Bracketed Flexibility: Standards of Performance Level the Playing Field

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I. Introduction

Standards of performance such as good faith and fiduciary duty make bargaining possible. Because standards of performance level the playing field, they enable the more vulnerable party to express its preferences and thus to bargain. The standards have this effect because they are both flexible and precise.

Unfortunately, the standards of performance are under siege in the United States and in Europe. While some of the strongest criticism of the standards concerns their vagueness, their flexibility allows parties to negotiate meaningfully and thus to express their preferences. Consequently, far from being sources of distortion, the standards give a voice to those who otherwise would not be heard. To use a political analogy, the standards enable, in the commercial realm, the democratic voice championed by Amartya Sen. [FN1] This is an affirmative reason to have standards of performance.

*1002 Although there is general agreement that the standards are flexible, the claim that they are precise is counterintuitive. While there is general acceptance of a floor--that is, of a minimum standard--the common complaint about the standards' vagueness presupposes the lack of a clear ceiling. In fact, actual behavior supported by law reveals that the standards of performance have an identifiable floor and a self-executing ceiling. By confirming the existence of a floor and a ceiling, I show that the standards are precise within a prescribed range; indeed, further specification would merely destroy the flexibility.

The flexibility of the standards provides the subtlety; their precision provides the predictability. Despite the current challenge to the standards, United States law still supports them, and because the standards' flexibility and precision make bargaining possible, business law should continue that support.
II. Standards of Performance Are Flexible and Designed to Level the Playing Field

Standards of performance are flexible and designed to level the playing field. They play a larger, more important role than merely to reduce agency costs, the role often used to justify good faith or fiduciary duty. [FN2] Standards of performance often make the bargain possible.

A. Leveling the Playing Field

Starting with an analogy to pollution, assume a downstream landowner who values clean water more than the upstream polluter values the right to pollute. Assume further that the downstream owner does not have the money to pay the upstream polluter to clean its effluents. In this context, the downstream owner is powerless. Regulation can level the playing field so that the downstream owner—before regulation, the weaker party—has the power to negotiate meaningfully. The downstream owner then can obtain the clean water that this owner values more than the polluter values the permission to pollute. [FN3] Standards of performance similarly operate to level the playing field in the context of contracts and of business organizations. They do so by correcting for unequal power and for conflicts of interest.

In order for the standards to level the field effectively, the greater the conflict and inequity of power, the higher must be the applicable standard. The four examples below, two from contract law and two from unincorporated business entity law, reflect this direct relationship between the standards of performance on the one hand, and power and conflict on the other. [FN4]

*1003 Before beginning our discussion of contract law, note that contract law is relevant to unincorporated businesses in part because contracts play a significant role in the formation of organizations, and in part because of decades of "nexus of contract" analogies. [FN5] In an arm's length transaction governed by contract law—that is, on a level playing field—each party is assumed capable of self-defense. In that context, any behavior to a standard higher than opportunism conforms to contract law good faith and is appropriate. [FN6] This result makes sense because neither party can overpower the other, even though their interests can conflict. The relative power equilibrium keeps abuse to a minimum.

In effect, the level of good faith in an arm's length transaction is another way of describing conformity with the parties' expectations. At least in the United States, this means an objective perspective with a touch of the subjective: What would a reasonable person in the parties' position expect?

Higher on the graph, the standard of performance reflects the obligations of a contracting party with significant control, for example, a party whose performance is the sole basis for calculating another party's return. Consider the percentage lessee, whose rent obligation depends on the lessee's own sales. Not only does the lessee have commercial power over the lessor because the lessor's return depends on the lessee's performance, but the lessee's interest clearly is in conflict with that of the lessor: If the lessee can maintain profits while pushing sales down, the lessee pays less rent and further increases profits. In the United States, that person will be held to a "best efforts" standard, both because the landlord is at the mercy of the tenant, and because the tenant has an inherent conflict. [FN7]

Moving up the graph yet further, we find, for example, the non-managing partner in a general partnership. The other partners would expect some minimum level of honesty and concern for the firm's well-being, but we also know that each partner invests in a firm in order to make profits. Thus, while a partner traditionally has a fiduciary duty of loyalty to the fellow partners, the partner expects (that word again) profits. [FN8] Inherent in the ordinary partnership relation is some degree of self-interest.

There is at the very least a potential conflict for a partner who does not have a role in management, but does have an acknowledged self-interest in acquiring profit. The risk *1004 could, for example, become manifest in an situation similar to theft of corporate opportunity: A partner, not involved in management, but still understood to be part of the firm, is informed of an opportunity because of that relationship. The partner, possessing the information, has the power to be a disloyal agent of the partnership and to steal the opportunity instead of taking only the aliquot share through the partnership. Such a disloyal agent breaches the fiduciary duty applicable to partners, a performance standard higher than best efforts. [FN9]

Further up the graph we find the partnership's managing partner in whom the fellow partners are
placing their faith. In the classic partnership, not only do the other partners depend on the managing partner's performance in order to maximize the value of their investment in the partnership, but they also rely on that managing partner to avoid activities that would create personal liability for all owners. [FN10] Thus, the managing partner clearly has power; specifically, the power to determine the future of the firm as a whole. The managing partner in this way has the power to choose for the firm a transaction in which the managing partner already has a personal interest. This is in addition to the conflict of interest inherent in the managing partner's desire to make a profit through the partnership. In the United States, the managing partner is held to a standard even higher than best efforts, but without denying the managing partner's legitimate desire for a share of partnership profits. [FN11] The highest level on the graph for a business organization still is lower than the standard applied to a trustee because the trustee, not the beneficiary, has total control over the corpus, and the trustee's conflict is inherent in that power. The trustee can, as a factual matter, do anything with the corpus, often without the beneficiary being aware and, therefore, is expected to behave selflessly. Indeed, the trustee, contrary to even a managing partner, is expected to take actions detrimental to the trustee if the actions benefit the corpus for the beneficiary. [FN12] This schematic description is doctrinally accurate whether the standard technically is good faith, fiduciary duty, or something else entirely—as is the case in some jurisdictions other than the United States when, for example, they focus on avoiding duress. [FN13] Thus, efforts to reduce the duty in the United States by speaking about good faith instead of fiduciary duty may have no practical effect; all that matters is relative power and conflict. [FN14] Titles are less important than reality. Thus, if there is a titular managing partner, but another partner has all the facts regarding a particular transaction, functionally the latter partner's duty rises. By taking into account the transactor's power and conflict, the person owing lower standards in most contexts can actually owe a higher standard in other contexts. This nuanced approach prevents the standards from providing so much protection to the usually vulnerable party that this party acquires excessive power in the particular circumstance. Thus, the standards level the playing field, but they do not overcorrect and tilt the field in favor of the formerly weak. This flexible standard of performance serves to level the playing field. The standard puts the parties in a position that allows them to bargain meaningfully. It is as though the downstream landowner, by regulation, were awarded the right to be free from pollution. Because the landowner then has an asset (the right) to sell, there is a basis from which the landowner can bargain with the polluter. In this same way, because the flexible standard grants the non-managing partner the right to have the managing partner not abuse its power despite the latter's conflict, the managing partner must engage the other partners. For example, if the managing partner requests permission to compete with the partnership in a particular transaction, the other partners know that they have no obligation to accede to the request, and that the managing partner is under a duty to disclose all information relevant to the negotiation. In this way, the flexible standard allows the parties to form, in accordance with their true preferences, a contract or even a business organization.

B. Limited Liability in the Mix
Limited liability, when combined with a reduction of standards of performance, substantially eliminates accountability. The practical consequences are significant because the expansion of limited liability is one of the major changes suggested for unincorporated businesses. Over the past ten years, partnerships in the United States have acquired the option of limited liability, [FN15] and various new limited-liability forms have evolved. [FN16] Thus, limited liability is an inevitable backdrop against which to consider standards of performance; in turn, as seen above, standards of performance make bargaining possible. [FN17] This expansion of limited liability has not only taken the United States by storm, but is also gaining credibility in the United Kingdom, as evidenced by the Limited Liability Partnership statute adopted in 2000. [FN18] What is the impact of this burgeoning limited liability on standards of performance? The limited liability of all owners in unincorporated businesses should not perceptibly affect the level of the standards of performance applicable to those owners. This is counterintuitive: Limited liability appears principally to reduce the risk of being a partner, [FN19] and thus to reduce the
damage that a managing partner can inflict on fellow partners. To this extent, it apparently diminishes the managing partner's power, although not necessarily the conflict of interest. Since it appears to reduce power, limitation of liability seems consistent with reduction of the standard of performance owed by a managing partner to fellow partners.

Consider an analogy to corporations formed in the United States and, to a lesser degree, in the United Kingdom. [FN20] Although this Article discusses only the responsibility of managers who are owners, consider specifically the director of a corporation. In very broad outline, whether or not the director is also a shareholder, the business judgment rule protects that director from liability, absent gross negligence or some form of disloyal behavior. In other words, the United States business form that for the past century has provided owners with limited liability also gives the managers wide latitude.

Nevertheless, the better result--at least for firms that are not publicly held--is to hold an owner-manager to the same high standard of performance whether or not the business limits the liability of owners. [FN21] We already recognize that a person who is both a manager and an owner should be held to a higher--not lower--standard than a non-manager owner because of the manager's extra power. Although the fact that all owners are protected by the limited liability provisions does appear to reduce the owner-manager's potential impact, consider the effect on that owner-manager directly. An owner that manages one of the new limited-liability business forms still has the full *1008 management authority of a managing partner. Due to the limitation on liability, however, the owner-manager is far less accountable than is the traditional managing partner. First, the owner-manager becomes unaccountable to third parties, beyond any initial investment in the firm. Second, unless subject to a sufficiently high standard of performance, the owner-manager will be unaccountable to fellow-owners as well. With respect to this balance of power, the owner-manager's unaccountability offsets the manager's decreased impact on co-owners who benefit from limited liability.

On the other hand, the standard imposed on the owner-manager should be higher than that applicable to a director who is not a shareholder, because of the inherent conflict in being both an owner and a manager. It makes sense that the schema requires increased responsibility when the manager is also an owner, even in a limited liability entity. Frequently, more passive investors do demand that managers become owners in order to align the managers' interests with those of the non-manager owners. Nevertheless, a higher standard of performance remains appropriate because the combination of management power and ownership still creates a conflict. In any event, aligning the managers' interests with the investors' interests merely increases the probability that the managers act as the non-manager owners would have done. It does not eliminate all situations where the managers have access to an opportunity that, because of their power, they can appropriate. In such a case, these managers can do serious damage even if the other owners are not subject to personal liability.

Doctrinally, standards of performance are flexible, and their flexibility levels the playing field. The standards are effective because their flexibility depends on the transactor's power and conflict. That flexibility even takes into account the owners' limited liability in the modern forms of business organization. On the other hand, the principal threat to the standards' effectiveness is that the salutary flexibility eases into vagueness. As discussed in the following section, these flexible standards do remain effective because they are bracketed by boundaries that protect their precision.

III. The Standards of Performance Are Precise and Predictable
To ascertain how precise the standards are, consider both the floor and the ceiling.

A. The Floor
The principal criticism of standards of performance has focused on the distortions that result when parties are forbidden from entering into a transaction that they both agreed to freely. In other words, if at least one of the parties is prevented from behaving to a standard as low as that to which the parties agreed, this, according to the neoclassical economists, entails a waste of resources. [FN22] As the previous discussion of the downstream landowner illustrates, however, the argument fails if the parties were in fact unable to bargain freely, because the resulting agreement does not reflect preferences. The weaker party would have lost the shelter of the
standards through the appearance of agreement, but without having truly bargained. Indeed, the
standards will not be able to level the *1009 playing field unless they can force the parties to
conform to a higher standard than that to which they appear to have agreed.
On the other hand, the standards' commendable flexibility may trigger an unintended
consequence. Instead of leveling the field, the standards may well tilt it if their contours are so
vague as to be unknowable. In this case, prudent parties may be driven by the standards' imprecision to adopt a standard higher than whatever is mandated. This concern about
excessively high performance touches on the rule-versus-standard debate articulated brilliantly
by Duncan Kennedy twenty-five years ago. [FN23] It also touches on the distinction between
risk, which is measurable, and uncertainty, which is not. [FN24] In a way, we are again talking about a by-product of the standards' flexibility, but I will show that the by-product is risk and thus is calculable within a range.
Note that the concept of the floor itself is not in controversy; even the fiercest critics of standards of performance accept some type of floor. Bad faith and opportunism, for example, are
universally condemned because they produce inefficient results. [FN25] Further, this floor is
supported by parties' behavior even without legal intervention. At least where the reputational
effects are sufficient, business people do act according to a standard even higher than required
by law. [FN26] The actual floor therefore is a behavioral norm, [FN27] reenforced by the law's
articulation of the flexible good faith and fiduciary standards.
Given that there is a floor defined by behavior, it is sensible to use statutory and judicial
pronouncements to support the floor. The potential abuse that falls through the floor is an abuse
of power, and a powerful transactor who has a conflict of interest may not be restrained by purely
extralegal means. The good faith and fiduciary standards discussed above provide a flexible
support; the problem is what happens above the floor.

B. The Ceiling
To assert there is a ceiling above this floor is more controversial. Together with the floor, the
ceiling allows the flexible standards of performance to escape vagueness. Not only are the
standards defined and limited by power and conflict, and not only are they limited by a floor, but
the ceiling, too, increases predictability. The flexibility of the *1010 minimum performance
requirement may be frustrating, of course, but the frustration is attenuated if the transactor
knows the maximum required performance. Those who reject standards of performance most
strenuously, asserting that they create distortions, are in fact concerned about a lack of ceiling.
[FN28] What is the highest level of performance that the law demands in a particular
circumstance? Put differently, where is the safe harbor?
If the opponents of standards believe that the sky is the limit, that there is no meaningful ceiling,
they are reasonable when they fear an inefficient result. They are reasonable when they fear
that, despite the standards' nuanced flexibility, the standards may ultimately tilt the field in favor
of the formerly vulnerable party. However, classic doctrine confirms that there is a ceiling, and
one that protects both parties while merely leveling the field. For example, while a partner
traditionally has an obligation to the co-partners, the partner is nevertheless expected to seek
profits and, unlike a trustee, does not have to sacrifice for other partners. [FN29] This provides a
safe harbor. The ceiling is further described by two games taken from a study by behavioral
economists Gary Charness and Matthew Rabin. [FN30]

1. Behavior Describes an Observable Ceiling
In general terms, each game consists of two parts. First, one player in a group has a choice to
take a prize or to enter the game. For ease of discussion, I will call each of the first players
"Albert," although the study does not discuss gender. If an Albert chooses to enter the game, he
does so by giving the other player, whom I will call "Barbara," a pre-ordained choice.
In the first game (Game One), Albert can take the entire prize, at which point Barbara receives
nothing. Astonishingly, seventeen percent of the Alberts act to all appearances hyper-generously
and forgo the sure prize. The next surprise is that almost two-thirds of the Barbaras respond to
their Albert's generosity in a self-regarding, Pareto sub-optimal way. [FN31]
*1011 The Barbaras' grasping response to the Alberts' hyper-generosity is consistent with the
traditional game theoretic perspective on the prisoners' dilemma where, in the absence of an
infinite time-horizon, initial cooperation may well trigger defection. [FN32] Clearly, this game does not reflect reciprocity since almost two-thirds of the Barbaras repaid their Albert's generosity by the meanest kind of greed. [FN33] However, the other game (Game Two) does suggest that the impetus behind the Barbaras' grasping behavior in Game One is something more than a mere failure to cooperate. The result in Game Two cannot be explained by simply asserting that people in the second half of any game tend to be grasping because Game Two's outcome is very different.

In Game Two, [FN34] Albert's original choice is either to give Barbara the entire prize and keep nothing, or to enter the game. The rational decision for Albert is to enter the game: if he does not enter, he is sure to receive nothing, but if he does enter, Barbara cannot put him in a worse position than receiving nothing, and she could decide to let him share in the prize. Thus, it is unsurprising that all the Alberts decide to enter the game. [FN35] What is surprising is the Barbaras' response in Game Two: when confronted with an Albert who acts rationally but not particularly generously, more than half the Barbaras respond in the most generous way by giving up the right to receive the entire prize in order to share it with this rational Albert. In summary, in Game One, when an Albert has acted hyper-generously and forgoes a sure prize, almost two-thirds of the Barbaras respond in a self-regarding, Pareto sub-optimal way. In Game Two, when an Albert has acted rationally but not particularly generously, over half of the Barbaras respond very generously. Thus, the Barbaras' grasping response to the Alberts' hyper-generosity in Game One cannot be explained by arguing that people in the second half of any game will tend to be grasping; clearly that did not happen in Game Two.

*1012 The authors of the study express puzzlement at the result of Game Two, [FN36] but I offer the following explanation that reconciles the seeming inconsistencies between Games One and Two. In many cases, the irrational negotiator succeeds beyond normal expectations because the inherent unpredictability of irrational positions renders that negotiator a particularly formidable and dangerous opponent. [FN37] The Barbaras in Game One are confronted with an irrational (albeit hyper-generous) Albert whose irrational behavior makes him dangerous. Why is he hyper-generous? What will he do next? A majority of the Barbaras respond in a self-protective way. In contrast, the Barbaras in Game Two are confronted with an Albert who is neither particularly generous nor ungenerous, but who is rational and, therefore, predictable. In that context, the Barbaras are less self-regarding.

These games help us think about predictability. They help us analyze the difference between uncertainty, which is unmeasurable, and risk, which is measurable and thus quantifiable. Irrational Albert of Game One represents uncertainty even though he is acting generously; a majority of the Barbaras punish him. Earlier, I noted that the Barbaras, faced with an irrational negotiator, would ask themselves why seventeen percent of the Alberts choose to be hyper-generous; precisely because of this uncertainty, there is no answer to that question. In contrast, Albert in Game Two represents risk, which is predictable and thus quantifiable, and a majority of the Barbaras reward him by sharing the prize.

In short, Albert's hyper-generous behavior in Game One is higher than any applicable standard of performance, and he has pierced the ceiling. The Barbaras provide the extralegal constraint: If Albert behaves too well he will be punished rather than rewarded because parties seek certainty. Therefore, the standard of performance is self-limiting because, if Albert behaves too well, Barbara's reaction eliminates his incentive to over-perform again. This ceiling simultaneously provides other Alberts with a safe harbor because an Albert who behaves as selflessly as the hyper-generous seventeen percent who entered Game One can be confident that, far from violating a duty to Barbara, he has exceeded every obligation.

To summarize, a majority of Barbaras punish an Albert's irrationally generous behavior; they reward an Albert's rational, predictable behavior. Albert in Game One engages in behavior that is too generous, and almost two-thirds of the Barbaras effect a Pareto sub-optimal split that deprives society of value. Importantly, these Barbaras punish each Albert by leaving him with the least possible amount, and thus deprive *1013 Albert of far more than the Barbaras' individual gain. [FN38] The Barbaras' behavior has defined the Alberts' ceiling.

2. The Ceiling, Applied
The challenge is to ascertain how, as a practical matter, the ceiling manifests itself and, together with the floor, describes a standard of performance sufficiently precise to satisfy practical expectations. In short: how do Game One and Albert's hyper-generosity manifest themselves in the context of contracts and unincorporated businesses? [FN39]

In the context of arm's-length contracts without special circumstances such as percentage leases, the floor is the familiar absence of opportunism and absence of bad faith, to use two formulations. Moving to the top of the standard of performance: the ceiling is behavior so aberrant that, to use the objective perspective, a reasonable person in Barbara's position would wonder whether Albert is dangerous. Barbara has no legal basis on which to sue Albert for Albert's generosity, of course, since Albert's hyper-generous behavior certainly is not illegal. Instead, it is the relationship itself that will control Albert, because his generosity is not reciprocated. Thus, there is a socially constructed, extralegal constraint on excessively generous behavior.

Essentially the same result occurs if, for example, Albert is a partner. If Albert as a partner behaves with unexpected selflessness, that behavior will be contained because the other partners will view it as dangerous and will not reciprocate. We know that a partner traditionally has a duty to benefit the firm, subject to the partner's expectation of profits from the partnership. Imagine a partnership in which Albert has a valuable asset that he is considering contributing to the firm. He also believes that his partner, Barbara, tends to shirk. Thus, he believes that any increase in value of the partnership will in unprovable ways disproportionately benefit Barbara, even if his ownership share increases to reflect his contribution. Barbara's shirking, if proved, would be a violation of her duty to the partnership, and Albert is under no duty to contribute a new asset. What should Albert do?

The doctrine-based recommendation to Albert would in all likelihood be that he should retain the asset. Based on the analysis outlined in this Article, the result would be the same. However, if he were in a group like the seventeen percent of hyper-generous Alberts in Game One, he would contribute the asset to the partnership in the hope that Barbara would work harder and that both partners could benefit proportionately through the firm. In response, most of the Barbaras would continue to shirk subtly and would derive a disproportionate benefit from the new asset. While Albert has not violated a duty by contributing the asset, his generosity will not be rewarded or otherwise supported, except in the unlikely event that his Barbara's shirking is proved. Thus, unexpectedly *1014 generous behavior is self-limiting. This is how we know that there is a ceiling, and that the ceiling is defined and enforced by extralegal means.

The definition of the ceiling as well as the floor thus is socially constructed; the corollary is that it can be socially destroyed. That definition will be less vulnerable if law encourages it. Thus, it is important to know the extent to which law supports this extralegal ceiling created by behavior. We already know that there exists a minimum commercial behavior [FN40] and that the law supports the standard of performance's floor by focusing on potentially abusive behavior. The law tells the party to the contract not to be opportunistic, and it tells the inevitably conflicted partner of the partnership not to abuse the position of power. In contrast, the law does not directly address the ceiling: it does not tell the party to the contract or the partner (Albert in our examples) not to be too generous. However, it does tell Barbara, once she acquires the choice and thus the power and conflict, not to be abusive, as abuse is defined within the relevant context. She has to take into account how able Albert is to bargain freely, including how diversified Albert is, for example. [FN41]

If Barbara's response falls through the floor of the standard of performance the law offers Albert protection against abuse. If Game One's Albert gives up the prize because, for example, Barbara fraudulently misrepresented facts, Barbara's behavior is abusive. Not only is Albert's behavior not censured, but he will be protected, at least indirectly, because Barbara's behavior will be punished. On the other hand, if a compos mentis but hugely generous Albert turns over the full prize to Barbara, Albert has pushed through the ceiling of required behavior and will not normally be protected.

Assume, for example, that Albert is a partner and the partnership agreement requires the first distributions of partnership assets to be those stipulated in Game One. Under these circumstances, Albert should be able to keep the full prize; that was the behavior of eighty-three percent of the Alberts. [FN42] However, when seventeen percent of Alberts hyper-generously
enter the game, and Barbara has a choice, she becomes the person with power, acting pursuant to a contract that was entered into properly. Under these facts, when she seizes that choice, Barbara has some potential for liability, depending on the reason why those seventeen percent of Alberts behaved hyper-generously. She is especially at risk if there is a significant question about Albert's competence. Here, the flexibility of the standard applies to Barbara, because Barbara owes a duty to Albert. On the other hand, if Barbara has no liability, she keeps the prize because Albert was hyper-generous, and the law supports the extralegal ceiling on Albert's behavior. If Barbara does have liability, Albert was in all probability more gullible than hyper-generous.

We can see what has happened: the players describe the maximum standard of performance that, like the floor, varies by context, including the transactor's power. The law, by contrast, does not directly determine what behavior is the maximum demanded of a transactor. Instead, the law stipulates when the other party's response is abusive. If, for example, Albert's behavior is generous beyond what is required by law, Game One reveals that this behavior may encourage Barbara to grab the maximum benefit even at Albert's expense. The fact that Barbara reacts in a brutally selfish manner without liability is an indication within the context provided by law that Albert exceeded the maximum required standard. Thus the law does indirectly confirm that Albert exceeded the maximum standard of behavior, and it thus does support extralegal constraints on hyper-generosity, such as those reflected in Game One. In this way, the law supports the extralegal efforts to rein in uncertainty.

IV. Standards of Performance Must Be Mandatory, or They Unravel

Understanding that the standards of performance are flexible and precise, should standards of performance be mandatory, or should these standards instead be waivable? In the United States there has been a significant push, partly by statute and partly by judicial decision, to conclude that even default standards are waivable. This is an unfortunate development. The problem with waivers is that it is precisely when a party is asked to waive protection that the party may be unable to bargain freely. It is deeply ironic that courts are invited to apply the lowest contract-law standard of performance when reviewing a waiver of the highest standard applied to operations. Instead, if the parties purport to agree that neither shall owe heightened duties to the other, that agreement at minimum should be subject to scrutiny on the same level as the duties to be waived. Otherwise, the standard unravels to the lowest applicable level. For example, assume that all partners execute a partnership agreement that allows each to compete freely with the partnership. Even though the agreement itself is a contract, remember that partnership formation, of which the contract is merely an element, is consensual rather than contractual. The agreement thus should be scrutinized as of the time of formation, even though doctrine otherwise rarely admits that even good faith applies to contract formation. The relevant questions are: At the time when the agreement was entered into, were all parties in a position to negotiate freely? And what were the parties' reasonable expectations concerning how a particular provision would be interpreted?

Furthermore, it is important to scrutinize the standards closely, taking into account the context, because the standards are bigger than any one aspect of contract or unincorporated business law. The underlying, interrelated concepts are that behavioral norms provide us a practical definition of Albert's floor and ceiling, within which the standards' flexibility works its corrective effects. These concepts specify, for example, that the ceiling is located where Albert's action creates uncertainty, and that this extralegal ceiling on Albert's behavior is supported by the standard of performance the law imposes on Barbara. Unless destroyed by statute, the concepts apply to all relationships within the business organization, not only to operations (already a huge arena). For instance, the concepts apply even to dissolution. Dissolution is a means of exit, and the question of whether a party should be able to exit under specific circumstances is essentially a question of who is behaving abusively--the person seeking the exit, or the person seeking to retain control of the business?

The standards have a broad impact on business relationships and permeate our commercial lives. As we learn how norms are formed and supported, we have to consider that we permit unbargained-for abuse when we start from the assumption that all parties are already on a level playing field and that the markets therefore are the proper arbiters of all disputes. Since norms are central to this analysis, we must remember that there is also a feedback effect on society at
large. Thus, the norms we embrace in our commercial lives affect those of the greater society. [FN47]

*1017 V. Conclusion

If the law speaks only in terms of bargains and markets, and assumes, contrafactually, a level playing field, it may well limit effective bargaining. The standards of performance are designed to rectify a pre-existing inequality and to correct the playing field’s tilt. They do so by introducing the flexible standard that rises in direct proportion to the transactor’s power and conflict of interest. These standards are predictable as well as nuanced. They are subject to both a floor and a ceiling: a floor defined by commercial realities which the law supports directly, and a ceiling (within a range defined by commercial behavior) which the law supports indirectly. Our efforts in the United States to reduce or even eliminate heightened standards of performance are wrong-headed and should be rejected. Certainly, they should not be exported. Standards of performance that are flexible, but cabined, make efficient bargains possible.

[FNa1]. Professor of Law and Arthur L. Dickson Scholar, Rutgers University Law School, Newark; A.B. 1971, Wellesley College; J.D. 1974, Columbia University; LL.M. in Taxation 1981, New York University. This piece is based on a presentation delivered May 18, 2001 at the conference on the Close Corporation and Partnership Law Reform in Europe and the United States, organized by the Center for Company Law of Tilburg University, The Netherlands. My thanks to the Center, the faculty of law of Tilburg University, the conference participants, and to the conference sponsors, Linklaters & Alliance and the Anton Philips Fund. Thanks, also, to research assistant Daniel A. Birnhak, Rutgers Law School, 2003.

[FN1]. Amartya Sen, Development As Freedom 16, 43 (1999) (asserting that no famine has ever been recorded in a "functioning democracy," and comparing the existence of famines in China's recent history with the absence of famines in India since independence.


are above the level of opportunism. See infra note 25.


[FN13]. See, e.g., Good Faith in European Contract Law 19, 39, 45 (Reinhard Zimmermann & Simon Whittaker eds., 2000) (discussing Germany's use of doctrines such as exceptio doli generalis to bolster the impact of treu und glauben; the United Kingdom does not recognize a general duty of good faith, but lawyers have long used interpretation to achieve a similar result).

[FN14]. See Dickerson, supra note 4, at 979-91 (discussing the role of good faith and fiduciary duty on a single continuum).


RUPA provides for limited liability by amending, inter alia, section 101(5) to add the definition of the limited liability partnership, section 306(c) to limit liability, and 1001 to provide for election of limited liability partnership status. States that have not yet adopted the upgrade from UPA to RUPA, but nevertheless wish to authorize the limited liability partnership form, have most importantly amended the liability provisions, in particular UPA § 15. See, e.g., N.Y. P’ship Law § 26 (McKinney 2001) (where section 26(a) is identical to section 15 of the UPA, and sections 26(b)-(d) of the New York Partnership Law provide for the registered limited liability partnership and the extent of any remaining liability).

[FN16] Other forms different from the classic general or limited partnership, and different from the corporation, have evolved recently. For example, there is now the limited liability company (LLC). See, e.g., Unif. Ltd. Liab. Co. Act (1995) (amended 1996); Del. Code Ann. tit. 6, § 18 (2000); see also Larry E. Ribstein, Changing Statutory Forms, 1 J. Small & Emerging Bus. L. 11, 20 (1997) (stating that the first LLC statute was adopted in 1977, but that the form took off after 1988 when the U.S. Internal Revenue Service facilitated the form's classification as a partnership for federal tax purposes); Allan W. Vestal, Special Ethical and Fiduciary Challenges for Law Firms Under the New and Revised Unincorporated Business Forms, 39 S. Tex. L. Rev. 445, 450 (1998) (noting that every state now has an LLC statute, and that the ABA has approved the NCCUSL’s Uniform Limited Liability Company Act).

Since 1993, a few states have adopted the concept of the limited liability limited partnership (LLLP). Texas and Delaware had an LLLP statute version by 1993. Robert R. Keatinge et al., Limited Liability Companies, Q-229, ALI-ABA 1, 132 n. 541 (1994). Tex. Rev. Civ. Stat. Ann. art. 6132a-2.14 (Vernon 2001); Del. Code Ann. tit. 6, § 17-214 (2000). In each case, the state's limited partnership statute was amended to allow a limited partnership to register as a limited liability partnership under the state's general partnership statute, thus sheltering even the general partner from personal liability. For a list of states that have adopted an LLLP statute, see J. William Callison, Partnership Law and Practice: General and Limited Partnerships § 30A.05, at 30A-10 (1992). NCCUSL is currently drafting a uniform statute further revising the Revised Uniform Limited Partnership Act, generally referred to as "Re-RULPA." See Revision of Unif. Ltd. Partnership Act (1976) with 1985 Amendments (March, 2000 draft). As the Re-RULPA draft stands today, a limited partnership will be deemed to be an LLLP unless the founders decide otherwise.

[FN17] See supra Part II.A.


[FN19] But see Henry Hansmann & Reinier Kraakman, The Essential Role of Organizational Law, 110 Yale L.J. 387 (2000) (stating that the real purpose is to protect the business from the owners' debts).

[FN20] Directors in U.K. corporations are held to a different standard than are those of U.S. corporations (although the details applicable to U.S. corporations necessarily vary by state). See, e.g., Deborah A. DeMott, The Figure in the Landscape: A Comparative Sketch of Directors' Self-Interested Transactions, 62 Law & Contemp. Probs. 243, 245-46, 267-68 (1999) (explaining that, in the U.K., normally shareholders, rather than disinterested directors, are privileged to cleanse a transaction); id. at 260-62 (stating that disinterested directors of U.K. corporations must receive full, formal notification of a corporate opportunity, and must reject it, before the interested
Arguably, publicly held businesses are different, because they tend to reflect a clearer separation of ownership from management, which creates a different problem of agency cost. The separation is attenuated with respect to a shareholder (even a shareholder of a publicly held corporation) who also is a manager. Nevertheless, the corporation cannot as a practical matter be publicly held unless there is significant separation, meaning that the manager-shareholder will tend not to have as much control as the owner-manager of a closely held business. Further, the manager-shareholder of a corporation is more likely than the owner-manager of a closely held business to have diversified financial interests. Easterbrook & Fischel, supra note 5, at 1441. There are, of course, a few manager-shareholders of publicly held corporations who resemble owner-managers of private firms, for example, Viacom's Sumner M. Redstone. See Paramount Communications Inc. v. QVC Network Inc., 637 A.2d 34, 38 (Del. 1994) (describing Redstone as the controlling shareholder of publicly-held Viacom).

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There already is evidence that at least some courts are applying the business judgment rule to managers of limited liability companies. See Froelich v. Erickson, 96 F. Supp. 2d 507, 520 (D. Md. 2000) (applying the business judgment rule to "directors" of an LLC, when the Operating Agreement incorporates by reference fiduciary duties under applicable corporate law). In any event, because of the defendant's conflict of interest, it would have been an inappropriate case to apply the business judgment rule even if the entity were a corporation. See Charles W. Murdock, Limited Liability Companies in the Decade of the 1990s: Legislative and Case Law Developments and Their Implications for the Future, 56 Bus. Law. 499, 538-39 (2001) (emphasizing that the business judgment rule is not applicable in corporate law when there is a conflict of interest, and thus should not protect an LLC's management in the event of such a conflict).

[FN21]. Richard A. Posner, Economic Analysis of Law § 4.1, at 104 (5th ed. 1998) (asserting that even the best efforts standard in exclusive-dealing contracts is defensible only as a default provision which the parties can change by contract).


[FN24]. Even the neoclassical law and economics scholars agree that opportunism is indefensible as Kaldor-Hicks inefficient. See, e.g., Mkt. St. Assoc. Ltd. P'ship v. Frey, 941 F.2d 588, 594 (7th Cir. 1991) (Posner, J.) (suggesting that opportunism is not permissible behavior because costs to monitor are too high); Posner, supra note 22, §4.8, at 130-131 (suggesting that the law can deter opportunism by imposing harsher sanctions on opportunistic breach); see also Oliver E. Williamson, The Economic Institutions of Capitalism 64-67 (1985) (opportunism increases transaction costs); Timothy J. Muris, Opportunistic Behavior and the Law of Contracts, 65 Minn. L. Rev. 521, 524 (1981) (same). See also Deborah A. DeMott, Do You Have the Right to Remain Silent?: Duties of Disclosure in Business Transactions, 19 Del. J. Corp. L. 65, 71 (1994) (explaining that, while the meaning of "opportunism" varies in cases and academic writing, "[a]ll such meanings convey moral disapproval").


[FN27]. John C. Turner, Social Influence 4-5 (1991) (stating that behavior is subject to, and exerts social influence whether the behavior is internally or externally motivated).

[FN28]. See, e.g., Frank H. Easterbrook & Daniel Fischel, Close Corporations and Agency Costs, 38 Stan. L. Rev. 271, 294-95 (1986) (criticizing fiduciary law because it can provide minority
shareholders with more protection than the parties would have bargained for); see also Larry E. Ribstein, The Revised Uniform Partnership Act: Not Ready for Prime Time, 49 Bus. Law. 45, 54-55 (1993) (criticizing fiduciary duty because it can provide partners with more protection than what they agreed to).

[FN29]. See supra Part II.A.


[FN31]. In Game One, A chooses (800,0) or lets B choose (400,400) vs. (750,375) (forty-two participants). Eighty-three percent of the Alberts chose to keep the full 800 and leave Barbara with nothing, displaying the kind of self-interest that the neoclassical economists have taught us to expect. However, seventeen percent of the Alberts decided to enter the game and thus gave each Barbara the choice of sharing the 800 evenly between Albert and Barbara, or of having Barbara give Albert 750 and keep only 375 for herself. Sixty-two percent of the Barbaras chose to share 800 evenly (400 to each of Albert and Barbara), instead of sharing a total of 1,125 (750 to Albert and 375 to Barbara). Id. at 29. The Barbaras' decision is Pareto sub-optimal because society gains 800 instead of 1,125; it is self-regarding because each Barbara's decision to preserve the last 25 (400 versus 375) would cost her Albert 350 (400 versus 750). The traditional ultimatum game starts from the opposite assumption: Albert acts selfishly, and Barbara punishes him by depriving herself in order to spite him. See, e.g., Owen D. Jones, Time-Shifted Rationality and the Law of Law's Leverage: Behavioral Economics Meets Behavioral Biology, 95 Nw. U. L. Rev. 1141, 1181-82 (2001).

[FN32]. The games do not disclose the time horizon: the Alberts and Barbaras may not have expected further iterations, in which case cooperation would not be expected. Robert Axelrod, The Evolution of Cooperation 10-11 (1984).

[FN33]. The time horizon may not be infinite. See supra note 32. Difference aversion is another possible explanation for the Barbaras' greedy behavior, since a Barbara arguably does not want her Albert to receive more than she does. However, that cannot be the full explanation because, in a dictator game that has Barbara decide only the second part, without Albert's first, generous move, only 38% of the Barbaras, instead of the 62% in Game Two, chose the greedy alternative. See Charness & Rabin, supra note 30, at 4.

[FN34]. In Game Two, A chooses (0,800) or lets B choose (0,800) vs. (400,400) (thirty-two participants). All the Alberts chose to enter the game: they chose to give up the certainty of receiving nothing, as against the possibility that their Barbara would accept to share the 800. Once in the game, only 44% of the Barbaras were selfish and took the whole 800; over half (56%) of the Barbaras gave up 400 to which they had a right and passed those 400 to their Albert. See Charness & Rabin, supra note 30, at 30. In Game Two, either choice of Barbara provides society with the same value, i.e., 800.

[FN35]. It arguably is surprising only to the extent that it is normally harder to give up the bird in hand than a mere opportunity to gain. See, e.g., Daniel Kahneman & Carol Varey, Notes on the Psychology of Utility, in Interpersonal Comparisons of Well-Being 127, 150-151 (Jon Elster & John E. Roemer eds., 1991) (describing mug experiment, where students demanded more to sell an ordinary mug than they would have been willing to pay to buy it). Nevertheless, while no Alberts gave up "nothing," fully 17% of the Alberts in Game One gave up a sure 800.

[FN36]. The authors' suggested explanation for second game is that, since A said it did not want to give the full 800 to B, perhaps B could not easily rationalize taking the whole amount. However, the authors confirm their "puzzlement" and note that their suggestion is a "weak explanation." See Charness & Rabin, supra note 30, at 30.

[FN38]. The Barbaras leave each Albert with 400 instead of 750, although each Barbara would have forgone only 25 (from 400 to 375) to have provided her Albert with the extra 350. See supra note 31 (describing Game One). See also Charness & Rabin, supra note 30, at 29.

[FN39]. It is unnecessary to speak further of Game Two because (1) the game reflects generosity only by Barbara without describing the consequences of Barbara's actions, and (2) the contribution of this game to the analysis here is thus merely to underscore that a Barbara's grasping behavior in Game One is not purely due to her appearance in the second tranche of the game.

[FN40]. See Macauley supra note 26; see generally supra Part III.A.

[FN41]. See, e.g., Easterbrook & Fischel, supra note 28, at 274 (noting that shareholders in a close corporation are more vulnerable, because less diversified, than shareholders in public corporations).

[FN42]. Assume for these purposes that, in order to avoid unraveling the standard of performance, the agreement was negotiated and signed in accordance with the same standard of performance applied to operations. At a minimum, we have to know that the parties, including Barbara, intended to enter into this agreement. See infra Part IV.

[FN43]. If Barbara acts abusively, she may actually be liable, but that liability would be based on her own actions, not those of Albert.

[FN44]. The default standards are probably not waivable on a blanket basis, however. Larry Ribstein, a long-time supporter of the contractarian perspective, doubts that full blanket waivers will be permissible even for Delaware LLCs. Larry E. Ribstein, Limited Liability Unlimited, 24 Del. J. Corp. L. 407, 445 (1999)

[FN45]. See Unif. P'ship Act § 6(1) (1914), 6 U.L.A. 256 (1995) (making no reference to contract); see also id. § 6(1), cmt., 6 U.L.A. 256-57 (1995) (expressly stating that a voluntary association, but not a contract, is needed for partnership formation); Rev. Unif. P'ship Act § 202 (amended 1997), 6 U.L.A. 56 (Supp. 2001) (making no reference to contract); id. § 202 cmt. 3, 6 U.L.A. 57 (Supp. 2001) (discussing intent, and noting that what distinguishes a partnership from agency is co-ownership). If co-ownership is the distinguishing factor, then a partnership is not necessarily contractual, because an agency relationship is not necessarily contractual. See Restatement (Second) of Agency § 1 (1984) (referencing consent, not contract); see also id. § 1 cmt. b (1984) (expressly stating that the agency relationship does not require a contract). As the drafters of the evolving Third Restatement of Agency confirm, common law still maintains that the agency relationship is not essentially contractual. See Restatement (Third) of Agency § 1.01 cmt. c (Tentative Draft No. 2 2001) (the agency relationship depends on assent and consent; there is no reference to contract). For the number of states operating under the UPA (1997) (or its predecessor lacking limited liability provisions), as opposed to the UPA, see supra note 15.

shareholders who also are employees on the premise that the at-will employment doctrine trumps all rights of employees, even those held in their shareholder capacity. See, e.g., Ingle v. Glamore Motor Sales, Inc., 535 N.E.2d 1311, 1313 (N.Y. 1989) (discussing the termination of an at-will employee who is also a shareholder). Even this case, which rejects a remedy for the shareholder-employee, confirms the close relationship between an oppression remedy and fiduciary duty: the majority finds no fiduciary rights in the minority shareholder, but includes dictum stating that the shareholder-employee might have obtained a better result had he argued under New York's § 1104-a, the oppression statute. Id. at 1314.