

Outline

Role of the Basic Business Associations Course: What It Is and Where It Is Going?

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- I. My perspective
 - A. An "old" junior
 - B. Twenty-six years of practice as litigator, outside corporate lawyer, divisional GC, public company GC
- II. The real differences between law practice and the academy
 - A. Business doctrinal silos: Law not practiced by doctrinal area, and need not be taught that way.
 1. The game analogy: teaching a complete neophyte how to play "Flog"
 - a. Game techniques as to which doctrine has developed
 - (1) Equipment
 - (2) The long hurl
 - (3) The short hurl
 - (4) The roll
 - b. All teaching is done by means of discussing what the other player's rights are if you wrongly perform the act to which the doctrine applies
 - c. You must figure out what it means to win from what you are taught.
 - d. The obvious conclusion - winners in Flog are those who catch the most mistakes made by the other player
 - e. But it turns out Flog players have a completely different objective.

2. Teaching the litigation game - cf. civil procedure
3. Teaching the business law game
 - a. What does it mean to succeed?
 - b. Means and ends - if you teach these means, what does it say about the ends?

(1) The doctrinal approach - Flog as the business litigation game

Agency
Partnership
Limited partnership
LLC
Corporations

(2) The functional approach - Flog as the business planning game

Liability to third parties
Management of the enterprise (rights and duties of owners and managers)
Finance and taxes
Ownership and transfer

B. Judgment, games, models, judgment, and the limits of the law

1. The litigation model

Tort law is still a classically Langdellian area of legal doctrine. There's not a huge gap, still, between tort law as academic enterprise and tort law as practiced. Transactional lawyers find far less continuity between what they learn and what they practice.

2. The economic model - trying to teach game players from a modeling perspective

a. Substance: Schwartz & Scott on contracts (see Appendix A)

b. Form: Gilson on transactional practice (see Appendix B)

3. Judgment as part of the business game (the limits of the law)

III. Proposals for change

1. Reorganizing the basic course (see Appendix C)
 - a. Business planning context
 - b. Functional approach applied (at least a start!)
 - (1) The basic forms of organization
 - (2) Rights, duties and liabilities of the participants
 - (3) Ownership, management, and control of the enterprise
2. Revising classroom techniques
 - a. "Pair and share"
 - b. Mock negotiations (see Appendix D)
 - c. Drafting exercises

APPENDIX A

Excerpt from *Models and Games: The Difference Between Explanation and Understanding for Lawyers and Ethicists*, 56 CLEV. ST. L. REV. 613 (2008)

To seek regular and invariant causes in the nature of a scientific model (i.e., what Hempel called “covering laws”) is possibly to ignore the context in which the activity takes place, and the common sense attribution of the causal reasons why something happened, in a way that parallels the natural scientists need to find the appropriate model for descriptive explanation. As the historian Thomas Haskell observes:

[t]he crux of the misunderstanding into which historians have been led by [Hempel’s] covering law thesis . . . is the notion that there is only one form of causal reasoning, the nomological-deductive. There is, as Weber knew, another mode of causal reasoning, the attributive mode, which we take so much for granted that we fail to recognize it for what it is: the very bone and sinew of which common sense is constituted.¹⁰⁰

Instead of trying to explain cricket or Tai Chi, suppose we are trying to explain what the parties meant when they used particular words in a contract. That is the stuff of everyday contract interpretation, something in which lawyers and judges engage all the time. Two of the pre-eminent social scientists of the law took on that challenge, using an economic model to find a rigorous way of setting the legal rules. Alan Schwartz and Robert Scott advocated the following rule of contract interpretation, at least for contracts between relatively sophisticated businesses—go by the plain meaning of the document, because business parties would choose Willistonian formalism over UCC-style contextualism as the mode of contract interpretation.¹⁰¹ I do not criticize their choice of legal default rule; rather the route they take is one that elevates deduction and universal law over common sense, and hence is entitled to some skepticism.¹⁰²

¹⁰⁰ *Id.* at 16.

¹⁰¹ Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541 (2003). This is really an empirical assertion, but Schwartz and Scott arrive at the conclusion as a matter of deduction from a number of assumptions that are the basis of the model. Because individuals and small businesses might not be rational (and therefore want solely to maximize joint surplus when contracting), the model only applies to relatively sophisticated businesses. These are defined as entities in the corporate form and having five or more employees, limited partnerships, or professional partnerships, such as law or accounting firms. *Id.* at 545.

¹⁰² I have taken courage from the example of Thomas Haskell’s review of *Time on the Cross*, by Robert William Fogel and Stanley L. Engerman, one of the most hotly debated historical studies of the last forty years. ROBERT FOGEL & STANLEY ENGERMAN, *TIME ON THE CROSS, THE ECONOMICS OF AMERICAN NEGRO SLAVERY* (1974). Applying a measure called “the index of total productivity,” a ratio of input to output, Fogel and Engerman argued that slave labor was more efficient than free labor. The crux of Haskell’s review was that the index measured productivity in dollars rather than units, and accordingly as much influenced by consumer behavior as producer behavior. Nevertheless, Fogel and Engerman concluded, largely without evidence, the gap in efficiency was due to superior management of planters and black labor. Haskell’s review in the *New York Review of Books* began with the following disclaimer:

The carnival of publicity attending the publication of *Time on the Cross* suggests that the

Schwartz and Scott argue that the legal model of contract interpretation should derive from an economic model which maps on a linguistic model which bears some relationship to a transaction between the parties. The critical link here is whether you can map an economic model onto a linguistic model. The model concludes as between business firms: (1) the parties really do want the court to interpret the contract in a way that maximizes joint surplus over the individual party's share of the splitting of the surplus (i.e., the negotiated price), and (2) in the long run, interpretive mistakes by courts even out, and using a minimum of evidence beyond the text is cheaper, so parties would prefer plain meaning textualism on the assumption that unbiased courts get to the correct answer about the parties' intention most of the time.

The model is based on a number of assumptions about the way firms do business that are open to debate. First, the authors contend that firms are not risk-averse like individuals, so money equals utility and each marginal dollar is valued as much as the last.¹⁰³ This is to neutralize the theoretical and empirical observation of behavioral psychology and economics that individuals are indeed risk averse—they would prefer \$1,000 to a one in ten chance of receiving \$10,000.¹⁰⁴ Second, shareholders and managers each want to maximize profits, and even if managers are diverting shareholder wealth to themselves, they would still not want to degrade the quality of the contracts.¹⁰⁵ Third, corporate executives go to business school and learn how to make optimizing rather than cognitively erroneous decisions, and to perform complex game-theoretic reasoning.¹⁰⁶ Fourth, optimizing parties who do not make cognitive errors will want to maximize joint gains at the negotiating stage, and will not behave strategically so as to injure joint surplus creation in the interest of increasing their own profit.¹⁰⁷

All of these assumptions require a leap of faith, and the last in particular. The concept of joint surplus (which the parties divide into consumer surplus and supplier surplus by setting the price) is an economic abstraction, albeit a powerful and useful one

authors . . . desire an audience embracing not only econometric historians but all reasonable people. I am not an econometric historian or a specialist in the history of slavery, but I am a reasonable man and, as such, entitled to judge the plausibility of the authors' argument

The most troublesome phase of any quantitative study is the translation of numerical procedures into plain English. In their research and calculations, Fogel and Engerman may have considered all the objections raised below. But even if their conclusions turn out to be procedurally well-founded, their presentation still fails, for they have not exposed to the reader's view any process of reasoning adequate to justify their conclusions.

Thomas L. Haskell, *Were Slaves More Efficient? Some Doubts about Time on the Cross*, N.Y. REV. OF BOOKS, Sept. 19, 1974, at 38, reprinted in HASKELL, *supra* note 97, at 31. Neither am I an economist, but I am a lawyer and a reasonable person, and feel entitled to judge the plausibility of the assumptions that underlie the economic formulae presented by Professors Schwartz and Scott.

¹⁰³ *Id.* at 541 n.16.

¹⁰⁴ RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW*, 10-11 (6th ed. 2003).

¹⁰⁵ Schwartz & Scott, *supra* note 101, at 550-51.

¹⁰⁶ *Id.* at 551 n.17.

¹⁰⁷ *Id.* at 552 (“On a deeper view, however, one can see that sophisticated parties at the negotiating stage prefer to write contracts that maximize total benefits.”).

when used to give an abstract and universal sense of why transactions occur at all, but far less so when used as a tool to measure the value of the transactions to the parties. Let us take an example. Seller is a brake manufacturer. It makes brakes for cars and trucks. It divides the business into the car unit and the truck unit. Seller wants to sell the truck unit as a going concern. That means all the assets and liabilities related to it, including its goodwill, will be sold. Seller thinks the business is worth \$300, and would take any price in excess of that. Buyer wants to buy a truck brake business. Buyer thinks Seller's unit is worth \$1,000, and would be willing to pay any price up to that. There is a potential economic surplus of \$700. Seller and Buyer do not know how the other values the business. Buyer makes an offer of \$400, which means that it would capture \$600 of whatever surplus there is. Seller counters with an offer of \$700, which means it would capture \$400 of whatever surplus is out there. They compromise at \$500, and this has been an efficient deal. They have created \$700 of surplus, of which Seller took \$200, and Buyer took \$500.¹⁰⁸

Why would Seller and Buyer look to maximizing joint surplus rather than merely taking more of a smaller surplus? Schwartz and Scott move past this quickly, offering no empirical evidence that they do, perhaps because maximizing joint surplus under the foregoing hypothetical would mean the parties actually knew how much each other valued the assets. That is the assumption of perfect information, required for rational actors, but so unusual in the real world that the assumption of asymmetric information is one of the bases of behavioral economics.¹⁰⁹ Moreover, the conclusion that parties want to maximize joint surplus requires the following additional assumptions. First, if each party's share of the surplus were to be set exogenously (i.e., not by the parties themselves in the negotiation), then strategic behavior would be useless and rational parties would not engage in it.¹¹⁰ Second, the parties' bargaining share are in fact set exogenously as a function of the parties' relative patience (in turn a function of the party's access to capital) and the "disagreement point," neither of which the parties can change. Hence, rational bargaining firms realize that they cannot do anything about either patience or disagreement point. They therefore realize and accept that their share of the maximum surplus is fixed before they ever sign the contract. So, the deductive logic of the model says, because that is the only way they make more money, their contracting behavior must be geared to maximizing the size of the pie.¹¹¹

Now we move to the second prong of the argument—that risk neutral parties desiring to maximize joint surplus actually, subjectively, in their own minds (or would if they thought about it), want the court to restrict its inquiry to the plain meaning of the text.

¹⁰⁸ This is Kaldor-Hicks efficiency. POSNER, *supra* note 104, at 13.

¹⁰⁹ OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS (1975); Oliver E. Williamson, *The Economics of Organization: The Transaction Cost Approach*, 87 AM. J. SOC. 548 (1981). For another critique of the assumption of the parties' knowledge of each other's expectations, see W. Brian Arthur, *The End of Certainty in Economics*, in J.H. CLIPPINGER, THE BIOLOGY OF BUSINESS (1999).

¹¹⁰ Schwartz & Scott, *supra* note 101, at 552-53.

¹¹¹ *Id.* at 553-54. Schwartz and Scott contend further that these assumptions hold even if the parties do not know precisely how much bargaining power they have. *Id.*, at 554 n. 24.

Let us continue with the brake business hypothetical. Having agreed on a price for the car brake business, Seller and Buyer send their lawyers off to write the contract. There are assets and liabilities that are purely part of the truck business, and the lawyers list them. But there are also lots of assets that are shared between truck and car, and again, they try to divide them up on a list. But they need a default to describe those assets that they have not considered specifically. That is because they want as complete a contract as possible. So they say in the contract that Seller is selling Buyer all the assets primarily related to the truck business, except those specifically listed otherwise in the agreement.

It turns out later that there is an asset they forgot to list, the Globulator. In terms of time of usage it was used exactly 50% for the car business which is not being sold, and 50% for the truck business which is being sold. The volume of parts was 51% truck and 49% car. The dollar value of parts was 49% truck and 51% car. Buyer realizes that it needs another Globulator, and they cost \$100 at retail, so now the value of the deal to the Buyer has been reduced by that much. Seller has quite a few Globulators, and values them at \$50, but is not in the charity business. Buyer sues Seller for \$100.

Now the court has to apply the plain meaning rule to the interpretation of “primarily used in” to the Globulator. What is the correct answer in the contract interpretation game with respect to the Globulator? The facts show a dead heat. If “primarily related to” means greater than 50%, Seller wins and has no obligation to transfer the Globulator. If “primarily related to” means 50% or greater, Buyer wins and gets the machine. Somebody has to win. Not to decide is to decide.

How do Schwartz and Scott propose that court deal with the interpretation problem? Their model first presumes the existence of a correct answer within the language of the contract.¹¹² But Schwartz and Scott acknowledge that words can be vague or ambiguous.¹¹³ Nevertheless, the model supposes that the contract is complete in the sense that the writing in fact expresses the parties’ solution to the contracting problem of defining the assets that were sold.¹¹⁴ Indeed, the model assumes that, if the contract were not the optimum drafting solution to maximizing joint surplus, the parties would have continued to invest in making it clearer.¹¹⁵ The parties had to be aware, however, because of the possibility of vagueness of language, that their meaning might not always be transparent to a later interpreter.¹¹⁶ Thus, there is a possibility that the court’s interpretation will deviate from the correct answer. Schwartz and Scott thus make the eminently reasonable suggestion that the court should adopt the interpretive protocol the

¹¹² *Id.* at 568. Schwartz and Scott do not say, but I am inferring that even if the parties cannot agree on the correct meaning of “primarily related to” because they are now both opportunists, the court can feel assured that they really intended the words to mean that which would maximize joint surplus.

¹¹³ *Id.* at 570. Schwartz and Scott understand vagueness as common in the sense that the set of objects to which a word applies is rarely delineated with absolute precision. *Id.*

¹¹⁴ *Id.* at 573. Or, in my more colloquial rendition, evoking Ronald Reagan, there is a pony in that manure pile.

¹¹⁵ Alan Schwartz & Robert E. Scott, *Contract Theory and the Limits of Contract Law*, 113 YALE L.J. 541, 574 (2003).

¹¹⁶ *Id.* at 573.

parties would want as most likely to arrive at the correct answer. Indeed, they note the court will frustrate this if it does anything other than ascertain the solution the parties actually adopted. The choice as to interpretive protocol really turns on the breadth of the evidentiary base that will be used. In short, as a default, would the parties want the court to be a Willistonian formalist or a Corbinian contextualist? Schwartz and Scott opt for the former, concluding that typical firms prefer courts to interpret contracts on as narrow an evidentiary base as possible, and the most significant component of that base is the written contract.

The justification of contract textualism requires an economic formula that takes into account risk to the parties, benefits, and the costs of resolution. Schwartz and Scott assume there is a direct relationship between the amount of evidence on which the interpretation is based and the likelihood of reaching that single correct answer. The evidence base ranges from the minimum (defined as the written contract, a performance narrative, a dictionary, and the interpreter's knowledge of the world) and expressed in formula as B_{\min} . Letting in course of dealing, course of performance, usage of trade, negotiations, and pre-contract documents extends the evidentiary base to B_{\max} . Academic contextualists prefer B_{\max} because the court is more likely to find the correct answer.

Schwartz and Scott conclude, based on their model, business people would prefer formalism, or B_{\min} . Recall that Schwartz and Scott have assumed a relationship between the breadth of the evidentiary base and the probability of a correct result in a specific dispute. They posit two different situations: first, a model that presumes a continuous relationship between the degree of interpretive error and the amount of the payoff, and second, a model in which the outcome is discontinuous. A continuous payoff dispute would occur, for example, if the interpretation involved a clause under which a seller had a duty to prepare certain machines before sale. The greater the duty the court finds in the language, the greater the payoff to the buyer. Our brake business example is a discontinuous payoff. The Seller either wins or loses and any interpretation error gives either the Seller or the Buyer a 100% payoff. But I believe the Schwartz and Scott rationale for the continuous payoff is in fact the one that applies to my hypothetical.¹¹⁷

The Schwartz and Scott model translates contract textualism into a formula.¹¹⁸ When translated back into plain English, the formula says that if there is a dispute over the meaning of the machine preparation clause, what the buyer can expect as his judicially determined share of the surplus, given the minimum evidentiary base used by the court, is the correct interpretation modified by some probability of error or variance from the correct interpretation. Think of an x-axis with zero in the middle, negative numbers representing pro-seller judicial error running to the left and positive numbers representing pro-buyer judicial error running to the right. The "correct interpretation" would be zero,

¹¹⁷ That is because, in my hypothetical, there are only two possible results. Schwartz and Scott devote a portion of their argument to showing how even if there are three possible discontinuous results, say two favoring Seller and one favoring Buyer, the parties would still want the court to use a textualist approach. I do not need to address that argument.

¹¹⁸ *Id.* at 575-76. The formula is $E[s_b(i)|B_{\min}] = s_b(i^*) + \epsilon$.

as long as the court is not biased. Assuming the court is unbiased, it would be equally likely to err for (i.e., reach a result in the positive numbers) or against (i.e., reach a result in the negative numbers) the buyer.

Schwartz and Scott contend the model, under the assumptions previously stated, establishes that business firms would prefer the minimum evidentiary base, or textualism. It assumes that, as the evidentiary base approaches the maximum, the likelihood of interpretation error approaches zero. Recall again the assumption that business firms are risk neutral. Risk neutral parties are indifferent to the risk that the court is wrong in any specific case, as long as in the long run, the zero (or mean) on our axis really represents the right answer. Risk neutral parties would thus want to make the interpretation on the minimum evidentiary base unless it would be costless to widen the base. Since trials are expensive, risk neutral firms are textualists, at least as to typical cases, because it is satisfactory if courts get interpretive disputes correctly decided on average.¹¹⁹ Finally, as noted above, parties writing contracts will invest resources until the writing is sufficiently clear, in an objective sense, so that the mean of possible judicial interpretations is the correct one. The parties are willing to allow error as long as it is not biased error.

The irony here is that I am as willing as Schwartz and Scott to advocate formalism. Schwartz and Scott are not satisfied, as I would be, with saying, “formalism and plain meaning are the rules of the ex post contract interpretation litigation game; if they fail to match up to what the parties actually wanted, well, you pay your money and you take your chances.” For economists, it is not enough that the ex post game have an object of “finding the correct answer to the interpretation problem.” To justify the game economically, it is important to conclude that the game actually models what the parties wanted—that is, that the parties themselves actually had a right answer. Schwartz and Scott want the rules of the ex post game to map on what the parties really wanted ex ante.¹²⁰

The problem, of course, is that the mapping comes out wrong in my hypothetical, which I contend is far more typical of the ordinary contract interpretation dispute. We can imagine in our hypothetical the court restricting itself to the contract, a dictionary, and the facts above. The word “primarily” means “for the most part.”¹²¹ In that case, “primarily related to” must mean a smidgen more than fifty percent, so any asset shared absolutely equally is not primarily related to the business, and hence stays with Seller. But note at least two problems in dealing with the assumption that the parties were maximizing joint surplus. Under the plain meaning of the “primarily related to,” Buyer loses, and the joint surplus of the deal turns out to have been only \$600, not \$700, of which Seller took \$200 and Buyer took \$400. Given that Seller only values the Globulator at \$50, joint surplus maximizing parties must have intended that “primarily” did *not* have its plain meaning, because if Buyer wins, the loss of joint surplus is only \$50, not \$100. Second, because

¹¹⁹ *Id.* at 576-77. A corollary to this is that in “bet the ranch” cases, one party may want a broader evidentiary base on the thesis that the court is more likely to get it right. *Id.* at 577.

¹²⁰ This, of course, assumes that the contract being interpreted was itself not wholly or partly a game or a thing, but purely a linguistic model of, and about, what the parties actually wanted.

¹²¹ MERRIAM-WEBSTER’S COLLEGIATE DICTIONARY 923 (10th ed. 2002).

the parties are naturally opportunistic, if the facts had been changed so that assets primarily related to the non-sold business were excluded, then the parties would have simply taken opposite sides on the argument, but this time consistent with the joint surplus maximization.

Does the correct answer in the contract interpretation game have anything to do with what the parties were actually intending when they wrote the provision? I suspect not.

To the extent my casual and personal empiricism is relevant, I have negotiated many deals, and I cannot remember ever thinking about total surplus at all, much less first. Why? It is because almost none of the perfect world assumptions of the economic model ever appear in pure form in the real world being modeled. We rarely have real auctions to achieve real allocative efficiency. We have no idea what the joint surplus is. In the real world, I cannot imagine the parties ever coming close to thinking strategic negotiation is meaningless, and that the whole game in writing that provision on “primarily related to” was to increase the joint surplus from the original deal.

In their desire to find a universal and nomological basis for contract formalism, it seems to me Schwartz and Scott have committed the covering law error. Understanding cause-and-effect in the thing-like game of contract creation requires an exploration of attributive cause—what were the parties doing, what were they thinking about? It is wholly legitimate to use the nomological rules of economics to set legal default rules. But trying to use them to understand or explain what the parties were doing has about the same sensibility as a physicist analyzing the cause of the pipes bursting in a northern Minnesota home on the night of January 15: the reduction of kinetic energy in the water led to crystalline ice formation, which increased the volume, which led to an increase in pressure beyond the metallurgical bursting point of the copper. The rest of us know the real cause—the furnace went out on a sub-zero night.

The irony is that I agree with the textualist default rule Schwartz and Scott propose. But almost everything they assume for the model justifying the rule fails to reflect what is actually happening. Contracting parties, even when they are business executives, full of intention and purpose and their special mix of ambition and hubris, cannot be the subject of a universal nomological model, and certainly not at the level of abstraction proposed by Schwartz and Scott.

A better way to view the entire hypothetical is not as the subject of a scientific model in which we posit a single explanatory theory of cause-and-effect (i.e., rational greed), but as a series of games in which we need to understand cause-and-effect at a different attributive level. Indeed, the parties have proceeded from game to game to game to game, and the rules continue to change along the way. In the ex ante contract writing game, it may well be that the parties reached the limit of their ability to model reality in the language game. In the larger ex ante contract negotiation game, the contract language itself may not have been a model of anything, but in fact a dummy provision inserted without meaning so that the deal would close.

Ex post contract interpretation litigation is another game, and the only question is how we set the rules. We can set the rules narrowly, as formalists, or we can set them broadly, as contextualists, but those will be the rules of the game. Lawyers writing business contracts will know that those are going to be the rules. But there is no reason to suppose that there are universal rules in every game. Even if contract formalism works as it does in the litigation game, suggesting that a rule is justified because it models what the parties actually wanted in the negotiation game is a category error of causal reasoning—mistaking scientific explanation for attributive cause. As Thomas Haskell says of Hempel’s claims of the supremacy of covering law explanations, they “collapse without the prop of radical abstraction.”¹²²

Though it is hardly pernicious and is probably intentional, Schwartz and Scott have been co-opted by the linguistic community of economists. In short, explaining the parties’ intent by a set of universal economic laws flies in the face of the common sense attribution of meaning; it flies only with the prop of radical abstraction. Academic lawyers have the luxury of proposing universal covering laws as though their model were the actual game; there is little real world effect in mistaking explanatory cause for attributive common sense cause. But practicing lawyers do not have that luxury. They need to understand why events occurring in the world appear to be causally related in model-like explanatory contexts, as well as in game-like attributive contexts.

¹²² HASKELL, *supra* note 97, at 17.

APPENDIX B



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Beetles, Frogs, and Lawyers: The Scientific Demarcation Problem in the Gilson Theory of Value Creation

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BEETLES, FROGS, AND LAWYERS: THE SCIENTIFIC DEMARCATIION PROBLEM IN THE GILSON THEORY OF VALUE CREATION

*Jeffrey M. Lipshaw**

ABSTRACT

Recently, Ronald Gilson described a transactional lawyer turned law professor as someone who was a beetle, but became an entomologist. This is not the first non-mammalian metaphor used by an economically inclined legal academic to demarcate those who study and those who are studied. As Richard Posner so colorfully explained rational actors as they appear to economists studying them objectively: "it would not be a solecism to speak of a rational frog." In this short essay, I suggest that both say something about the prevailing view of theorizing that is entitled to privileged epistemic status in the legal academy. Some economic explanations of the activities of beetles, frogs, and lawyers are entitled to this status, and some are not. I assess Professor Gilson's classic 1984 article on value creation by lawyers in terms of its implicit claims to (social) scientific knowledge, and conclude that it is not.

In 1984, Ronald Gilson published what, by almost all accounts, has become a classic in the academic literature of the legal profession: a theory explaining how it is that lawyers add value to business transactions.¹²³ Though it will take a scholar of my great-grandchildren's generation to determine whether it was a classic in terms of explanatory power or was instead a cultural artifact, I will go out on a limb now, almost a quarter of century after its publication. I suggest its assumptions, methodologies and conclusion are those of a particular place and time, during which what Jürgen Habermas called the "nomological-deductive" approach to human interaction reached its peak.¹²⁴ In the eighteenth and nineteenth centuries, more and more of what used merely to fall within the broad reach of philosophy peeled away to become science. In the physical sciences, natural philosophy became the separate disciplines of physics, chemistry, biology and so on. What marked these fields as science was the substitution of observation and logic for metaphysics. The job of science was to observe regularities and to subsume them under hypotheses, theories, and laws capable of predicting, based solely on previous observation and logic, what would occur if the same conditions presented themselves in the future.

In the late nineteenth century, there developed for the first time something known as "social science," in which this same "nomological-deductive" approach came to

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¹²³ Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 *YALE L.J.* 239 (1984).

¹²⁴ JÜRGEN HABERMAS, *ON THE LOGIC OF THE SOCIAL SCIENCES* (tr. Shierry Weber Nicholsen & Jerry A. Stark, 1990).

dominate the methodical study of human affairs. In the late twentieth century, it came to dominate the study of law as a human institution. In the meantime, however, philosophers of science (usually not the scientists themselves) spilled gallons of ink trying now to demarcate between true science, which takes on a privileged epistemic status, and pseudo-science, like phrenology or astrology, disciplines we want to argue are not so privileged. To put it otherwise, we would all agree that Einstein's theory of general relativity or Newton's theory of gravity are science, even if they are ultimately shown not wholly to explain natural phenomenon. On the other hand, very few of us accord the same level of epistemic respect to the Biblical account of creation in the first chapter of Genesis. While Genesis may provide "truths," they are not of the scientific kind. Somewhere in between the two extremes are the close cases over which philosophers of science argue, and that is the "demarcation problem."

My argument is not that Gilson's theory of value creation fails as a matter of explanation. It is that the explanation is not entitled to privileged epistemic status; i.e., worthy of being given respect as an approach to truth in a scientific way, particularly as compared to cultural or hermeneutical explanations of the role of the lawyer in the transaction process.¹²⁵ To put this a different way, Professor Gilson said this at a recent conference of a deal practitioner turned legal academic: "He was a beetle before he was an entomologist." The implication is that the entomologist's view of the beetle's place in the world has a privileged epistemic status over the beetle's perspective.¹²⁶ I disagree, or at least I think the matter needs to be explored.¹²⁷

We can begin by positing an example of an economic hypothesis that seems both unremarkable and testable. Microeconomic theory predicts that firms will stop production of a good when the marginal cost of production exceeds the marginal revenue.

¹²⁵ For a recent and thorough critique of the Gilson thesis, see George W. Dent, Jr., *Business Lawyers as Enterprise Architects*, 64 BUS. LAW. 279 (2009). The thrust of the criticism is that the Gilson article is flawed or incomplete because it bases its generalizations about value creation on a narrow segment - mergers and acquisitions work - of what lawyers actually do. Most of Professor Dent's criticisms are well taken, but he is as willing as Gilson, based merely on common sense, to accept that economics drive clients' decisions to hire lawyers. *Id.*, at 286. Professor Dent, however, does not deconstruct the basis of the economic model by which Gilson concludes that lawyers have to be involved because they increase the value of the transaction for the clients jointly and not separately.

¹²⁶ D. Gordon Smith, "He was a beetle before he was an entomologist," *The Conglomerate*, <http://www.theconglomerate.org/2008/11/he-was-a-beetle.html> (Nov. 15, 2008). Professor Gilson has confirmed to me via e-mail that this is accurate. He also made clear something that was already obvious to me from the 1984 article: he was looking for a systematic way of explaining what he had done as lawyer. I am sympathetic to Professor Gilson's overall project, in that I am also a beetle turned entomologist. I prefer, however, to think of what I do as "making sense" of my life as a beetle. Therein lies a subtle difference. I did not before hearing from him, nor since, think he was attributing privileged status to lawyer-entomologists over lawyer-beetles. Nevertheless, the reason the quip is clever is because it suggests that the objective study of the beetle using the tools of social science is privileged in a way inquiry into the beetle's (or the beetle's clients') subjective attribution of meaning to the activity is not.

¹²⁷ This is not the first non-mammalian metaphor used by an economically inclined legal academic to demarcate those who study and those who are studied. As Richard Posner so colorfully explained rational actors as they appear to economists studying them objectively: "it would not be a solecism to speak of a rational frog." RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW*, 6th ed. 17 (2003).

There, it seems to me, the allusion to beetles and frogs as the objects of study make sense. We really do not care what is going on in their minds; rational beetles, frogs or clients should not be making widgets when the costs of the very last widget is more than the firm will receive in revenue. We can study hundreds of firms and see if the theory holds: if firms are producing and selling widgets at a loss on the marginal output, something needs to be done about the theory.

Professor Gilson's explanation of value creation is problematic in a way that the foregoing theory is not. Indeed, my claim is that explanation is at the very edge, if not over the edge, of what may be called science. Here we need to unpack the economic view of value. All transactions occur because buyers value an asset more than sellers. The difference between the two values is surplus. Haggling over the split of the surplus is of no interest generally to economists; that is mere strategic bargaining. Each party, being rational, would know that hiring a lawyer to grab a bigger portion of the surplus won't work, because the other side will respond in kind, and the lawyers, not the parties, would get the benefit of the surplus. So, in the long run, rational actors being what they are, it must be the case that "[t]he increase must be in the overall value of the transaction, not merely in the distributive share of one of the parties. That is, a business lawyer must show the potential to enlarge the entire pie, not just to increase the size of one piece at the expense of another."¹²⁸

This is a key move (and one worthy of a good lawyer) because how Gilson frames the issue largely dictates the outcome. He identifies three perspectives on the question of value - those of clients, some of whom would suggest that lawyers reduce the value of transactions, those of business lawyers themselves, who would view their value-enhancing status favorably, and the "neutral but still positive view offered in the academic literature."¹²⁹ That is to say, everybody seems to agree there is a relationship between the lawyer's involvement and transaction value; rational actors hiring lawyers would not allow that involvement to reduce transaction value; thus, the only remaining question is the uncovering of the regularities under which we can expect that lawyer involvement does indeed create value. Note how far we have already come. In the philosophy of the natural sciences, causation is a hotly debated issue. When we observe regularity in nature, theory now supplies an explanation why there is regularity. But here we have simply assumed, on anecdotal evidence or the exercise of reason (not logic), that there is such a relationship.

What if there is no relationship? My theory is that lawyers sometimes add economic value to deals, sometimes subtract economic value, but also appear during the deal for the same reason Hermes scarves or Neiman Marcus neckties in business attire do: it's part of the ritual. There is no intrinsic reason they have to be there. Lawyers, like scarves or necktie, may well have economic value, not because they necessarily make the pie bigger, any more than scarves or neckties make the pies bigger, but because somebody values the lawyer enough to pay more for her to be there than it cost for her to get there

¹²⁸ Gilson, *supra* note 1, at 246.

¹²⁹ *Id.*, at 241-43.

(marginally speaking, of course). That's the reason we buy expensive scarves and neckties and Raymond Weil watches as well. But we don't feel a need to justify the presence of the scarf or necktie in connection with the value of the transaction other than to buy the product. In other words, why not assume lawyers are there because they have value to their clients that exceeds the cost of their being involved in the transaction, rather than assuming that they are there because they actually increase the overall surplus the transaction creates for *both* parties?

It is the word “value” that is value-laden. What if lawyers’ involvement in business transactions is not explained at all by the increase in transactional surplus, or even that lawyers cause clients to get a larger share of a fixed surplus, but because the work of lawyers in deals has cultural or hermeneutic significance? That is, we look not necessary for economic value in the lawyer-client relationship but *meaning*. I am persuaded by years of observation of great lawyers (I have met Jim Freund, whom Professor Gilson cites regularly, but I never saw him in action) that their involvement may add value, but it is meaningful. The linkage of that involvement to what lawyers do *qua* lawyers (e.g., argue for hours over the wording of myriad representations and warranties), however, is attenuated. Some have suggested that the real role is akin to deal manager or quarterback. That strikes me as an aspect of leadership, something business schools teach, but with which law schools and law practice (*qua* what lawyers actually *do* in the transaction) struggle immensely.

Consider the analogy to the role of a rabbi in a Jewish wedding. A Jewish marriage is not a sacrament. It is a contractual relationship, evidenced by an agreement called the *ketubah*. The *ketubah* is a standard form drafted by rabbis, who in this regard can be considered practitioners of Jewish civil law. In traditional practice, it is signed at the betrothal or engagement, not at the actual marriage ceremony, and is considered more important than the ceremony. Nevertheless, the rabbi officiates at a ceremony, even though the marriage itself consists of commitments the bride and groom make to each other without the rabbi. Rabbis get paid for doing this. Should assume that rational spouses-to-be would only pay the rabbi if the rabbi added value to the transaction (say, for example, by pre-marital counseling), given that the rabbi is not a legally mandatory part of the process? Or is the role of the rabbi somehow meaningful to the participants apart from the impact the rabbi has on the marriage transaction?

As a beetle turned entomologist, I find just as much explanatory power in seeing lawyers’ involvement in the deal process as part of a ritual or ceremony that creates a physical contract, and which gives the parties some limited assurance of certainty in a highly uncertain and contingent world. I find it equally plausible that lawyers would continue to be present in deal making even if we found they do nothing to make the pie bigger. They are necessary, and but it is at least as much in either the value they bring to the individual clients, even if at the cost of overall surplus and otherwise not reducible to dollars. Their value might be in what they do to give the parties the courage to overcome fear, panic, seller's remorse, buyer's remorse, and risk averseness. Even more radically,

are lawyers present not so much for any value at all, but for cultural or ritual significance?¹³⁰

Professor Gilson might well concede all of this, but the implication is that there is something privileged about his particular method of explanation, and that is what I want to address. Why do I mean by privileged status? In 1997, Nobel laureate Amartya Sen published an essay criticizing the foundations of rational actor theory, arguing that the prevailing rational theory of preference failed sufficiently to account for the behavior he termed “commitment.”¹³¹ Some years later, Eric Posner responded: “[S]imply assuming that people operate out of principle *and* rational calculation gives one less methodological purchase than the ordinary rational choice assumptions do, without, as far as I can tell, compensating for this loss by producing a methodological gain.”¹³² In short, if you cannot measure the variable sufficiently to prove the hypothesis, the hypothesis is not social scientific, and therefore not entitled to privileged status as a contribution to social scientific knowledge.

My point is that Sen’s concept of commitment or my theory of transactional lawyering may well not be privileged as a contribution to social scientific knowledge, but neither is Gilson’s classic explanation of the value of lawyers to the transactional process. Robert Ellickson described the issue charitably as “creative tension between the yin of social-scientific universalizers and the yang of humanistic particularizers.”¹³³ Gilson, I think it is fair to say, expects that his explanation is an instance of social-scientific universalizing. My suggestion is that it is at best on the borderline of science. To resolve that issue, we need to revisit the demarcation issue - what distinguishes science from pseudo-science? Put another way, I am arguing conceptually there is simply no way ever of proving or disproving the theory, and as such it loses its privileged status as a way in which scientific knowledge has progressed. As a way of making sense or explaining, it is no better, and perhaps worse, than cultural studies or hermeneutics (at least to the extent that those disciplines have not claimed privileged status for themselves as against other disciplines). Again, I repeat, this is not a criticism of the creativity or the brilliance or the power of Gilson’s explanation; it is a denial of its privileged status as scientific truth.

I suggest it is a fair project to review the best thinking about what science is, and to let the observer decide if the value-creation theory measures up. Professor Gilson acknowledges: “a truly empirical approach to measuring the impact of a business lawyer's participation seems impossible.”¹³⁴ Nevertheless, his methodology is an

¹³⁰ Cf. Marc Suchman, *Contract as Social Artifact*, 37 L. & SOC'Y REV. 91 (2003).

¹³¹ Amartya K. Sen, *Rational Fools: A Critique of the Behavioral Foundations of Economic Theory*, 6 PHIL. AND PUB. AFF. 317 (1977) (a transcript of the Herbert Spencer Lecture, delivered at Oxford University in October, 1976).

¹³² ERIC A. POSNER, *LAW AND SOCIAL NORMS* 192 (2000).

¹³³ Robert C. Ellickson, *The Twilight of Critical Theory: A Reply to Litowitz*, 15 YALE J. L. & AND HUM. 333, 333 (2003). See also James Bohman, *Critical Theory as Practical Knowledge: Participants, Observers, and Critics*, in Stephen P. Turner & Paul A. Roth, eds., *THE BLACKWELL GUIDE TO THE PHILOSOPHY OF THE SOCIAL SCIENCES* 91-109 (Malden, MA & Oxford: Blackwell, 2003).

¹³⁴ Gilson, *supra* note 1, at 247.

interesting one. He accepts the capital asset pricing model, a theory that describes what factors ought to matter to buyers and sellers in valuing the asset to be sold. He then engages in a thought experiment, walking through the provisions of a typical acquisition agreement to determine whether, as a matter of reason rather than observation, there is a connection between what the agreement does and the factors in the capital asset pricing model.¹³⁵ “That is,” Professor Gilson tells us, “it would be possible to inquire positively into the efficiency of the common ‘lawyer.’”¹³⁶ Not surprisingly, he concluded there is a connection, and enough of one to propose normative conclusions as to what lawyers should do if they want to enhance value.¹³⁷

¹³⁵ Professor Gilson spends many pages on the information-exchanging value of representations and warranties, and puzzles over the lack of any indemnification mechanism in public company deals (the representations and warranties expire at closing largely because once the proceeds in stock or cash are distributed to widely dispersed shareholders, there is no putting Humpty-Dumpty back together again). He acknowledges that indemnification may be partial or limited in time (there's also the "basket" or deductible, but he doesn't mention that), but the real questions, it seems to me, are (a) whether backward-looking information in the representations and warranties is all that important to the deal, versus the softer forward information that is extra-contractual and conveyed by management presentations, plant tours, customer interviews, etc., and (b) whether the actual instances of acting on the indemnification clauses warrant the investment in the representations and warranties, given that escrows may not be all that common. My guess is representations and warranties have a certain amount of *in terrorem* effect, but neither of us have a whole lot of data to go on. Professor Gilson also extols the value-creating potential of the earn-out provision, but it's not clear to me that lawyers invented that concept, nor that earn-outs turned out to be very successful tools for compromise.

The one empirical study of which I'm aware on this subject is by Steven Schwarcz, and it is based on surveys of clients who hire transactional lawyers. Steven L. Schwarcz, *Explaining the Value of Transactional Lawyering*, 12 STAN. J. L. BUS. & FIN 486 (2007). To quote Professor Schwarcz's SSRN abstract: "Contrary to existing scholarship, which is based mostly on theory, this article shows that transactional lawyers add value primarily by reducing regulatory costs, thereby challenging the reigning models of transactional lawyers as 'transaction cost engineers' and 'reputational intermediaries.'"

¹³⁶ *Id.*, at 249.

¹³⁷ If I were to apply an economic model to lawyers in deals it would be the Prisoner's Dilemma. Both clients would be better off cooperating by throwing all the lawyers out of the room for most of the issues in the deal, hence eliminating the transaction cost of arguing over myriad reps and warranties and other contract niceties that don't make any difference anyway. So imagine a Prisoner's Dilemma matrix with Party A and Party B, and the choice for each is "Lawyer" or "No Lawyer." The payoff for each side choosing "No Lawyer" is a huge reduction in costs (say, 5, 5) compared to both sides choosing "Lawyer" (say, 10, 10) But both sides keep their lawyers, for fear of the (1, 20) or (20, 1) outcomes in the Lawyer/No Lawyer boxes that are akin to one prisoner confessing but the other one not.

Indeed, Professor Gilson alluded to this as a way perhaps of a rational explanation to the sociological question about the relative paucity of lawyers in Japanese business, albeit by way of comparison to American business. The standard explanation of cooperation in Prisoner's Dilemma games is repeat play, where the prisoners learn to trust each other and to cooperate to the optimum solution. Gilson, *supra* note 1, at 310, n. 196. Professor Gilson's speculates that in Japan the players have learned by repeated play that they will work out their future differences without opportunism. That means lawyers are simply not as important in that society. Professor Gilson wants to argue, I think, that American lawyers *actually* constrain opportunism by contract as much as Japanese culture *actually* eliminates opportunism. That means accepting the empirical assertion that American contracts actually constrain opportunism. (I have argued elsewhere that they do not, at least to the extent that future disputes involve the conflicting interpretations of language as to which there is no other dispositive evidence of "mutual intention." Jeffrey M. Lipshaw, *The Bewitchment of Intelligence: Language and Ex Post Illusions of Intention*, 78 TEMP. L. REV. 99 (2005).)

What if the better explanation is that the Japanese business culture really are less opportunistic,

The first significant and influential theory of scientific demarcation was Popper's falsification principle. I will allow that Gilson's thesis cannot presently be falsified by empirical evidence, for the very reasons Gilson suggests. I do not intend to use that as my basis for challenging its privileged status because there are theories in the physical sciences that also cannot presently be falsified, nor is there any presently foreseeable means for learning how to falsify them. Instead, I propose "a tale of two theories" to demonstrate the point. The first theory is unquestionably scientific, but not presently falsifiable. Under the theory of genomic imprinting developed by David Haig, an evolutionary biologist at Harvard, certain conditions in pregnancy (e.g., the condition known as preeclampsia) is the result of maternal-fetal conflict over uterine resources.¹³⁸ Natural selection theory suggests that paternal genes expressed in the fetus favor the survival of the fetus over the survival of the mother, whereas maternal genes so expressed would favor the survival of the mother over the fetus. The experimental evidence has shown that genes indeed carry an imprint marking whether they come from the mother or the father. Two non-geneticists have recently applied the Haig theory to mental disorders. Brain chemistry genes expressed from the mother tend to create sensitivity to mood in oneself and others: at the extreme, psychosis like schizophrenia and bipolar disorder. Genes expressed from the father tend to favor focus on patterns, objects, and systems over social development: at the extreme, Asperger's Syndrome or autism. There is presently no experimental methodology for testing the theory. Nevertheless, there does not seem to be any serious question that this is a contribution to science, not pseudo-science. The *New York Times* reported:

"The reality, and I think both of the authors would agree, is that many of the details of their theory are going to be wrong; and it is, at this point, just a theory," said Dr. Matthew Belmonte, a neuroscientist at Cornell University. "But the idea is plausible. And it gives researchers a great opportunity for hypothesis generation, which I think can shake up the field in good ways."¹³⁹

The economic value-creation theory, unlike the application of the genomic imprinting theory, is conceptually not falsifiable. The existence of a genomic marking that explains mental disorders is independent of a theory that might render it false. In contrast, economic value creation as posited by Professor Gilson is theory-laden in the sense that

American lawyers indeed do not create value in transactions, but their presence in transactions is instead a rational game-theoretic response to what the sociologists would describe as American *gesellschaft* (modern organization) versus Japanese *gemeinschaft* (community)? See ALEX INKELES & DAVID H. SMITH, BECOMING MODERN 15-35 (1974). Indeed, it may well be that it is American culture that is exceptional in this regard. At least until the onset of globalized law firms, German contracts were also shorter, and in the view of at least two other observers, explainable by a real difference in how the German business community viewed opportunism over cooperation. Claire A. Hill & Christopher King, *How Do German Contracts Do as Much with Fewer Words?*, 69 CHI.-KENT L. REV. 889 (2004).

¹³⁸ See DAVID HAIG, GENOMIC IMPRINTING AND KINSHIP (Rutgers U. Press, 2002).

¹³⁹ Benedict Carey, *In a Novel Theory of Mental Disorders, Parents' Genes are in Competition*, N.Y. TIMES, Nov. 10, 2008.

Ian Shapiro criticized in *The Flight from Reality in the Human Sciences*.¹⁴⁰ What comes first is the economic model and its assumptions about value and rationality, which is imposed on a linguistic exercise, which is in turn an imperfect model of a complex world. The economic theorist of human rationality would like the conclusion to have the patina of science, but it is not science. That is not to say it is without explanatory power, but that power is entitled to no greater deference as a contribution to scientific knowledge (rather than, say, belief or normative judgment) on account of science than hermeneutics, cultural studies, or philosophy. It is instead, perhaps, the social entomologist's delusion of objectivity.

¹⁴⁰ IAN SHAPIRO, *THE FLIGHT FROM REALITY IN THE HUMAN SCIENCES* (2005).

APPENDIX C

Course Syllabus

Business Enterprises I
Fall Semester, 2006

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Casebook:

The reading assignments followed by page references below are to Klein, Ramseyer, and Bainbridge, *Business Associations* (6th ed., 2006) (“KRB”). The statutory supplement is Klein, Ramseyer, and Bainbridge, *Business Associations: 2006 Statutes and Rules* (“Supp”).

I recommend but do not require William A. Klein and John C. Coffee, Jr., *Business Organization and Finance* (“BOF”) if you want to read about the subject matter with more structure than the casebook provides. There will be a couple times when I assign readings from BOF and other sources, but I will make those generally available.

The reading assignments, by topic, correspond approximately to sets of class sessions. The correspondence is provisional; our pace may vary according to the content of the reading material. I may add or delete materials as we go along.

Subject Matter and Class Organization:

I confess off the bat that I did not find a casebook that completely corresponds to the way I would like to teach the course, so I took one of the widely-used standards, and I will jump around a little. I have spent most of a professional lifetime doing things in this area, so I am inclined to organize the theory around the way we would go about organizing a business venture, rather than following the doctrine subject by subject. Nevertheless, I am confident we will cover all the substance by the time we are done.

Here is my pedagogical rationale. My guess is that most of you will not have much experience in organizing businesses. I didn’t; I was a clueless history major. There are some basic choices to be made, and the legal issues stem from those choices. Why would I want to do business as a sole proprietor, or in a partnership, or an LLC, or a corporation; what are the advantages and disadvantages of each; what are the legal ramifications of conducting business in that form? But teaching focused on doctrine tends to move progressively from the law of agency to the law of partnership to the law of corporations, meaning that it is not until well into the semester we start to get the feel of why we care, for example, about the arcane aspects of agency law.

Even though the same body of state corporation laws can apply to a merchant who organizes a corporation to open a wine shop across from the Hotel DuPont in Wilmington, Delaware (well, there's a caveat we will discuss) as to General Electric or ExxonMobil, there is a Rubicon we cross when we undertake to have the corporation owned by shareholders who otherwise have no connection to the operation of the business. At Tulane, by and large, the special laws and regulations that apply to those so-called "public corporations" will be covered either in Business Enterprises II or in Securities Regulation. But many of the basic principles applicable to large corporations we will learn here, and it will be hard not to touch on matters that you may cover again in those courses.

So I propose to organize the course by first touching on the basic legal forms and concepts we might consider if we want to undertake a business, and then return to address more advanced issues. You will see the outline in the reading assignments below.

I am also hoping to have a senior corporate partner in one of the big New York firms speak to the class later in the semester on directors' fiduciary obligations in practice.

Topics and Reading Assignments

What is an agent? What is a partnership? What is a corporation? And why do we care?

1. Agents and Principals

Class 1 Introductions and administrivia

The context of business enterprise law

Ford Sloan comes to you for advice about getting his business started. He has developed a prototype of a device that can be adapted into most cars with power steering, ABS brakes and airbag systems. The device relies on motion sensors, GPS, radar and a complex set of algorithms in the software to sense an oncoming crash, take control of the steering and braking, and guide the car to a safe stop. There is still some development and testing work that needs to be done.

So far he has just spent his own money (relying on a small inheritance), and has been building the prototype in his garage. To get this business going, he is going to need more money to invest. He expects his customers to be companies like Honeywell, Johnson Controls, and Magna, who sell safety systems to the major automobile companies, as well as to the automobile companies themselves. The prototype looks like a small plastic box with wires protruding from it.

The first thing Ford says to you is: "So my brother in law, Manny, told me I should get this organized as a subchapter S corporation, but consider an LLC which we could convert into a C corp just before we go public with the IPO. Do you think we should go with a blank check authorization in the certificate of authority to get ready for a Series A Convertible Preferred in a mezzanine round?"

You say, “hold on, Ford, we’ve got the cart before the horse. Before we talk about the solution, let’s figure out the problem. Let’s have a discussion about all the things you are going to be doing to get this business going, and the things you and I ought to be concerned about and planning for, legally speaking.”

Ford stares at you blankly. So you start brainstorming with him all the different things that need to be considered when determining the kind of legal entity into which you will organize the business

- (a) Organizing a business: inputs and outputs.
- (b) The different role of a business lawyer: ex ante and ex post

BOF: pp. 1-4 (optional)

Class 2 What are agents and principals?

KRB: *Gorton v. Doty* (pp. 1-6)
 Jenson Farms v. Cargill (pp. 6-13)

Class 3 How the agent binds the principal: apparent authority

KRB: *Mill St Church v. Hogan* (pp. 14-16)
 Lind v. Schenley Indus (pp. 16-22)
 370 Leasing v. Ampex (pp. 22-25)

SUPP: Rest (2d) § 8

BOF: pp. 14-19 (optional)

How the agent binds the principal: inherent authority

KRB: *Watteau v. Fenwick* (pp. 25-28)
 Kidd v. Edison (pp. 28-31)
 Nogales Serv. Center v. ARC (pp. 31-36)

SUPP: Rest (2d) §§ 8A, 161

2. *What is a partnership?*

Class 4 What it really means to be business partners

KRB: *Fenwick v. UCC* (pp. 91-96)
 Martin v. Peyton (pp. 96-101)

Southex v. RIBA (pp. 101-105)

SUPP: Revised Uniform Partnership Act (“RUPA”) § 202

BOF: pp. 62-70 (optional)

Economic Interest

KRB: *Putnam v. Shoaf* (pp. 132-136)
Kovacik v. Reed (pp. 177-180)

SUPP: RUPA §§ 401(a)-(e), 402

3. *What is a corporation?*

Class 7-8 Overview: the nature of the corporate entity; historical background

Readings TBA

Limited Liability

KRB: *Walkovszky v. Carlton* (pp. 207-212)
Sea-Land v. Pepper Source (pp. 212-218)
Roman Catholic Archbishop v. Sheffield (pp. 218-222)
In re Silicone Gel (pp. 222-229)

BOF: pp. 106-112 (optional)

Class 9 Role and Purpose

KRB: *Smith v. Barlow* (pp. 282-288)
Dodge v. Ford (pp. 288-293)
Shlensky v. Wrigley (pp. 293-297)

SUPP: MBCA §§ 3.01-3.04

What duties and liabilities of the business participants in the different forms of organization?

1. *The Duties and Liabilities of Principal and Agent*

Class 10-12 Ratification; Agent’s Liability

KRB: *Botticello v. Stefanovicz* (pp. 36-39)

Atlantic Salmon v. Curran (pp. 43-46)

SUPP: Rest (2d) §§ 320-323, 329, 331

Master-Servant versus Independent Contractor

KRB: *Humble Oil v. Martin* (pp. 48-50)
Hoover v. Sun Oil (pp. 50-53)

SUPP: Rest (2d) §§ 219-220

Fiduciary Obligations

KRB: *Reading v. Regem* (pp. 80-82)
General Auto v. Singer (pp. 83-87)
Town & Country v. Newbery (pp. 87-90)

2. *Duties and Liabilities of Partners*

Class 13 Fiduciary Obligations

KRB: *Meinhard v. Salmon* (pp. 109-114)
Meehan v. Shaughnessy (pp. 117-125)
Lawlis v. K&G (pp. 125-131)

SUPP: RUPA §§ 103, 404

3. *Duties and Liabilities in the Corporation*

Class 14-15 Duty of Care

KRB: *Kamin v. American Express* (pp. 328-331)
Smith v. Van Gorkom (pp. 332-345)

Brehm v. Eisner [handout]

Francis v. UJB (pp. 356-361)

Caremark (pp. 362-372)

SUPP: MBCA §§ 8.01-8.25, 8.30-8.33

BOF: pp. 154-159 (optional)

Class 16-17 Duty of Loyalty

KRB: *Bayer v. Beran* (pp. 374-379)
Broz v. CIS (pp. 384-388)

SUPP: MBCA §§ 8.60-8.63

BOF: pp. 16-164

What are the relationships among ownership, control and management in partnerships and corporations?

1. *Managing a Partnership*

Class 18 Rights of Management and Conduct

KRB: *Nabisco v. Stroud* (pp. 140-142)
Summers v. Dooley (pp. 142-144)
Day v. Sidley & Austin (pp. 146-151)

SUPP: RUPA §§, 401(f)-(k), 403

BOF: pp. 21-26, 90-94 (optional)

2. *Management and Control in Corporations*

Class 19-20 Controlling Shareholders

KRB: *Sinclair Oil v. Levien* (pp. 394-398)
Zahn v. Transamerica (pp. 399-404)

Shareholder Rights

KRB: *Stroh v. Blackhawk* (pp. 585-589)

SUPP: MBCA §§ 6.01-6.03, 6.20-6.21, 6.30-6.31, 6.40, 8.33

BOF: pp. 164-166, 205-210 (optional)

Control Agreements and Freeze-Out Protections in Close Corps

KRB: Ramos v. Estrada (pp. 623-626)
Wilkes v. Springside (pp. 630-636)

SUPP: MBCA §§ 7.01-7.08, 7.30-7.32

Sale of Control

KRB: Essex Univ. v. Yates (pp. 705-711)

Okay, is there a form of business organization that combines the best qualities and fewest downsides of all of ones we've studied?

Class 21 Limited Liability Companies

KRB: Introduction to LLCs (p. 299)
Elf Atochem v. Jaffari (pp. 305-311)
McConnell v. Hunt Sports (pp. 317-322)

SUPP: Uniform Limited Liability Company Act §§ 103, 301-303, 404

BOF: pp. 102-104 (optional)

APPENDIX D

**CLASS EXERCISE 1-1: SWEET TOOTH TECHNOLOGY PROBLEM - MOCK
NEGOTIATION VERSION**

Lawyer for Mary Williams

CONFIDENTIAL INSTRUCTIONS – DO NOT SHARE WITH YOUR FELLOW GROUP MEMBERS.

You have agreed to represent a friend, Mary Williams, who is a bright young electrical engineer working at Opticon Laboratories in Waltham in an upcoming discussion with two other lawyers. (You are doing this for free for the time being because she can't afford your hourly rate.) Opticon develops holographic applications. In her spare time, she has developed a prototype of a micro-device that will project a hologram of a QWERTY keyboard from a typical cell phone. What this means is that while clipped to the user's belt, the phone will project the image of the keyboard out in front of the user, and the user can type text messages effectively in mid-air. She calls the technology "Sweet Tooth." The technology is promising but not production-ready. Mary has discovered at least two technical problems. First, people tend to focus on the image and not their surroundings, creating a safety issue and, second, in certain hotspots, the device can cause a small electrical shock to the user and a person standing close to the user. She is pretty sure these issues can be resolved, but thinks it will take at least \$750,000 of outside electrical engineering work.

Last week, she mentioned the concept to a co-worker at Opticon, who said it sounded like a great idea, but thought that there was a patent pending on the same concept coming out of Opticon's Silicon Valley development group. Mary doesn't have a non-competition agreement with Opticon, but she has heard about Opticon suing some ex-employees and competitors over what they call the "inevitable disclosure" doctrine.

Mary's other main challenge is marketing the concept to the big phone manufacturers. She doesn't have any contacts with them, but she recently attended an entrepreneurship seminar and chatted with another attendee, Carl Vaughn, who works with one of the big consulting firms, and seemed to know his way around Nokia, Motorola, LG, and some of the other cell phone manufacturers. Carl seemed interested in getting together with her. But Mary has confided to you that she has some reservations about Carl. He seemed a little full of himself and prone to exaggeration. Mary is understated and risk-averse, and doesn't like making promises she can't keep.

Mary's Uncle Benny, a retired dentist, has always taken an interest in her technical ability, and is interested in investing some money to help the business get started.

Mary is open-minded about how this is structured, but she clearly wants to own the business, and have control of its management. She would be willing to quit her job at Opticon and spend full time at developing Sweet Tooth under the right circumstances.

There is a meeting scheduled with the lawyers for Carl and Uncle Benny. Your task at this first meeting is not to select a business structure. All you are expected to do is make a list of the business and legal issues that need to be addressed if this is all to go forward.

Lawyer for Carl Vaughn

CONFIDENTIAL INSTRUCTIONS – DO NOT SHARE WITH YOUR FELLOW GROUP MEMBERS.

You have agreed to represent a friend, Carl Vaughn, who is a sales consultant in the wireless telecommunications industry, in an upcoming meeting with two other lawyers. (You are doing this for free for the time being because he can't afford your hourly rate.) He worked as a sales representative for a number of years at Telemetry Corporation. Telemetry made one of the key pieces of circuitry in cell phones. So he knows the people in the purchasing and engineering departments at the big cell phone manufacturers.

He hangs out at the monthly Waltham entrepreneurship club meetings, trolling for business prospects. Last month, he met Mary Williams, an electrical engineer who is working at Opticon Laboratories in Waltham. Carl knows that Opticon develops holographic applications. Mary told him that, in her spare time, she has developed a prototype of a micro-device that will project a hologram of a QWERTY keyboard from a typical cell phone. What this means is that while clipped to the user's belt, the phone will project the image of the keyboard out in front of the user, and the user can type text messages effectively in mid-air. She calls the technology "Sweet Tooth."

Carl says that when he probed her about the technology, she was a little reticent, but Carl has the impression that there are still some technical issues to be resolved, and he thinks maybe there is a patent or some other kind of intellectual property issue.

Carl doesn't have any money to invest, but he'd love to explore getting in on the ground floor, doing the marketing for a technology like this to his old contacts in the cell phone manufacturing industry.

Carl also tells you that Mary has a relative by the name of Ben (he thinks) with money to invest.

There is a meeting scheduled with the lawyers for Mary and Ben. Your task at this first meeting is not to select a business structure. All you are expected to do is make a list of the business and legal issues that need to be addressed if this is all to go forward.

Lawyer for Ben Moore

CONFIDENTIAL INSTRUCTIONS – DO NOT SHARE WITH YOUR FELLOW GROUP MEMBERS.

You have been doing legal work for many years for Benjamin Moore, a retired Belmont dentist. Ben has also done very well over the years both in the stock market, and participating as an “angel investor,” that is, somebody who invests in early stage companies. He doesn’t generally take an active role in the companies in which he invests as an angel, but he likes to have some ability to step in if he sees a problem.

What Ben really has a passion about is not paying taxes if he doesn’t have to. In fact, his desire to reduce his tax bill is so intense that you’ve had to talk him out of some squirrely looking tax shelter schemes in the past.

Ben’s favorite niece, Mary Williams, is a bright young electrical engineer working over at Opticon in Waltham. Opticon develops holographic applications. Mary told him that, in her spare time, she has developed a prototype of a micro-device that will project a hologram of a QWERTY keyboard from a typical cell phone. What this means is that while clipped to the user’s belt, the phone will project the image of the keyboard out in front of the user, and the user can type text messages effectively in mid-air. She calls the technology “Sweet Tooth.” She has told him, however, that there are some technical “bugs” that have to be worked out. She estimated, in her engineering judgment, it would take about \$750,000 in investment dollars to get the project off the ground.

Ben thinks the world of Mary, and would not mind investing the \$750,000. But he has the following concerns:

- He doesn’t want to pay taxes if humanly possible.
- He thinks the venture is going to lose money for at least the next five years.
- He does not want to put more than his \$750,000 at risk.
- He thinks Mary’s skills as an engineer far exceed her skills as a business manager or as a sales person.

On the latter issue, Mary says she has met a fellow named Carl who seems to know a lot about selling these products to the cell phone manufacturers, and appears to be interested in getting involved.

There is a meeting scheduled with the lawyers for Mary and Carl. Your task at this first meeting is not to select a business structure. All you are expected to do is make a list of the business and legal issues that need to be addressed if this is all to go forward.