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Man O War Restaurants, Inc. v. Martin: Law Altering Economic Performance

BY JONATHAN M. SKEETERS*

INTRODUCTION

Scholarship has been intrigued with the interplay of law and economics since the revolutionary writings of Adam Smith1 began circulation in 1776. However, modern scholastic discourse in law and economics is credited to Ronald Coase, Guido Calabresi, Henry Manne, and Richard Posner.2 Posner3 and his disciples espouse ideas

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1 Adam Smith (1723-1790) wrote and lectured on a variety of subjects, but is most well known for his 1776 treatise entitled An Inquiry Into the Nature and Causes of the Wealth of Nations. Smith is recognized for his illustration of the economic relations in market societies.

In one way or another Adam Smith remains a central figure in the law and economics movement. More than 200 years after the publication of the Wealth of Nations he remains the key philosophical reference point from which most economists seek validation or distinguishment. Nowhere is this more true than in the evolution in legal theory brought on by the emergence of law and economics as a legitimate subdiscipline. For within the realm of discourse and disputes concerning the allocation of scarce resources and political power there are a number of influential scholars that invoke Smith or his ideas as reference points for their own work.


3 Richard A. Posner, born in 1939, is a noted federal judge, lecturer, and author. He received a Bachelor of Arts degree in English from Yale in 1959 and a law degree from Harvard in 1962. He clerked for Justice Brennan of the U.S. Supreme Court from 1962 to 1963, was an assistant to the
of economic principles describing human behavior, rational self-interest, and efficiency as a guide in decision-making. For their efforts, critics have accused them of "building theory upon theory" and using "proselytizing efforts" to attract "[s]cholars disenchanted with big government" in an attempt to justify their logic.

Despite the criticism, the legal system is slowly accepting and incorporating the combination of law and economics. The science of economics can be applied to the entire spectrum of jurisprudence. Economic analysis of the law has the potential to become an important discipline, as it has already been exercised in contract law, tort law, criminal law, family law, and even in the legal policy towards AIDS. Nevertheless, a recent opinion issued by the Kentucky Supreme Court, *Man O War Restaurants, Inc. v. Martin*, failed to apply the logic of law and economics and has endangered the future economic well-being of Kentucky.

Mainstream law and economics operates within three main assumptions. First, all humans are economically rational. Second, human relations are equivalent to market exchanges. Third, markets are the best social institutions in that they are self-correcting. However, before

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4 See MERCUR & MEDEMA, supra note 2, at 57.
5 Downs, supra note 3, at 35.
6 Id.
7 Id.
9 Man O War Restaurants, Inc. v. Martin, 932 S.W.2d 366 (Ky. 1996).
10 See generally MERCUR & MEDEMA, supra note 2, at 57-60 (describing the foundational theory behind what many scholars believe to be the basic elements of the "classic" approach to law and economics).
11 See id.
12 See id.
decision makers can apply the theories behind law and economics, they must first understand its logic.

Part I of this Note establishes the framework from which decision makers can perform an economic analysis of the law. By becoming aware of the cause and effect relationship between changes in law and economic performance, grasping the necessary assumptions, and understanding the central theory, decision makers will have a baseline from which to create efficient legal rules. Part II outlines the Man O War decision and the court's preference for creating an equitable rule over an efficient rule. Part III examines stock repurchase provisions with a view towards judicial authority and the economic logic behind the decisions pronouncing the majority rule. Part IV addresses the future implications of the Man O War decision, focusing on the potential problems it will cause for Kentucky and proposing possible solutions and corrective measures that could be taken to foster meaningful economic activity.

I. FRAMEWORK FOR AN ECONOMIC ANALYSIS OF THE LAW

A. General Premise

The United States is a mixed-market economy comprised of a private sector, public sector, and a communal sector. These three distinct sectors each possess their own unique legal rights. However, "[t]he scope and character of each of these sectors is contingent upon the extant legal relations governing [our] society." Moreover, the reality of each sector creates an integrated mix of legal relations that "directly affect the economic performance of the mixed-market economy, specifically, the economic performance in the economy's private sector, its public sector, and its communal sector."

13 See infra notes 17-50 and accompanying text.
14 See infra notes 51-79 and accompanying text.
15 See infra notes 80-131 and accompanying text.
16 See infra notes 132-153 and accompanying text.
17 BARRON'S DICTIONARY OF BUSINESS TERMS 363 (1987) [hereinafter DICTIONARY OF BUSINESS TERMS] ("[An] economy in which both market forces and government intervention and direction are used to determine resource allocation and prices.").
18 See MERCUCO & MEDEMA, supra note 2, at 22.
19 Id.
20 Id.
The very nature of the mixed-market economy is such that changes in the legal rights of one sector create a reaction in the other sectors that produces an overall alteration in human behavior.

Altering the Law, that is changing the legal relations governing society in any one or all of the three sectors, or changing the working rules, will ultimately alter economic performance. Thus, the logic underlying Law and Economics suggests the following line of reasoning: Change the legal relations governing society and/or its working rules and you will ultimately and systematically affect economic performance.  

Working from this premise, if the law is changed, the logic of law and economics predicts the following chain of events: first, incentives will be altered, then, behavior of individuals will be altered, and finally, the economic performance of the mixed-market economy will be altered.

It follows that when the judicial system creates bad law, bad economic outcomes will follow. The causal relationship between legal rules and economic performance cannot be ignored. Decision makers must be aware of the consequences that legal rules have upon human behavior in market transactions. Laws have the ability to constrain economic activity by extinguishing the incentives for individuals and entities alike to behave in ways that will positively impact the economy. On the other hand, laws can increase the incentives for action and thereby enhance economic activity. It is the responsibility of decision makers to ensure the latter results.

B. Requisite Assumptions

While it may be true that "all important human values [cannot] be reduced to supply and demand curves," there are certain assumptions about human behavior that are employed in the economic analysis of law. The following is a framework for the study of law based on economic principles and human behavior:

a. Individual consumers can get access to good information;
b. Individuals know what they want;
c. Individuals can take cues generated by the market;

21 Id.
22 See id.
23 Downs, supra note 3, at 35.
d. The market does not care about the issue of fairness and justice. Allocation of scarce resources is made on “votes of dollars.” The market leaves it to society to provide equal opportunity;

   e. The market will price whatever product or issue is under consideration;

   f. There is a certain degree of competition in that there are multiple buyers and sellers;

   g. People and resources are freely moveable;

   h. There is acceptance of the current distribution of income and resources;

   i. The supply and demand theories, and the graph curves which represent them, are substantially correct;

   j. The corollary to the supply and demand theories is also true, that as the price (cost) of a thing increases, its demand (utilization) will decrease;

   k. Efficiency is understood to mean the acquisition of a thing (including products, rights, etc.) by the person who values it most;

   l. Efficiency is a worthy objective;

   m. Rules of law (whether judicially or legislatively defined) should encourage people toward efficient behavior;

   n. Regardless of which rule of law is applicable . . . the parties will, in the absence of transaction costs, reach the same solution to their problem, and that solution will be efficient; and

   o. There is no fundamental right or wrong to . . . conflicts, since each party may be properly characterized as imposing costs upon the other.24

Although classified as assumptions, the above list is a valid illustration of the relationship between economic principles and human behavior. People know what they want and are able to use market mechanisms to achieve their desires. The market always provides a price for exchanges by facilitating an arena where buyers and sellers can openly negotiate for goods and services. Furthermore, advancing efficient markets within which to operate will generate productive exchanges that improve the lives of all humans.

Law and economic scholarship draws on these assumptions to formulate its theories and underlying principles. However, these so-called assumptions are played out everyday in a capitalist society, and as they become more recognized by the legal profession, society will be rewarded by increased economic performance.

24 Id. at 12-13.
C. Central Theory

Operating within this framework, it is obvious that economics is not reserved to the study of supply and demand, unemployment, price elasticity, inflation, interest rates, or the comparison of firms operating in an oligopoly to those in perfect competition. Rather, economics is "the science of rational choice in a world—our world—in which resources are limited in relation to human wants."28

The concept of rational choice is the central theory in the arena of law and economics scholarship. At the core of this theory is the assumption that every human is a rational maximizer of his or her ends. Thus, people act in their self-interest and will rationally choose the best means to their chosen ends. Based on the requisite assumptions of economics and human behavior, people have the ability to process information and form preferences. To achieve these preferences, people "compute the cost and benefits of alternative courses of action"29 and then choose the action that maximizes their return. Conversely, people will choose not to act where the cost/benefit analysis reveals no benefit or too little benefit to satisfy the actor.

Skeptics of rational choice theory predict that humans will not always act in a rational sense to maximize their self-interest in non-market settings.30 However, whether in market transactions or non-market

25 The relationship between the total amount spent on a good in the market and the price of the good. It is the percentage change in quantity divided by the percentage change in price. If a price decrease results in larger total expenditure (and vice versa), the good is price elastic. If a price results in less total expenditure (or vice versa), the good is price inelastic.

DICTIONARY OF BUSINESS TERMS, supra note 17, at 446.

26 "An industry in which a few large sellers of similar products, such as automobiles, dominate the market." Id. at 395.

27 A market condition wherein no buyer or seller has the power to alter the market price of a good or service. Characteristics of a perfectly competitive market are a large number of buyers and sellers, a homogenous (similar) good or service, an equal awareness of prices and volume, an absence of discrimination in buying and selling, total mobility of productive resources, and complete freedom of entry. Perfect competition exists only as a theoretical ideal.

Id. at 425-26.


29 Ulen, supra note 8, at 457.

transactions, as long as the transaction is at arm’s length, human behavior predicts that all possible outcomes will be gauged and the one that maximizes the chooser’s utility will be chosen.

The concept that humans are rational maximizers of their self-interest “implies that people respond to incentives.”\(^{31}\) Certainly then, when people are presented with the right incentives, they will act rationally and choose what is the best outcome for them, thus promoting efficient exchanges.

D. Creating Efficient Legal Rules

Law and economics has developed into a useful tool to “predict the consequences of various legal rules.”\(^{32}\) With this in mind, decision makers must analyze the end result of their decisions. Will their decision promote efficiency, thereby maximizing wealth, or will their decision promote equity, thereby creating fairness? Overall, “[d]eciding which legal rule to adopt will depend (in part) on which social goal or goals the legal policymaker deems important.”\(^{33}\)

Efficiency as defined in a law and economics sense is embodied in the phrase “wealth maximization.” Wealth maximization occurs when “the gains to the winners exceed the losses to the losers.”\(^{34}\) A legal change promotes efficiency “if the wealth of society (as measured by willingness to pay) is increased”\(^{35}\) such that people can be made better off without making other people worse off. Thus, the “economic task from the perspective of wealth maximization . . . is to influence [individuals] so as to maximize [their] output.”\(^{36}\)

Equity is, in economic jargon, concerned with the distribution of income among individuals based on justice and fairness. That is to say that if “efficiency corresponds to ‘the size of the pie’ . . . equity has to do with how it is sliced.”\(^{37}\) The principles of justice and fairness have been the cornerstones of law since its conception. The concept of equity, when

\(^{31}\) POSNER, supra note 28, at 4.


\(^{33}\) Id. at 2104.

\(^{34}\) MERCURIO & MEDEMA, supra note 2, at 59.

\(^{35}\) Id.

\(^{36}\) Id. (quoting RICHARD A. POSNER, THE PROBLEMS OF JURISPRUDENCE 382 (1990)).

\(^{37}\) A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7 (1983).
discussed in law and economics, focuses on "questions of distribution under the guise of legal doctrines built on the precepts of justice and fairness." Equity is no more than a "social comparison" whereby "people compare the ratio of their ‘outcomes’ to ‘inputs’ with the same ratio for others."

The problem with valuing equity over efficiency is that "in the real world the equitable result may depart from the efficient result." In fact, "equity can be attained more effectively if the courts and legislature adopt efficient legal rules." By implementing rules that promote efficiency—i.e., wealth maximization—the judiciary and legislature can increase the pool from which to draw tax revenue and thereby increase the amount of wealth redistribution.

Focusing on wealth maximization through efficient legal rules permits efficient exchanges and maintains a "‘fair’ net increase in utility for each party so as to prevent disproportionate gains by the stronger marketplace participants." In other words, efficient legal rules allow the "pie" to grow larger, giving everyone a bigger piece and making society as a whole better off. In addition, efficient legal rules promote exchanges and facilitate the spread of wealth.

Society benefits from an "open, accessible marketplace" because it "allows citizens to imagine, create, produce, distribute, exchange, and share scarce resources." This free market exchange produces the profits necessary "to pay taxes that pay benefits and provide services, such as medical care, for those unable to pay for them."

This is as it should be. A society based strictly on legal rules of equity would be in direct conflict with natural market forces and produce counterproductive outcomes. In fact, a society using only equitable legal rules as a "driving moral authority for a government’s interference in the

38 MERCURO & MEDEMA, supra note 2, at 187.
40 Id.
41 Cotter, supra note 32, at 2105.
42 Id.
43 This is called the “tax and transfer” method. See id.
45 See id.
46 Id.
47 Id.
48 Id.
lives of its citizens fails to recognize the still valid, invisible hand of laissez-faire economics.\textsuperscript{49} It is still true that "people are generally better off overall when they are allowed to seek and maximize their preferences in an open marketplace, and government interference is confined to making the marketplace more efficient."\textsuperscript{50}

II. THE MAN O' WAR DECISION

Man O' War Restaurants, Inc. ("MOWR"), a closely held corporation, was formed on February 23, 1989.\textsuperscript{51} At the organizational meeting, John E. Martin, Jr., along with three other men, became the shareholders, officers and directors of MOWR.\textsuperscript{52} Each member of MOWR agreed to purchase twenty-five percent of the corporation (100 shares) for a purchase price of $1000.\textsuperscript{53} The corporation owned a Sizzler franchise restaurant located in Lexington, Kentucky.\textsuperscript{54} On March 1, 1989, MOWR entered into an employment agreement with Martin in which Martin was to serve as the general manager of MOWR's Sizzler restaurant. The employment agreement was a five-year contract and provided Martin with a salary of $27,000 per year on top of his monthly dividends as a shareholder.\textsuperscript{55}

In addition, the employment contract entered into by the two parties included a stock repurchase provision.\textsuperscript{56} This provision provided MOWR with the ability to "buyback" Martin's stock for the amount he paid, without interest, if his employment was terminated during the five-year term.\textsuperscript{57} The terms of the employment contract authorized the board of directors to terminate Martin's employment for any reasonable cause.\textsuperscript{58}

During Martin's employment as general manager of MOWR's Sizzler restaurant, Martin continuously failed to perform his managerial duties in

\textsuperscript{49} Id. at 291.
\textsuperscript{50} Id. at 291-92 (citing ADAM SMITH, THE WEALTH OF NATIONS (Kathryn Sutherland ed., 1993) (1776)).
\textsuperscript{51} See Plaintiff's Memorandum of Law in Support of Motion for Temporary Injunction (Feb. 8, 1992) (Fayette Circuit Court) (Case no. 92-CI-0447).
\textsuperscript{52} See Plaintiff's Memorandum of Law in Support of its Motion for Partial Summary Declaratory Judgment (July 7, 1992) (Fayette Circuit Court) (Case no. 92-CI-0447).
\textsuperscript{53} See id.
\textsuperscript{54} See id.
\textsuperscript{55} See id.
\textsuperscript{56} See Man O War Restaurants, Inc. v. Martin, 932 S.W.2d 366, 367 (Ky. 1996).
\textsuperscript{57} See id.
\textsuperscript{58} See id.
accordance with the standards established by the franchiser, Sizzler Restaurants International, Inc. Consequently, on January 17, 1992, MOWR's board of directors voted to terminate Martin's employment. Thereafter, the president of MOWR requested that Martin surrender his stock certificate to the corporation as required by the employment agreement. However, Martin refused to turn over his MOWR stock.

Because the employment agreement gave Martin the right to sell or transfer his MOWR stock to a third party who was not subject to the terms of the agreement, MOWR was forced to file suit in order to protect itself. MOWR filed an action for a declaration of rights in the Fayette County Circuit Court on February 5, 1992.

The central issue in *Man O War* was the enforceability of the contract provision by which Martin, a corporate shareholder and employee of MOWR, was required upon termination of his employment to return his stock for the sum he originally paid. The provision in question provided:

> If Employee owns stock in Employer and this Agreement is terminated under paragraph 9 hereof or by the voluntary action of Employee, then Employee shall tender to Employer for purchase by it all of his stock in Employer, the purchase price of which stock shall be a return of the consideration paid by Employee for such stock, without interest.

The trial court held for MOWR, enforcing "the contract provision on grounds that the parties enjoyed broad freedom of contract and that no bad faith was shown in process of termination of the employment." In a bench decision, the trial judge stated that "[w]hen grown men have seen fit to place as a requirement in the contract without condition, qualification or

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59 *See* Plaintiff's Memorandum of Law in Support of its Motion for Partial Summary Declaratory Judgment (July 7, 1992) (Fayette Circuit Court) (Case no. 92-CI-0447).
60 *See* id.
61 *See* id.
62 *See* id.
63 *See* Complaint (Feb. 5, 1992) (Fayette Circuit Court) (Case no. 92-CI-0447).
64 Paragraph 9 provided a list of reasons why the Employer may terminate the employment agreement, including termination for any other cause reasonably determined by the Board of Directors. *See* Man O War Restaurant, Inc. Employment and Non-Competition Agreement (Mar. 1, 1989) (Fayette Circuit Court) (Case no. 92-CI-0447).
65 *Id.* ¶ 11.
provision against unforeseen circumstances, I do not feel a Court should modify it."\(^{67}\)

On appeal, the Kentucky Court of Appeals reversed, holding that "the stock return provision of the Agreement operated as a forfeiture or penalty for breach of a contract and, therefore, is unenforceable."\(^{68}\) Here, the court found that the provision forced Martin to forfeit the appreciation of the MOWR stock. The court reasoned that "[e]quity detests forfeiture provisions and frequently will find them unenforceable."\(^{69}\) Consequently, the court would not enforce the repurchase provision of the employment contract. This forced MOWR to petition the Kentucky Supreme Court for reversal.

However, the supreme court adopted the court of appeals' position, holding that the court felt "compelled by principles of equity and fair-dealing"\(^{70}\) to invalidate the contract provision. The court decided that the contract was flawed because of "its failure to recognize that upon transfer of the stock to Martin, he held it independently of his status as an employee."\(^{71}\) If the contract had provided Martin with compensation for the appreciation of the stock, the provision would not have amounted to forfeiture. Accordingly, the court concluded that when the shares of MOWR were transferred to Martin, the stock "became his property and strong public policy against forfeiture protects property from being taken without appropriate compensation."\(^{72}\)

In the court's view, "[a] corporation and its shareholders are allowed to contract for a re-purchase or 'buyback' right"\(^{73}\) only if "[t]he exercise of such a right requires that a valuation be placed on the stock."\(^{74}\) However, by its decision, the court implied that only certain valuations will meet with its approval.\(^{75}\) It held that "[a]ll accepted valuation methods take into consideration the corporation's fiscal performance as well as its current

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\(^{67}\) Judge James E. Keller, Bench Decision (Mar. 30, 1992) (Fayette Circuit Court) (Case no. 92-CI-0447).

\(^{68}\) Man O War, 932 S.W.2d at 368.

\(^{69}\) Id. (citing Sebastian v. Floyd, 585 S.W.2d 381 (Ky. 1979); C.I.T. Corp. v. Thompson, 169 S.W.2d 820 (Ky. 1943)).

\(^{70}\) Id.

\(^{71}\) Id. at 369.

\(^{72}\) Id.

\(^{73}\) Id. at 368 (citing ROBERT CLARK, CORPORATE LAW 765 (1986); 18B AM. JUR. 2D Corporations § 1965 (1985)).

\(^{74}\) Id. (citing ROBERT CLARK, CORPORATE LAW 765 (1986)).

\(^{75}\) See id. at 368-69.
financial condition, and it suggests that the valuation used by MOWR and Martin amounts to "liquidated damages"... grossly disproportionate to actual injury. Consequently, the court held the repurchase agreement unenforceable because the valuation established requires Martin to forfeit his equity in the stock.

III. STOCK REPURCHASE AGREEMENTS

Agreements like the one in *Man O War*, whereby the corporation or the remaining shareholders are given an option to repurchase stock that was issued to an employee upon the occurrence of designated contingencies, are utilized by many corporations. These agreements that restrict the transfer of shares have proven most valuable in the closely held corporation setting.

These provisions, which require an employee shareholder to sell back stock upon severance from corporate employment, are designed to ensure that ownership of all of the stock, especially of a close corporation, stays within the control of the remaining corporate owners-employees; that is, those who will continue to contribute to its successes or failures.

Statutes codifying the existence of these agreements and court opinions upholding their validity recognize the prevalence of these agreements in the corporate arena.

A. Statutory Law

The Kentucky Revised Statutes address the close corporation's need to restrict the transferability of corporate stock in Chapter 271B Subtitle 6-270. This statute, which mirrors the Revised Model Business Corporation Act, provides that "an agreement among shareholders, or an agreement

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76 Id. at 368 (citing 18A Am. Jur. 2D Corporations § 702 (1985)).
77 An amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches. Black’s Law Dictionary 164 (pocket ed. 1996).
78 *Man O War*, 932 S.W.2d at 369 (citing Mattingly Bridge Co. v. Holloway & Son Constr. Co., 694 S.W.2d 702 (Ky. 1985)).
79 See id.
Section 6.27, entitled "Restriction on Transfer of Shares and Other Securities," provides:

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between shareholders and the corporation may impose restrictions on the transfer . . . of shares of the corporation\textsuperscript{82} as long as the restriction is valid, enforceable, and authorized by statute.\textsuperscript{83} The condition of consequence for validity and enforceability is that the holder of the shares or the transferee to the shares must have actual knowledge of the restriction or the existence of the restriction must be noted conspicuously on the front or back of the stock certificate.\textsuperscript{84} As to the authorization of a restriction, Kentucky

\begin{itemize}
  \item[(a)] The articles of incorporations, bylaws, an agreement among shareholders, or an agreement between shareholders and the corporation may impose restrictions on the transfer or registration of transfer of shares of the corporation. A restriction does not affect shares issued before the restriction was adopted unless the holders of the shares are parties to the restriction agreement or voted in favor of the restriction.
  \item[(b)] A restriction on the transfer or registration of transfer of shares is valid and enforceable against the holder or a transferee of the holder if the restriction is authorized by this section and its existence is noted conspicuously on the front or back of the certificate or is contained in the information statement required by section 6.26(b). Unless so noted, a restriction is not enforceable against a person without knowledge of the restriction.
  \item[(c)] A restriction on the transfer or registration of transfer of shares is authorized:
    \begin{enumerate}
      \item to maintain the corporation's status when it is dependent on the number or identity of its shareholders;
      \item to preserve exemptions under federal or state securities law;
      \item for any other reasonable purpose.
    \end{enumerate}
  \item[(d)] A restriction on the transfer or registration of transfer of shares may:
    \begin{enumerate}
      \item obligate the shareholder first to offer the corporation or other persons (separately, consecutively, or simultaneously) an opportunity to acquire the restricted shares;
      \item obligate the corporation or other persons (separately, consecutively, or simultaneously) to acquire the restricted shares;
      \item require the corporation, the holders of any class of its shares, or another person to approve the transfer of the restricted shares, if the requirement is not manifestly unreasonable;
      \item prohibit the transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.
    \end{enumerate}
  \item[(e)] For purposes of this section, "shares" includes a security convertible into or carrying a right to subscribe for or acquire shares.
\end{itemize}

\textsuperscript{83} See id. § 271B.6-270(1).
\textsuperscript{84} See id.
Revised Statutes section 271B.6-270 establishes that "[a] restriction on the transfer . . . of shares shall be authorized [f]or any reasonable purpose."\textsuperscript{85}

The promulgation of Kentucky Revised Statutes section 271B.6-270 acknowledges legislative acceptance of restrictions on the transferability of stock shares and legitimizes the value these restrictive agreements play in the continuation of corporate enterprise. Consequently, it is surprising that the \textit{Man O War} court abrogated the stock repurchase agreement entered into by Martin and MOWR. Because Kentucky Revised Statutes section 271B.6-270 merely requires the holder or the transferee to have actual knowledge of the restriction or the restriction to be conspicuously noted on the stock certificate for the restriction to be enforceable, it is entirely logical to conclude that if the parties involved satisfy the statutory requirement, the court may not set the restriction aside. In \textit{Man O War}, Martin, a shareholder and party to the repurchase agreement, never alleged any unawareness of the restriction. Therefore, with statutory compliance, there is no statutory basis for not enforcing the stock repurchase agreement.

\textbf{B. Common Law}

\textit{1. Kentucky Courts}

Although the stock repurchase agreement at issue in \textit{Man O War} is described by the Kentucky Supreme Court as being one of "first impression in this jurisdiction,"\textsuperscript{86} situations dealing with repurchase agreements have been before the courts of Kentucky in the past.\textsuperscript{87} In fact, in 1953 the court ruled on the enforceability of a seemingly unfair stock repurchase agreement in \textit{Krebs v. McDonald}.\textsuperscript{88} The repurchase agreement among the stockholders stated:

\begin{quote}
[T]hat in the event either of us shall at any time quit his or her active connection with the Southern Optical Company, voluntarily or involuntarily, or in the event of our death (in which event this agreement shall be binding on our heirs, personal representatives, and assigns) or in the event any of us desire to sell, assign, or transfer any share of the said capital
\end{quote}

\textsuperscript{85} \textit{Id.} § 271B.6-270(3)(c).
\textsuperscript{86} \textit{Man O War Restaurants, Inc. v. Martin}, 932 S.W.2d 366, 367 (Ky. 1996).
\textsuperscript{87} \textit{See Taylor's Adm'r v. Taylor}, 301 S.W.2d 579 (Ky. 1957); \textit{Avritt v. O'Daniel}, 689 S.W.2d 36 (Ky. Ct. App. 1985) (examining the enforceability of shareholder stock repurchase agreements).
\textsuperscript{88} \textit{Krebs v. McDonald}, 266 S.W.2d 87 (Ky. 1953).
stock . . . then in any of the said events, the remaining stockholders shall have the option and right to purchase the same for a reasonable time at a reasonable price, to be fixed by the stockholders . . . .

Consequently, when Clarence B. McDonald, shareholder and party to the shareholder agreement died, his shares were subject to repurchase by the remaining shareholders of the Southern Optical Company. The repurchase price fixed by the shareholders was $100 per share while the value of the stock was $218 per share. Despite the apparent unfairness in the disparity between these prices, the court enforced the repurchase agreement. The Krebs court reasoned that since "Mr. McDonald was a signer of [the shareholder] agreement and one of the architects of the method of evaluating the stock," he must have "considered the values thus set to be reasonable." The stock price set by the shareholders "did not sensitively reflect the fluctuations in real or actual value, but appeared to be approximations accepted by all concerned as the proper values for the purposes of the agreement."

It appears that the court favored the efficient result of the free market transaction as opposed to the equitable solution of remaking the bargain between the parties involved. The aperture between the two stock prices was uncomfortable; however, the court stated that "[w]hile a precise method of evaluating the stock might be desirable from our standpoint, such restrictive agreements often allow a lot of leeway." Moreover, the possible effects on economic performance presented by this decision did not escape the Krebs court. The court justified the repurchase price as appropriate because a "restrictive stock agreement is one of the devices evolved for assuring the succession in interest of persons most likely to act harmoniously with the other shareholders."

Accordingly, when balancing the value of the restrictive agreement against the stock valuation problem, the need to preserve the restrictive agreement will outweigh the need to correct the apparent unfairness of the repurchase price.

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89 Id. at 88-89.
90 See id. at 88.
91 Id. at 89.
92 Id.
93 Id.
94 Id.
95 Id.
In order to induce desired individuals into investing their capital in such closely held corporations with the stock restrictions often imposed, the price must be attractive as well as the prospects of future earnings. In a service corporation such as the Southern Optical Company, the maintenance of a harmonious personnel, as well as a skilled one, is admitted to be essential to the success of the business.\textsuperscript{96}

Taking these factors into consideration, the court did "not find that enforcement of the agreement at the valuation so established would be inequitable and against conscience."\textsuperscript{97}

2. Other Courts

A look at other judicial authority further reveals the deficiencies of the \textit{Man O War} decision. The United States Court of Appeals for the Eighth Circuit in \textit{St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}\textsuperscript{98} enforced a stock repurchase provision that allowed Merrill Lynch to repurchase its own stock from the executors of an employee shareholder at book value.\textsuperscript{99} Although a subsequent public offering which Merrill Lynch had been planning at the time of the repurchase increased the stock value to three times the amount paid to the executors, the court held the repurchase valid.\textsuperscript{100} Other courts have also enforced repurchase agreements even when the repurchase price was extremely low in relation to the fair market value of the stock at the time the repurchase option was triggered.

For example, in \textit{Georesearch v. Morriss},\textsuperscript{101} the United States District Court for the Western District of Louisiana enforced a stock repurchase provision that set the buyback price at a fixed rate. In 1955, Herbert Morriss and George Howard, the president and vice president, respectively, of Georesearch, Inc., sought additional capital to finance their operations

\textsuperscript{96} \textit{Id.}

\textsuperscript{97} \textit{Id.} at 90.

\textsuperscript{98} \textit{St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.}, 562 F.2d 1040 (8th Cir. 1977).

\textsuperscript{99} \textit{See id.} at 1043. "‘Book value’ refers to assets, calculated as actual cost less allowances for any depreciation. Book value may be more or less than current market value." \textit{Dictionary of Business Terms, supra} note 17, at 59.

\textsuperscript{100} \textit{See St. Louis Union Trust Co.}, 562 F.2d at 1043.

through a merger with J-O Oil Company, a joint venture\textsuperscript{102} of Oil and Gas Property Management and Justiss-Mears. Through this transaction, Georesearch became a wholly-owned subsidiary\textsuperscript{103} of J-O Oil, and Morriss and Howard became employees of J-O Oil.\textsuperscript{104} The stock repurchase provision was part of the employment agreements negotiated between the new Georesearch and Morriss and Howard. Like the repurchase provision in \textit{Man O War}, the repurchase provision in \textit{Georesearch} was triggered by termination of employment. The provision gave the employer the right to purchase one-half of the employee's stock in the corporation at $0.07 per share.\textsuperscript{105}

At the time the agreement was entered into, the shares Morriss and Howard received had a par value\textsuperscript{106} of $1.00 per share.\textsuperscript{107} Less than two years after this agreement, Morriss and Howard were terminated and Georesearch sued for enforcement of the buyback provision.\textsuperscript{108} Morriss and Howard argued that "the obligation to sell one half of their shares at $0.07 a share [was] excessive,"\textsuperscript{109} but the court held that the repurchase provision was enforceable despite the discrepancy between the fair market value and the repurchase price.\textsuperscript{110} The court reasoned that "the true cause of the Agreement was to enable [Morriss and Howard] to receive an opportunity—an opportunity to ... obtain capital with which to explore for oil and gas."\textsuperscript{111}

By upholding the terms of the repurchase provision, the court promoted efficiency. Morriss and Howard acted as rational maximizers when they

\footnotesize{\textsuperscript{102} The term "joint venture" refers to an "agreement by two or more parties to work on a project together. A joint venture, which is usually limited to one project, differs from a partnership, which forms the basis for cooperation on many projects." DICTIONARY OF BUSINESS TERMS, \textit{supra} note 17, at 308.

\textsuperscript{103} A wholly-owned subsidiary is a company whose voting stock is 100% owned by another company, with the wholly-owned subsidiary company becoming part of the other company. \textit{Cf. id.} at 559 (defining "subsidiary company" as a "company whose voting stock is more than 50 percent owned by another firm. A subsidiary company is part of another company.").

\textsuperscript{104} \textit{See Georesearch}, 193 F. Supp. at 166.

\textsuperscript{105} \textit{See id.} at 164.

\textsuperscript{106} "Par value" refers to "stated or face value of a stock or bond. It has little significance for common stock." DICTIONARY OF BUSINESS TERMS, \textit{supra} note 17, at 418.

\textsuperscript{107} \textit{See Georesearch}, 193 F. Supp. at 166.

\textsuperscript{108} \textit{See id.} at 164.

\textsuperscript{109} \textit{Id.} at 170.

\textsuperscript{110} \textit{See id.} at 180.

\textsuperscript{111} \textit{Id.} at 172.}
entered into the agreement with Georesearch. They acted in their self-interest by rationally choosing the best means to their chosen ends, and by so choosing, they maximized their wealth in that transaction. Consequently, allowing the provision to stand as it was originally bargained, the court recognized that it is more efficient for the law not to interfere with the economics of this transaction.

Likewise, in State ex rel. Howeth v. Davidson & Co., the Supreme Court of Montana examined the enforceability of a stock repurchase provision executed between an employer and its employee that required the employee to sell the employer its stock back at fifty percent of the book value upon the employee’s termination. In this case, D.A. Davidson & Company, a closely held corporation, employed James R. Howeth. As an employee, Howeth was allowed to purchase sixty shares of the corporation at a fifty percent discount from the book value. The shares purchased by Howeth were subject to a restriction that gave Davidson & Co. an option to buy back the shares at fifty percent of the book value upon the termination of Howeth’s employment.

When Davidson & Co. sought to enforce this provision, Howeth refused the request and argued that “forced sale of his stock at fifty percent of book value [was] a harsh forfeiture from which [the court] should grant him relief.” Emphasizing that Howeth had agreed to the terms of the provision when he signed the repurchase agreement, the court specifically held that forced sale of Howeth’s stock at fifty percent of book value was not a harsh forfeiture. Here again, this court valued efficiency over equity. Howeth acted as a rational maximizer when he bargained for the Davidson stock with the knowledge that the stock was subject to the repurchase agreement. Realizing the efficiency behind the transaction, the court logically refused to set the agreement aside based on a theory of forfeiture.

It is apparent that the courts in St. Louis Union Trust Co., Georesearch, and Howeth felt secure in limiting their role. They refused to nullify agreements that were freely negotiated by consenting parties. By limiting their paternalistic instincts, they allowed the behavior of individuals in our mixed-market economy to govern their undertakings, thereby maintaining the natural efficiency of market transactions.

113 See id. at 724.
114 See id.
115 Id. at 730.
116 See id.
This same economic reasoning is prevalent throughout the decision in *Gallagher v. Lambert*.\(^{117}\) James Gallagher was employed by Eastdil Realty as an officer and director. As an executive, Gallagher was allowed to “purchase [Eastdil] stock subject to a mandatory buy-back provision, which provided that upon ‘voluntary resignation or other termination’ prior to January 31, 1985, [he] would be required to return the stock for book value.”\(^{118}\) Gallagher’s employment with Eastdil was terminated on January 10, 1985, three weeks prior to the provision’s cutoff date, which would have increased the buyback price.\(^{119}\)

Had Gallagher been fired after January 31, 1985, he would have realized the full value of his shares, since the post-cutoff date “formula for the buyback price was keyed to the company’s earnings.”\(^{120}\) Despite the seeming unfairness of the termination, the court enforced the provision. The court explained its decision by stating that:

> the parties negotiated a written contract containing a common and plain buy-back provision. [Gallagher] got what he bargained for . . . . There being no basis presented for the courts to interfere with the operation and consequences of this agreement between the parties, the order of the Appellate Division granting summary judgment to defendants, dismissing the first three causes of action, should be affirmed . . . .\(^{121}\)

Clearly, the court recognized the efficiency of allowing the parties to rationally maximize their outcome in the transaction by freely bargaining and establishing ex ante expectations.

Furthermore, the court held that stock buyback provisions “should not be undone simply upon an allegation of unfairness.”\(^{122}\) Rather, the court’s decision to enforce the buyback provision was based on the “application of fundamental contractual principles to the plain terms in the parties’ own stock repurchase agreement.”\(^{123}\) Underscoring the court’s decision were the law and economic principles of efficiency and wealth maximization. The court reasoned that allowing fairness to trump efficiency would “frustrate the agreement and would be disruptive of the settled principles governing

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\(^{118}\) Id.

\(^{119}\) See id.

\(^{120}\) Id. at 136-37.

\(^{121}\) Id. at 137.

\(^{122}\) Id. at 138.

\(^{123}\) Id.
like agreements where parties contract between themselves in advance so that there may be reliance, predictability and definiteness between themselves on such matters."

The economics at work in this decision are unmistakable. The court refused to alter the law in a way that would encourage inefficiency in market transactions and ultimately have a negative effect on economic performance. Its decision was predicated on the rational behavior of the parties during the transaction and the realization that it is not the responsibility of the decision maker to make a better deal after the fact for someone who made a bad bargain. This is especially true where ex post bargaining would create an inefficient rule.

Moreover, decision makers who fashion rules that facilitate efficiency and take advantage of free market dynamics will capture the essence of law and economics. This paradigm was precisely applied by the New York Court of Appeals in Allen v. Biltmore Tissue Corp. Faced with a stock repurchase agreement that gave a corporation the right to purchase a deceased shareholder’s stock at the price the shareholder originally paid, the court held the restriction to be reasonable and valid.

The court enforced the agreement despite the inequity of requiring the shareholder to sell his stock back to the corporation for the same price at which he bought it and ultimately forfeiting any appreciation in value. In a case identical to Man O War, the Allen court reasoned that “the validity of the restriction on transfer does not rest on any abstract notion of intrinsic fairness of price” because “[i]t[ ]to be invalid, more than mere disparity between option price and current value of the stock must be shown.”

Repurchase agreements act as a “pre-emptive right through which [shareholders] may, if they choose, veto the admission of a new participant.” The economy that these ex ante agreements provide is absolutely clear. Consequently, to remake the bargain in order to rid the agreement of unreasonableness or unfairness would dissolve that economy. In fact, the Allen court stated that “[c]arried to its logical conclusion, such a rationale would permit, indeed would encourage, expensive litigation in every case where the price specified in the restriction, or formula for fixing the price, was other than a recognized and easily ascertainable fair market value.”

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124 Id.
126 See id.
127 Id. at 817.
128 Id.
129 Id. at 816-17.
130 Id. at 816.
As the majority of closely held corporations do not trade on a public market, the valuation of a close corporation's stock is an internal matter best determined by the corporation's insiders. In Man O War, the insiders agreed to a price formula that economic theory tells us enabled the parties to reach their desired objectives in this particular market transaction. Thus, efficiency was achieved, and decision makers should not disturb the result.

IV. IMPLICATIONS OF THE MAN O WAR DECISION

By choosing equity as the valued social goal, the Man O War court was determined to focus on the unfairness of denying Martin, the beneficial owner of the stock, the benefit of the stock's appreciation. However, by using equity as its baseline, the court ignored the economics of the free market transaction.

Acting as rational maximizers, MOWR and Martin reached an agreement that provided the means to achieving their desired ends. A look at the free market transaction process reveals a two-step approach, which was clearly followed by Man O War and Allen. In the first step, the parties discover "a potential exchange that will increase the well-being of both parties." Being comprised of only four shareholders, MOWR was simply protecting itself against unwanted share distribution. Martin was interested in employment and the income associated with that employment, and MOWR was interested in Martin's services. Therefore, the two parties bargained in order to increase their respective well-being.

In the second step, the parties determine "what will be viewed by both parties as a way to fairly divide the gain from the exchange." MOWR anticipated profiting from Martin's skills and was willing to divide its gain with Martin. Likewise, Martin anticipated profiting from the employment provided by MOWR and was willing to divide his gain with MOWR.

From this perspective, an economic analysis of the Man O War decision reveals its want of efficiency. Economic analysis focuses on the ex ante rather than ex post perspective and the idea that "[r]ational people base their decisions on their expectations of the future rather than on their regrets about the past." The ex ante bargaining in which MOWR and Martin engaged provided the basis for their expectations. Based on legal precedent concerning closely held corporations' ability to restrict the

\[1^{131}\] See DICTIONARY OF BUSINESS TERMS, supra note 17, at 95.
\[1^{132}\] Harrison, supra note 39, at 4.
\[1^{133}\] Id.
\[1^{134}\] POSNER, supra note 28, at 8.
transferability of their stock. MOWR reasonably believed that the contract would be entirely enforceable.

In addition, Martin had no reason to believe that the entire contract would not be enforceable. The two parties priced the bargain at the outset, taking into account past performance and future contingencies. Therefore, setting the stock repurchase provision aside amounted to an evisceration of the parties' expectations and altered economic performance because "[i]f a party for whom a contract to which he freely agreed turns out badly is allowed to revise the terms of the contract ex post, few contracts will be made."136

A. Economic Performance

Currently, Kentucky's economy is strong, as the entire United States continues to experience a long period of prosperity brought on by low interest rates, low unemployment, and a bull market on Wall Street. Economic forecasters predict "Kentucky's annual total employment growth rate . . . to exceed the national growth rate by 0.5 percent on average from 1998 through 2000."137 That equates to "26,000 additional jobs for Kentucky over the three year period."138 Indeed, employers are drawn to Kentucky. In the period "from January 1993 to August 1998, 3,400 companies announced investments of more than $13 billion, with a commitment to create nearly 126,000 jobs for Kentuckians."139

Kentucky's appeal is that it "offers great advantages for new and expanding businesses, including a great location, low utility rates, low taxes and a pro-business government."140 In addition, Kentucky has moved "away from just being driven by tobacco and coal and become a much more diverse state."141 Kentucky now has employers in distribution, manufacturing, and white-collar industries that combine to provide a better balance of job opportunities.142 This diversity and flexibility has the

135 See supra Part III.
136 POSNER, supra note 28, at 8.
138 Id.
140 Id.
141 Adam Burns, Corporate Bait: Luring Business to the Bluegrass, LANE REP., July 1, 1998, at 32, 33.
142 See id.
potential to stimulate wealth-maximizing market transactions and hence, a greater gain for everyone. Consequently, these developments have Kentucky economically well-positioned for the twenty-first century.

B. Altering Economic Performance

Although the Man O War decision may potentially reach beyond Kentucky, and its scope ultimately broadened to include more than repurchase agreements, its implications will be felt first by the Kentucky economy. While Kentucky enjoys current economic prosperity and continues to push for more employers, the Man O War decision and its underlying logic may prove to be a pitfall with the potential to stall, and eventually recess, economic performance throughout Kentucky.

The Man O War decision unbalances the current state of the law and exposes the judicial system to an explosion of litigation. Because stock repurchase provisions are well accepted ways for closely held corporations to protect their going concern, the Man O War decision places all of the existing agreements in doubt. Did the corporation use the correct valuation method? Is the result fair to the shareholder? Should the court remake the bargain? These are questions that now have no certain answer.

The phenomenon of increased litigation was specifically addressed by the Allen court when it refused to strike down a set value for stock in a repurchase agreement as unfair or unreasonable. Certainly, the logic behind the Man O War decision will “permit, indeed, would encourage, expensive litigation in every case where the price specified in the restriction, or formula for fixing the price, was other than a recognized and easily ascertainable fair market value.”

In addition, as employers are alerted to the change Man O War has made in the law, they will inevitably be discouraged from establishing their businesses in Kentucky. The prospect of the judicial system remaking a corporation’s contracts after the fact will detract from the competitive advantages Kentucky presents. In effect, the Man O War decision has removed the incentives associated with free market transactions, eliminating Kentucky’s ability to compete for employers and changing the way Kentucky does business.

The reality of this situation is altered economic performance. The "governmental regulation of corporations and other business entities,

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143 See supra Part III.
144 See supra Part III.B.2.
including rules governing owners, managers and third parties, is inappropriate except to the extent that such regulation may, in rare circumstances, provide the most efficient rule." When the most efficient rule is not provided, incentives to exchange are altered, then human behavior is altered, and consequently, the economic performance of the economy is altered.

C. Corrective Measures

It has been said that "[t]he single most important contribution that law and economics has made to the law is the use of a coherent theory of human decision-making ("rational choice theory") to examine how people are likely to respond to legal rules." Operating from this position, "the goal of law under a purely economic theory becomes the creation of rules which decrease transaction costs, so that parties may, as nearly as possible, achieve efficient solutions to their problems."

Applying economics to the law, decision makers will understand that "people who make a transaction—thus putting their money where their mouths are—ordinarily are more trustworthy judges of their self-interest than a judge (or jury), who has neither a personal stake in nor first-hand acquaintance with the venture on which the parties embarked when they signed the contract." Decision makers should realize that changing the law changes incentives and ultimately alters economic performance. In addition, decision makers should know that if provided with efficient rules, humans, as rational maximizers, would choose the best means to their chosen ends, thereby increasing the aggregate wealth of society.

Conversely, decision makers should know that if they provide merely equitable rules, humans would have a disincentive to exchange, which will negatively alter economic performance. Therefore, "if the goal . . . is to promote efficiency . . . enforcing the parties' agreement insofar as it can be ascertained may be a more efficient method of attaining this goal than rejecting the agreement when it appears to be inefficient."

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147 Ulen, supra note 8, at 436.
148 Downs, supra note 3, at 13.
149 Posner, supra note 28, at 93.
150 See supra Part I.A.
151 See supra Part I.C.-D.
152 See supra Part I.C.-D.
153 Posner, supra note 28, at 93.
CONCLUSION

The weight of authority supports the principle that when the holder or transferee of stock knows of the restriction on transferability, the restriction will be enforced just as the parties agreed.154 By refusing to enforce a stock repurchase agreement that restricted the transfer of stock because it was not fair, Man O War stands on its own and changes the current state of the law.

An economic analysis of the Man O War decision reveals its deficiencies and illustrates the need for rules that promote efficiency to take advantage of free market transactions. From a law and economics perspective, the change that Man O War presents can potentially affect future market transactions, including stock repurchase agreements, by altering transaction incentives. Once the incentives to exchange are altered, human behavior will change, ultimately causing a change in economic performance. Thus, Man O War is law altering economic performance.

154 See supra Part III.B.2.