

THE TALE OF THE SILVER FOX: THE CO-EVOLUTION OF PROPERTY RIGHTS AND CONTRACTUAL ARRANGEMENTS IN LIMITED LIABILITY COMPANIES¹

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“...[W]hen we compare the dray-horse and race-horse, the dromedary and camel, the various breeds of sheep fitted either for cultivated land or mountain pasture, with the wool of one breed good for one purpose, and that of another breed for another purpose; when we compare the many breeds of dogs, each good for man in different ways; when we compare the game-cock, so pertinacious in battle, with other breeds so little quarrelsome, with ‘everlasting layers’ which never desire to sit, and with the bantam so small and elegant; when we compare the host of agricultural, culinary, orchard, and flower-garden races of plants, most useful to man at different seasons and for different purposes, or so beautiful in his eyes, we must, I think, look further than to mere variability.”

Charles Darwin, *The Origin of Species*, 105 (150th anniv. ed. 2009).

I. INTRODUCTION

Law, in particular the law of business organizations, is a byproduct of normative solutions, or a sort of *extended phenotype*. Facing the emergence of new forms of business organizations, legislatures in European countries such as Portugal, Spain, Italy, France, the United Kingdom and also in the United States have created systems of property rights in order to ensure equilibrium not only within the corporate structure, but also among the

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interests and protections each corporate constituency claims for itself.² One of the ways to facilitate this equilibrium is to provide default rules that restrict the transfer of shares of private limited liability companies (“PLLCs”) or give leeway to company members to introduce such restrictions in the articles of association.

In this article, I adopt a bottom-up perspective to evaluate the dynamics and evolution of the markets, and I compare them to evolution in nature by looking at the environment where this evolution occurs. It has long been claimed that evolution in nature is different from institutional evolution.³ However, the law provides the tools necessary for institutional engineering just as biology supplies the scientist with the necessary cognitive equipment to undertake experiments based upon the artificial selection of species. The output of this comparison should be one that, normatively speaking, enables legislatures, regulators, and courts—in particular, those in common-law jurisdictions⁴—to create optimal legal solutions that are able to break the engrained status quo and manifestations of socio-economic and doctrinal path-dependence, or situations of *pleiotropy* in the law, if necessary. The term pleiotropy is used here to explain that, evolutionarily, there are unintended consequences for legal rules and legal institutions stemming from the interaction between market and law. Pleiotropy refers to the inheritance of legal solutions, which is different from the concept of path-dependence often used in economics and political science. Thus applied, fields of corporate law, contract law, and property law are shown to be related in unexpected ways.

Using transfer restrictions or restrictions on changes to the structure of ownership of PLLCs as a ground for experimentation, the first section tries to unveil the legal and economic purposes of setting such restrictions.⁵ There, I present a three-level model that provides legislatures, regulators and courts with methodological tools for implementing optimal legal solutions. In addition, I expose the contractual features of the articles of association by defining them as a “contract for governance opportunity”

² By equilibrium, I mean a balance between influences that enables the maintenance of a stable system as opposed to the definition of equilibrium in economic terms, that is, the reference to the value of the relevant variables such that without external influences, things will remain unchanged. For example, imagine a soup plate turned upside down. If there is even the smallest surface area that is even, a ball will stay there in an equilibrium. However, even the slightest nudge will make the ball roll away, which shows that this equilibrium is unstable. Now, imagine that one flips the plate over and puts the ball in the middle. If one bounces the ball back and forth, the ball will always go back to the same position. This stands for a stable equilibrium.

³ See John W. Pratt & Richard J. Zeckhauser, *Principals and Agents: An Overview*, in *PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS* 1, 35 (John W. Pratt & Richard J. Zeckhauser eds., 1985) (saying that “the evolutionary processes for institutional structures are quite different from those for species. Desirable contracts are impossible to draw. Human environments change swiftly. Hence, there is no assurance that the institutions we observe are best”).

⁴ In common-law systems, law is based on case law developed by courts. Courts are, thus, more likely to adopt an activist role than in civil law systems.

⁵ See Lars-Göran Sund & Per-Olof Bjuggren, *Family-Owned, Limited Close Corporations and Protection of Ownership*, 23 *EUR. J. LAW L. ECON.* 273, 274 (2007) (asking “Why should we impose restrictions on transfers?”).

provided by the law.⁶ I will also give a comparative overview of the most important possible restrictions, and combinations thereof. In the second section, I propose an explanation for the effects that these restrictions may have on the configuration of property rights in shares, similar to the effects of the taming process on the silver fox. I not only advance a thesis of path-dependence of legal solutions, but I also develop the idea of pleiotropy in the law. In the third section, I inquire into the normative justifications behind the restrictions, especially considering the prevailing relational element in a PLLC. I conclude by disclosing my view of corporate and contractual evolution through an equivalent principle of artificial selection similar to that which took place with the selective breeding of the silver fox. My view is that legislatures have the ability to shape the behavior of market agents. They can do it in a dynamic way: by providing efficient default rules that are liable to change social phenomena that are commonly labelled “path-dependence.” This implies legal engineering and experimentation at different levels. It also implies a new theory of defaults that sees default rules as commodities that can be used to achieve the best contractual solutions within an evolutionary framework.

II. THE LAW AND ECONOMICS OF RESTRICTIONS ON TRANSFER OF SHARES: UNCERTAINTY AND LEGAL POLICY

Articles of association, as the contracts that they are, are necessarily incomplete: they cannot encompass all possible situations that shareholders, as “residual claimants,”⁷ will have to manage throughout the life of the firm. Hence, uncertainty and incomplete information in these circumstances are basic elements informing the so-called “theory of incomplete contracts.”⁸ Uncertainty is affected by several phenomena, such as incomplete or asymmetrical information, and opportunism in its different expressions.⁹ Uncertainty is an essential variable that must be considered and its implications must be understood in order to explain the purpose of market agents’ behavior, especially when it comes to applying or making good law. I view the market as a system to which the Darwinian principle of natural selection can be analogously applied, as it is applied to biological

⁶ When I first presented an early draft of this chapter at Fordham University Law School in 2013, I intuitively came up with the concept of the “organizational contract”; however, I dropped the concept. I believe that referring to the articles of association as contracts for the governance opportunity better illustrates the possibility of governing PLLCs and the relationships between corporate constituencies through contract. It also alludes to a particular view of default rules, by which legislators give an opportunity to members to govern their company’s articles of association.

⁷ See Sanford Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691, 695 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119, 1122 (1990).

⁸ This is almost intuitive with respect to the corporation, which in most cases is based on a long-term contract. See Larry E. Ribstein, *Close Corporation Remedies and the Evolution of the Closely Held Firm*, 33 W. NEW ENG. L. REV. 531, 548 (2011) (claiming that “[n]o statute or agreement can cover all the contingencies involved in a complex and open-ended contract like a business association”).

⁹ For a definition of uncertainty, see Armen A. Alchian, *Uncertainty, Evolution, and Economic Theory*, 58 J. POL. ECON. 211, 212 n.5 (1950) (defining uncertainty as “the phenomenon that produces overlapping distributions of potential outcomes”).

evolution.¹⁰ This approach is based upon a model of legislative policy that is intended to overcome the limitations of uncertainty in bargaining, markedly when what is at stake is the negotiation of property rights. Ultimately, this model should carry within it the potential to favor the development of the firm, and strengthen the property rights of members in weak bargaining positions. I distinguish between three levels of the legal system: the first level is that of the society; the second level is the level of the legislatures, the regulator, and the courts; and the third level is that of the market.

Level One is characterized by a degree of “social embeddedness” caused by traditions, customs and culture that is difficult to cut through.¹¹ It has, nevertheless, a pervasive effect on the economics of law. Therefore, the welfare effects of legal solutions must be considered. Level Two—the level Oliver Williamson calls the “institutional environment”¹²—features legislatures, courts, regulators and politicians.¹³ They act as selective agents with the ability to shape the environment wherein rules apply. Level Three is filled with “impersonal market forces.”¹⁴ This model emphasizes the interwoven nature of the second and third levels. It also shows how their interaction can affect the first level. It illustrates my perception of the often-discussed, bottom-up approach to law, and sustains a springboard for legal policy.¹⁵

Designing articles of association by including restrictions on the transfer of shares of company members is one way for lawyers to avoid the uncertainty that accompanies the inclusion of a third party in the company’s business. A distinction should be made at the outset between restrictions imposed by default rules provided by the legislature and particular restrictions agreed upon by the members and settled in the articles of association or operating agreements. The distinction is important because default rules established by a legislature fall within its work as selective agent (Level Two).¹⁶ On the other hand, rules established by members in

10 I will not draw here on the definition of market, much less on the definition of European Internal Market. However, it is easy to find in the literature conceptual references to “market.” See, e.g., ADOLF A. BERLE & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 313 (Harcourt rev. ed. 1967) (mentioning an economic organism typified by the corporation).

11 Oliver E. Williamson, *The New Institutional Economics: Taking Stock, Looking Ahead*, 38 J. ECON. LIT. 595, 596 (2000).

12 *Id.* at 598.

13 Courts are more interventive in common-law countries than in civil-law countries when there are lacunae in the law.

14 See Alchian, *supra* note 9, at 213.

15 This evolutionary approach is simultaneously very Ribsteinian. See Ribstein, *supra* note 8, at 560 (arguing, while discussing the potential of judicial dissolution, that “[l]egislatures should reject close-corporation-type language such as that found in the Revised Uniform Limited Liability Company Act § 701(a)(5), which provides for judicial dissolution based on ‘illegal,’ ‘fraudulent,’ or ‘oppressive’ acts without a clear reference to the agreement.” This is clearly a call for legal policy that is able to take contractual technology seriously and for legislatures to “invite the courts to bring those contracts to bear...”).

16 The selective agent is an environment agent which can influence the process of natural selection. It determines the desirable features to be inherited. In biology, some examples can be mentioned such as the selective breeding of pigeons, cows, horses, and dogs theorized by Darwin in

the articles of association are manifestations of private ordering, which are subject to natural selection (Level Three).¹⁷ This is a metaphor that I use throughout the article to illustrate that law, like nature, is the result of complex relationships that evolve over time and space. I suggest that there is a genetic component (e.g., market elements) which legislatures have to necessarily deal with. Market agents tend to agree on rules with a genetic predilection to survive, and this should be relevant for matters of legal policy.¹⁸

This article demonstrates that even though historically most articles of association introduce restrictions on transfer (even when the law adopts a liberal principle of free transferability), there is a status quo that shareholders prefer to maintain regarding the company's ownership and governance structure. This holds true even when it may not be in the economic interests of the company and may in fact harm its competitive position. Shareholders often ignore restrictions they have set up and frequently do not understand the law and rules they themselves have included in the articles of the company. Why, then, do members set up restrictions on transfers in the first place?

Uncertainty, as I stressed above, is the key answer. It lies in the fact that market agents do not know the outcome nor the probability of all possible outcomes. Members adopt restrictions as a safety balloon for naturally incomplete contracts. One might think that if contracts are kept unchanged, it means that they are somehow beneficial for market agents and, therefore, efficient. In principle, there should be no uncertainty here. One might think that the competitive purpose of markets always causes agents to make optimal choices, and this behavior is, for the most part, what nurtures market evolution. Nevertheless, this is not quite the case. Despite the principle of natural selection, there are circumstances where mutations (or, economically speaking, innovations) are subject to limitations. Change is unlikely to come about, and, if it does come, it is not consistent. First, there are physical limitations to evolution. Second, in the course of evolution, all intermediary forms must be advantageous. It is not possible to go from point A to point B if, along the way, point AB is not functional. Legislatures face similar difficulties. As much as evolution is desired, the fact is that legislatures can only go from point A to point B if the intervening

The Origin of the Species. See generally CHARLES DARWIN, *THE ORIGIN OF SPECIES*, 105 (150th anniv. ed. 2009).

¹⁷ I must clarify that I am aware that claims that human behavior is genetically determined tend to be extremely controversial. A case in point is the field of evolutionary psychology and the debates about it. Similar concerns appeared among anthropologists and others in respect to the research work developed by Napoleon Chagnon among the tribe Yanomani. In this case, accusations were highly inflamed and were not limited to genetic determinism. See Emily Eakin, *How Napoleon Chagnon Became Our Most Controversial Anthropologist*, N.Y. TIMES MAG. (Feb. 3, 1984), <http://www.nytimes.com/2013/02/17/magazine/napoleon-chagnon-americas-most-controversial-anthropologist.html>. I am not suggesting in this article any sort of genetic determinism of human behavior.

¹⁸ The term selective breeding is used by Darwin in reference to the farmer selecting the horses that are used for breeding. Level 2 is an allusion to the idea of the farmer selecting the animals. Level 3 is an allusion to the process of natural selection.

manifestations of doctrinal and socio-economic path-dependence are pulling in that direction.¹⁹

I now return to the model. Even if alterations to the law are introduced to reflect what is being undertaken at Level Three of the market, not all of them are efficient.²⁰ Some phenomena survive at Level Three, despite the enactment of new legislation. One example worth mentioning is the persistence of insider trading in American corporations even after it was banned in 1961 by the Securities and Exchange Commission (“SEC”).²¹ It was only in the wake of new technological developments, by which computers began to be used to track these unlawful practices, that firms became available to police the application of the rule banning insider trading. This only happened because the costs of enforcement decreased due to technological developments.²² Yet, not all limitations are insurmountable. Some can be overcome. The fact that some limitations to evolution are transposable and others are not is a puzzle that most likely can only be solved through legal engineering. Given that survival does not always occur for optimal reasons, there is a window of opportunity for legislatures who—through cognitive awareness, imagination and some courage to break with manifestations of path-dependence in both Levels Two and Three—have the possibility to create efficient laws. Legal engineering is, in this way, deeply rooted in the market’s dynamics. This is where Levels Two and Three meet.

The scheme I present here may be more obvious to economists who, in the face of uncertainty, are trained to make assumptions and create models that, with mathematical and economic tools, postulate certainty.²³ However, I think that legislatures can also take up the position of “outside observer” and cause a change in the legal system when and where it is needed. Additionally, this scheme reconciles the “institutional environment” with “governance structures” established in the market. It reconciles property-rights literature and transaction-costs economics. It does this by setting out a middle ground. Here, legislatures can create property rights to overcome contractual inefficiencies ex-ante and facilitate the creation of governance mechanisms to resolve contractual inefficiencies ex-post.

19 Path-dependency has not only been discussed in biology and law, but also in economics and economic history. See Paul A. David, *Clio and the Economics of QWERTY*, 75 AM. ECON. REV. 332, 333 (1985) (exploring the QWERTY world and explaining that QWERTY became historically locked-in as the dominant keyboard arrangement, despite other offers in the market. In a passage of his paper, David affirms that, “while they [the agents engaged in production and purchase decision in today’s keyboard market] are, as we now say, perfectly ‘free to choose,’ their behavior, nevertheless, is held fast in the grips of events long forgotten and shaped by circumstances in which neither they nor their interests figured...”).

20 There are limitations to selective breeding. Zebras, for example, have never been domesticated. Several factors play a role in determining the feasibility of selective breeding. The social structure is one of them.

21 See Frank H. Easterbrook, *Insider Trading as an Agency Problem*, in PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 81, 90–95 (John W. Pratt & Richard J. Zeckhauser eds., Harvard Bus. Sch. Press 1985).

22 *Id.*

23 Some lawyers and some economists may think this is a misunderstanding of the function of mathematical models.

The types of restrictions included in the articles of association, either by literal transcription of the default rule or designed by their members and lawyers, vary depending on the approaches taken by legislatures to the transfer of shares,²⁴ and on the size of the company, governance, business purpose, and other factors which might be germane to the regulation and operation of the company. The restriction to which I am referring is the requirement of consent of all shareholders, directors, or of one particular member (in principle, the majority member). Resolutions at the companies' general meetings providing for the consent of the company are made either by majority or unanimous consent of the members. Other restrictions that articles of association in all six jurisdictions provide for can be mentioned, without prejudice of their own specificities.²⁵ They are pre-emption rights and rights of first refusal, clauses prohibiting the pledge of shares, liens, or any charges over the shares, and their usufruct, formulas determining the price of sale of shares, which are especially associated with the exercise of pre-emption rights by the company and the members, and administrative corporate procedures prior to which a transfer will not be effective.²⁶ The operating agreements of American limited liability companies ("LLCs"), which are considerably longer than the constitutional documents of companies in European countries such as Portugal, Spain, Italy, France, and even the United Kingdom, also establish tag-along rights, rights of co-sale, sale purchase rights or "compelled sales," buy-sell agreements, put-rights, and similar rights.²⁷ Similar to private companies in the United Kingdom, management boards or managing members of American LLCs have wide powers to discretionarily or reasonably consent or refuse the transfer. There are, however, situations in which the transfer, especially of managing rights and the admission of new members, depends on the consent of the members. Vesting requirements, forfeiture provisions, minimum retained ownership requirements or other similar provisions, clauses limiting transfers to competitors, and lock-up prohibitions are other kinds of restrictions that can be found in the companies' articles. The analysis of these types of transfer restrictions backs up a broad concept of consent (consent *lato sensu*). It basically spells out the idea that transfers or changes in ownership require some sort of acceptance or approval. Additionally, I adopt a restricted concept of consent (consent *stricto sensu*) which refers to the variety of restrictions embodied in the companies' articles and LLC agreements.²⁸

24 Legislatures may take a contractualist or statutory approach to the transfer of shares.

25 Clauses foreseeing pre-emption rights can be very specific. The clauses of the articles of association of the Spanish SRL are a case in point. Moreover, triggering factors of restrictions (e.g., pre-emption rights or rights of first refusal) vary pursuant to the size of the company (i.e. the number of members, governance structure, and business purpose of the company—the purposes of equity funds, for example, are different from those of traditional family firms).

26 Indeed, corporate law doctrine has come a long way since the old debate about the validity of restrictions on stock that is defined as personal property. See generally William H. Painter, *Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal*, 6 VILL. L. REV. 48 (1961).

27 All these terms can be found by reading the clauses of the respective agreements.

In general, restrictions established in the articles of association of the companies of all six jurisdictions are very similar. One might think in this situation of a phenomenon of crossover of legal solutions. This is certainly true in the case of legal transplants.²⁹ In the particular case of restrictions on transfers, there is at least some of it. Some restrictions established in the law cross over jurisdictions. In other words, these restrictions share the same genetic material, despite the distance between the jurisdictions, their legal institutions, and stakeholders. They share the same historical origin, as opposed to a later transplant. The fact is that the more closely related the two jurisdictions are, the more they will share. For example, companies in the same legal family or with the same legal origin share “genetic” material by virtue of their shared “ancestry.” In this context, one can question whether there is a clear-cut way of distinguishing between a shared genetic origin and convergent evolution. For example, both insects and birds have wings.

This shared genetic material results in recombinant legal formulas.³⁰ Rather than innovation or exchange of new policies, legal solutions are inherited. There can be, however, mismatched alignments of policies, or unbalanced recombinations of legal rules. If this is the case, there will most likely be a genetic rearrangement of legal solutions from one country to another, a translocation of legal solutions from one body of law to the other (e.g., from corporate law to securities law), or an inversion of legal solutions.³¹ This idea, I think, surmounts the scarcity of explanations provided by specialized literature for the timing in which a

28 See generally Roger Brownsword, *Contract, Consent, and Civil Society: Private Governance and Public Imposition*, in 3 GLOBAL GOVERNANCE AND THE QUEST FOR JUSTICE 5 (Peter Odell & Chris Willett eds., Hart Publishing 2008) (presenting the concept of ‘originating consent’). It means the agreement parties give to the application of a rule-set to govern the deal they are making).

29 See Pierre Legrand, *The Impossibility of “Legal Transplants,”* 4 MASTRICHT J. EUR. & COMP. L. 111, 111 (1997).

30 This is a metaphor alluding to chromosomal crossover, which is an exchange of genetic material between homologous chromosomes.

31 See Henry Hansmann & Reinier Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439, 454–55 (2001) (advocating the convergence of corporate law into a uniform standard model—evolutionary convergence). Those that propose the idea of convergence think that global competition will determine an overall change in companies worldwide. There is the inherent assumption that states can change the law when they please, without limitations. I challenge this understanding with the idea of path-dependence and that mutations do not always occur in the same way. See MARK ROE, *POLITICAL DETERMINANTS OF CORPORATE GOVERNANCE: POLITICAL CONTEXT, CORPORATE IMPACT I* (Oxford Univ. Press, 2003) (arguing that there are still significant differences between the corporate governance in different jurisdictions, caused by differences in their political orientation. He shows there is a correlation between a social democratic form of government and certain corporate governance patterns). There are other arguments in favor of path-dependence closely linked with politics, economics, culture, social and commercial norms, and legal doctrines. I advance an argument of path-dependence based on an analogy with biology. Additionally, in the wider research framework I conducted and where this article is included, I look at the ways legal systems have historically responded to change, and this is something that neither side of the argument (pro-convergence v path-dependence) clarifies. See generally Lécia Vicente, *The Requirement of Consent for the Transfer of Shares and Freedoms of Movement: Toward the Liberalization of Private Limited Liability Companies: A Comparative Study of the Laws of Portugal, France, Italy, Spain, and the United Kingdom and the United States and Its Interplay with EU Law* (2014) (unpublished Ph.D. dissertation European University Institute) (on file with the Department of Law, European University Institute), <http://hdl.handle.net/1814/32211>.

follower country adopts law coming from a leader country.³² This sort of inheritance suggests that there are some genetic traits in the law likely to cross over jurisdictions and generations of legal rules.³³ Change occurs when there is a mutation. Mutations occur when market agents feel that it is advantageous to alter the genetic frequency or the evolution of the law, and that mutation is favored by natural selection.³⁴

The following sections develop these issues. They particularly focus on the role of legislatures as selective agents. The experiment of selective breeding of the silver fox fits here. They also point out the many ramifications of uncertainty of contractual relations within the firm. They do that by establishing a link to situations of equilibrium or stable strategies in the company, and to the relational element prevalent in these business organizations. Before moving on, however, some words should be offered as to the features of the articles of association. They are genetically contractual and a good showcase of private ordering (Level Three).

A. THE ARTICLES OF ASSOCIATION AS “CONTRACTS FOR THE GOVERNANCE OPPORTUNITY”

Corporate legal theory has been dominated by a powerful contractarian view for more than three decades, since the publication of the seminal

32 See Holger Spamann, *Contemporary Legal Transplants: Legal Families and the Diffusion of (Corporate) Law*, 2009 BYU L. REV. 1813, 1871 (2009) (stating that “[a]llowing a considerable lag between adoption in the leader country and adoption in the follower country is to recognize that other, complimentary forces affect the timing of adoption in the follower country. Such modesty, however, is a feature shared by all theories attempting to explain differences between legal families, which are obviously just a fraction of the variance between countries around the world. For example, the almost universal adoption of insider trading laws in the first half of the 1990s in both common and civil law countries cannot be explained by any theory focused on differences between common and civil law countries. What might be explained by such theories, however, is why the details of the laws adopted differ between common law and civil law countries.”).

33 This idea, expressed in the text, also tries to overcome the limitedness of criteria used by La Porta, Lopes-de-Sinales, Shleifer, and Vishny (informally known as LLSV) in explaining their legal origins theory, especially because I understand that legal systems cannot be understood as ahistorical, exogenous, immutable variables. One could say that in their theory, “legal origins” is the gene. However, the gene does not always express itself in the same way in each organism (each country) because there are different environmental factors. Some civil law countries may still have better investor protection than some common law countries. This can be related to the nature v. nurture debate. See Jérôme Sgard, *Do Legal Origins Matter? The Case of Bankruptcy Laws in Europe 1808–1914*, 10 EUROP. REV. ECON. HIST. 389, 411 (2006) (claiming that “Legal Origins” are a proxy for a social entity whose shape, structure, and quality remain elusive.). See also Rafael La Porta et al., *The Economic Consequences of Legal Origins*, 46 J. ECON. LIT. 285, 310 (2008).

34 See Paolo Di Martino, *Lobbying, Institutional Inertia, and the Efficiency Issue in State Regulation: Evidence from the Evolution of Bankruptcy Laws and Procedures in Italy, England, and the U.S. (c. 1870-1939)*, in STATE AND FINANCIAL SYSTEMS IN EUROPE AND THE USA: HISTORICAL PERSPECTIVES ON REGULATION AND SUPERVISION IN THE NINETEENTH AND TWENTIETH CENTURIES 41, 42 (Stefano Battilossi & Jaime Reis eds., Ashgate 2012) (noting that the persistence of sub-optimal legal institutions remains a puzzle. Referring to the adoption of new bankruptcy laws, Martino says that “[d]espite the general phenomenon of convergence towards similar principles and instruments, this evolution was not uniform across countries. Diversity did not necessarily manifest itself in the formal characteristics of the various laws, but more often either in the use of specific counterbalances, or in the timing of the introduction of various pieces of legislation. In terms of the efficiency of various bankruptcy systems, these differences were not neutral. In fact, specific procedures or norms failed to be adopted, or were introduced with a substantial lag, even when substantial agreement among contemporaries existed on their superior level of efficiency.”).

article of Jensen and Meckling.³⁵ There are several reasons for this. First, commentators who have significantly influenced the field have embraced this view. Second, the contractarian view, espoused with the methodological approach of law and economics, has created a strong platform, particularly in the United States, where traditional legal views have been debated, contested, and reformulated in line with welfare considerations. Third, contractarianism had the ability to reconcile conservative and liberal views of the market, in particular following the movement of deregulation in the 1970s in the United States, and to establish the foundations for superior normative constructions tackling the relationship between corporate constituencies.³⁶ Europe is developing its own system of law and economics, even though the gap between the two sides of the Pond has still to be filled.³⁷ Perhaps this has not yet happened because there still has not been a selective sweep that would encourage change.

I too adopt a contractarian view of corporate law. However, my contractarian view is mitigated by the opinion that property rights have an important (and often underestimated) role to play in the development of corporate law and its foundational principles.³⁸ Therefore, I try to avoid any sort of contractual determinism to provide a normative account of articles of association which is able to accommodate the introduction of contractual clauses establishing restrictions on transfers. I call the company's articles a "contract for the governance opportunity" (hereinafter also referred to as the company's contract).³⁹ I use this expression to escape from the determinism of the "nexus-of-contracts" theory. The articles of association of a private limited company are not just a contract or a bundle of contracts. The "nexus-of-contracts" theory should be mitigated with an adequate theory of property rights. The term "contract for the governance

³⁵ See generally Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976); FRANK H. EASTERBROOK & DANIEL R. FISCHER, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* (Harvard Univ. Press 1991); BRIAN R. CHEFFINS, *COMPANY LAW: THEORY, STRUCTURE, AND OPERATION* (Clarendon Press 1997).

³⁶ See Paul L. Joskow, *Deregulation and Regulatory Reform in the U.S. Electric Power Sector*, in *DEREGULATION OF NETWORK INDUSTRIES: WHAT'S NEXT?* 113, 118 (Sam Peltzman & Clifford Winston eds., Brookings Institution Press 2000) (referring to the rapid expansion of wholesale electricity markets in the United States in the 1970s).

³⁷ See Nuno Garoupa, *Ronald Coase and Law and Economics in Europe*, 59 INT. REV. LAW & ECON. 223, 223–24 (2012).

³⁸ For an opposition to the contractarian theory, see Sandra K. Miller, *Fiduciary Duties in the LLC: Mandatory Core Duties to Protect the Interests of Others Beyond the Contracting Parties*, 46 AM. BUS. L.J. 243 (2009). Miller shows herself against the "nexus of contracts approach," *id.* at 268, and advancing a "Theory of Mandatory Core Duties," *id.* at 243. With this theory she stresses the importance of fiduciary duties to overcome the limitations of the contractarian theory. She recommends a vision of the "LLC as a social entity that must be subject to mandatory fiduciary duties in the interest of public policy," *id.* at 271. See also John Armour & Michael J. Whincop, *The Proprietary Foundations of Corporate Law*, 27 OXFORD J. LEGAL STUDIES 429, 462 (2007) (stating clearly the importance of property law in complementing the economic theory of the firm).

³⁹ See Frank H. Easterbrook & Daniel R. Fischel, *The Corporate Contract*, 89 COLUM. L. REV. 1416, 1416 (1989) (referring to the corporate charter as "contract of adhesion"). In French law and doctrine, articles of association are referred to as the *contrat de société*. This nomenclature also is used in French-based legal systems.

opportunity” is a reference to contract governance or, in Williamson’s words, “governance of contractual relations.” There is, however, one peculiarity. I try to reconcile transaction-costs economics (“TCE”) and the property-rights literature by creating mechanisms to solve contractual inefficiencies both ex-ante and ex-post. TCE views the transaction as a “basic unit of analysis.”⁴⁰ Assuming that contracts are incomplete due to transaction costs, private ordering is seen as an essential element to overcome ex-post contractual inefficiencies. Property-rights literature centers on creating incentives such as “residual rights of control” to overcome ex-ante contractual inefficiencies.⁴¹ Therefore, I assume a middle position in the transaction-costs v. property-rights debate. The term “opportunity” in this context is related to the purpose of default rules. By providing a default rule, legislatures and courts, where they are allowed to by law, give market agents the opportunity to contract around a default rule. One may note that this can be said of almost any contract. The problem is that when default rules are not provided by legislatures or courts, lawyers tend to use their imagination to draft the contract. When default rules are provided, the tendency is to use them and not to contract around them, unless the client really wants something different. The point is, when default rules are provided, members and their respective lawyers should take the opportunity to govern their relationships either by keeping the default rule or by adopting some different legal framework as long as it is Pareto efficient. In this sense, the definition of “contract for the governance opportunity” is broader than “organizational contract” because it implies a theory of defaults as commodities that can be used to steer contractual relations within an evolutionary framework. This means that defaults become tools for the regeneration of contractual relations. In this context, not only property rights are relevant ex-ante, but also their governance by contract is important ex-post.⁴²

I tend to look at principles of corporate law through the lens of contract.⁴³ This is consistent with the idea of law as a byproduct of private

40 See OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM: FIRMS, MARKETS, RELATIONAL CONTRACTING* 18 (Free Press 1985).

41 See Grossman & Hart, *supra* note 7, at 695.

42 See Hart & Moore, *supra* note 7, at 1122 (“First, the incompleteness of contracts means that the future return on an individual’s current action will depend on his ‘marketability’ or bargaining position tomorrow in ways that cannot be controlled via the original contract. Second, the existence of asset specificity means that an agent’s marketability or bargaining position will depend on which assets he has access to and hence will be sensitive to the allocation of asset ownership.”). See also Raghuram G. Rajan & Luigi Zingales, *Power in a Theory of the Firm*, 113 Q.J. ECON. 387, 387–88 (1998) (refining Grossman, Hart, and Moore’s work on property rights by providing a framework for public corporations that promotes the ability to retain power in a firm or business organization as a form to create ex-ante incentives to investment); Margaret M. Blair & Lynn A. Stout, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 271–76, 267 n.38 (1999) (presenting a non-mathematical version of Rajan’s and Zingale’s aforementioned paper).

43 Larry Ribstein, who has provided a considerable contribution to the normative understanding of the “unincorporation” in the United States, stands out in the literature as a contractarian. In the jurisprudence see, for instance, *Fisk Ventures, L.L.C. v. Segal*, No. 3017-CC, 2008 Del. Ch. LEXIS 158 (2008) (contemplating a dispute on breach of fiduciary duties and of the relevant LLC agreement, the court held that limited liability companies are creatures not of state but of contract). Furthermore, this is in line with the ideas promoted by advocates of transaction-costs economics. See

ordering manifestations or *extended phenotype*. I concede, however, that there are basic principles of corporate law theory which cannot be developed by contract. Cases in point are limited liability, capital lock-in, and even fiduciary duties.⁴⁴ These core features of business associations are not contractual in their essence. They are conceived to protect the investors and third parties (i.e., creditors, the tax administration, or any other persons to whom compensation is due). This is why they are regulated by organizational law.⁴⁵ Furthermore, contractual freedom is, paradoxically, liable to create deadlocks, problems of interpretation, asymmetries of information, and difficulties in combining action. (This is not to demonize freedom of contract, which I praise, but simply to point out the paradox.)⁴⁶ These problems are particularly enhanced when property rights are weak or poorly defined ex-ante.⁴⁷ Additionally, the exercise of freedom of contract is not able to undo per se bilateral monopoly-like situations or hold-ups in

WILLIAMSON, *supra* note 40, at 398 (stating that contract is a “unifying concept of organization that illuminates” areas such as antitrust, regulation, corporate governance, and labor).

44 I reckon my statement regarding fiduciary duties is disputable. I refer to them, however, because of duties directors owe to creditors if the company becomes insolvent, for example. See *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communication*. See also *Communs. Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215, at *108 (1991). See also Holger Fleischer, *The Responsibility of the Management and of the Board and its Enforcement*, in *REFORMING COMPANY AND TAKEOVER LAW IN EUROPE* 373, 393-396 (Guido Ferrarini et al. eds., Oxford Univ. Press 2004) (discussing whether directors owe fiduciary duties to creditors.); *Liquidator W. Mercia Safetywear Ltd. v. Dodd.*, Court of Appeal, Civil Division, (1988) 4 BCCB.C.C. 30 at *30 (Eng.).

45 See Henry Hansmann & Reinier Kraakman, *The Essential Role of Organizational Law*, 110 *YALE L. J.* 387, 406 (2000) (presenting several arguments explaining the distinctive features of business associations and organizational law, which cannot be otherwise adequately covered by property law, contract law, and agency law). See also Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 *UCLA L. REV.* 387, 414 (2003) (providing a historical account of the development of organizational law in the United States).

46 This paradox may echo another paradox heeded by Polanyi: the existence of self-regulated markets and the opposite move towards needed state intervention. It also may resound another debate regarding state intervention in building and shaping the market through the idea of “embedded autonomy” treated by Peter Evans. See KARL POLANYI, *THE GREAT TRANSFORMATION: THE POLITICAL AND ECONOMIC ORIGINS OF OUR TIME* 210-13 (Beacon Press 2nd ed. 2001); PETER B. EVANS, *EMBEDDED AUTONOMY: STATES AND INDUSTRIAL TRANSFORMATION*, 3-4 (Princeton Univ. Press 1995). I am not here advocating such interference of the state.

47 See Kenneth E. Scott, *Agency Costs and Corporate Governance*, in *THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW* 26 (Peter Newman ed., Palgrave 2002) (asking “Why are shareholders’ property rights so poorly defined?” His argument then runs like this: “The usual answer is that the stockholders’ essential function necessitates that condition. They are the bearers of the residual risk of the firm, enabling debtholders and others to contract with it on more definite terms; their claims come last, after all the other various contingencies and claims are satisfied, and hence it is impractical to try to spell them out in detail under all states of the world. The status of stockholders provides a paradigm of the (highly) incomplete contract.”). See Hansmann & Kraakman, *supra* note 45, at 440 (claiming that the contractual functions of organizational law such as default rules or even mandatory rules protecting the interests of the parties who would otherwise be disadvantaged in the contracting process are undoubtedly useful. They are not, however, essential “in the sense that modern firms could not feasibly be constructed if organizational law did not perform them. A far more important function of organizational law is to define the property rights over which participants in a firm can contract.”). See also Michael J. Whincop, *Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law*, 19 *OXFORD J. LEGAL STUDIES* 19 (1999) (referring to the improvement of the contractarian theory “by supplementation with a richer theory of entitlements and property rights”); Antonio Nicita & Matteo Rizzolli, *Hold-up and Externality: The Firm as a Nexus of Incomplete Rights?*, 59 *INT. REV. ECON.* 157, 159 (2012) (suggesting that “the missing step in the Coasean legacy is a theory of the firm as a transaction cost-minimizing institution with reference both to incomplete contracts and to incomplete property rights.”).

the company (in particular companies with fifty-fifty partners) and to overcome the challenges often created by inefficient laws.⁴⁸

Consequently, for the above-noted reasons, my commitment to contractarianism is more normative than positive.⁴⁹ The paradigm of the company as a “nexus of contracts” is frequently presented in its positive feature in the sense that it does not give theoretical insights as to the type of rules corporate law (or the standard contract Easterbrook and Fischel refer to) should provide for the development of business associations.⁵⁰ It does not provide a normative account as to the role each corporate constituency has or should have in the development of the corporation.⁵¹

I do not think that corporate law is an extension of contract law.⁵² However, corporate law should enable interrelationships between

48 See Gary D. Libecap, *Property Rights in Economic History: Implications for Research*, 23 EXPLORATIONS ECON. HIST. 227, 244 (1986) (saying apropos private contracting to limit oil production that the investigation undertaken by Libecap and Wiggins in the field of unitization in Oklahoma and Texas from 1926 to 1935 showed that “private unit agreements were uncommon. Examination of bargaining on seven fields in Texas reveals that agreement took from 4 to 8 years, with contracts completed only late in field life after most common pool losses had been inflicted...” He goes on to say, “These findings temper the optimistic belief of some economists that private solutions will emerge to prevent serious efficiency losses.”).

49 See Grant M. Hoyden & Matthew T. Bodie, *The Uncorporation and the Unravelling of “Nexus of Contracts” Theory*, 109 MICH. L. REV. 1127, 1134 (2011) (“To be sure, Ribstein is committed to nexus of contracts theory in its normative instantiation; he believes that individual participants in a business organization should be left free to construct that organization as they see fit.”). See also Henry N. Butler & Larry E. Ribstein, *Opting Out of Fiduciary Duties: A Response to the Anti-Contractarians*, 65 WASH. L. REV. 1, 1 n.1, 25 (1990). But see Jensen & Meckling, *supra* note 35, at 310–11; Easterbrook & Fischel, *supra* note 39, at 1426–27; Jonathan R. Macey, *Fiduciary Duties as Residual Claims: Obligations to Non-shareholder Constituencies from a Theory of the Firm Perspective*, 84 CORNELL L. REV. 1266, 1266 (1998–99).

50 See Easterbrook & Fischel, *supra* note 39, at 1444 (“...[W]hy law? Why not just abolish corporate law and let people negotiate whatever contracts they please? The short but not entirely satisfactory answer is that corporate law is a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting.”).

51 To be fair, I am not sure whether law will necessarily provide information as to the role each constituency must have in the development of the company. Legal rules, however, should be designed to bear out the evolutionary paradigm of the sort I assert in this article.

52 The PLLC in the countries referred to in the text is more “contractarian” than the publicly held corporation. For example, the fact that the Spanish Companies Law (*Ley de Sociedades de Capital*) specifically foresees in its Article 28 the principle of freedom of contract is noteworthy. It states that “En la escritura y en los estatutos se podrán incluir, además, todos los pactos y condiciones que los socios fundadores juzguen conveniente establecer, siempre que no se opongan a las leyes ni contradigan los principios configuradores del tipo social elegido” (“All the agreements and conditions which the founding shareholders deem necessary to establish may be included in the deed of incorporation and articles of association, if they are not contrary to the law and they do not contradict the principles of the type of business association selected [by the shareholders]”). *Ley de Sociedades de Capital* art. 28 (B.O.E. 2010, 161) (Spain). However, it is important to stress the differences between countries regarding the evolution of these business organizations and the extent of influence of the state. For example, whilst in the United Kingdom the private company derived from a sort of “license” granted by the state, in the United States, the LLC developed from partnership law.

Differently, in the Portuguese literature, see CARLOS FERREIRA DE ALMEIDA, *CONTRATOS I: CONCEITOS, FONTES, FORMAÇÃO* 28 (33rd ed., Almedina 2005) (Port.) (adopting a broad concept of contract. Almeida considers, therefore, that articles of association of business associations are indeed contracts). Also in the United Kingdom case, the explanatory notes referring to the Companies Act 2006, c. 46, § 18 (Eng.), explain that the articles of association “form a statutory contract between the company and its members, and between each of the members in their capacity as members, and are an integral part of a company’s constitution...” Companies Act 2006, c. 46, Explanatory Notes ¶ 64 (Eng.). This idea is captured by the Companies Act 2006, c. 46, § 33(Eng.), stating that “[t]he provisions of the company’s constitution bind the company and its members to the same extent as if there were covenants

corporate constituencies in the most efficient way. (This idea includes creating the most efficient tools to prevent the occurrence of agency problems and hold-ups). For instance, in the United Kingdom, historically, shareholders' primacy in terms of influence in the company is a myth. Often, decisions are taken by directors even though the level of dependence of the corporation on its shareholders is high.⁵³

Therefore, I use the rhetoric of contract to understand how, in fact, corporate constituencies interrelate, and how this interrelation may contribute to better corporate law rules. I use this kind of rhetoric to express the significance of contractual aspects of the company without wanting to be understood as conveying the message that the company is a contract. It is not. Consequently, the expression 'contract for the governance opportunity' in the title of this section tries to capture the importance of *both* shareholders and non-shareholders in the company. It also attempts to avoid 'one size fits all' type of answers as to the nature of the articles of association or operating agreements. Above all, the reference to "contract for the governance opportunity" illustrates my view that articles of association and operating agreements are instruments that reconcile the interests of the corporate constituencies in accordance with the organizational structure of the company.⁵⁴

on the part of the company and of each member to observe it." See also PAUL L. DAVIES, GOWER AND DAVIES: PRINCIPLES OF MODERN COMPANY LAW 65-76 (8th ed., Sweet & Maxwell 2008) (considering that the articles constitute a rather particular form of contract. He calls them a "multi-party contract"); J.E. Penner, *Voluntary Obligations and the Scope of the Law of Contract*, in 2 LEGAL THEORY 325, 344 (Cambridge Univ. Press 1996) ("...[E]xamples from English law show that it may be important to find a 'doctrinal home' for some kinds of agreement or relationships that are, at present, rather ill-suited to their present accommodation."). I quote this passage because I consider it can be used for the articles of association of a company.

As to the Italian case, see, for instance, CODICE CIVILE ANNOTATO CON LA GIURISPRUDENZA 2681 (7 Francesco Caringella & Giuseppe De Marzo eds., 7th ed., Simone, 2004) (defining Article 2247 (*contratto di società*) articles of association as a genre of plurilateral associative agreements (*contratti plurilaterali di tipo associativo*). This designation translates the idea that the scope of the corporation does not end in a general purpose of revenue; it also consists of the distribution of dividends among shareholders.

⁵³ This is interesting because, in general terms, corporations in Europe display a higher level of shareholders' autonomy and control vis-à-vis the company. This is not the case, for instance, in the United States where boards of directors are quite strong. They are known for their insulation vis-à-vis shareholders and other non-shareholders constituencies. I concede, however, that it is important to distinguish private from public companies, and understand the kind of influence shareholders are liable to have in the former. See Martin Gelter, *The Dark Side of Shareholder Influence: Managerial Autonomy and Stakeholder Orientation in Comparative Corporate Governance*, 50 Harv. Int'l L.J. 129, 147 (2009) (distinguishing explicit from implicit shareholders' influence in public companies. The comparison, I believe, may be made with private companies provided considerations as to the nature of these companies are duly made. The key is the high level of ownership concentration in private companies).

⁵⁴ I take into consideration aspects such as limited liability, the number of shareholders, directors and employees, the terms in which the decision-making process of the company is organized, the allocation of shares and division of the share capital, the number of votes each shareholder has, the quorum needed for resolutions at the company's general meetings be validly taken, etc. See G.H. Treitel, THE LAW OF CONTRACT 586 (11th ed. 2003) ("Under the Companies Act the memorandum and articles of association of a company bind the company and its members as if they had been signed and sealed by each member and contained covenants by each member to observe the provisions of the memorandum and articles."). In addition, Treitel defines the memorandum and articles as a "statutory contract."

The use of this rhetoric does not imply that the company is based on a cluster of arms-length contracts. Instead, it means that the company is the background for never-ending negotiations and bargains. Often, such processes are related to the adoption of institutional solutions and compromises, or to the decision-making process as it takes place at the company's general meetings or board of directors meetings, or even related to the ex-post definition of property rights. Although this discussion about the contractual nature of the company has lost much of its glow regarding the publicly-held company, it makes complete sense with regard to the private company.

B. THE MANY PURPOSES OF SETTING FORTH CONSENT *STRICTO SENSU* IN THE ARTICLES OF ASSOCIATION OR OPERATING AGREEMENT OF THE COMPANY

In principle, people enter into contracts that they deem to be optimal. For some members of PLLCs, restrictions on transfer of shares are optimal. Perhaps, they hold a common social capital that cannot be produced or enforced by law if they cooperate with outsiders. Empirically, it is apparent that there are bargaining failures with regard to transfer of shares of PLLCs where there existed this common social capital.⁵⁵ Interestingly, bargaining failures adjudicated by courts in the aforementioned countries are similar. Bargaining failures may be grouped into four clusters: interpretation, functionality of restrictions on transfers, un-consented transfers, and formalities. The reader may legitimately ask: if there are bargaining failures where there is a social capital, what is the purpose of these restrictions? There are different restrictions, which are perceived differently, in each country. Restrictions on transfer of shares have many purposes, but in general they are set forth in the articles of association to:

1. Guarantee the quality of human capital and that contractual commitments in this regard are complied with;
2. Protect the day-to-day operations of the company;
3. Tame property rights of shareholders by internalizing, through contract, the risks inherent to owning property rights in shares;⁵⁶
4. Guarantee tax obligations are met and the company status for tax purposes is kept, that is, that the company is not taxed as a corporation;⁵⁷
5. Ensure that the company's members can operate anonymously;

⁵⁵ See Vicente, *supra* note 31.

⁵⁶ This suggests basic principles, such as the principle of tipicity in property, should be revisited.

⁵⁷ See Jonathan R. Macey, *The Limited Liability Company: Lessons for Corporate Law*, 73 Wash. U. L.Q. 433, fn. 21 (1995) ("The desire to protect the tax status of limited liability companies explains why every state's enabling statute authorizing the formation of such companies restricts, without exception, the transferability of interests."). See also Robert R. Keatinge et al., *The Limited Liability Company: A Study of the Emerging Entity*, 47 Bus. Law 375 (1992); Daniel S. Kleinberger, *Two Decades of "Alternative Entities": From Tax Rationalization through Alphabet Soup to Contract as Deity*, 14 Fordham J. Corp. & Fin. L. 445 (2008).

6. Avoid regulatory restrictions;
7. Combine the PLLC structure with the closed nature of the company, and in this way enable the respective members to insulate themselves from passive investors acquiring control over their investments;
8. Prevent “introduction of a stranger into the contracting parties” relationships and assure performance by the original contracting parties. In some business relationships the continued personal involvement of an original contracting party is a material premise of the contract itself. In such cases any assignment is problematic. In other cases, the parties fear the assignee will perform inadequately, in which case what is problematic is not the assignment per se but the identity of the assignee;⁵⁸
9. Preserve the identity of the company or managers who exercise ultimate control over the business partners;⁵⁹
10. Prevent the transfer of a controlling interest in a partner entity because such transaction effectively transfers a partner interest to the party acquiring the controlling interest of the partner entity;
11. To define members’ contractual rights and limit the authority of courts to redo their deals;⁶⁰
12. Preclude a third party from assuming, at least, those parts of the contract granting special rights and particular obligations to the member because the operating agreement is viewed as an executory contract that makes the member a key element of the company and also of its management on a going-forward basis;⁶¹
13. Facilitate the succession of the business to future generations, considering that, during the lifetime of the company, most investors do not take the necessary steps to initiate, plan and carry out the succession in due time;⁶²
14. Facilitate the transmission of “idiosyncratic knowledge” created within the family. This knowledge can be most easily given to the next generation within a family;⁶³

58 See *EIG Global Energy Partners, LLC v. TCW Asset Mgmt. Co.*, No. CV 12-7173 CAS (MANx), 2012 U.S. Dist. LEXIS 171412 (C.D. Cal. Nov. 30, 2012).

59 See *Re Zinotty Properties Ltd.*, [1984] 1 W.L.R. WLR 1249 (Ch).

60 See *Re Swaledale Cleaners* [1968] 1 W.L.R. WLR 432 (AC). In respect to the definition of members’ rights this case is interesting because it stresses the general principle that a transfer duly lodged should be brought before the board within a reasonable time after it was lodged where the articles of association contain a restriction on transfer. If it is not the case, directors lose the right to refuse the transfer which was attributed to them by the articles of association and Table A which, in this case, was adopted even if with some alterations.

61 See *Milford Power Co., LLC v. PDC Milford Power, LLC*, 866 A.2d 738 (Ch.; 2004 Del. 2004).

62 See Per-Olof Bjuggren & Lars-Göran Sund, *Strategic Decision Making in Intergenerational Successions of Small and Medium-Size Family Owned Businesses*, 14 FAM. BUS. REV. 11 (2001) [hereinafter *Strategic Decision Making*]. See also Lars-Göran Sund & Per-Olof Bjuggren, *Ownership Restrictions, Risk and Team Considerations in Family-Owned Businesses*, 22 E.B.L.R. 93 (2011).

63 See *Strategic Decision Making*, *supra* note 62.

15. Control minority shareholders. “Poison pills,” which are normally used as defensive measures, can also operate as restrictions. This comes along with oppression of minority shareholders;⁶⁴
16. Keep the special competitive advantages (e.g., idiosyncrasies) of the business, especially when the firm is a family business;⁶⁵
17. Protect the family ties of the business to allow members to be part of a “transaction cost reducing social network”;⁶⁶
18. Avoid the complexities arising from the death of the owner of the shares: whether she is a single owner, a majority owner, or a minority owner;⁶⁷
19. To create an “internal market” among shareholders that aims to circumvent the lack of liquidity as a result of the inexistence of an external market for the shares of the PLLC;⁶⁸
20. Prevent a successful business team from being changed in an unwanted way;
21. Reduce transaction costs;⁶⁹
22. Set up a corporate governance strategy for the company;
23. Guarantee that those who manage are compatible managers;⁷⁰
24. To achieve a balance between managers’ and shareholders’ power so as to turn the company into a shared enterprise;⁷¹
25. To exclude investors who may upset the apple cart, either because they have conflicting interests such as a stake in a competitor firm

64 See *eBay Domestic Holding, Inc. v Newmark*, No. 3705-CC, 2009 Del. Ch. LEXIS 175 (Del. Ch. Oct. 2, 2009). In this case, the board of directors of Craigslist, Inc. approved a rights plan (poison pill). Craigslist, Inc. is a close corporation with a control group formed by the following shareholders: Craig Newmark, James Buckmaster, and eBay Holdings, Inc. Both Newmark and Buckmaster served as two of the three members of the board of directors. eBay brought an action claiming that the effects of the rights plan restricted eBay from purchasing shares in Craigslist and it prevented eBay from freely selling its Craigslist shares to third parties.

65 See *Strategic Decision Making*, *supra* note 62.

66 See Per-Olof Bjuggren & Lars-Göran Sund, *A Transaction Cost Rationale for Transition of the Firm within the Family*, 19 *SMALL BUS. ECON.* 123, 130 (2002).

67 See *Strategic Decision Making*, *supra* note 62.

68 See Lars-Göran Sund & Per-Olof Bjuggren, *Protection of Ownership in Family Firms: Post-Sale Purchase Clauses and Management Perspective*, 33 *Europ. J. Law Econ.* 359 (2012). For instance, buy-sell clauses as those inserted in the articles of association of Spanish SRLs and in the operating agreements of American LLCs are good examples.

69 See Antonio B. Perdices Huetos, *Clausulas Restrictivas de la Transmision de Acciones y Participaciones*, Madrid: Editorial Civitas 26 (1997) (“The reason for restrictions on transfer of shares rests, in my opinion, on the general problem of reduction of transaction costs and, in particular, the costs to assure the compliance with the obligations accepted from a long-term contract of collaboration such as that of a corporation.”) (translated).

70 See Frank H. Easterbrook & Daniel R. Fischel, *Close Corporations and Agency Costs*, 38 *Stan. L. Rev.* 271, 273 (1985).

71 See Christopher M. Bruner, *The Enduring Ambivalence of Corporate Law*, 59 *Ala. L. Rev.* 1385, 1422–23 (2008) (focusing on the ambivalence of what he calls power constituencies and stressing that Delaware courts have achieved a balance between the board’s and shareholders’ power in publicly held companies through takeover jurisprudence similarly to what they did in respect to other transactions such as mergers).

or different investment goals, or are just difficult to do business with;⁷²

26. To control who becomes a fellow member in the company, especially if the the company is equally owned by only two parties and one of them invested a large amount of money in a risky, long-term project;⁷³ and
27. To avoid registration of units of American LLCs under the Securities Act of 1933 or other stringent federal or state securities or blue sky law.⁷⁴

The variety of reasons for establishing restrictions on transfers suggests a strong presence of a relational element in these companies and ever-changing needs of the business environment.⁷⁵ The fact is that it is difficult for legislatures to keep up with this. Not only legislatures, but also courts, lawyers, and other stakeholders are liable to shape the environment in which rules are potentially applied. However, agreements change much faster than legislatures. This is particularly true given the fact that the relational element is prevalent in these business associations. So, why do legislatures create default rules restricting transfers (Level Two of the model)? Through default rules, legislatures are in a position to choreograph those events which can potentially destabilize the development of a company. The selection of the events that should be protected by the law and the creation of rules for that purpose are liable to trigger fundamental changes in legal solutions and rules already embedded in the legal system. By setting forth defaults restricting transfer of shares, legislatures are taming property rights in shares.⁷⁶ This way, it maintains the closed nature of the company, assures that transfers or changes in the companies' ownership structures are approached from a property rights perspective, and affects the behavior of market agents as to their perception of the investment they have made in the company and the relationships of power between members and managers or directors of the corporation. However, it is important to note that artificial selection is not always successful. It may find resistance at the level of social structures (Level One of the model) and market structures (Level Three of the model).⁷⁷ I deal with this

⁷² See George W. Dent Jr., *Business Lawyers as Enterprise Architects*, 64 *Bus. Law* 279, 305 (2009).

⁷³ See *Court of Chancery of Del. Eureka VIII, LLC v. Niagara Falls Holdings Del. Ch., LLC*, 899 A.2d 95 (2006).

⁷⁴ The term "blue sky law" is generally used to refer to regulation that protects investors from securities fraud. This type of clause can also be found in the operating agreements of American LLCs.

⁷⁵ See Henry Hansmann, *Corporation and Contract*, 8 *Amer. Law Econ. Rev.* 1, 10 ("the relations within a corporation are also long-term relational contracts"). See also Robert E. Scott, *A Relational Theory of Default Rules for Commercial Contracts*, 19 *J. Legal Stud.* 597 (1990).

⁷⁶ I use the word "taming" to refer to domestication. Domestication is undertaken through selective breeding or artificial selection. This is a process by which desirable characteristics in a living organism are selected to be inherited by future generations. Artificial selection determines a change in the phenotype of the characteristics of an organism such as morphologic and physiologic traits and behavior. In my analogy, legislatures may be compared to the farmer selecting animals for breeding which Darwin talked about in *The Origin of Species*.

⁷⁷ Similarly, in nature, not all animals can be domesticated.

process of artificial selection by legislatures below, and suggest an explanation for the effects that restrictions may have on the configuration of property rights in shares. Again, we may return to the taming of the silver fox.

III. THE DOMESTICATION OF PROPERTY RIGHTS AND THE SILVER FOX

In the late 1950s, Russian geneticist Dmitry K. Belyaev kicked off what became a long standing set of experiments based upon the domestication of the silver fox. His hypothesis was that changes in the physics and morphology of dogs and other domesticated animals could be the result of selecting the trait of friendliness towards human beings.⁷⁸ More simply, the action of taming dogs would directly affect the way they looked and the structure of their bodies. This was also true of the silver fox. According to Belyaev, domestication would result in silver foxes behaving in the same manner as dogs and developing similar morphological and physical traits such as: fur color, tooth shape, ear size, skull, similar legs and tails, similar barking, and submission as opposed to their wild forebears. Through his experiments, Belyaev also found that silver foxes developed a white spot on their forehead that was similar not only to dogs, but also to cats and horses. This became a sign of domestication.

One may wonder if a similar evolutionary pattern can be found in the law. The crossover of legal solutions mentioned above regarding the introduction of restrictions on transfer of shares, which was spelled out by almost 200 articles of association of companies included in my samples, suggests that there is a similar evolutionary pattern with respect to the configuration of property rights in shares.⁷⁹

The story of the silver fox is not new. In his acclaimed *Origin of Species*, while discussing the probable origin of domestic pigeons, Darwin stressed that there are differences between several types of pigeons. There are differences that have accumulated for many successive generations. Variations in pigeons are the result of natural selection. Darwin wrote that “The key is man’s power of accumulative selection: nature gives successive variations [and] man adds them in certain directions useful to him. In this sense, he may be said to have made for himself useful breeds.”⁸⁰ This principle of selection is not a modern discovery.

By setting up this analogy, I am dressing law in hand-me-down principles of other fields such as biology to explain its evolution, which in many instances takes place in a very organic way. Hence, the story of the silver fox illustrates how legal institutions and fields are connected in an

⁷⁸ Lyudmila N. Trut, *Early Canid Domestication: The Farm-Fox Experiment*, 87 *Am. Sci.* 160, 162 (1999).

⁷⁹ See Vicente *supra* note 31.

⁸⁰ Charles Darwin, *The Origin of Species* 34 (1859).

unexpected fashion. It tries to show the unintended consequences of this interconnection. The way market agents behave should be regulated by reaching a balance between endogenous elements, which are engrained in the market and which transmit signals from a market's sensitive area to targeted agents. These endogenous elements also transmit the signals or messages sent by certain market agents which will have an effect on other market agents. The way the signals of the market are conveyed can be controlled by the law.

The analogy rests on the fact that the introduction in the articles of association of restrictions on transfer of property rights in shares has far-reaching effects. The related biological term is "pleiotropy."⁸¹ It not only posits that property rights in shares should be analyzed differently from intellectual property rights or property rights in real estate for example, but also that corporate law, due to its specificity, tames property rights and their features such that the rights owners hold to determine the use of their own assets, the return from those assets, and to freely transfer their assets are adapted to the nature and purpose of the business form. Corporate law, contract law, and property law are linked in an unexpected way.⁸² In the PLLC context, this can be illustrated with an example. Let us think of a case where PX sells five shares in the company to her mother MX. In her turn, MX transfers the shares to her daughter MMX. As a consequence, the company files a suit against MMX claiming the invalidity of the transfer. However, the articles of the company provide that transfers are free between ascendants and descendants. Hence, the court considered that the transfer of shares of PX to her mother MX and, subsequently, the transfer by the latter to her other daughter MMX were lawfully executed. The company claims that these transactions were a fraud since their ultimate goal was to circumvent the transfer clause established in the articles of association. Still, the court held that the concomitance of two transfers was not enough to define these transfers as fraudulent or to determine that the transferors were acting in a deceitful fashion. Therefore, it would be unjustified not to consider MX a shareholder with the right to transfer her share to her daughter MMX. The company appeals to a higher court. The court of appeal validates the decision of the lower court, but not without explaining that if there had been evidence that the concomitant transfer of shares entered into and between MMX and her mother MX did not have any *affectio societatis*,⁸³ and did not have as a sole objective to allow the

81 Pleiotropy happens when one gene affects several phenotypic traits. In the silver fox, the genetic unexpected connection between physical and behavioral characteristics is a manifestation of pleiotropy.

82 This explains why restrictions on transfer of property rights in shares are generally valid, even though shares are frequently defined as personal property. See William H. Painter, *Stock Transfer Restrictions: Continuing Uncertainties and a Legislative Proposal*, 6 Vill. L. Rev. 48, 49-50 (1960 (1961) (dwelling on this issue).

83 *Affectio societatis* is a fundamental principle of French corporate law. It has been adopted in corporate laws of other civil law countries such as Italy, Portugal, and Spain. *Affectio societatis* is the members desire to associate in the form of a business organization. This desire is legally informed by the articles of association or company's contract.

transfer of shares to MMX but rather to subsequently transfer them to third parties outside the company, and by doing so, avoid the articles of association, then the lower court's decision would not have been justified.⁸⁴ This is an example, among several others, that shows how the exercise of property rights (property law) can be limited by a previous agreement entered into by the members of a business organization (contract law) and by what is defined as the *affectio societatis* of the company (corporate law). This shows how there can be manifestations of *pleiotropy* in law. In this case, property rights in shares are differently configured in their physiology and morphology due to the restrictions imposed on their transfer.

Moreover, there are manifestations of path-dependence in the development of the relevant legal provisions in each field. Nothing new is created. This is something certainly true in the biological context. For example, the organs of certain mammals were retooled when they developed. This was the case of whales and dolphins whose limbs were reshaped into fins. The analogy in comparative law is doctrinal path-dependence. The analogy in the PLLC is organizational path-dependence.⁸⁵ Changes overlap with previous solutions. There is no real mutation or genetic drift. This is what the metaphor of the silver fox is all about.⁸⁶ The holder of property rights in shares of a PLLC is vested with management rights and economic rights, which they cannot transfer freely if restrictions are set forth.⁸⁷ Case law shows that in many instances this is not an ex-post efficient solution.⁸⁸ However, even in these instances, members do not seem to have incentives to change the regulatory framework of their agreement. Still, change in the way corporate defaults are provided, even slight ones, will inevitably affect the channels of communication among market agents and between them, legislatures, and other stakeholders. This means that members would be more likely to change the regulatory framework of their agreement as well as be more active with respect to its implementation if an adequate model of default rules is implemented.

⁸⁴ For a similar case, see Cour de cassation [Cass.] [supreme court for judicial matters] com., Jan. 21, 1997, Bull. civ. IV, No 94-19016 (Fr.).

⁸⁵ See generally Jörg Sydow et al., *Organizational Path Dependence: Opening the Black Box*, 34 ACAD. MGMT. REV. 689 (2009).

⁸⁶ Darwin pointed out the importance of breeding for the inheritance of good and bad qualities. This connection between breeding, adaptation, and heritance is obvious to him. Darwin, *supra* note 82, at 41 (“On the view given of the important part which selection by man has played, it becomes at once obvious, how it is that our domestic races show adaptation in their structure or in their habits to man’s wants or fancies.”). No mistakes, however, should be made. Changes introduced by this selection are gradual, slow, varying and insensible, to use Darwin’s words.

⁸⁷ See *In Re Copal Varnish Co. Ltd.* [1917] 2 Ch 349, 349, 353 (UK) (quoting *In re Bede Steam Shipping Co.* [1917] 1 Ch 123 (UK)) (“A shareholder . . . has property in his shares, a property which he is at liberty to dispose of, subject only to any express restrictions which may be found in the articles of association of the company.”). This is different in U.S. law where there is a dual concept of the share or units, and economic rights may be transferred separately and freely.

⁸⁸ Yet, it could have been ex-ante efficient because parties enter into contracts they find optimal.

IV. THE RELATIONAL ELEMENT IN PLLCS AND THE CONCEPT OF EQUILIBRIUM: AN ENQUIRY ABOUT THE NORMATIVE JUSTIFICATION OF RESTRICTIONS

The analysis of almost one hundred Portuguese, French, Italian, Spanish, United Kingdom, and United States court decisions regarding transfer of shares revealed several problems worth mentioning.⁸⁹ I clustered these problems into four groups: 1) interpretation, 2) functionality of restrictions on transfers, 3) un-consented transfers, and 4) formalities. These clusters suggest that shareholders have problems combining their actions.⁹⁰ There is an inherent status quo that shareholders want to keep in PLLCs.⁹¹ Therefore, they do not contract around those defaults, even when it would be desirable to do so. One of the reasons for this status quo bias is the fact that shareholders, and often managers, are too risk-averse.⁹² In line with arguments of behavioral economists, people tend to more heavily weigh changes that will likely make things worse than changes that will likely make things better, even if taking both decisions has the same expected economic value.⁹³ This, in part, may explain why members of these business associations restrict transfers.

This returns us to the question of uncertainty. However, these members often do not understand or do not know the ruleset they have chosen (probably because they were poorly advised).⁹⁴ They often transfer their shares in breach of the articles of association, including the defaults they have selected. Default rules are weakly enforced and members do not have

⁸⁹ See Vicente, *supra* note 31.

⁹⁰ This is rather surprising considering the strong contractual basis of these companies.

⁹¹ See generally Russell Korobkin, *The Status Quo Bias and Contract Default Rules*, 83 Cornell L. Rev. 608 (1989); Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 Yale L.J. 87, 91, 97 (1989) (proposing “penalty default rules” to induce the disclosure of information in a context of strategic behavior of one of the parties to the contract); see also Roberta Romano, *Regulating in the Dark*, in REGULATORY BREAKDOWN: THE CRISIS OF CONFIDENCE IN U.S. REGULATION 86 (Cary Coglianese ed., 2012) (referring to the stickiness of the status quo in the U.S. political system which renders it difficult to revise).

⁹² See Williamson, *supra* note 11, at 607 (noting that the importance of risk aversion to commercial contracting has been placed in doubt). Risk aversion is, however, a fact in respect to the PLLC. For example, LLC agreements often provide clauses restricting the situations where members can file for a suit. This is understandable for litigation threatens the relational element and closed nature that characterize these business organizations.

⁹³ See Stephen M. Bainbridge, *The Business Judgment Rule as Abstention Doctrine*, 57 Vand. L. Rev. 83, 12383 (2004) (“Behavioral economists have demonstrated that people evaluate the utility of a decision by measuring the change effected by the decision relative to neutral reference point. Changes framed in a way that makes things worse (losses) loom larger in the decision-making process than changes framed as making things better (gains) even if the expected value of the decisions is the same. Hence, a loss averse person (as are most people) will be more perturbed by the prospect of losing \$100 than pleased by that of gaining \$100. A bias against risk taking is a natural result of loss aversion, because the decision maker will give the disadvantages of a change greater weight than its potential advantages. Hence, the so-called status quo bias.”).

⁹⁴ See *Business and Suing Lawyers on Malpractice*, N.Y. TIMES, May 25, 1987, at 1.34 (“The malpractice crisis swirling about the legal profession will not soon subside, according to lawyers and insurance experts.”). See also Ronald J. Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants not to Compete*, 74 N.Y. U. L. REV. 575, 599 (1999) (“When lawyers design procedures that are inconvenient for those who actually must implement them, the procedures tend to be ignored.”).

strong or well-defined property rights. Defaults demonstrate weak enforceability because sanctions foreseen therein are not sufficient to deter shareholders from transferring. For example, in the Portuguese case, by default, un-consented transfers of shares are valid between the parties but have no effect towards the company. Surprisingly, this problem has not been thoroughly discussed in this country's literature.⁹⁵ The problem of relative unenforceability has been discussed in Spanish and French literature and jurisprudence. Default rules demonstrate that members do not have strong or well-defined property rights because their property rights are not sufficient to give them a competitive advantage in the bargaining process. There are other problems too. Parties collude to achieve the purposes they established with the execution of the share sale and purchase agreement in disregard of the company and non-transferring shareholders. For example, the transferor may act as an agent of the transferee in the company to circumvent the existence of restrictions on transfer. This means that in these circumstances, non-transferring shareholders of PLLCs will have to deal with rival claims (e.g., claims regarding the distribution of dividends) in respect to the shares they hold in the company.⁹⁶ For instance, the transferee, who is entitled to economic rights, may instruct the transferor to vote in a certain way in the company's general meeting. The question is: given all these circumstances, why do members of these companies choose to restrict transfer of shares in the first place? This question goes beyond the purposes for which restrictions are set forth. They are listed above. It also goes beyond the idea of a status quo bias. It is indeed part of the story, but it is not the whole story. This question delves into the need of consent for the formation of legal obligations given the relational element and the fact that legislatures inflict environmental changes by taming property rights through default rules providing restrictions. As I have submitted above, these changes do not create anything new or provoke any genetic sweep. Instead, they build on previous legal solutions. Thus, since manifestations of behavioral and doctrinal path-dependence are blatant, I focus on providing a normative justification for restrictions on transfer of property rights in shares. Considering the crossover of legal solutions suggested by the empirical data and the relational element that stands out in the list of purposes for setting restrictions on transfers, I try to understand why different contractual practices (Level Three of the model) do not evolve in these companies over time when members do not abide by the rules they agreed upon in the articles of association. One could legitimately wonder why it would be expected for people to abide by the rules. There can be many reasons for them not to. It does not necessarily imply that the rules are inefficient. For example, pursuant to the efficient breach theory, parties should be free to breach a contract and pay damages, if applicable,

⁹⁵ For a brief approach, see Lécia Vicente, *Un-consented Transfers of Shares: A Comparative Perspective*, 9 EUR. CO. L. 300 (2012).

⁹⁶ See Nicita & Rizzolli, *supra* note 47.

provided that breaching the contract is more efficient than performing it. Nevertheless, there can be welfare costs sliding through the three levels of the model policy if corporate rules are not the best market agents can have.⁹⁷ In other words, if rules are bad because they are inefficient, the market (Level Three) and the legislative process (Level Two) become inefficient. This would have negative implications for the welfare of the whole society (Level One).

A. THE CONCEPT OF EQUILIBRIUM

I said in the introduction to this article that, facing the outgrowth of new forms of business organizations, policy-wise legislatures have created systems of property rights in order to assure that there is equilibrium not only within the corporate structure, but also among the interests and protections each corporate constituency claims for itself. Equilibrium, in this context, is the balance between the influences that enable stability in the company. There is an idea that a population in stable equilibrium will tend to return to stability after it has been disturbed.⁹⁸ A stable equilibrium is like a spring that regains its initial form after being pressured or extended in one way or another. This is a stable equilibrium not because it benefits any particular individual, but because it is immune to “treachery from within.” This notion does not hold true with contracts or agreements such as articles of association and LLC agreements, which as a result of parties’ opportunistic behavior are precisely subject to “treachery from within.” Thus, because stable strategies such as that mentioned above are hardly adopted, it is difficult to trace a line through which contractual strategies could evolve. A certain behavior favors a stable equilibrium if it cannot be invaded by other behaviors. That is to say, other rival behaviors will not succeed.⁹⁹ This stable equilibrium may be broken if the environment changes. Environmental changes determine that the types of behavior favored by natural selection (Level Three) change as well. Hence, a stable equilibrium depends on the circumstances. The analogy, if applied to the PLLC and, in particular, if the relational element prevalent therein is sticky, suggests that if the design of default rules changes or members feel any market incentives to change, their strategy to restrict transfers to maintain an enduring state of stability in the company also is likely to change.¹⁰⁰

97 One can reasonably ask why market agents would ask for legislation at all. Would they want to enhance their contractual freedom or restrict it? Historically, the efforts to lobby with legislatures to adopt PLLCs law were driven by the attempt to fill in the needs of those who wanted to implement new investment strategies. However, the enactment of laws owed much more to the popularity of the matter and resolve of politicians and important interest-groups than to the lobby power of market agents alone.

98 See generally JOHN MAYNARD SMITH, *EVOLUTION AND THE THEORY OF GAMES* (1982).

99 See RICHARD DAWKINS, *Aggression: Stability and the Selfish Machine*, in *THE SELFISH GENE* 71 (1976) (referring to the famous example of fighting strategy between hawks and doves).

100 The text explores this dilemma between opportunistic behavior, or “treachery from within,” that is inherent to the contractual nature of the PLLC and the stickiness of the relational element that favors the status quo and the mummification of legal solutions. The adequate design of rules is liable to overcome such dilemma.

B. THE RELATIONAL ELEMENT

PLLCs, unlike publicly-held companies, are more likely to encompass manifestations of private ordering, that is, different types of contractual solutions. These phenomena are intrinsically linked to the closed nature of these business associations. I believe that they are also related to the fact that these business associations, at least in the selected jurisdictions, were created ahead of the law, the law being a byproduct of such manifestations of private ordering. By the time the law was implemented, they already had institutionalized dynamics that organically pulled together shareholders and non-shareholders constituencies. Moreover, PLLCs' legal regime, being mostly composed of default rules, is inherently flexible and contractual. Data also shows that their socioeconomic structure indisputably rests on relational elements.¹⁰¹ These elements are easier to spot when the companies' dimensions are smaller and the ownership is less dispersed. Also, because these relational elements exist, corporate constituencies do not feel the need to enter into complex contracts. Contracts are often incomplete and the bargaining process does not end with the parties' consent to a particular set of rules.¹⁰²

In many instances, parties ignore default rules especially if circumstances allow them to bargain informally. When they care about defaults, they often enforce these rules through non-legal mechanisms of governance.¹⁰³ The analysis of operating agreements of American LLCs allows me to illustrate this. Frequently, parties introduce clauses through which members agree that irreparable damage would be done to the good will and reputation of the company if a member should bring an action in court to dissolve the company. In some cases, it is further agreed that each member acknowledges and agrees that in the event that an investor or member seek, or attempt to seek, any action in violation of or inconsistent with the provisions of the LLC agreement, the company shall be permitted at any time, at its sole and absolute discretion, to redeem that investor's units and to immediately cause the company to purchase such investor's LLC interest. Yet, empirical data suggests that, in certain cases, parties do not spend much time trying to understand the legal framework applicable to a deal, much less the rules of the articles of association or LLC agreements. They do not engage in time-consuming inquiries about

101 See Ian R. Macneil, *The Many Futures of Contracts*, 47 S. Cal. L. REV., 691, 760 (1974) (referring to articles of incorporation and to general incorporation statutes as relational agreements and perceiving corporations as relational vehicles which have been historically capable of overcoming the dichotomy between "promise" and "market").

102 See ALBERT O. HIRSCHMAN, *EXIT, VOICE, AND LOYALTY: RESPONSES TO DECLINE IN FIRMS, ORGANIZATIONS, AND STATES* 120–26 (1970) (referring to the family, tribe, nation, church, and parties in non-totalitarian one-party systems as forms of human grouping from which exit is rare).

103 See Penner, *supra* note 53, at 342 ("In the same way that bilateral agreements provide the basis for notions of good faith or fair dealing, which is quite outside the unilateral coincidental promises model of contract, the relational analysis emphasizes this aspect [the maintenance in long-term economic relations of relations engendering good faith, give-and-take, cooperation, the mutual sharing of burdens and benefits and so on] to the point where the notion of agreement itself becomes attenuated. . . . These [default] norms give rise to obligations quite outside the precise terms of any agreement recognized by classical contractual analysis.").

the accuracy of the words they should use to close a deal. They just close it by shaking hands, assuming that both parties know exactly what that means.¹⁰⁴ Still, members of these companies enter into PLLC agreements even when they have not fully understood or do not know the rules they have decided to agree on. This may be the case because they have been poorly advised or they give a proxy to their lawyers to take care of the legal issues while they concentrate on making the firm operational.

Legal culture is largely transmitted by imitation, with one of the most vivid examples being the practice of law. Often, by-laws, charters, articles of association, and operating agreements are imitated by lawyers. They draft minutes based on previous ones and send them to the client who simply puts her signature at the bottom of the final page and signs each page in the corner to provide written evidence of her agreement. This does not mean that clients do not read documents sent to them. Nevertheless, at times, the choice of defaults seems more an imposition than a clear choice by the parties.¹⁰⁵ If parties to a contract chose the law because they were poorly advised, what bite do freedom of contract and sanctity of contract really have? Is this not equivalent to a pathological case of consent in which parties did not truly agree on the ruleset governing the deal? This idea challenges concepts such as “ostensive originating consent”¹⁰⁶ and other theories of consent that view the contract as a framework that reveals the relationships among contractual principles.¹⁰⁷ These theories place a

104 See *In re McKenzie*, No. 08-16378, 2011 WL 6140516, at *22 (E.D. Tenn. Dec. 9, 2011) (“Under the acts, the court notes that there is an exception for effectiveness of the restrictions on transfers. The restrictions may not be effective against a person without knowledge of the restrictions if the restrictions are imposed by a written resolution adopted by all the members, or by a written agreement among, or other written action by, all the members as opposed to being contained in the articles or operating agreement.”). American courts, in particular Delaware courts, tend to adopt an objective approach to contracts. See e.g. *Bruns v. Rennebohm Drug Stores, Inc.*, 442 N.W.2d 591, 596 (“Courts are beginning to support the proposition that the state has little interest in refusing to enforce agreements among shareholders in close corporations We consider that the rule of strict construction of a share transfer agreement between shareholders in a close corporation is anachronistic.”).

105 See ROGER BROWNSWORD, *Contract, Consent, and Civil Society: Private Governance and Public Imposition*, in 3 GLOBAL GOVERNANCE AND THE QUEST FOR JUSTICE 5, 14 (Peter Odell & Chris Willet eds., 2008) (presenting a concept of default rules that is tilted towards contractualising business agreements (e.g., business-to-business agreements and business-to-consumer agreements)). These rules treat parties as if they have an intention to create legal relations and are coupled with the option of expressly opting out. The problem with this rule is illustrated in this passage: “the twin default rules tilting towards and against contractualisation are problematic. Most obviously, the effect of these rules is that some persons (probably most consumers) will walk into a contractual relationship without realizing it – and this will happen because, in business marketplaces, participants are deemed to have engaged the rules of the law of contract. Granted, the law permits such persons to opt-out; but, if they do not realize that they are being co-opted in, they will hardly seize the opportunity to opt-out. De jure, there might be the option of opt-out; but, de facto, we are dealing with imposition.” A bridge may be created to the idea of “bounded rationality” coined by Herbert A. Simon insofar the rational behavior of market agents is limited to the information and time they have to make independent and rational choices as to their contractual framework.

106 See *id.* at 16–24 (developing the concept of “originating consent,” which means the agreement parties give to the application of a ruleset to govern the deal they are making).

107 See Randy E. Barnett, *A Consent Theory of Contract*, 86 Colum. L. Rev. 269, 300–07 (1986). Barnett is committed to explaining the nature and sources of legal rights and the way they can be transferred. His arguments, as he himself recognizes, lay on a definition of contractual obligation which resembles Ronald Dworkin’s distinction between rules and principles. The concepts of will,

heavy and unrealistic cognitive burden on the parties. They also do not take into account the situations in which parties' intentions change or the law works against their expectations. The same criticisms hold as to some doctrinal constructions that perceive the principle of contractual freedom in the context of markets guided by competition.¹⁰⁸ The fact is, however, that as much as competition has the potential to create better rules and to optimize economic activity, it does not provide the parties with information as to the set of rules they must choose in order to demonstrate their consent. There must be an external mechanism liable to push parties to compromise in a competitive scenario. Even though parties give their consent to a particular contract, they do not always have the intention to create legally enforceable obligations.¹⁰⁹

V. CONCLUSIONS

By methodologically connecting law, economics, and biology, I suggest that the uncertainty of contractual relations is not always negative. In fact, it gives legislatures, regulators, and courts the opportunity to establish new legal policies that put aside inefficient legal solutions. This opportunity follows from the uncertainty of contractual relations because contracts are naturally incomplete. I suggest that legislatures can try to aim at establishing new legal policies through a three-level model policy that informs the legal system in an integrated manner. This model embodies society at the first level. It includes the legislatures, regulators (politicians), and courts at the second level. It establishes the market as the third level. Law should be the result of the interaction of these three levels at a point that comes all the way from the bottom-up. The method legislatures can use to create law is illustrated by the design of default rules establishing restrictions on transfer of property rights in shares which is, I aver, equivalent to the taming of the silver fox. Legislatures act like the researcher who artificially selects the desirable characteristics of legal rules that should be reproduced. This task should involve a meticulous observation of reality, which cannot be undertaken by simply mimicking the market.¹¹⁰ It also cannot be achieved by only creating mechanisms that

reliance, efficiency, fairness, or bargain all of which are considered principles that must be ordered by a framework showing where each is in relation to another. Barnett explains that that framework is provided by the theory of consent which is, as he presents it, an entitlements-based theory. In other words, a contract is the same as a transfer of entitlements or rights.

¹⁰⁸ See Jürgen Basedow, *Freedom of Contract in the European Union*, 6 E.R.P.L. 901, 916–18 (2008).

¹⁰⁹ For an opposite view, see Katharina Pistor, *A Legal Theory of Finance*, 41 J. Compar. Econ. 315, 317–18 (2013) (affirming that financial markets are legally constructed and do not stand outside the law).

¹¹⁰ This is true in particular in the Portuguese and Spanish cases. In these countries, legislatures clearly decided to mimic the market and create default rules foreseeing restrictions on transfers. However, problems resulting from the relative unenforceability of un-consented transfers disclosed by contentious disputes challenged the merit of market-mimicked rules. See Bernard S. Black, *Is Corporate Law Trivial?: A Political and Economic Analysis* 84 Nw. U. L. Rev. 542, 544 (1990) (arguing that the four situations in which rules may be trivial are when they are market mimicking, avoidable, changeable, or unimportant).

determine the periodic review of rules.¹¹¹ I propose that it be achieved through a system of legal policy by which legislatures look at the reality of things in order to avoid a sort of “blackboard law.”¹¹² In other words, legal policy should merit form and substance. Yet, reality keeps showing that this is a challenging task.¹¹³ Thus, perhaps the construction of a network of gatekeepers that binds legislatures, lawyers, notaries, market agents, and civil society throughout the three levels of the model policy will facilitate a debate about legal policy held on three levels instead of a debate held on one level only.

Normatively, restrictions are mechanisms of governance which have the effect of adapting property rights in shares to the purpose of the business organization. Yet, legislators can select any other elements and shape the market environment differently.¹¹⁴ Depending on this selective pressure, there may be a status quo that members and other corporate constituencies will want to keep. Moreover, the stickiness of the relational element (Level Three of the model) is liable to trigger a stable equilibrium that is difficult to curtail. In a scenario like this, default rules establishing restrictions on transfer are, for the most part, irrelevant if market agents adopt behaviors which can be perceived as in a stable equilibrium. However, even a slight change in the environment, that is, even a small change to the types of rules provided to market agents, has the potential to alter the state of the universe. This is how I see the promise of corporate and contractual evolution—through an equivalent principle of artificial selection that is able to create a line through which contractual practices can truly evolve.

The property rights-silver fox analogy highlights a fundamental change in the conception of property rights. This change may even be compared to the revolution in ownership Berle and Means refer to in the *Modern Corporation and Private Property* apropos the development of big businesses and the corporation as of the first half of the twentieth century onwards.¹¹⁵ This conceptual change may be driven by exploring the

¹¹¹ See Romano, *supra* note 92; Hansmann, *supra* note 77.

¹¹² This is an allusion to a term used by Ronald Coase. He uses this expression to describe systems that live in the minds of economists, but not on earth. “Blackboard economics,” economics’ as the term is used by Ronald Coase, means that “the firm and the market appear by name but they lack any substance.” R. H. Coase, *The Institutional Structure of Production*, 82 *Amer. Econ. Rev.* 713, 714 (1992).

¹¹³ See Stephen Bainbridge, *Regulating in the Dark*, STEPHEN BAINBRIDGE’S J. OF L., RELIGION, POL., & CULTURE (Jan. 11, 2012), <http://www.professorbainbridge.com/professorbainbridge.com/2012/01/regulating-in-the-dark.html> (agreeing with Roberta Romano’s proposal of two key procedural requirements to overcome the stickiness of the status quo in the US political system: “1) a requirement of automatic subsequent review and consideration of the legislative and regulatory decisions at some point in time; and 2) and regulatory exemptive or waiver powers, that encourage, where feasible, small scale experimentation, as well as flexibility in implementation” but registering “zero confidence in the wisdom of Congress or the SEC, and hence no confidence that this sensible proposal will be adopted.”)

¹¹⁴ See Lars-Göran Sund et al., *A European Private Company and Share Transfer Restrictions*, 23 *E.B.L.R.* 483, 484 (2012) (arguing that transfer restrictions are not always beneficial and referring to the multiple policy-related options open to legislatures).

¹¹⁵ See Adolf A. Berle & Gardiner C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* 65 (revised ed., 1967) (In respect to the dispersion of ownership, “[w]ealth is less and less in

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effects that the taming process can have on property rights, just like the size of the members, skull, fur color, and behavior have changed in the silver fox. It may be carried out by explaining how the establishment of restrictions in the contract of the company can alter the physiology and morphology of property rights in shares. In sum, the reconceptualization of property rights, due to the way specific contractual arrangements affect their dynamics, is intimately linked to the idea of *pleiotropy* in law. The development of this concept may be useful to solve some puzzles in corporate law theory and business organizational law.

a form which can be employed directly by its owner. When wealth is in the form of land, for instance, it is capable of being used by the owner even though the value of land in the market is negligible. The physical quality of such wealth makes possible a subjective value to the owner quite apart from any market value it may have. The newer form of wealth is quite incapable of this direct use. Only through sale in the market can the owner obtain its direct use.”). Finally, in the corporate system, the “owner” of industrial wealth is left with a mere symbol of ownership while the power, the responsibility, and the substance which have been an integral part of ownership in the past are being transferred to a separate group in whose hands lies control.

