arguing that law’s preoccupation with fixed categories is more a matter of aesthetic preference than underlying reality: “In the grid aesthetic, law is framed as a field, a territory, a two-dimensional space that can be mapped and charted.”).

<sup>85</sup> Anecdotal evidence suggests that this is not an unheard of phenomenon. Without advance planning, a shareholder’s divorce may affect the interests of other shareholders by introducing a new, possibly unwelcome participant. See, e.g., *Alaska Plastics, Inc. v. Coppock*, 621 P.2d 270, 271–74 (Alaska 1980) (involving a claim of minority shareholder oppression brought by a plaintiff who received her interest in the corporation in a divorce from her husband, one of the co-founders).

<sup>86</sup> See, e.g., MANFRED F.R. KETS DE VRIES ET AL., FAMILY BUSINESS ON THE COUCH: A PSYCHOLOGICAL PERSPECTIVE 9 (2007) (“[I]n a business family, normal family goals may come into conflict with the business’s economic goals because an important theme within the family system is to meet the human and psychological needs of its members rather than to arrive at the best economic return.”).

<sup>87</sup> Means, *supra* note 3, at 1207; see AMY SCHUMAN ET AL., FAMILY BUSINESS AS PARADOX 2 (2010) (stating that family businesses “have a longer time horizon than most non-family firms, as they view the business as crucial to perpetuating the family into future generations”).

<sup>88</sup> See ELIZABETH ANDERSON, VALUE IN ETHICS AND ECONOMICS 25 (1995).

<sup>89</sup> BLAKE E. ASHFORTH, ROLE TRANSITIONS IN ORGANIZATIONAL LIFE: AN IDENTITY-BASED PERSPECTIVE 24 (2001). If “social roles are incompatible, family business has a built-in conflict.” Means, *supra* note 3, at 1209.

otherwise distributing resources based on need—or whether to insist upon market tests of value. Moreover, as discussed in the sections that follow, the laws applicable to family relationships and business relationships also reflect different values and overlap in the family-business context.

## B. *Household Economics*

A family business is, among other things, an extension of family relationships. For married couples, two problems can arise. First, can the business assets be distinguished from the broader economic life of a household? Second, in the event of divorce, to what extent do equitable principles of family law control the distribution of business assets?

### 1. *Spousal Contributions*

In a marriage that involves an equal sharing of economic resources, it may not appear necessary to define a spouse's role in a business entity owned by the other spouse. Yet, especially in smaller, unincorporated businesses, the nature of the business can turn on the characterization of spousal contributions.<sup>90</sup> No bright-line test will do, however, as the sharing of control, profits, and losses that define a business partnership also describe a marriage, and a spouse's involvement in a business might not fit neatly into either category.<sup>91</sup> According to a leading treatise, “[t]he exercise of control by a spouse may be simply that of a helpmate in marriage rather than that of a partner; one spouse may share proceeds of the business in order to satisfy a support obligation.”<sup>92</sup> Thus,

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<sup>90</sup> If only one spouse has an ownership stake, the business enterprise may not count as a family business at all. Otherwise, the definition of family business would depend upon the marital status of the founder. Also, most people, married or not, have significant family ties, but, without more, those attachments cannot convert every sole proprietorship into a family business.

<sup>91</sup> See Larry E. Ribstein, *Incorporating the Hendricksons*, 35 WASH. U. J. L. & POL'Y 273, 296 (2011) (“Although the relationship may seem to have the usual partnership indicia of control and profit-sharing, these may actually be domestic arrangements.”). Some feminist legal scholars cite unpaid labor in family business to ground “critiques of the market/family dichotomy, including the portrayal of market actors as self-sufficient individuals.” Lisa Philipps, *Helping Out in the Family Firm: The Legal Treatment of Unpaid Market Labor*, 23 WIS. J. L. GENDER & SOC'Y 65, 66 (2008).

<sup>92</sup> ALAN R. BROMBERG ET AL., 1 BROMBERG & RIBSTEIN ON PARTNERSHIP § 2.10 (2d ed. 2014); see also *LaRoque v. LaHood*, 613 A.2d 1033, 1042 (Md. Ct. Spec. App. 1992) (holding that the fact both spouses “made management decisions for the business” did not, by itself, demonstrate the existence of a partnership); *Cleland v. Thirion*, 268 A.D.2d 842, 844 (N.Y. App. Div. 2000) (refusing to recognize partnership, despite the parties' apparent agreement, because “plaintiff's name was never placed on a certificate of doing business as partners, no partnership tax returns were ever filed and there never was any sharing of profits or losses”).

disputes concerning alleged business partnerships turn on conceptions of business, family, and the appropriate relations between the two.

Consider, as an illustration, a family farm bankruptcy case in which each spouse sought to withhold \$7,500 in farming equipment under an exemption for “tools of the trade.”<sup>93</sup> The bankruptcy trustee challenged the wife’s claimed exemption on two grounds: either the farm equipment was solely owned by the husband, consistent with tax records listing the farm as a sole proprietorship in his name; or, in the alternative, the farm had been operated as a partnership, in which case the personal equipment exemption was inapplicable. Accepting this logic, the bankruptcy court rejected the claimed exemption.<sup>94</sup>

On appeal, the Tenth Circuit held that both spouses could claim the exemption because the trustee had not met its burden of showing either a lack of ownership or the existence of partnership. Regarding the issue of joint ownership, the court noted that although Kansas does not treat all property within a marriage as community property,<sup>95</sup> there was both testimony and evidence that the farm had been operated jointly.<sup>96</sup> Also, “[a]ll proceeds from the farming operation were placed in a joint account, and funds to pay for the equipment came out of this account.”<sup>97</sup> Both spouses signed the relevant loan documents in acquiring the farm equipment.<sup>98</sup>

However, the satisfactory resolution of the ownership issue threatened to confirm the disqualifying existence of a partnership, which is formed whenever two or more persons co-own a business for profit.<sup>99</sup> The prima facie case for partnership looked strong, as it was alleged by the debtors that they “co-owned the farm equipment, jointly participated in the work, and shared the profits.”<sup>100</sup> Yet, the court further observed that the “usual indicia of a partnership are blurred by the marital relationship.”<sup>101</sup> For instance, “[t]he co-owning of property, sharing of profits, and the apparent authority for one spouse to act on behalf of the other are all common to the marital relationship even absent a

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<sup>93</sup> *In re Lampe*, 331 F.3d 750, 752 (10th Cir. 2003) (“Debtors Donald and Shelia Lampe are husband and wife farmers who filed for Chapter 7 bankruptcy.”).

<sup>94</sup> *See In re Lampe*, 278 B.R. 205, 208 (B.A.P. 10th Cir. 2002) (citing and reversing unpublished bankruptcy court order that had concluded Mrs. Lampe lacked a separate “ownership interest” and, therefore, could not assert the tools-of-the-trade exemption).

<sup>95</sup> *See* Alvin E. Evans, *Primary Sources of Acquisition of Community Property*, 10 CALIF. L. REV. 271, 271 (1922) (“Whatever is acquired by the joint efforts of the husband and wife shall be their community property.” (internal quotation marks omitted)).

<sup>96</sup> *In re Lampe*, 331 F.3d at 756 (“Shelia Lampe worked on the farm and operated all equipment except the planter and combine.”).

<sup>97</sup> *Id.*

<sup>98</sup> *Id.* (“Shelia Lampe co-signed on the notes and security agreements to obtain operating loans for which the farm equipment served as collateral.”).

<sup>99</sup> Specifically, under Kansas law, “the association of two or more persons to carry on as co-owners a business for profit forms a partnership, whether or not the persons intend to form a partnership.” KAN. STAT. ANN. § 56a-202 (West 1998).

<sup>100</sup> *In re Lampe*, 331 F.3d at 757.

<sup>101</sup> *Id.*

business.”<sup>102</sup> The “indicia” of partnership overlap with those of marriage, and the trustee could not sustain its burden of establishing the existence of a partnership separate from the marriage itself.<sup>103</sup> Thus, because of the family relationship, it was possible to conceive of the farm as occupying a space between the sole-proprietorship and the general partnership, an unrecognized hybrid in which shared ownership is defined more by marriage than by business agreement.

Definitional disputes involving households and business ventures can arise even in more formally established business entities. For example, the Supreme Court of North Carolina concluded, in a divorce proceeding involving the ownership of a Kentucky Fried Chicken franchise, that the husband’s ownership claim could be sustained as a contract claim based on a preexisting partnership even though it would not have merit under the North Carolina business law, which requires shareholder agreements to be in writing.<sup>104</sup> The intermediate appellate court, by contrast, had held that “any agreement [between] the husband and wife for the husband to join her in the business was not enforceable under contract law because [it was] not supported by valuable consideration, since plaintiff’s interest in the business evolved from his status as a husband, and not as a business partner.”<sup>105</sup> Thus, a broadly contractual view of the parties’ relationship supplanted a status-based view of marriage, on the one hand, and a formalistic application of corporate law, on the other.<sup>106</sup>

Likewise, another court held that the distribution restrictions in an antenuptial agreement did not preclude the wife from asserting a 50% partnership interest in a business enterprise that had grown “from approximately

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<sup>102</sup> *Id.*

<sup>103</sup> *Id.* (“Although the Lampes deposited profits in a joint account, no evidence suggested this arrangement was required by an agreement to share profits as partners rather than the voluntary co-mingling of funds as spouses.”). Accordingly, “[a]bsent a showing of some other indicia of a partnership beyond those incident to the marital relationship, the Trustee has not met its burden of proving a partnership existed, and Shelia Lampe therefore is entitled to claim the ‘tools of the trade’ exemption.” *Id.*

<sup>104</sup> *Penley v. Penley*, 332 S.E.2d 51, 64 (N.C. 1985) (“Plaintiff has properly chosen an alternate legal theory, premised primarily on defendant’s oral agreement to convey an interest in the corporation—a question of simple contract law. Accordingly, we do not view the parties’ agreement as an unenforceable shareholders’ agreement.”).

<sup>105</sup> *Id.* at 56 (summarizing *Penley v. Penley*, 310 S.E.2d 360 (N.C. Ct. App. 1984)). According to the wife’s testimony, there was no separate business agreement: “[A]s far as him owning the franchise, he didn’t own it. He knew he didn’t own it, and it never was his. But being married to somebody, you more or less take him as a partner. I didn’t take him as a partner in 1968 when he went to work over there; we were partners in marriage.” *Penley*, 310 S.E.2d at 363.

<sup>106</sup> *See Penley*, 332 S.E.2d at 62 (holding that “the jury could find that plaintiff reasonably premised his decision to render services on a full-time basis on promises made to him by defendant-wife, which led plaintiff to reasonably conclude and expect that his contributions would be rewarded by sharing in the business equally”). Although the jury could instead have found “that plaintiff joined the business . . . solely because he was the husband of an ill wife, the jury was not *required* as a matter of law to so find.” *Id.* at 61.

\$430,000 at the date of marriage to over \$12 million at the date of the dissolution judgment.”<sup>107</sup> Under the antenuptial agreement, she was entitled to the home equity, \$6,000, the family car, and household furniture.<sup>108</sup> However, she alleged successfully that she was a partner in the family business. Although she did not receive salary, after the marriage she “began working full time in [the] husband’s business.”<sup>109</sup> As her role in the company expanded, she acted as “the head of the office when [the husband] was away on business” and the “business name registration” was later updated to reflect that the company was “a proprietorship of husband and wife.”<sup>110</sup>

The court concluded that the wife’s waiver of interest in the husband’s property “does not preclude wife from asserting an interest in the company by virtue of her partnership with husband, but rather only precludes her from asserting an interest in husband’s undivided one-half interest by virtue of the marriage.”<sup>111</sup> Thus, because of the overlap of business law and family law, a claim to ownership that might have been waived by a marital agreement was sustained under an alternate theory of business partnership. In each of the cases discussed so far, the question of business ownership is complicated because the economic partnership of marriage coexists with any separate business arrangements that the parties may have made.

## 2. Double-Exit Dilemmas

The impact of divorce law on family businesses co-owned by married couples further illustrates the entanglement of family law and business law. Not only must the parties exit the marital relationship, but also their separation will also in most cases involve the exit of one or both parties from the co-owned business. Just as a practical matter, the simultaneous winding up of two different legal entities creates problems of coordination.<sup>112</sup> Further, the parties’ rights are not identical in each context and equitable principles of divorce law often trump conflicting corporate law rules.

In a corporation, for instance, it is fundamental that the allocation of residual profits is determined by stock ownership.<sup>113</sup> Equally fundamental, the

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<sup>107</sup> *In re Marriage of Leathers*, 779 P.2d 619, 621 (Or. Ct. App. 1989).

<sup>108</sup> *See id.* at 620.

<sup>109</sup> *Id.*

<sup>110</sup> *Id.* at 621.

<sup>111</sup> *Id.* at 623.

<sup>112</sup> *See* Brandon Southward, *Double Trouble: When Spouses Who Share a Business Call It Quits*, FORTUNE (Apr. 9, 2014, 10:28 AM), <http://fortune.com/2014/04/09/double-trouble-when-spouses-who-share-a-business-call-it-quits/>, archived at <http://perma.cc/6Q3N-6Y8M>.

<sup>113</sup> *See* JAMES D. COX & THOMAS LEE HAZEN, CORPORATIONS § 13.01 (2d ed. 2003) (“A share of stock is primarily a profit-sharing contract, a unit of interest in the corporation based on a contribution to the corporate capital.”).

corporation is a legal person independent of any of its shareholders.<sup>114</sup> Thus, unlike a general partnership, a corporation cannot be dissolved by the express will of a shareholder. In order to exit the investment, a shareholder has to find a willing purchaser.<sup>115</sup> A family-owned business is subject to the same corporate-law rules as any other business.<sup>116</sup>

Yet, when family business assets are at issue in a divorce proceeding, a narrow focus on corporate law rules can be misleading.<sup>117</sup> Once a petition for divorce invests a family law court with jurisdiction, the court has broad, equitable discretion to identify and divide marital assets.<sup>118</sup> In a recent case involving the Los Angeles Dodgers, for instance, Jamie McCourt did not own any stock but was able to claim 50% in her divorce from Frank McCourt, the team's sole owner.<sup>119</sup> Despite her role as chief executive to the Dodgers before the divorce, and her unofficial designation as the team's co-owner, she would not otherwise have had any legal claim to ownership. Yet, regardless of who owns the stock, the principle of equal division that governs exit from a marriage can dictate the terms of a business separation.<sup>120</sup>

Divorce law may crowd out corporate law, even if the parties have negotiated a shareholder agreement with tailored dispute-resolution provisions. For example, the Supreme Court of Oklahoma recently held in *Colclasure v.*

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<sup>114</sup> See *id.* § 1.02 (“A business corporation is a legal device for carrying on a business enterprise for profit, a legal unit with a status or capacity of its own separate from the shareholders or members who own it.”).

<sup>115</sup> See Lee, *supra* note 72, at 153; Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. REV. 1684, 1701 (1996). In closely held corporations, the absence of a secondary trading market effectively locks in shareholder investments. A minority shareholder may petition for corporate dissolution (or to compel a stock buy out) but will succeed only if the shareholder can establish oppression or, in other words, fault. The nature of the oppression claim varies across jurisdictions as corporate law is mostly a matter of state law.

<sup>116</sup> Analogous principles apply in LLCs. See Douglas K. Moll, *Minority Oppression & the Limited Liability Company: Learning (or Not) from Close Corporation History*, 40 WAKE FOREST L. REV. 883, 928 (2005).

<sup>117</sup> The same caution applies in cases involving partnerships or other forms of business organization. See, e.g., *Bobrow v. Bobrow*, No. 29D01-0003-DR-166, 2002 WL 32001420, at \*20 (Ind. Super. Sept. 20, 2002) (“Courts across the country agree with Indiana that a partnership agreement that governs the distribution of assets among partners upon withdrawal from the partnership cannot and does not control what constitutes ‘property’ under state law for purposes of marital dissolution.”).

<sup>118</sup> See EDWIN T. HOOD ET AL., *CLOSELY HELD BUSINESSES IN ESTATE PLANNING* § 8.10[G] (2d ed. 1998). Indeed, a spouse who held no stock and did not participate in a business may nevertheless argue that the business assets should be treated as marital assets.

<sup>119</sup> See Bill Shaikin, *McCourts Agree on Dodgers*, L.A. TIMES, Oct. 17, 2011, at C1 (reporting that Jamie McCourt had agreed to relinquish her ownership claim in exchange for \$130 million).

<sup>120</sup> See Carolyn J. Frantz & Hanoch Dagan, *Properties of Marriage*, 104 COLUM. L. REV. 75, 100 (2004) (“The cornerstone of the contemporary law of marital property . . . is the rule of equal division upon divorce.”). Although mandatory “in only three jurisdictions[,]” the principle operates as a strong presumption elsewhere. *Id.* at 100–01.



*Colclasure* that the equitable principles of divorce law, rather than the terms of a buyout agreement, should control the “valuation of the marital business.”<sup>121</sup> Before marriage, the wife was “the sole owner and operator” of an LLC, and she sold a 49% stake to her fiancée for a nominal sum.<sup>122</sup> Approximately two years after getting married, the couple entered into an operating agreement that provided a number of triggers for dissolution or buyout, including divorce, and specified a valuation mechanism.<sup>123</sup>

By filing a petition for divorce, the wife triggered the dissolution provision of the LLC’s operating agreement. However, the court observed that “[a] divorce suit is one of equitable cognizance in which the trial court has discretionary power to divide the marital estate.”<sup>124</sup> Moreover, the court stated that, absent a valid antenuptial agreement, it was bound to follow Oklahoma’s divorce statute, which mandates an equitable division of marital assets.<sup>125</sup> Even assuming that the parties’ operating agreement might count as a nuptial agreement, it had been signed after the marriage and was not cognizable under Oklahoma’s divorce law.<sup>126</sup> Accordingly, the court rejected the husband’s argument that the operating agreement’s valuation mechanism should control.<sup>127</sup> The court emphasized that the issue to be resolved was one of divorce law, not business law.<sup>128</sup>

Whatever the merits of the *Colclasure* decision,<sup>129</sup> the broader lesson is that family-law rules applicable to divorce have significant business implications.

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<sup>121</sup> *Colclasure v. Colclasure*, 295 P.3d 1123, 1125 (Okla. 2012). The valuation question was the sole issue before the court on appeal. *Id.* A trial court judge had taken the opposite tact, valuing the husband’s share of the business according to the agreement. *Id.*

<sup>122</sup> *Id.* at 1126.

<sup>123</sup> *Id.* at 1126 n.7. The agreement stated that the value was to be “determined as of the last day of the month immediately prior to the month in which the Event of Dissolution occurred.” *Id.* at 1127.

<sup>124</sup> *Id.* at 1128–29.

<sup>125</sup> *Id.* at 1129 n.13 (citation omitted) (“[T]he court shall, subject to a valid antenuptial contract in writing, make such division between the parties as may appear just and reasonable . . .”).

<sup>126</sup> *Id.* at 1129 (holding that the trial court erred in failing “to ensure a fair and just division of the marital assets” because “the only mechanism permitted by statute to override that obligation is an antenuptial agreement between the parties.”). The court did not address whether an LLC operating agreement entered into before marriage would constitute an antenuptial agreement under the statute.

<sup>127</sup> *Colclasure*, 295 P.3d at 1129 (“[A] mere valuation of [the company] as of a date certain . . . does not determine what portion of the value of the business was the result of the husband’s efforts, the wife’s efforts, or their joint efforts.”).

<sup>128</sup> *Id.* at 1131 (“The question is not whether he may be sued for breach of fiduciary duty, but rather whether his actions lowered [the company’s] value so that he received more money in the property settlement than he should have received.”). In a strongly worded dissent, three justices accused the court of “re-writing the parties’ contract for what appears to be the single purpose of increasing the wife’s settlement award.” *Id.* at 1132.

<sup>129</sup> Although the court did not squarely address the issue, it is unclear whether the court would have been willing to treat the shareholder bargain as a marital agreement, even though

Moreover, the threat posed by divorce continues if a family business survives long enough to include children and grandchildren, as their spouses may also be entitled to a share of business assets as marital property. Indeed, since nearly half of all marriages fail, the legal complications of divorce should be seen as a predictable, recurring feature of family-business ownership.<sup>130</sup>

### *C. Family Trusts*

Family law can also affect business law when control of a family business passes to the next generation. As one commentator observes, “succession law is characterized by a need to manage multiple sets of legal rules from different subject matter areas that converge on the nexus of a business succession.”<sup>131</sup> For example, the family owners might create a trust to effectuate a transition, because it is possible to allocate company stock and managerial control to one or more members of the family without depriving other family members of business profits.<sup>132</sup> Technically, the trust owns the stock and the children, who are beneficiaries of the trust, are not themselves owners.<sup>133</sup> Thus, a more capable child or an outside manager could be selected to serve as trustee while the remaining offspring receive some measure of economic security through their beneficial trust interest.<sup>134</sup> Alternatively, parents might give children a

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the husband and wife were the only two shareholders and their agreement expressly contemplated the allocation of the firm’s assets in the event of their divorce. A refusal to credit the bargain elevates form over substance because overlapping substantive issues concerning a family business might be covered in marital agreements, shareholder agreements, or both. Thus, the court’s holding may have been correct as a matter of Oklahoma law, but it rejected the parties’ own clearly expressed intentions.

<sup>130</sup> See Long & Sissel, *supra* note 6, at 30 (“In a mature family-owned business, one that has been in existence long before the marriage of one of its young shareholders, the founders should have engaged in business-succession planning that contemplates the possibility of a shareholder’s divorce.”). According to one commentator, the parties should consider using a buy-sell agreement to specify “that, in the event of a divorce, a former spouse would be required to sell any stock acquired during the marriage for its fair market value.” Sildon, *supra* note 6, at 41.

<sup>131</sup> Kenneth M. Rosen, *Company Law and the Law of Succession Droit Commercial/Commercial Law*, 62 AM. J. COMP. L. 387, 405 (Supp. 2014).

<sup>132</sup> See BORK, *supra* note 16, at 129 (“As a general principle, countless problems can be avoided if family members who do not intend to be active in the business are not left stock in it.”). In some cases, a simpler alternative to the creation of a trust would be to give one child sole ownership of the business and to leave other assets to the non-participating heirs.

<sup>133</sup> The trust creates “a fiduciary relationship with respect to property, subjecting the person by whom the title to the property is held to equitable duties to deal with the property for the benefit of another person . . . .” RESTATEMENT (SECOND) OF TRUSTS § 2 (1959).

<sup>134</sup> See, e.g., Karen E. Boxx, *Too Many Tiaras: Conflicting Fiduciary Duties in the Family-Owned Business Context*, 49 HOUS. L. REV. 233, 234–35 (2012) (describing the estate plan of jeweler Harry Winston). As Professor Boxx notes, “Mr. Winston had the same instincts as most parents in this situation: he wanted to treat his sons equally financially but also wanted his business-oriented son in charge of the company.” *Id.* at 235.

stake in a business, even a majority share, without relinquishing their own control.<sup>135</sup>

In trust-controlled businesses, the law of trusts supplements and can even supersede otherwise applicable business law.<sup>136</sup> As settlors of the trust, parents appoint the trustee and have the power to ensure that their preferences are respected regarding the manner in which assets are disbursed. For instance, the settlors can direct a trustee to increase a beneficiary's share based on need.<sup>137</sup> No analogous mechanism would permit a corporate manager to distribute assets to a particular shareholder simply because the shareholder had unrelated educational or medical expenses. Separating assets from the beneficial interest conveyed via trust may also insulate a family business should a child (or grandchild) divorce, and the trust structure can minimize taxes by limiting control and marketability with respect to the beneficial interest.

In addition, although trustees and corporate managers owe fiduciary duties to beneficiaries and shareholders, respectively, the fiduciary standards are distinct. To the extent the fiduciary duties of a trustee are stronger than those of a corporate trustee, this state of affairs may provide more protection to trust beneficiaries than they would have as minority shareholders.<sup>138</sup> For instance, while corporate managers can claim the protection of the business judgment rule for anything short of gross negligence, "the trustee's default duty of care is set at the more restrictive reasonable person standard."<sup>139</sup> On the other hand, if the fiduciary standard is too exacting, trustees may fail to maximize business profits for fear of personal liability.<sup>140</sup>

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<sup>135</sup> See Jeffrey G. Sherman, *Posthumous Meddling: An Instrumentalist Theory of Testamentary Restraints on Conjugal and Religious Choices*, 1999 U. ILL. L. REV. 1273, 1275; Sitkoff, *supra* note 64, at 646 n.122 (observing that this control can, in some cases, become oppressive when settlors seek "to maintain dominance over their family after death").

<sup>136</sup> This may be true even for governance issues involving the settlors. See Scott Cacciola, *Plan B Eased Clippers Deal: Sterling's Diagnosis*, N.Y. TIMES, June 10, 2014, at A1, B12 (reporting that Rochelle Sterling invoked a trust provision to force the sale of the Los Angeles Clippers over the objection of her husband, and team co-owner, Donald Sterling). Apparently, the relevant "provision in the trust that controlled the Clippers . . . stipulated that if Mr. or Mrs. Sterling was found to have a cognitive impairment, the other had a fiduciary responsibility to become sole trustee." *Id.* at B12. At his wife's behest, Mr. Sterling had agreed to undertake a neurological examination, and her lawyers used the results of that examination as "the weapon they needed to strip the team from Mr. Sterling." *Id.*

<sup>137</sup> See Sitkoff, *supra* note 64, at 654. In this regard, the settlors might define medical and educational expenses as needs justifying an increased share or even invasion of the trust corpus.

<sup>138</sup> Cf. Boxx, *supra* note 134, at 235–36 (expressing concern that when both duties may apply, neither is entirely satisfactory to protecting the beneficiary's interests while also providing managers with the discretion necessary to manage a business).

<sup>139</sup> Sitkoff, *supra* note 64, at 657.

<sup>140</sup> See EASTERBROOK & FISCHEL, *supra* note 5, at 100 ("Exposure to liability causes managers' incentives to diverge from the path of wealth maximization.").

The overlap of trust law and business law is also significant if a beneficiary would have grounds to object to the management of the business under the relevant business statute but faces obstacles to asserting those objections as a matter of trust law. When trust beneficiaries lack the ability to seek corporate records in order to monitor their investment or to pursue lawsuits against those in control of the corporation, they are more vulnerable to predatory misconduct.<sup>141</sup> As a threshold matter, in order to bring an action that belongs to shareholders, a beneficiary must establish standing despite the lack of stock ownership.<sup>142</sup>

In one case, a plaintiff sued his parents and petitioned for corporate dissolution alleging that the parents had abused the trust set up for his benefit because of their disapproval of his marriage.<sup>143</sup> The parents each held a 1% stake in the business that the father had founded, and the remaining 98% was owned by the son as the beneficiary of a family trust managed by the parents. Thus, as a result of their gifts to him, the son held an overwhelming economic interest in the family business but had no control rights and no direct stock ownership. The court concluded that the son was, in effect, a minority shareholder as he lacked control of the investment and permitted him to petition for dissolution.<sup>144</sup>

Of course, even if a beneficiary has the right to seek judicial intervention, additional hurdles may limit a plaintiff beneficiary's practical ability to challenge trust distributions. First, distributions need not be made on a pro rata basis, unless the trust agreement so specifies.<sup>145</sup> Thus, subject to a general

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<sup>141</sup> See Judith Schemel Suelzle, Note, *Trust Beneficiary Standing in Shareholder Derivative Actions*, 39 STAN. L. REV. 267, 267–68 (1986) (analyzing trusts, including various employee pension and stock ownership plans, and noting substantial state disagreement as to whether beneficial owners of stock can assert derivative actions when the trustee fails to do so).

<sup>142</sup> *Id.*

<sup>143</sup> *Berger v. Berger*, 592 A.2d 321, 322 (N.J. Super. Ct. Ch. Div. 1991) (noting that plaintiff's marriage "affected the family's operations of its business and resulted in . . . litigation").

<sup>144</sup> *Id.* at 328. The court properly rejected the defendants' alternative argument that their son could not bring a claim as a minority shareholder because, if his beneficial interest counted as stock ownership for purposes of standing, 98% was not a minority position. *Id.* at 326–28. The court instead adopted a functional perspective and allocated fiduciary duties to the parents because they had the power to control the investment. *Id.* at 327–28. For a similar approach, see *Smith v. Atlantic Props., Inc.*, 422 N.E.2d 798, 801 (Mass. App. Ct. 1981), holding that twenty-five percent shareholder's veto power gave him the ability to obstruct corporate action and, therefore, a fiduciary responsibility not to damage the business.

<sup>145</sup> See UNIF. TRUST CODE § 816(22), 7C U.L.A. 629–30 (2000) (authorizing trustee to "allocate particular assets in proportionate or disproportionate shares"). By contrast, "the law . . . provides certain core protections to minority shareholders in both public and close corporations, including the prohibition of non-pro-rata distributions . . ." Means, *A Voice-Based Framework*, *supra* note 67, at 1239; see also *Sinclair Oil Corp. v. Levien*, 280 A.2d 717, 721–22 (Del. 1971).

obligation of impartiality, the trustee can exercise discretion concerning the distribution of assets.<sup>146</sup> Second, because a beneficiary has no legal claim to benefits beyond whatever a settlor chooses to provide, the beneficiary's interest may be tied to conditions,<sup>147</sup> including even a prohibition against challenges to the operative agreement.<sup>148</sup>

For example, the six siblings who now own Luray Caverns, a tourist-attraction near Washington, D.C., have been battling for years, aligned roughly in two camps—the older siblings and the younger siblings.<sup>149</sup> A key issue concerns “the management of the trusts that control[] their inheritance.”<sup>150</sup> As a reporter explains, “[i]n the middle of all this fighting—and allegedly unbeknownst to [the older siblings]—their parents rewrote their wills and put in no-contest provisions that would be triggered if any of the siblings opposed their parents on appointments to the trusts.”<sup>151</sup> Relying on those provisions, now that the parents have both died, the younger “siblings sued [the older siblings] to void their inheritances.”<sup>152</sup> The battle for corporate control is also, centrally, a family dispute about inheritance.

Finally, it is worth noting that the shape of family-business ownership is affected by the *absence* of family law controls over testamentary choices. Unlike many other countries in which children have a legal claim to their parent's wealth,<sup>153</sup> jurisdictions within the United States adhere with few exceptions to a principle of testamentary freedom that gives individuals the discretion to distribute their assets in any manner they see fit.<sup>154</sup> While it may

<sup>146</sup> See Sitkoff, *supra* note 64, at 651 (contending that trust law's flexibility can be explained by the need to reconcile the often “conflicting interests of different classes of beneficiaries”). In a corporation, the law “assumes that all shareholders share the basic aim of profit maximization . . .” *Id.*

<sup>147</sup> See Adam J. Hirsch, *Freedom of Testation/Freedom of Contract*, 95 MINN. L. REV. 2180, 2193 (2011) (“A testator may saddle a bequest with conditions.”).

<sup>148</sup> *Id.* at 2207 (noting that “[s]tates have divided over whether . . . a ‘no-contest’ or ‘in terrorem’ clause is effective”).

<sup>149</sup> See Ken Otterbourg, *The Rift—A Family Dynasty Fights over the Future of Luray Caverns*, WASH. POST, (Mar. 14, 2013), <http://www.washingtonpost.com/blogs/liveblog/wp/2013/03/14/magazine-the-rift-a-family-dynasty-fights-over-the-future-of-luray-caverns/>, archived at <http://perma.cc/J2EC-SYMW>.

<sup>150</sup> *Id.*

<sup>151</sup> *Id.*

<sup>152</sup> *Id.* The dispute has not yet been resolved on its merits. *Id.*

<sup>153</sup> See Hirsch, *supra* note 147, at 2233 (“In most countries, bequests to children are compulsory.”).

<sup>154</sup> See RESTATEMENT (THIRD) OF PROP.: WILLS AND OTHER DONATIVE TRANSFERS § 10.1 cmt. a (2003). Disinherited family members must allege undue influence, coercion, or the like in order to overturn a will. See, e.g., Anemona Hartocollis, *Two Wills, One Private Heiress*, N.Y. TIMES, Sept. 15, 2013, at MB1 (describing a will that includes the statement “I intentionally make no provision in this my Last Will Testament for any members of my family”). Instead, the decedent left her \$300 million estate to an arts foundation as well as a non-family caretaker, a doctor responsible for her care, her accountant, and her lawyer. *Id.* Her “grandnephews, grandnieces, great-grandnephews and great-grandnieces” now allege

be natural to expect that family members will care for each other, and to rely upon family as the institution of first resort for handling illness and infirmity,<sup>155</sup> adult children and their parents have no legal claims upon one another. Accordingly, obligations concerning a family business may be created and adjusted through private ordering and may reinforce or reject expectations created by more intimate connections among the participants.

#### D. Tax Considerations

The previous examples focus on disputes within the family business, describing how family law affects issues of ownership, governance, distribution, and fiduciary duty. Business law offers an incomplete account of such disputes because it neglects the relevance of legal obligations rooted in family relationships. This section shows that the connection between business law and family law can also be inverted: in some cases, a family business offers a mechanism for preserving family wealth by recharacterizing it.<sup>156</sup>

For instance, while there is no rule prohibiting family members from doing business together as partners, “a family partnership may represent no more than a thinly veiled attempt to fracture the personal income of a taxpayer in a high-income tax bracket between himself and related persons . . . in lower brackets.”<sup>157</sup> Such allocations violate the basic principle that income should be assigned to the person responsible for generating it.<sup>158</sup>

Before changes to the tax code were adopted to tax household income jointly,<sup>159</sup> the assignment-of-income question could be particularly troublesome

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that she was “coerced into changing [her will] by people around her, who, along with the hospital, kept her dependent and exploited her age and vulnerability.” *Id.* at MB1, MB6. None of these would-be heirs had seen the deceased in many years. *Id.* at MB6. However the dispute may eventually be resolved, it underscores that the transmission of family wealth across generations is a matter of choice, not right.

<sup>155</sup> See Martha Albertson Fineman, *The Vulnerable Subject and the Responsive State*, 60 EMORY L.J. 251, 263 (2010) (“The family is the mechanism by which we privatize, and thus hide dependency and its implications.”).

<sup>156</sup> Cf. Kerry Abrams, *Marriage Fraud*, 100 CALIF. L. REV. 1, 4 (2012) (“This Article approaches the issues of how to define marriage and its proper place in our legal landscape from a different perspective. Instead of asking the question of what marriage *is*, the Article tries to determine what marriage *is not*. It does so by examining when and why the law determines that a particular marriage is a ‘sham’ or a ‘fraud.’”). As Professor Abrams observes, studying the legal restriction of a concept can help illuminate its core purpose: “[t]he fraud doctrines, in other words, tell us what work the law is asking marriage to do.” *Id.* at 5.

<sup>157</sup> William S. McKee et al., *Development of the Family Partnership Rules*, FED. TAX’N OF PARTNERSHIPS & PARTNERS ¶ 15.01 (2012).

<sup>158</sup> See *id.*

<sup>159</sup> See Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339, 339 (1994) (“The federal income tax treats a married couple as a single economic unit. Spouses report their combined income on a joint return, and calculate their tax liability based on that

if a household allocated business income to a spouse in a lower tax bracket, thereby reducing the family's overall tax obligation.<sup>160</sup> When the IRS challenged the existence of a business partnership, courts had to decide whether both spouses were genuinely involved in a productive enterprise or whether business partnership designations had been made purely for tax purposes.<sup>161</sup>

Because family businesses are embedded in a family context, with overlapping economic considerations, such distinctions are not easily drawn. In *Commissioner v. Culbertson*, the Supreme Court held that the inquiry into partnership status for tax purposes was necessarily fact intensive and included an assessment of

[W]hether, considering all the facts—the agreement, the conduct of the parties in execution of its provisions, their statements, the testimony of disinterested persons, the relationship of the parties, their respective abilities and capital contributions, the actual control of income and the purposes for which it is used, and any other facts throwing light on their true intent—the parties in good faith and acting with a business purpose intended to join together in the present conduct of the enterprise.<sup>162</sup>

Rejecting the *Culbertson* approach, Congress amended the law to clarify that a partnership designation for tax purposes is valid if the partner “owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.”<sup>163</sup> The tax rules are complex,<sup>164</sup> and the requisite “ownership” can be debated, but it is enough for our purposes to see that Congress decided

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combined income.”). This approach was first instituted in 1948. *See* Revenue Act of 1948, Pub. L. No. 80-471, §§ 301, 303, 305, 62 Stat. 110, 114–16.

<sup>160</sup> *See, e.g.,* *Lucas v. Earl*, 281 U.S. 111, 114–15 (1930). By contrast, the current approach uses a “joint-return rate schedule” that awards a “marriage bonus” to single-earner families, because the rate schedule achieves the equivalent of income splitting by applying a lower rate than would apply to an individual’s income, and imposes a “marriage penalty” on dual-earning families with equal incomes, because the rate schedule is higher than the equivalent split if each earner were taxed as an individual. *See Zelenak, supra* note 159, at 340–41. For further discussion of the consequences of the joint-filing rules, see Dorothy A. Brown, *Race and Class Matters in Tax Policy*, 107 COLUM. L. REV. 790, 800–03 (2007) and Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1395–96 (1975).

<sup>161</sup> *See, e.g.,* *Comm’r v. Tower*, 327 U.S. 280, 283 (1946).

<sup>162</sup> *Comm’r v. Culbertson*, 337 U.S. 733, 742 (1949).

<sup>163</sup> 26 U.S.C. § 704(e)(1) (2012).

<sup>164</sup> For instance, and to cite only one difficult issue, the availability of the classification turns on the distinction between partnerships in which capital is material to the generation of income and those in which it is not. *Id.* One commentator observes that our tax system actually relies upon two distinct conceptions of family, depending upon whether the objective is to facilitate the extension of benefits or to constrict abuses. *See* Tessa R. Davis, *Mapping the Families of the Internal Revenue Code*, 22 VA. J. SOC. POL’Y & L. (forthcoming 2014) (manuscript on file with author).

not to examine the details of family business structure, so that “questions regarding the business or tax avoidance motivation for a transfer of a partnership capital interest to a family member are thus largely irrelevant.”<sup>165</sup> Households are now taxed as a unit, but issues concerning the allocation of taxable income within a family continue to arise in partnership cases involving children or other relatives.<sup>166</sup>

Tax considerations also explain the use of limited partnerships and LLCs as an estate-planning device. The crucial features for tax purposes are that the limited partners have no right to control the investment—only general partners or voting members of the LLC have that authority—and no right to exit the investment and to redeem their membership interest. Accordingly, the IRS accepts substantial deductions to account for a limited partner’s lack of control and the absence of an available market for the partnership interest, even if those vulnerabilities are of no real consequence within a family context.<sup>167</sup> Thus, transferring limited-partnership shares to a child, instead of the equivalent cash value in a will, helps the transferor take advantage of the gap between family expectations and objective market value.<sup>168</sup>

The notion that a limited-partnership interest would trade at all, apart from the family context, is unrealistic for reasons that Professor Brant Hellwig has explained:

Because the transferee of a partnership interest is guaranteed only to receive distributions that would have been made to the transferor, an unrelated third party would discount the value of the transferred interest on account of the inability to participate in decisions affecting management of the partnership affairs. Furthermore, due to the transferee’s inability to require the partnership interest to be redeemed and the absence of an established market on which an

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<sup>165</sup> McKee et al., *supra* note 157, ¶ 15.01[2] (citing S. REP. NO. 82-781, at 38 (1951) and H.R. REP. NO. 82-586, at 32 (1951) (stating intent to “harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business”)).

<sup>166</sup> Note that the tax rule applicable to married couples defeats, if only for tax purposes, any contrary allocation of ownership interests in a partnership that the couple might otherwise devise. In effect, the equal profits default rule of partnership law becomes mandatory. See Zelenak, *supra* note 159, at 344 (“The standard justification for joint returns is that the typical married couple pools its income. Since the couple acts as a single economic unit, it should be taxed as a single economic unit.”).

<sup>167</sup> Brant J. Hellwig, *Revisiting Byrum*, 23 VA. TAX REV. 275, 278 (2003).

<sup>168</sup> *Id.* at 277–78 (“It is common knowledge that valuation discounts are the driving force behind the widespread use of limited partnerships to transmit wealth.”). Given the law’s refusal to acknowledge the family setting in which limited partnerships often operate, “these entities are well suited to exploit a structural flaw in the transfer tax system—the requirement that ‘value’ be measured on an objective basis by hypothesizing an exchange between unrelated, disinterested third parties.” *Id.* at 278. However, the family limited partnership planning technique remains contentious and, in some circumstances, may not be viable. See Carter G. Bishop, *The Ebb and Flow of the Federal Tax Role of Fiduciary Duties in Family Limited Partnerships: From Byrum to Bongard*, 35 CAP. U. L. REV. 61, 64 (2006).



interest in a closely held partnership can be readily liquidated, the value of the transferred interest will be discounted to reflect its lack of marketability. While one may sense an air of fabrication relating to the asserted discounts, the discounts are genuine. The air of fabrication exists because the likelihood of an interest in a family owned partnership ever being sold in an arm's-length exchange to an unrelated third party is virtually nonexistent.<sup>169</sup>

Nevertheless, the law hypothesizes a bargain negotiated at arm's length, and limited partnership interests can often claim a substantial deduction for supposed impairments of value.<sup>170</sup> Whether or not the use of limited partnerships as a family tax-planning device undermines the integrity of the estate tax through a kind of relationship arbitrage,<sup>171</sup> the popularity of the technique highlights the overlap of family relationships and business choices. In sum, the subtlety of family and business connections can create opportunities for tax reduction strategies that the law only imperfectly apprehends and sometimes chooses to ignore. The choice of business entity form reflects family and business considerations.

#### IV. PRIVATE ORDERING IN FAMILY BUSINESSES

This Part contends that a contractual conception of the firm can account for distinctive characteristics of family businesses. Part IV.A shows that private ordering already exists on both sides of the family-business equation and provides a flexible model for mapping their intersections. Part IV.B contends that the shared language of contract does not ignore family values and, instead, provides a useful mechanism for expressing them. Part IV.C further defends the contractual approach by examining how marital, trust, and inheritance agreements can align legal rights and expectations in a family-owned business.

##### A. *Common Ground*

Though their formal legal doctrines diverge, businesses and families are both institutions that facilitate cooperative relationships designed, in important part, to achieve economic objectives.<sup>172</sup> Business organization laws permit the entry of individuals into long-term relationships to achieve shared purposes,

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<sup>169</sup> Hellwig, *supra* note 167, at 278 n.8.

<sup>170</sup> *See id.*

<sup>171</sup> *See id.* at 279 (citing Laura E. Cunningham, *Remember the Alamo: The IRS Needs Ammunition In Its Fight Against the FLP*, 86 TAX NOTES 1461, 1466 (2000) ("It is apparent that the family limited partnership, as evolved, is in danger of making the estate tax truly voluntary.")).

<sup>172</sup> *See* Alchian & Demsetz, *supra* note 37, at 777 ("The mark of a capitalistic society is that resources are owned and allocated by such nongovernmental organizations as firms, households, and markets.").

partly defined by the state and subject to its regulation.<sup>173</sup> Similarly, the institution of marriage gives legal recognition to the voluntary union of two people, and, if needed, judicial monitoring of their rights and obligations.<sup>174</sup> In each context, the parties' relationship is said to be contractual,<sup>175</sup> even if some aspects are mandatory or subject to fiduciary constraint.<sup>176</sup>

Accordingly, in addressing the needs of family businesses, it would be a mistake to treat the business-law aspects as contractual and the family-law aspects as status-based.<sup>177</sup> Historically, it is certainly true that the marriage contract represented the voluntary assumption of a state-determined status.<sup>178</sup> Increasingly, however, courts and legislatures have permitted individuals to strike bargains concerning their family relationships.<sup>179</sup> Building upon these

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<sup>173</sup> See A. A. Berle, Jr., *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365, 1365–66 (1932); E. Merrick Dodd, Jr., *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145, 1147–48 (1932).

<sup>174</sup> See MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 761 (11th ed. 2003) (defining traditional marriage as "the state of being united to a person of the opposite sex as husband or wife in a consensual and contractual relationship recognized by law"). Until relatively recently, "the state, and not individual marriage partners, determined many of the consequences of marital status." Singer, *supra* note 13, at 1446.

<sup>175</sup> Courts treat questions of governance and distribution largely as default matters subject to modification by the parties. See Mary Anne Case, *Marriage Licenses*, 89 MINN. L. REV. 1758, 1779 (2005); Singer, *supra* note 13, at 1567 ("A preference for private over public ordering has characterized the development of family law over the past quarter century.").

<sup>176</sup> See Shahar Lifshitz, *Married Against Their Will? Toward a Pluralist Regulation of Spousal Relationships*, 66 WASH. & LEE L. REV. 1565, 1597 (2009) ("Traditionally, legal regulation of marriage expressed and supported shared moral principles and interests of society as a whole, sometimes even at the cost of limiting the couple's freedoms."); Eisenberg, *supra* note 19, at 1505 (observing that the characterization of corporate law as a series of default rules ignores important mandatory provisions that cannot be abrogated by the parties).

<sup>177</sup> See, e.g., BAINBRIDGE, *supra* note 2, at 808 (describing the shift toward codification of the principle that shareholder bargains are valid in close corporations, even if they impinge upon the role of the board of directors); Means, *supra* note 3, at 1220 ("In some respects, the gradual recognition of contractual bargaining within domestic relationships resembles the process by which courts became willing to enforce shareholder agreements in close corporations . . .").

<sup>178</sup> See 1 WILLIAM BLACKSTONE, COMMENTARIES ON THE LAWS OF ENGLAND 154 (1765–1769) (stating that because "husband and wife are one person in law" a contractual relationship is conceptually impossible); Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 371 (1978) (arguing that courts "refused to enforce agreements between husband and wife affecting the internal organization of family life" because legal intervention is inconsistent with "successful human association [that] depends upon spontaneous and informal collaboration").

<sup>179</sup> See Martha M. Ertman, *Marriage as a Trade: Bridging the Private/Private Distinction*, 36 HARV. C.R.-C.L. L. REV. 79, 81–82 (2001) (listing "matters such as entry into marriage, contractual ordering of marriage, nonmarital relationships, divorce, adoption, the use of reproductive technologies, and the privatization of domestic relations dispute resolution").

advances, and the freedom of contract now widely recognized in business organization law,<sup>180</sup> family law scholars have argued for even greater recognition of private ordering in family law.<sup>181</sup> Through contract, families can define their own boundaries and recognize new forms of intimacy.<sup>182</sup>

As a practical matter, given the availability of contract in the family context, private ordering in family businesses extends beyond the traditional subject matter of business contracts. This is as it should be. After all, the central insights of the contractual conception of the firm are that “shareholders’ rights and duties are (or should be) defined by contract[,] . . . that corporate law should be ‘enabling’ rather than mandatory[,] . . . [and] that no particular set of outcomes is best for all firms.”<sup>183</sup> Rather than adhering to a formalistic and narrow conception of business law that would limit the parties’ ability to integrate their business and family objectives, the contractual nexus should encompass all agreements that relate to the family business.<sup>184</sup>

The participants’ family relationships may also provide important context for the interpretation of family-business contracts. For instance, in a post-trial decision upholding a daughter’s contractual claim based upon the termination of her employment with the family business, the court recognized that family considerations had motivated the parties’ business bargain:

The parties’ intent in entering into the Shareholders Agreement was not to establish an operational model for the Company, defining the individual

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<sup>180</sup> See Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 WASH. U. L. Q. 365, 370 (1992).

<sup>181</sup> See Adrienne D. Davis, *Regulating Polygamy: Intimacy, Default Rules, and Bargaining for Equality*, 110 COLUM. L. REV. 1955, 2039–40 (2010); Ertman, *supra* note 179 at 81–82. Other scholars contend that describing families as contracts ignores power disparities and elides the parties’ emotional commitments. See, e.g., Laura Weinrib, *Reconstructing Family: Constructive Trust at Relational Dissolution*, 37 HARV. C.R.-C.L. L. REV. 207, 209 (2002) (“The contractualization of family law has led to the sterilization of the family.”).

<sup>182</sup> See Elizabeth F. Emens, *Monogamy’s Law: Compulsory Monogamy and Polyamorous Existence*, 29 N.Y.U. REV. L. & SOC. CHANGE 277, 364 (2004). Even when family law rules remain mandatory, rational business participants will still take them into account. See Larry E. Ribstein, *The Important Role of Non-Organization Law*, 40 WAKE FOREST L. REV. 751, 754 (2005) (“Federal tax, securities, bankruptcy laws, and some state non-organization laws are important because firms can minimize their impact only by complying or changing their transaction form.”).

<sup>183</sup> See Macey, *supra* note 65, at 1269.

<sup>184</sup> To erect a barrier to voluntary contracting when family relationships are at issue would be inconsistent with the more general recognition that the parties themselves are in the best position to establish the rules for their business venture. See DEL. CODE ANN. tit. 6, § 18-1101(b) (2013) (“It is the policy of this chapter to give the maximum effect to the principle of freedom of contract and to the enforceability of limited liability company agreements.”).

shareholders' rights and responsibilities. Rather, the Shareholders Agreement was meant to be an estate-planning tool.<sup>185</sup>

Accordingly, the plaintiff's contractual argument regarding the meaning of "executive duties" prevailed notwithstanding her limited role in the business.<sup>186</sup> That is, because the parents intended to distribute assets to their daughter through the company, her level of participation was not relevant to the arrangement.<sup>187</sup>

However, some might counsel a narrower view of private ordering in family-owned businesses in order to respect the supposedly "separate spheres" of intimacy and markets.<sup>188</sup> According to this objection, family relationships are extraneous to the nexus of business contracts because firms are economic institutions and economic actors will rationally pursue their own advantage.<sup>189</sup> By contrast, family is an institution that protects a sphere of intimacy apart from competitive market relationships.<sup>190</sup> Even if families could be re-described in the language of economics,<sup>191</sup> the typical range of family concerns may seem far removed from the narrower economic objectives of a business corporation.<sup>192</sup> Thus, according to some scholars, the residual role of family relationships is to establish a background of trust that can reduce the transaction costs of forming and operating a firm.<sup>193</sup>

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<sup>185</sup> *Federico v. Brancato*, No. 50902(U), slip op. at \*7–8 (N.Y. Sup. Ct. June 9, 2014) (citing Peter Mahler, *Interview with Law Professor Benjamin Means on Conflict in Family-Owned Businesses: Part Two*, N.Y. BUS. DIVORCE (Feb. 4, 2013), <http://www.nybusinessdivorce.com/2013/02/articles/interviews/interview-with-law-professor-benjamin-means-on-conflict-in-family-owned-businesses-part-two>).

<sup>186</sup> *Id.* at \*8.

<sup>187</sup> *Id.*

<sup>188</sup> See ZELIZER, *supra* note 12, at 23 (noting that "worries about the incompatibility, incommensurability, or contradiction between intimate and impersonal relations are long-standing and persistent").

<sup>189</sup> See O'Kelley, Jr., *supra* note 2, at 220 ("Rational individuals invest their human and money capital with a view to maximizing the value of such resources."); Butler, *supra* note 9, at 109 (noting that the contractual theory of corporate law is "based in part on the assumption that the shareholders' primary interest is in the maximization of the value of their investments").

<sup>190</sup> Singer, *supra* note 13, at 1522 ("[T]he values associated with a 'successful' family—altruism, sympathy, mutualism—were precisely those that were viewed as incompatible with success in the economic sphere."). Also, some aspects of family life may not be commodities, or ought not to be treated as such. See Margaret Jane Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849, 1923–28 (1987).

<sup>191</sup> See RICHARD A. POSNER, *THE ECONOMICS OF JUSTICE* 237 (1981) (extending assumption of rationality to choices regarding marriage, children, and friendships); GARY S. BECKER, *THE ECONOMIC APPROACH TO HUMAN BEHAVIOR* 169–94 (1976).

<sup>192</sup> See ASHFORTH, *supra* note 89, at 139 ("Work and home are often stereotypically perceived as opposites on many dimensions.").

<sup>193</sup> For instance, "if family-owned ventures reduce the agency costs of management, there will be gains for all to share." EASTERBROOK & FISCHER, *supra* note 5, at 232.

In truth, families cannot be excluded from the economic sphere, because no family can avoid economic considerations.<sup>194</sup> The household is the original unit of economic analysis and the source of the word *economics*.<sup>195</sup> Consider, for example, one successful author's account of marital problems caused by a changed economic dynamic:

We expected that things would proceed one way—he'd be the primary breadwinner, a successful attorney, and I'd make less money, stay home with the kids, with fiction essentially a lucrative hobby . . . . When it didn't work out that way, I think we both had a hard time rewriting the contract of the marriage.<sup>196</sup>

Whether or not a family owns and operates a business, the family must address questions of economic production and exchange and reconcile economic activity with other expectations.<sup>197</sup>

In sum, because the economic concerns of business and family do not reside in separate spheres, contractual adjustments can help to clarify the parties' expectations. Indeed, the parties may use contracts to establish a boundary between family and business, as when a prenuptial agreement defines business assets as non-marital property. Regardless of the parties' objectives, if private ordering is accepted in the family-law context, and if the stakeholders in a business are also free to bargain amongst themselves, there seems to be little basis left for rejecting broader bargains that address real-world concerns in family businesses.<sup>198</sup>

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<sup>194</sup> See ZELIZER, *supra* note 12, at 13 (“Economic transactions include all social interactions involving consumption, production, and distribution of goods, services, or the means of acquiring them—for example, when one sibling buys a car from another, an immigrant father supervises his daughter's work in the family store, a salesman spreads free samples among his close friends, or parents lend their children money for purchase of a home.”); Piper v. Hoard, 13 N.E. 626, 629 (N.Y. 1887) (“Marriage has its sentimental and its business sides.”).

<sup>195</sup> Robert C. Ellickson, *Unpacking the Household: Informal Property Rights Around the Hearth*, 116 YALE L.J. 226, 232 n.14 (2006) (“Although *oikos* [house] is the etymological root of ‘economics,’ until recent decades few economists have paid more than passing attention to home economics.”).

<sup>196</sup> Rebecca Mead, *Written Off: Jennifer Weiner's Quest for Literary Respect*, NEW YORKER, Jan. 13, 2014, at 37, 40.

<sup>197</sup> See ZELIZER, *supra* note 12, at 13.

<sup>198</sup> To be clear, this does not mean that family dynamics of power and status should be irrelevant to contract interpretation and enforcement. Rather, those concerns exist across different contractual subject matter and should be addressed in consistent fashion. See, e.g., Melvin Aron Eisenberg, *The Bargain Principle and Its Limits*, 95 HARV. L. REV. 741, 801 (1982) (arguing that the administrative simplicity of strict enforcement of contractual bargains should be weighed against the possible injustices that can result). See also *infra* Part V.C.

## B. Respecting Values

Acknowledging the economic concerns that families and businesses share should not obscure differences in their respective values. From a certain remove, one could instead argue that families and businesses amount to the same thing—ways of organizing to accomplish collective, largely economic purposes. In this vein, one commentator defines marriage as “a written, oral, or customary long-term contract between a man and a woman to produce children, food, and other commodities in a common household.”<sup>199</sup> If family and business were “nothing-but” economics and their only differences concerned the goods sought by the parties, the nature of transaction costs, and the terms of the default contract, then the goal of family-business law would be to provide a single, coherent conception of value, largely consistent with the law and economics view of rational choice.<sup>200</sup>

Notwithstanding its origins in financial economics, the contractual conception of the firm places no such limits on the interests of contracting parties and, therefore, does not require us to deny the distinctive values of families and businesses.<sup>201</sup> Recall that the economists’ theory of the firm uses the building block of open-market transactions—contract—to construct an alternative to markets.<sup>202</sup> Contract should be seen as a means of expressing values and making them legally enforceable, rather than a concept that imposes values.<sup>203</sup> Accordingly, the fact that businesses and families engage in private ordering tells us little about what it is they value and have reason to value.<sup>204</sup> In a family business, the ability to choose among different plausible options is particularly important.

Even so, as a practical matter, it is unclear whether the participants in a family business benefit from the freedom to order their business affairs with as

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<sup>199</sup> GARY S. BECKER, *A TREATISE ON THE FAMILY* 43 (enlarged ed. 1991).

<sup>200</sup> According to Professor Vivian Zelizer, “[i]mpatient with stark dualisms, critics have sometimes countered separate spheres and hostile worlds accounts with reductionist nothing but arguments: the ostensibly separate world of intimate social relations, they argue, is nothing-but a special case of some general principle.” ZELIZER, *supra* note 12, at 29.

<sup>201</sup> See Ivan Lansberg S., *Managing Human Resources in Family Firms: The Problem of Institutional Overlap*, 12 *ORGANIZATIONAL DYNAMICS* 39, 42 (1983) (“The exchange of resources in the family is guided by implicit affective principles that focus . . . on the needs and long-term well-being of the other, rather than on the specific value of the goods and services . . .”). By contrast, “the norm of fairness that operates in the firm is based on the concept of merit.” *Id.*

<sup>202</sup> See Jensen & Meckling, *supra* note 4, at 311.

<sup>203</sup> However, courts may still invoke public policy concerns and refuse to enforce a private bargain if the subject matter is perceived as inimical to “the public good.” Kaiponanea T. Matsumura, *Public Policing of Intimate Agreements*, 25 *YALE J.L. & FEMINISM* 159, 163 (2013).

<sup>204</sup> At the most, we might say that the immanent value of contract is that autonomy and choice at a local level is to be given effect, up to a point, even when individual choices conflict with public values.

little interference as possible.<sup>205</sup> It could be the case that autonomy creates more problems than it solves in many situations, and that family members might prefer a more stable set of legal outcomes that could defuse tension in the family-business context by providing an external rationale for choices that might otherwise engender competition, conflict, and allegations of favoritism.<sup>206</sup> Perhaps, then, flexibility and stability are opposing values.

The contractual conception of the firm does not, however, force family members to bargain at arm's length and to rethink all aspects of their mutual relationships. To the contrary, family-business law informed by evidence of the choices families make, including common mistakes, could serve as a resource—a best-practices synthesis of business law and family law. In some cases, as when a child is given a beneficial interest in a trust or shares of a corporation, there is no literal bargain.<sup>207</sup> Nevertheless, envisioning a broad set of voluntary business and family relationships makes it possible to catalogue options so that default rules broadly match expectations. Indeed, “contract supposes and depends on a rich background of social norms to stabilize the parties’ expectations and to guide legal interpretations of their obligations.”<sup>208</sup>

Moreover, even to the extent a contractual approach to family-business law might encourage the parties to replace informal relationships of trust with more explicit bargaining, the consequences of a move from relationship to contract

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<sup>205</sup> In some circumstances, a policy designed to maximize individual autonomy can produce perverse results and may not even reflect the values of the individuals whose autonomy is at stake. See Carl E. Schneider, *After Autonomy*, 41 WAKE FOREST L. REV. 411, 437 (2006) (summarizing research that “while patients largely wish to be informed about their medical circumstances, substantial numbers of them do not want to make their own decisions, or perhaps even to participate in those decisions in any truly significant way”).

<sup>206</sup> In this sense, the external character of the legal rule may be important. For instance, in affirming the constitutionality of a school drug-testing program, Justice Breyer cited evidence of the efficacy of such programs: in particular, they help vulnerable children resist peer pressure by providing an acceptable rationale for avoiding drugs. See Bd. of Educ. of Indep. Sch. Dist. No. 92 v. Earls, 536 U.S. 822, 840–41 (2002) (Breyer, J., concurring) (“It offers the adolescent a nonthreatening reason to decline his friend’s drug-use invitations, namely, that he intends to play baseball, participate in debate, join the band, or engage in any one of half a dozen useful, interesting, and important activities.”). Without equating adults with children, it may be true, and for similar reasons, that family business law can provide a neutral, authoritative answer to questions that would otherwise provoke conflict.

<sup>207</sup> See Sitkoff, *supra* note 64, at 639 (contending, in the context of trust law, that “even if the beneficiaries do not literally contract with the other principal parties, . . . contractarian principal-agent modeling nonetheless illuminates the problems of governance relevant to the beneficiaries’ welfare”). Therefore, according to Professor Sitkoff, “greater insight into the nature and function of trust law will come from a conception of the trust as a de facto entity that serves as the organizing construct for an aggregation of contractarian relationships.” *Id.*

<sup>208</sup> Ronald J. Gilson et al., *Braiding: The Interaction of Formal and Informal Contracting in Theory, Practice, and Doctrine*, 110 COLUM. L. REV. 1377, 1446 (2010) (citing EMILE DURKHEIM, *THE DIVISION OF LABOR IN SOCIETY* 211–12 (George Simpson trans., Macmillan Co. 1933) (1893)).

can be overstated.<sup>209</sup> Admittedly, it is possible that impersonal legal protections can substitute for human relationships, thereby undercutting an important rationale for family-business ownership.<sup>210</sup> In the right circumstances, though, invoking contractual values can induce family-business participants to be more deliberative, anticipating conflicts before they arise.<sup>211</sup>

If done in a manner respectful of the relationships that exist among the parties, the process of tailoring default principles can be as beneficial as the agreed-upon substantive rules. In this regard, the formality inherent in operating a business might help family members to broach sensitive issues in the first place. For instance, a conversation about a prenuptial agreement could be perceived as constructive and appropriate in the context of a family business that involves other family members.<sup>212</sup>

### *C. The Nexus of Family-Business Contracts*

This section argues that the contractual conception of the firm, as applied to family businesses, includes marital agreements, trust instruments, and inheritance contracts because they empower families to allocate the ownership and control of business assets. That contractual flexibility has particular

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<sup>209</sup> The concerns, to be clear, are that contractual explanations lack the nuance necessary to appreciate the importance of social trust and that private ordering is not an adequate substitute for interpersonal trust. *See, e.g.*, Lyman Johnson, *Individual and Collective Sovereignty in the Corporate Enterprise*, 92 COLUM. L. REV. 2215, 2233 (1992) (reviewing FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (1991)) (“One problem with such an account is the abiding expectation that people, presumably being detached rogues bound only by ‘gappy’ contracts rather than real trust, would invariably cheat if only they could find more ingenious ways to do so.”).

<sup>210</sup> *See Means, supra* note 3, at 1194 (noting that family businesses can offer “intrinsic and not merely instrumental value”).

<sup>211</sup> The constructive role of contract is one reason that family law scholars have argued in favor of private ordering as a strategy for organizing family life. *See, e.g.*, Ertman, *supra* note 179, at 79.

<sup>212</sup> On the other hand, this strategy may produce the opposite result:

#### Rule #5: Do Not Blame Your Parents

My best friend’s boyfriend wanted a prenup. He had a trust fund. Of like \$500,000. He raised the subject one night. She balked. So immediately he reverted to this pussyfooted excuse: “My dad is making me!” That line of reasoning didn’t go over so well. “It made me even madder!” she tells me. “It’s one thing if he owned up to it, but it’s a whole different issue if he’s just blindly obeying his parents. Who wants to marry someone who doesn’t make his own decisions?” Touché. (P.S. They are now happily married with kids and *no* prenup.)

Siobhan Rosen, *With This Prenup, I Thee Wed*, GQ.COM (Sept. 2013), <http://www.gq.com/life/relationships/201309/prenup-agreement-marriage-engagement?mbid=gqpr>, archived at <http://perma.cc/3EZT-HR7R>.



importance when the default rules of business law or family law would otherwise violate the parties' expectations.

### 1. *Marital Agreements*

Because marriage superimposes an economic partnership in which assets are shared equally on top of business arrangements that may contemplate a different allocation, marital agreements may be needed to align the parties' rights and expectations. Further, the terms and conditions of marital agreements may be part of a broader business bargain.<sup>213</sup> Consider, for instance, the Swigs, whose marriage "united two of America's great real estate clans."<sup>214</sup> After suffering huge losses during the economic downturn of 2008, Mr. Swig obtained a business loan of \$200,000 from his in-laws, the Macklowes.<sup>215</sup> In exchange, Mr. Swig entered into a postnuptial agreement providing that, "[i]n the event of a divorce, Ms. Swig would get both homes, while he would assume responsibility for the debts against the properties."<sup>216</sup>

The loan from the Macklowes might be described, in isolation, as establishing a debtor-creditor relationship with respect to a discrete business venture, but it can only be appreciated in the full context of the family relationship.<sup>217</sup> In particular, the Macklowes' help was conditioned upon a postnuptial agreement that protected the economic interests of Ms. Swig, their

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<sup>213</sup> In fact, the absence of a marital agreement may be notable. See David F. Larcker et al., *Separation Anxiety: The Impact of CEO Divorce on Shareholders*, STAN. CLOSER LOOK SERIES, Oct. 1, 2013, at 1 ("[W]hen news leaked that Harold Hamm, Chairman and CEO of Continental Resources, was getting divorced from wife Sue Ann of 25 years, shares of the company fell 2.9 percent. The Hamms did not sign a premarital contract, making Harold's 68 percent ownership stake (worth \$11.2 billion) subject to equitable distribution under Oklahoma family law."); Tom Fowler, *Divorce Clouds Billionaire's Stake in Oil-Drilling Giant*, WALL ST. J., Mar. 22, 2014, at B4.

<sup>214</sup> Julie Creswell, *Breakup at 740 Park Avenue*, N.Y. TIMES, Feb. 2, 2014, at B1. Even before the marriage, each spouse had a stake in the real-estate world because of family connections. See *id.* at B4 ("Mr. Swig had reached this lofty perch the old-fashioned way: inheritance. He is the grandson of Benjamin Swig, who . . . began building a real estate dynasty.").

<sup>215</sup> *Id.*

<sup>216</sup> *Id.* ("She would also get almost \$12 million in art-work, including works by Jeff Koons and Takashi Murakami."). The business loan may not state that it is conditional upon the marital agreement, but both contracts were entered on the same day and the timing cannot have been coincidental. *Id.*

<sup>217</sup> *Id.* For instance, the loan contained "an unusual clause: The Macklowes agreed that they would not encourage or support any attempt to push Mr. Swig into involuntary bankruptcy." Although an unusual stipulation for an ordinary business creditor, it can be explained by the Macklowes' interest in the stability of their daughter's marriage. When the apparent rationale for the no-bankruptcy clause vanished, the Macklowes disregarded it: "Five months later, in March 2010, Kent Swig filed for divorce. And soon Harry Macklowe . . . began to break the promise he had made when he gave his son-in-law the loan." *Id.*

daughter. Functionally, the business loan and the marital agreement were connected, just as the Swigs' marriage mixed real estate and intimacy. A few months later, when the Swigs entered into divorce proceedings, the *New York Times* observed that the Swigs' divorce "ends more than a married life of galas at the Whitney and scenes in the Hamptons. It also represents the dissolution of the Macklowe-Swig business relationship."<sup>218</sup> A contractual model that includes family and business bargains helps us to perceive the Swigs' real-estate business as they themselves would have understood it: an economic partnership founded by marriage in which family and business interests were inseparable.

Marital agreements are not just a bargaining chip; they can play a crucial, independent role in family-business planning by specifying whether business assets are to be treated as marital property.<sup>219</sup> While the Swigs' marital agreement seems to have been designed to protect Ms. Swig's interest in the non-business assets of the marriage by allocating those assets to her, it also designated Mr. Swig as the owner of the real-estate businesses, including their debts. With his ownership rights clarified by contract, Mr. Swig is now in a position to resuscitate the business ventures, if he can.<sup>220</sup> Thus, setting aside the Macklowes' apparent ability to dictate terms, the parties used a contract to allocate their assets in accordance with the risk tolerances and preferences of each spouse.

In a contested divorce, the enforceability of a marital agreement may decide the fate of the family business.<sup>221</sup> A recent divorce involving the Los Angeles Dodgers provides a useful illustration.<sup>222</sup> In 2004, Frank McCourt purchased the Dodgers team (including the stadium and surrounding real property) for 421 million dollars. Mr. McCourt had been very successful in Boston real estate and Jamie McCourt, after attending law school, served as General Counsel of the McCourt Companies—the family business. In early 2009, Ms. McCourt "became chief executive of the team and the highest-ranking woman in Major League Baseball . . ."<sup>223</sup> In July 2009, however, the couple separated and Ms.

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<sup>218</sup> *Id.*

<sup>219</sup> Carolyn J. Frantz, *Should the Rules of Marital Property Be Normative?*, 2004 U. CHI. LEGAL F. 265, 268 ("A large proportion of marital property rules are defaults: the law leaves some room for spouses to contract around provisions for the division of property on divorce and for the governance of marital property during marriage.").

<sup>220</sup> Creswell, *supra* note 214, at B4 ("In the real estate game, fortunes are made, lost and, sometimes, remade. Mr. Swig, his spokesman said, is 'currently seeking real estate opportunities in which to invest and develop.'"). The article does not indicate any challenge to the terms of the marital agreement.

<sup>221</sup> The consequences of divorce will be particularly harsh in so-called "'copreneurial businesses'—firms where husbands and wives jointly own or work in a business together." W. Gibb Dyer et al., *Should My Spouse Be My Partner? Preliminary Evidence from the Panel Study of Income Dynamics*, 26 FAM. BUS. REV. 68, 68 (2012). Worldwide, "copreneurial firms represent about one third of all family businesses." *Id.*

<sup>222</sup> See also *supra* Part III.B.

<sup>223</sup> Bill Shaikin, *Jamie McCourt Wanted to 'Renege' on Post-Marital Agreement Involving Dodgers Because of Political Ambitions, Attorney Says*, L.A. TIMES (Aug. 30,

McCourt filed for divorce in October. The ensuing litigation concerned ownership of the Dodgers. Mr. McCourt claimed sole ownership, while Ms. McCourt alleged that she was a 50% owner.<sup>224</sup>

As a matter of family law, this would have been an easy case. The Dodgers were acquired during the marriage and there was no question that Ms. McCourt contributed substantially to the effort. Therefore, the business would be subject to division as marital property. Even though the stock ownership was solely in Mr. McCourt's name, the default rules of family law determine the disposition of marital assets in a divorce. However, shortly after acquiring the Dodgers, the couple had entered into a marital property agreement and its enforceability controlled what the *Los Angeles Times* called "the central issue in the couple's divorce: Does he own the team or do they own it jointly?"<sup>225</sup>

Ms. McCourt claimed that she signed the agreement without reading it, and that she believed the purpose of dividing assets was to separate the couple's business assets from their homes and other personal property.<sup>226</sup> In other words, she alleged that the goal was to protect the family's assets from possible creditors, not to allocate marital property in the event of a divorce. Mr. McCourt contended that Ms. McCourt wanted to insulate herself from the risks associated with the Dodgers—it had been losing \$50 million a year at the time of the McCourt investment, and Mr. McCourt had agreed to indemnify Major League Baseball for all losses going forward—and that the agreement accomplished its purpose.<sup>227</sup>

In December 2010, the court threw out the marital property agreement, in large part because the lawyer representing both parties had altered the provision

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2010, 4:02 PM), <http://latimesblogs.latimes.com/lanow/2010/08/jamie-mccourt-wanted-to-renege-on-post-marital-agreement-involving-dodgers-because-it-would-impinge-.html>, archived at <http://perma.cc/9CSE-RX6V>.

<sup>224</sup> *Id.*

<sup>225</sup> Carlos Lozano & Bill Shaikin, *McCourt Divorce Trial Opens*, L.A. TIMES (Aug. 30, 2010, 9:03 AM), <http://latimesblogs.latimes.com/lanow/2010/08/mccourt-divorce-trial-opens.html>, archived at <http://perma.cc/S9TP-SFD4>.

<sup>226</sup> Shaikin, *supra* note 223 ("Jamie McCourt has maintained she never would have knowingly signed away her right to the Dodgers. She says she signed the agreement without reading it, trusting her husband when he said the document was designed to protect the couple's homes from creditors.")

<sup>227</sup> *Id.* ("Frank McCourt says the document did exactly what he said it did and that Jamie McCourt wanted it that way, that she insisted upon such an agreement so as not to risk losing the homes if the McCourts failed to reverse the Dodgers' financial losses."). As to the public statements regarding joint ownership, he testified at trial "that a news release identifying himself and his wife as owners of the Dodgers was meant to emphasize that family ownership had returned to the team after six years under the corporate stewardship of Fox Entertainment Group." Bill Shaikin, *Frank McCourt Says Wife Could Not Own Dodgers and Retain Homes [Updated]*, L.A. TIMES (Sept. 2, 2010, 3:12 PM), <http://latimesblogs.latimes.com/lanow/2010/09/frank-mccourt-says-wife-could-not-own-dodgers-and-retain-homes.html>, archived at <http://perma.cc/NGT3-YNUU>.

at issue without notifying either party.<sup>228</sup> The court could not conclude whether either version of the agreement accurately reflected the parties' intentions. Accordingly, under the default rules of divorce, which now applied, Ms. McCourt was able to claim half-ownership of the Dodgers. In the end, Mr. McCourt had no choice but to sell his interest in the Dodgers in order to fund the divorce settlement.<sup>229</sup>

The narrow point is that poorly drafted agreements can have serious consequences. More broadly, though, the lesson to be drawn from the experience of the Swigs and the McCourts is that family-business planning cannot rest at the formal boundaries of the firm but encompasses and organizes a wider set of "[c]onnected contracts[,] [which] may be thought of as shorthand for a fluid, nonlinear, nonhierarchical set of interactions and interrelationships."<sup>230</sup> Put plainly, no family-business plan is complete unless it takes into account possible disruptions of family relationships, including divorce.<sup>231</sup> Marital agreements that address the status of business assets are, therefore, an important part of the nexus of family-business contracts.

## 2. Family Trusts

Trust instruments that control family-business assets also fall within the contractual nexus, because the trust agreement defines the trustee's authority as business manager.<sup>232</sup> Any characterization of the family business that failed to

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<sup>228</sup> The lawyer had the parties sign a version of the agreement that included the Dodgers as marital property. He later substituted what he claimed was the correct language without notifying the parties. Bill Shaikin, *McCourt Divorce: Damaging Admission from Lawyer who Negotiated Dodgers Agreement*, L.A. TIMES (Sept. 23, 2010, 2:30 PM), <http://latimesblogs.latimes.com/lanow/2010/09/jamie-mccourt-wins-damaging-admission-from-lawyer-who-negotiated-dodgers-ownership-agreement.html>, archived at <http://perma.cc/RMW4-DLFS>.

<sup>229</sup> See Shaikin, *supra* note 119.

<sup>230</sup> Gulati et al., *supra* note 15, at 894.

<sup>231</sup> In general, there are strong reasons to prefer private ordering concerning the consequences of a divorce to a state-imposed solution. See Robert H. Mnookin & Lewis Kornhauser, *Bargaining in the Shadow of the Law: The Case of Divorce*, 88 YALE L.J. 950, 956–57 (1979) (“[A] negotiated agreement allows the parties to avoid the risks and uncertainties of litigation, which may involve all-or-nothing consequences . . . [and] a consensual solution is by definition more likely to be consistent with the preferences of each spouse, and acceptable over time, than would a result imposed by a court.”).

<sup>232</sup> In one case, for instance, the settlor “treated [the trust] and [the corporation] as a coordinated operation . . . intend[ing] the Trustees to work with and through the [corporation] . . . to make coordinated investments and gain control of businesses.” *Bartlett v. Dumaine*, 523 A.2d 1, 8 (N.H. 1986) (quoting master’s report). Families often use trusts to effectuate the transfer of property and other assets, including family-owned businesses. See Thomas P. Gallanis, *The New Direction of American Trust Law*, 97 IOWA L. REV. 215, 217 (2011); see also John H. Langbein, *The Secret Life of the Trust: The Trust as an Instrument of Commerce*, 107 YALE L.J. 165, 165 (1997) (“The trust originated at the end of the Middle

acknowledge the controlling trust would be a sterile and pointless exercise.<sup>233</sup> Rather, when trust law overlaps with business-organization law, the vital question is whether there is some appropriate mechanism for coordinating the parties' rights and obligations.<sup>234</sup>

For example, the applicable fiduciary standards differ significantly.<sup>235</sup> Unless modified, the default duty of loyalty owed by a trustee requires disgorgement of all profits, even if the dealings were fair.<sup>236</sup> A controlling shareholder, by contrast, is entitled to benefit from the share ownership as long as any self-interested transactions are fair to the other shareholders.<sup>237</sup> The trustee who manages a trust-controlled business appears to owe fiduciary duties in both capacities.

The inconsistency of fiduciary obligations becomes especially problematic when a family member is empowered as trustee to manage a family business for the benefit of other members of the family.<sup>238</sup> This arrangement involves a plain conflict of interest if the trustee is a beneficiary of the trust or a controlling shareholder of the family business.<sup>239</sup> For a recent example, consider Rupert Murdoch's estate plan for transferring control of his multi-billion dollar stake in News Corp, the company he founded, to his children. A principal means to that end includes, reportedly, a family trust to be run by the children from his first two marriages for their own benefit and the benefit of the children of his third marriage.<sup>240</sup>

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Ages as a means of transferring wealth within the family, and the trust remains our characteristic device for organizing intergenerational wealth transmission . . .").

<sup>233</sup> See Frank T. Becker, *Control of Trust-Held Companies by Trustees*, 19 J. CORP. L. 41, 41 (1993) ("Trusts often hold sufficient voting interest in business entities to effectively control them.").

<sup>234</sup> See Boxx, *supra* note 134, at 235–36.

<sup>235</sup> The duties may also apply to different parties. See Boxx, *supra* note 134, at 235 (noting "complex dilemma" when trustee "must act both as corporate fiduciary, running the business in the best interests of all the stakeholders in the business, and as trustee to her sibling, owing undivided loyalty to this one shareholder").

<sup>236</sup> See Langbein, *supra* note 45, at 656 ("The trustee who deals with trust property for the trustee's own account is liable to disgorge the profits to the trust even if the trustee paid fair value for the property.").

<sup>237</sup> See *Pepper v. Litton*, 308 U.S. 295, 306 (1939).

<sup>238</sup> See Boxx, *supra* note 134, at 233 (noting that trusts are a "popular solution" to the problem posed by multiple heirs, not all of whom are capable or interested in assuming a leadership position in the family business).

<sup>239</sup> See *id.*

<sup>240</sup> According to news accounts, Mr. Murdoch's disclosure of the unequal control arrangement during a television interview several years ago nearly caused the breakup of his third marriage. See Peter Lattman & Amy Chozick, *Wendi Murdoch Hires a New Lawyer, Suggesting a Divorce May Turn Messy*, N.Y. TIMES, July 30, 2013, at B3 ("The slip almost created a separation, and prompted Mrs. Murdoch to negotiate more favorable terms for her daughters, according to people close to the couple."). Mr. Murdoch has now initiated divorce proceedings seeking to end the marriage, and commentators speculate that any private

Even for families that lack the complexity of the Murdoch clan, the trustee's role remains an issue. As one commentator explains:

Low-grade conflicts of interest are especially endemic in family trusteeships. We see constantly in real-world practice some version of the case in which my father names me trustee for my mother for life, remainder to a group including me, with a power in the trustee to invade the corpus of the trust for the benefit of my mother in the event the life interest becomes inadequate for her comfort and support. My father has insisted on choosing a conflict-tainted trustee, making the judgment that I am to be trusted not to pauperize my mother to enrich myself. These situations are especially dangerous when the trust is given a controlling interest in a close corporation, and I am an officer of that firm.<sup>241</sup>

From the standpoint of the family member who is appointed trustee, the challenge is to discharge the trustee's obligations faithfully while also sharing in the benefits of the family business, both as beneficiary of the trust and as a controlling shareholder.<sup>242</sup>

The contractual conception of the firm can help to clarify the trustee's role by focusing attention on the family-business bargain in its entirety.<sup>243</sup> Thus, whether or not the settlor defines the trustee's obligations explicitly, those obligations should be interpreted according to the overall context:

If he is well counseled, my father spells out broad authority for me as trustee, expressly trumping the default standards of the duty of loyalty. But when he neglects that step, contractarian analysis encourages us to look at the real nature of the trust deal, that is, what he and I understood, or what we would have understood about the purposes of the trust and the standard for my trusteeship.<sup>244</sup>

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settlement will involve the terms of the family trust arrangement, as his third wife will follow legal counsel and seek more solid protection for her children. *Id.*

<sup>241</sup> See Langbein, *supra* note 45, at 667.

<sup>242</sup> See Boxx, *supra* note 134, at 235 (noting that the “[d]uties of a corporate fiduciary are much more lenient than that of a trustee”).

<sup>243</sup> See Langbein, *supra* note 45, at 630 (“In fields ranging from corporations and partnership, to landlord and tenant, to servitudes, to the law of marriage, scholars have come to understand our legal rules as resting mainly on imputed bargains that are susceptible to alteration by actual bargains.”). Context should also factor into the interpretation: “Family and personal trustees often have interests adverse to the trust. The settlor’s determination to ask these conflicted persons to serve bears materially on the standard of fiduciary duty that the trust deal embodies.” *Id.* at 666.

<sup>244</sup> *Id.* at 667; see also *Bartlett v. Dumaine*, 523 A.2d 1, 11 (N.H. 1986) (applying corporate business-judgment rule deference rather than enhanced scrutiny under trust law’s prudent-investor rule: “[w]here, as in this case, a trust instrument allows the trustees to operate trust-controlled corporations, the trustees have wide discretion in running the corporate enterprises”).

Such assessments of intent require a “sympathetic reading of the [trust instrument] as an entirety and in view of all the facts and circumstances under which the provisions . . . were framed.”<sup>245</sup>

Trust agreements can also align the goals of the business organization with the values of the family owners. For example, the Green family that owns Hobby Lobby operates it “through a management trust (of which each Green is a trustee), . . . governed by religious principles.”<sup>246</sup> Although Hobby Lobby is a for-profit business, the trust instrument designates a religious purpose—“to create, support, and leverage the efforts of Christian ministries”—and every beneficiary is required to affirm that religious purpose as a condition of membership in the trust.<sup>247</sup> By imposing religious conditions in the context of a family transfer of wealth, rather than as part of the governance structure of the underlying business, the Green family seeks to avoid the possibility that its religious mission might be stymied someday by a dissenting shareholder insistent upon the pursuit of profits.<sup>248</sup>

It might be objected that trusts are not part of the contractual nexus because “a trust is ‘essentially a gift, projected on the plane of time and so subjected to a management regime.’”<sup>249</sup> However, even if the trust organizes a transfer of property,<sup>250</sup> the rules by which the trust operates are set by mutual agreement between the settlor and the trustee—a relationship that resembles a third-party

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<sup>245</sup> *In re Estate of Winston*, 205 A.D.2d 922, 923 (N.Y. App. Div. 1994) (internal quotation marks omitted) (analyzing a trust created by a will). According to one commentator, the “answer cannot be as simple as choosing one standard over the other but rather requires fashioning a distinct standard that both protects the beneficiary and allows sufficient management autonomy to allow the business to prosper.” Boxx, *supra* note 134, at 236.

<sup>246</sup> *Hobby Lobby Stores, Inc. v. Sebelius*, 723 F.3d 1114, 1122 (10th Cir. 2013).

<sup>247</sup> *Id.* Each Green family member is bound to this mission, which encompasses Hobby Lobby, by a required signature joining a “Trust Commitment.” *Id.* The use of a trust to require religious commitments is not an aberration. In another case, for instance, a son “transferred the control of his stock in the family corporations to his father in trust, a trust [that the son] could revoke without his father’s consent only if he married a Jewish woman.” *Meiselman v. Meiselman*, 307 S.E.2d 551, 553 (N.C. 1983).

<sup>248</sup> See RESTATEMENT (THIRD) OF PROP.: WILLS & OTHER DONATIVE TRANSFERS § 10.1 (2003) (stating that the “donor’s intention is given effect to the maximum extent allowed by law”). For discussion of the importance of shareholder unanimity, see Hall & Means, *supra* note 82, at 160 n.57 (distinguishing possible free-exercise interests of privately held corporations from public corporations in which shareholder unanimity is impossible: “Given the diverse corporate congregation, the duty to maximize profits may be the only overarching tenet of the faith”).

<sup>249</sup> Gallanis, *supra* note 232, at 217. To effectuate the gift over time, “[l]egal title to the trust assets is transferred from the settlor to the trustee; equitable title is transferred from the settlor to the trust’s beneficiaries.” *Id.*

<sup>250</sup> Traditionally, the trust has been viewed as a means of conveying property. See Langbein, *supra* note 45, at 644 (citing RESTATEMENT (SECOND) OF TRUSTS § 197 cmt. b (1959)). Professor Langbein further contends that “our doctrinal account of the trust remains inimical to recognizing the contractarian basis of the trust.” *Id.*

beneficiary contract in that it is a voluntary, legally-enforceable commitment undertaken for the benefit of another party.<sup>251</sup> In short, “trusts are contracts.”<sup>252</sup> More important, whether trusts ought to be classified as property or contract in some hypothetical, linnaean schema,<sup>253</sup> the trustee’s role is contractual within the meaning of the nexus-of-contract theory because it is an economic relationship defined by voluntary agreement.

### 3. *Inheritance Contracts*

A contractual approach to family business can also account for promises to convey wealth, including family-business assets, in exchange for assistance during the testator’s lifetime.<sup>254</sup> The details vary, but in each case “the aging person makes the . . . promise: ‘Take care of me, and someday all this will be yours.’”<sup>255</sup> Notwithstanding the principle of testamentary freedom, as well as the conventional belief that relatives ought to provide services to one another without compensation, courts have generally recognized that inheritances can be the subject of contract.<sup>256</sup>

Thus, private ordering regarding the transfer of family wealth can establish the functional equivalent of a work-to-own employment agreement. For instance, in *Wright v. Trask*, a grandfather promised to leave his ranch and cattle in exchange for his grandson’s management of the ranch.<sup>257</sup> As the older man’s health declined, his desire to retain control of the ranch did not, and the relationship “became so strained” that the grandfather disinherited his grandson and took away his managerial rights.<sup>258</sup> The grandson sought specific

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<sup>251</sup> Although the trust provides a mechanism for transferring property from a settlor to certain beneficiaries, “[t]he distinguishing feature of the trust is . . . the trust deal that defines the powers and responsibilities of the trustee in managing the property.” *Id.* at 627. Whether the trust specifies particular obligations or relies upon default rules, “the deal between settlor and trustee is functionally indistinguishable from the modern third-party-beneficiary contract.” *Id.*

<sup>252</sup> *Id.*

<sup>253</sup> *See id.* at 628 (arguing that the contractual features of trust law involve more “than mere labeling” and that “greater attention to the contractarian character of the trust would improve outcomes”).

<sup>254</sup> *See generally* HENDRIK HARTOG, SOMEDAY ALL THIS WILL BE YOURS: A HISTORY OF INHERITANCE AND OLD AGE (2012) (exploring the legal and emotional realities of conveying wealth to family members upon old age).

<sup>255</sup> Dubler, *supra* note 14, at 2293–94. Bargains involving wills can be struck with non-family members, *see, e.g.*, *Bock v. Brody*, 870 P.2d 530, 532 (Colo. App. 1993), *aff’d in part, rev’d in part*, 897 P.2d 769 (Colo. 1995) (enforcing promise made regarding transfer of ownership via will to keep Bock employed in Brody’s stock brokerage firm), but they are more typical in a family context.

<sup>256</sup> Even when inheritance contracts are not in writing, many jurisdictions allow partial performance to establish clear and convincing evidence. *See* HARTOG, *supra* note 254, at 204.

<sup>257</sup> *Wright v. Trask*, 495 S.E.2d 222, 224 (S.C. Ct. App. 1997).

<sup>258</sup> *Id.* at 225.



performance of an oral agreement, and the trial court required the grandfather to execute a will leaving the ranch to the grandson and enjoined him from taking any steps to reduce value of the ranch.<sup>259</sup>

Other courts have reached similar results. In *Shepherd v. Mazzetti*, the Delaware Supreme Court affirmed a grant of specific performance of a father's oral promise to convey real estate to his son.<sup>260</sup> Likewise, a New York appellate court held that a son's decision to "remain as the manager of the family business . . . [and] to forego other professional opportunities in reliance upon [his mother's] promise constituted sufficient consideration for purposes of imposing a constructive trust."<sup>261</sup> In each case, the bargained-for, economic aspects of the parties' relationship gave rise to an enforceable obligation even though the existence of family connections might otherwise have suggested an alternative explanation for one-sided labor arrangements.

The recognition that inheritance contracts can cement business relationships supports the descriptive claim that family businesses include family bargains. However, in interpreting such bargains, courts seem to treat intimacy as a polluting factor. For instance, had the court in *Wright v. Trask* concluded that the grandson's services were motivated in substantial part by a sense of family obligation, that finding would have derailed the grandson's legal claim to the family business. Understandably, courts must separate enforceable obligations from gratuitous undertakings, but it does not aid the analysis to insist upon a false category distinction—business or family, not both.

Under existing law, though, lawyers representing family members in inheritance-contracts cases have reason to guide their clients to "repress much . . . emotional complexity" in order to fall on the correct side of the category distinction: "It would be the lawyer's job to identify contractual motivations and to make them appear as the dominant and real ones, those that had transformed lives."<sup>262</sup> And yet, in many cases, the attention devoted to the older generation is motivated by love as well as rational calculation.<sup>263</sup> To

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<sup>259</sup> Even though the agreement was oral, the part performance evidenced by prior wills devising the ranch to Wright provided sufficient evidence of the terms. *Id.* at 228 (citing *McLauchlin v. Gressette*, 79 S.E.2d 149, 158–59 (S.C. 1953) ("[N]otwithstanding the statute of frauds, the specific performance of such a contract (to devise real property, interpolated) may be enforced in equity, where there has been part performance of the contract by the party seeking relief.")). An appellate court affirmed, holding that "Trask and Wright entered into an oral contract to make a will . . . [and that] Trask breached the contract by executing a new will, which did not leave the ranch, the cattle, and the equipment to Wright." *Id.* at 229.

<sup>260</sup> *Shepherd v. Mazzetti*, 545 A.2d 621, 622 (Del. 1988).

<sup>261</sup> *In re Urdang*, 758 N.Y.S.2d 125, 126–27 (N.Y. App. Div. 2003); *see also* *Quadrozzi v. Estate of Quadrozzi*, 952 N.Y.S.2d 74, 78 (N.Y. App. Div. 2012) (imposing constructive trust to protect brother's interest in family business).

<sup>262</sup> HARTOG, *supra* note 254, at 204.

<sup>263</sup> *See* Dubler, *supra* note 14, at 2307 (noting that in claims for payment, asserted when a deceased family member failed to convey property as promised, "legal incentives sometimes actually disincentivized any mention of love"). In its zeal for order, "law cannot

acknowledge this reality—the overlapping values of business and family—ought not undercut the force of the disinherited plaintiff’s grievance.<sup>264</sup> Contractual choices made by family members regarding a family-owned business are embedded in a broader family context of trust and reciprocity.<sup>265</sup>

## V. FAMILY-BUSINESS DEFAULTS

This Part contends that greater appreciation of the context for family-business bargains would spur the development of default rules and interpretive principles consistent with the parties’ business and family relationships. Although this is not the place to give full consideration to the appropriate role of default rules within a contractarian framework,<sup>266</sup> or to delineate a comprehensive law of family business, three examples will suffice to illustrate the point: first, that existing limitations on exit rights in business statutes facilitate estate planning; second, that oral agreements and implicit understandings among family members will often provide the best evidence of family-business bargains; and, third, that equity should play a consistent role in evaluating bargains across doctrinal categories.

### A. *Exit Rights*

In closely held businesses, family-owned or not, minority investors are vulnerable to mistreatment at the hands of the majority.<sup>267</sup> Unless they have bargained for veto rights, board representation, or other checks on majority power, the practical ability of minority investors to earn a return on their investment depends upon the majority’s decisions regarding dividends, employment, and other distributions of assets. The minority’s vulnerability is

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quite figure out what to do with the role that love should play in people’s familial choices and commitments.” *Id.* at 2306.

<sup>264</sup> See HARTOG, *supra* note 254, at 204 (“They were in the lawyer’s office and willing to go to court because they believed they had been cheated . . . . But for promises made, they would have gotten better jobs, learned trades, moved to Montana, not become a drunk, and had happier marriages. They knew . . . that taking care of elderly people had been a distraction at best from the lives they were supposed to lead.”).

<sup>265</sup> See Means, *supra* note 3, at 1189 (“In a family business . . . the values associated with family life must coexist with the values of the marketplace.”) (citing MANFRED F.R. KETS DE VRIES ET AL., FAMILY BUSINESS ON THE COUCH: A PSYCHOLOGICAL PERSPECTIVE 9 (2007)).

<sup>266</sup> See, e.g., Ian Ayres, *Regulating Opt-Out: An Economic Theory of Altering Rules*, 121 YALE L.J. 2032, 2034–35 (2012); Ian Ayres & Robert Gertner, *Majoritarian vs. Minoritarian Defaults*, 51 STAN. L. REV. 1591, 1591 (1999); Ayres & Gertner, *Filling Gaps*, *supra* note 16, at 87.

<sup>267</sup> See Means, *A Voice-Based Framework*, *supra* note 67, at 1217. Many classic cases of shareholder oppression involve family-owned businesses. See GRANT GORDON & NIGEL NICHOLSON, FAMILY WARS: CLASSIC CONFLICTS IN FAMILY BUSINESS AND HOW TO DEAL WITH THEM 3–4, 10 (2008).

exacerbated if the business-entity form provides no right of exit.<sup>268</sup> Thus, unless investors need assurances regarding the stability of their capital investment,<sup>269</sup> limited exit rights are puzzling from an internal governance perspective.<sup>270</sup>

Yet, as a matter of tax law, vulnerability has value because it enables a family to transmit wealth between generations while claiming a substantial reduction in value for lack of control and lack of marketability.<sup>271</sup> Family members who receive shares of a business from loved ones as a gift may have less reason to worry about oppression—and, in any case, the shares do not represent an investment bargain. In order to accommodate family tax planning through closely held businesses, most jurisdictions restrict exit rights in limited partnerships, LLCs, and trusts.<sup>272</sup> Indeed, default LLC rules that once provided for easy exit were altered to suit the needs of family businesses.<sup>273</sup>

The default no-exit rule can be defended on efficiency grounds, even if it turns out that most closely held businesses would be well advised to adopt more liberal exit rules. Crucially, the Internal Revenue Code calculates discounts for lack of control and marketability based upon the language of the business statute and may disregard private ordering that cuts back on exit rights that the statute would otherwise provide.<sup>274</sup> Business owners can include exit provisions at relatively low cost; however, families that want the lock-in rule for tax

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<sup>268</sup> See Means, *A Voice-Based Framework*, *supra* note 67, at 1217.

<sup>269</sup> See Edward B. Rock & Michael L. Wachter, *Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in Close Corporations*, 24 J. CORP. L. 913, 915 (1999) (arguing that “the close corporation form is best suited to companies that require extensive investments in match assets. In such cases, the close corporation acts as an incubator and the lock-in is a benefit, not a cost.”).

<sup>270</sup> See Ribstein, *supra* note 182, at 772 (“[R]estricting exit may involve significant costs in closely held firms by subjecting members who have neither management power nor exit rights to potential oppression by the managers and controlling owners.”); J.A.C. Hetherington & Michael P. Dooley, *Illiquidity and Exploitation: A Proposed Statutory Solution to the Remaining Close Corporation Problem*, 63 VA. L. REV. 1, 44–45 (1977).

<sup>271</sup> See *supra* Part III.D.

<sup>272</sup> See Robert H. Sitkoff & Max M. Schanzenbach, *Jurisdictional Competition for Trust Funds: An Empirical Analysis of Perpetuities and Taxes*, 115 YALE L.J. 356, 360–61 (2005); Kenneth P. Brier & Joseph B. Darby, III, *Family Limited Partnerships: Decanting Family Investment Assets into New Bottles*, 49 TAX LAW. 127, 128 (1995).

<sup>273</sup> See RIBSTEIN, *supra* note 63, at 179–80.

<sup>274</sup> See Ribstein, *supra* note 182, at 771 (“Family members cannot avoid receiving full market value simply by a partnership agreement provision restricting transfers because only state statutory restrictions matter under the IRC.”) (citing I.R.C. § 2704(b)(1) (2000)); HOWARD M. ZARITSKY, 2 TAX PLANNING FOR FAMILY WEALTH TRANSFERS DURING LIFE: ANALYSIS WITH FORMS ¶ 10.03[2][b][i] (5th ed. 2013) (noting that Section 2704(b) ignores “limitations on the ability to liquidate the partnership that are more restrictive than those generally extant under applicable state law” if the limitations “will lapse or if the transferor or his or her family can remove [the limitations] after the transfer”).

planning are much better off relying on a statutory default rule.<sup>275</sup> Thus, an opt-out approach helps all business investors to maximize the value of their investment.<sup>276</sup>

A possible compromise position—tailoring the no-exit defaults more narrowly to qualifying family businesses that have elected to be treated as such under special statutory provisions<sup>277</sup>—would not necessarily lead to better outcomes in the aggregate.<sup>278</sup> First, while creating a separate set of statutory provisions for family businesses has some appeal, given the distinctive characteristics canvassed in this Article, it would also require a more precise articulation of which businesses qualify, and any defined boundary would be both under- and over-inclusive. Unlike a fixed statutory definition, the contractual approach has enough flexibility to respond to family-controlled businesses with widely varying features.

Second, even if it were possible to identify “qualifying” family businesses in a satisfactory manner, those businesses would then have to elect the special family coverage. That is, if investors in non-family businesses behave irrationally by failing to include exit rights, it seems likely that family-business owners will make similar mistakes. For a separate family-business designation to serve its purpose, we must be able to assume that family owners will, in fact, elect that status when appropriate.<sup>279</sup> Also, although the lock-in rule applies to

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<sup>275</sup> See ZARITSKY, *supra* note 274, at ¶ 10.03[2][b][i] (noting that the Internal Revenue Code “causes the partnership interest to be valued without regard to the restrictions on liquidation contained in the partnership agreement”).

<sup>276</sup> Perhaps this disparity explains why business statutes accommodate family interests in this one respect and not in others. Of course, the need for a business entity with restricted exit features does not necessarily mean that all business organizations should contain that feature. See Larry E. Ribstein, *The New Choice of Entity for Entrepreneurs*, 26 CAP. U. L. REV. 325, 340 (1997) (arguing that “at least one type of statute should be kept ‘safe’ for non-family firms that do not have tax reasons to restrict member exit”).

<sup>277</sup> See Moll, *supra* note 116, at 974 (“[E]ven if family-business tax concerns are viewed . . . as issues of paramount importance, the elimination of default exit rights in *all* of a particular business structure seems unnecessarily overbroad.”).

<sup>278</sup> Note that the argument in text assumes that tax benefits and avoidance of governance problems are goods of roughly equal value. If the tax benefits for lack of control and marketability provide less value to family owners than the commensurate harm suffered in oppression cases, then the efficiency argument regarding opt-out provisions might be outweighed by the impetus to mitigate shareholder oppression whenever possible. An analysis of the issue, however, would turn on empirical data regarding harm to minority investors, including the causal role of exit provisions, as well as normative assessments of the social value of tax deductions, or lack thereof.

<sup>279</sup> This may be a reasonable assumption because sophisticated tax planning requires expert advisers, and those advisers ought to be able to counsel family owners regarding available choices of business entity form. However, it also seems likely that some family businesses would be reluctant to make an election that segregates them from other businesses—a problem that has limited the usefulness of optional supplements to corporate codes designed to address the needs of close corporations. See, e.g., CAL. CORP. CODE § 158(a) (West 2012) (defining “close corporation” as “a corporation . . . whose articles

family and non-family businesses alike, family businesses are a significant percentage of all businesses.<sup>280</sup> Accordingly, while it is true that only a subset of businesses can take advantage of the tax benefit, that number is far from inconsequential.<sup>281</sup>

In any event, whether no-exit rules can or should be tailored to family businesses, the risk of abuse of control exists even in those family businesses that have the most to gain from favorable tax treatment. Thus, the selection of an appropriate statutory default rule regarding exit rights should be coupled with consideration of the judicial role: when asked to adjudicate a claim of oppression in a closely held business with no bargained-for exit rights, a court could conclude that capital lock-in default must have been important to the investors, or they would have bargained around it.<sup>282</sup>

However, in family businesses—at least those that fall outside the realm of the high-technology driven, entrepreneurial startup—an explanation based upon the supposed desirability of capital lock-in for business purposes is generally unpersuasive.<sup>283</sup> Rather, tax considerations supply the obvious reason for retaining the no-exit rule. While the existence of a tax-driven rationale does not mean that courts should provide, after the fact, a right that the parties chose to exclude, neither should courts reinforce the no-exit rule by inventing an implausible rationale for it. Instead, the absence of a statutory exit right should feature only as background that explains the majority's power; whether the majority has abused its power is a separate matter to be resolved according to a jurisdiction's shareholder-oppression law.

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contain . . . a provision that all of the corporation's issued shares . . . shall be held of record by not more than" thirty-five persons); DEL. CODE ANN. tit. 8, §§ 341–356 (2014) (offering "special provisions" in subchapter for qualifying close corporations that make the election).

<sup>280</sup> See DRAKE, *supra* note 1, at 274.

<sup>281</sup> The objection that "policymakers should resist allowing the needs of a subset of business owners to dictate important default rules that apply well beyond that subset," Moll, *supra* note 116, at 973, has less force if the subset is also a majority. Of course, not all family businesses have assets that merit sophisticated tax planning, and ascertaining the true percentage would be relevant to assessing the utility of imposing a no-exit default rule for all closely held businesses.

<sup>282</sup> See, e.g., Rock & Wachter, *supra* note 269, at 920 (discussing the needs of a high-tech startup company: "If participants can trigger dissolution at will, they will be unwilling, ex ante, to make investments in match for fear that, ex post, they will be held up.").

<sup>283</sup> However, if business owners anticipate a messy inheritance dispute, they may prefer a locked-in structure that avoids the dissipation of capital. For instance, I.M. Singer & Company incorporated in the late 1800s, not to raise capital or limit shareholder liability, but because it came to light that one of the two principals, Mr. Singer, had many children by several women. See Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387, 446 (2003) ("Singer's heirs, however many of them there might be, would all have some legal claim to some share of the business, and it would probably require years of court battles to establish who was to get what."). After incorporation, "[h]eirs could be given equity shares in the business out of Singer's estate without disturbing or breaking up the assets and governance structure of the business." *Id.*

## B. Oral and Implied Agreements

The nexus of contracts that defines a family business includes the parties' various written and unwritten contracts, connections, and understandings, all of which bear upon the parties' expectations. Accordingly, unless the parties have a written agreement that excludes collateral provisions and expressly requires that modifications be in writing, evidence of oral agreements and implicit understandings among family-business participants should be admissible. While an economically rational actor negotiating at arm's-length might insist upon reducing important terms to writing, the participants in a closely held business, especially one that is family-owned, are unlikely to pay scrupulous attention to niceties of documentation.

A jurisdictional split concerning the enforceability of oral LLC agreements highlights the importance of the issue. Notwithstanding the fact that participants often rely upon unwritten understandings, some jurisdictions require LLCs to have a written operating agreement.<sup>284</sup> For instance, New York provides that "the members of a limited liability company shall adopt a written operating agreement" and makes no provision for unwritten obligations.<sup>285</sup> In the absence of a written agreement, New York courts abandon the effort to understand the parties' actual bargain and resort instead to a statutory default operating agreement.<sup>286</sup>

Yet, the statutory default rules applicable to all LLCs describe a hypothetical bargain among generic investors and will miss many of the important features of family businesses. Not only will the default rules depart from the parties' intentions in significant respects, but a retreat to false simplicity may not even save judicial resources. If a jurisdiction's LLC law lacks the conceptual resources to address the parties' comprehensive bargain, the excluded elements might be raised in collateral proceedings or causes of action, such as when a spouse alleges an economic partnership that enfolds the assets of the business entity,<sup>287</sup> or a trust beneficiary alleges that the fiduciary obligations of trust administration supersede the discretion that a business

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<sup>284</sup> See, e.g., N.J. STAT. ANN. § 42:2B-27(b)(1) (2009); WIS. STAT. ANN. § 183.0102(16) (2014).

<sup>285</sup> N.Y. LIMITED LIABILITY COMPANY LAW § 417(a) (McKinney1996); see also Peter Mahler, *The Oral LLC Agreement: Boon or Bane?*, N.Y. BUS. DIVORCE (Feb. 3, 2014), <http://www.nybusinessdivorce.com/2014/02/articles/llcs/laurel-hill/>, archived at <http://perma.cc/DZJ5-2WT7> ("My own view, perhaps reflecting my New York home pride, favors the relative certainty provided by the judicially imposed, statutory operating agreement that comes into play when the parties fail to enter into a written agreement.").

<sup>286</sup> *In re Spires*, 778 N.Y.S.2d 259, 266 (N.Y. Sup. Ct. 2004) ("When there is no written Operating Agreement, these statutory default provisions become the terms, conditions, and requirements for the conduct of the members for the operation of the limited liability company.").

<sup>287</sup> See *Penley v. Penley*, 332 S.E.2d 51, 63–64 (N.C. 1985).

manager might otherwise have. Business statutes should, instead, facilitate coherent evaluation of the parties' mutual expectations.

In Delaware, and a majority of jurisdictions, the LLC operating agreement is more helpfully defined to include "any agreement . . . written, oral or implied, of the member or members as to the affairs of a limited liability company and the conduct of its business."<sup>288</sup> Even though this more permissive approach can generate litigation and uncertainty, the alternative would effectively exclude many family-business bargains, thereby violating the parties' own expectations.<sup>289</sup> In other words, predictability at the adjudication stage should not be achieved by undermining settled expectations crucial to the overall business relationship. Instead, courts can protect against abuse by requiring adequate evidence to establish the alleged terms of an oral or implied agreement.

### C. Equity's Role

In order to develop a coherent set of rules for family businesses, courts invoking the equitable dimension of family law should note a corresponding interest in business predictability. Without forcing all contracts into a single template, equitable considerations should be applied more even-handedly to reduce the chance for confusion or manipulation. For instance, if family courts reviewing marital agreements apply a high degree of scrutiny in order to achieve an equitable result, *ex post*,<sup>290</sup> that judicial scrutiny can produce unintended consequences within a family business involving overlapping obligations. The contracts in a nexus are contingent upon one another; constricting certain options may only change the overall shape of the nexus.<sup>291</sup>

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<sup>288</sup> DEL. CODE ANN. tit. 6, § 18-101(7) (2014). The work of the National Conference of Commissioners on Uniform State Laws, which captures the majority view, provides similarly that an operating agreement can be "oral, in a record, implied, or in any combination thereof . . ." REVISED UNIF. LTD. LIAB. CO. ACT, § 102(13), 6B U.L.A. 429 (2006).

<sup>289</sup> In general, then, "[t]he benefits of certainty must be balanced against the potential costs of frustrating the parties' intent by refusing to enforce oral agreements, particularly in informal firms." Larry E. Ribstein, *An Analysis of the Revised Uniform Limited Liability Company Act*, 3 VA. L. & BUS. REV. 35, 45 (2008). Of course, if one refuses to accommodate informality, it is possible to conclude that no expectation can be reasonable unless expressed in a form that meets minimum statutory requirements.

<sup>290</sup> See Katharine B. Silbaugh, *Marriage Contracts and the Family Economy*, 93 NW. U. L. REV. 65, 75 (1998) (stating that many jurisdictions use a strict unconscionability review to police the fairness of marital bargains).

<sup>291</sup> See Steven L. Winter, *Human Values in a Postmodern World*, 6 YALE J.L. & HUMAN. 233, 244 (1994) (noting original definition of contingent, from the Latin *contingentem*, means "touching together or on all sides") (citing III THE OXFORD ENGLISH DICTIONARY 825 (2d ed. 1989)). As one scholar observes, restrictions on premarital agreements could also affect the willingness of individuals to enter into marriages in the first place. See Brian Bix, *Bargaining in the Shadow of Love: The Enforcement of Premarital*

Accordingly, if a parent doubts that a child's marital agreement will be enforceable, the parent can exclude the child from any direct business ownership and rely on generation-skipping trusts rather than risk the dissipation of family-business assets in a divorce.<sup>292</sup>

Divergence in the scrutiny of family and business contracts may have an historical explanation. Until fairly recently, for instance, courts rejected the idea of marital agreements.<sup>293</sup> Even today, a prenuptial bargain in some jurisdictions will be subject to enhanced scrutiny, and a judge can set aside the bargain as coercive if the spouse in a superior bargaining position failed to disclose material information, took advantage of his (or, more rarely, her) position, or if enforcement of the bargain as written would produce a result beyond the parties' contemplation at the time it was entered.

By contrast, although shareholder bargains were also considered void at one time, corporate law now permits shareholders wide freedom to modify the rules to suit their interests. The same principle of contractual freedom applies generally to other types of business organization. As long as the terms are clear, a party to the bargain will be hard pressed to persuade a court to rewrite or disregard it. This remains true even if, viewed after the fact, the agreement leads to a one-sided outcome based upon events that could not easily have been anticipated at the time the agreement was signed.

The Uniform Premarital and Marital Agreement Act, adopted in some form in about half the states, splits the difference between these positions in a way that could be useful for family businesses.<sup>294</sup> The Act creates a presumption of enforceability and places the burden on the objecting party to show that the

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*Agreements and How We Think About Marriage*, 40 WM. & MARY L. REV. 145, 169–70 (1998).

<sup>292</sup> Nor is this a fanciful scenario. In a recent high-profile divorce case involving a Canadian family business, the court threw out a postnuptial agreement that was drafted by the founder for the signature of his daughter-in-law in order “to pass on his wealth through generations of his bloodline, not fragmented by marital breakups.” Joseph Brean, ‘Over-Reaching’ Marriage Contracts: McCain Divorce Case Shows Pitfalls of Keeping Fortune in the Family, NAT’L POST (Jan. 13, 2013, 9:17 PM), <http://news.nationalpost.com/2013/01/13/over-reaching-marriage-contracts-mccain-divorce-case-shows-pitfalls-of-keeping-fortune-in-the-family/>, archived at <http://perma.cc/3SCM-978U> (quoting affidavit of Michael McCain). In exchange for a payment of \$300,000 and a right to claim up to \$7 million and the marital home, the daughter-in-law gave up her right to treat the full value of her husband's interest in the family business as marital property. *Id.* Further, as both husband and wife acknowledged, the father agreed not to “structure his estate planning and trusts to ensure that the wealth would skip a generation from us to our children.” *Id.* Despite her prior waiver, the wife was entitled to support payments calculated to include the value of the husband's stake in the business. *Id.*

<sup>293</sup> UNIF. PREMARITAL & MARITAL AGREEMENTS ACT, prefatory note, 9C U.L.A. 12–14 (Supp. 2014) (“Forty years ago, state courts generally refused to enforce premarital agreements that altered the parties' right at divorce, on the basis that such agreements were attempts to alter the terms of a status (marriage) or because they had the effect of encouraging divorce . . .”).

<sup>294</sup> *Id.*



agreement was the product of duress, undue influence, or other bargaining defect.<sup>295</sup> However, the Act also provides a clear mechanism for raising such challenges and identifies important factors, including aspects of procedural due process.<sup>296</sup> Further, because a “significant minority of states authorizes some form of fairness review based on the parties’ circumstances at the time the agreement is to be enforced, [the uniform act] offers the option of” adding a “substantial hardship” provision.<sup>297</sup> Thus, the Act recognizes the importance of contract without ignoring the context of family relationships that may make arm’s-length bargaining more difficult.

The consistency that the Act aims to achieve across marital agreements could be extended to other kinds of agreements among family members—particularly, shareholder agreements and similar business arrangements.<sup>298</sup> In family businesses, many of the same concerns about power and information disparities apply to business dealings, and the bargains are often between the same individuals. Thus, it would be helpful for courts to operate from a common set of interpretive principles. All bargains should come with a presumption of enforceability. However, to the extent courts take into account gross unfairness in substantive terms, disparate bargaining positions, or other equitable considerations, the equitable analysis properly applies to business and family bargains alike.

## VI. CONCLUSION

In a family business, the competing claims of business law and family law can leave a residue of doubt, even when the parties have engaged in private ordering. If a dispute arises, courts must interpret and enforce the parties’ agreements concerning their business and family obligations. The task presupposes some common principles for aligning, or at least prioritizing the parties’ contractual choices. Absent clear interpretive guidance, court decisions may vary even in cases with similar facts. Judicial inconsistency interferes with rational business planning and invites arbitrage across doctrinal categories by sophisticated parties.<sup>299</sup>

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<sup>295</sup> *Id.* (“The general approach of this act is that parties should be free, within broad limits, to choose the financial terms of their marriage.”).

<sup>296</sup> *Id.* § 9(a) (stating that a “marital agreement is unenforceable if a party against whom enforcement is sought proves” duress, lack of access to independent legal counsel, or lack of “adequate financial disclosure”).

<sup>297</sup> *Id.* prefatory note.

<sup>298</sup> Further, the Act contemplates that “[w]hile most . . . marital agreements will be stand-alone documents, a fragment of a writing that deals primarily with other topics could also constitute a . . . marital agreement . . .” *Id.* § 2 cmt.; *cf. supra* note 129 (discussing segregation of shareholder and marital agreements in *Colclasure v. Colclasure*, 295 P.3d 1123 (Okla. 2012)).

<sup>299</sup> *See, e.g.*, Thomas J. Handler, Op-Ed., *A Stealthy Prenup Can Help Protect Assets*, N.Y. TIMES (Mar. 21, 2013) <http://www.nytimes.com/roomfordebate/2013/03/21/the-power-of-the-prenup/a-stealthy-prenup-can-help-protect-assets?emc=etal>, archived at

This Article argues that the dominant model of corporate law, according to which a firm is primarily a nexus of contracts, offers the basis for a coherent law of family business. The immediate benefit is to show how the parties' expectations reflect all aspects of their mutual relationships. Further, a contractual perspective helps to catalogue an array of questions one would ask in developing default rules tailored to the needs of typical family businesses. Put differently, the open texture of contract provokes repeat players—scholars, lawyers, judges, legislators, and business owners—to define the elements of a workable family-business law.<sup>300</sup>

Ultimately, the goal is to support the voluntary participation of family members in a shared venture by protecting their expectations. As is true of any closely held business, contracts in family businesses establish relationships rather than the terms of specific, bargained-for exchanges, and the parties cannot be expected to anticipate and adequately address all eventualities that may occur over time.<sup>301</sup> For family businesses, relational aspects are particularly significant: the time horizon stretches across generations, objectives often include more than simple profit maximization, and business dealings involve emotional consequences for the participants that also need to be acknowledged.<sup>302</sup>

Accordingly, family-business law should offer a resource—a set of principles that credit the parties' negotiated bargain in full context that also compensate for what family members cannot anticipate or adequately address regarding their business venture. By drawing upon a rich inventory of experience, courts and legislatures can use the contractual conception of the firm to establish the foundation for a law of family business.

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<http://perma.cc/8LAV-TSNW> (opining that, in light of the uncertainty as to whether a court will enforce a prenuptial agreement, wealthy individuals can achieve the same asset protection through a combination of business entity forms). Mr. Handler, who is a lawyer, created an alternative that he describes as follows: "It's a carefully organized combination of three legal entities: a management company (L.L.C., S Corp. or C Corp.); a family limited liability company (F.L.L.C.); and an international asset protection trust. Each entity has distinct characteristics and benefits, and each is organized in a different jurisdiction." *Id.* For similar, if less cynical advice describing utility of multi-entity forms to shield family assets, see DRAKE, *supra* note 1, at 40.

<sup>300</sup> Hanoch Dagan & Michael Heller, *Freedom of Contracts* 19 (Tel Aviv Univ. Law Faculty Papers, Working Paper No. 176), available at [law.bepress.com/taulwps/art176](http://law.bepress.com/taulwps/art176) ("[C]ontract law is not 'merely passive'—it can influence the social practices it supports, reinforce and extend such practices, and make them more reliable . . .").

<sup>301</sup> See Robert B. Thompson, *The Law's Limits on Contracts in a Corporation*, 15 J. CORP. L. 377, 394 (1990). For further discussion of relational contracts in closely held businesses, see Means, *A Contractual Approach*, *supra* note 67, at 1195–1203.

<sup>302</sup> Judicial monitoring remains important as a backstop to prevent opportunism and oppression when relationships falter and one party is in a position to exercise its power over another. See Thompson, *supra* note 301, at 394 ("A fully contingent contract cannot be drafted, so some *ex post* settling up by courts is used to support these [unstated] assumptions.").

