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Law and Entrepreneurial Opportunities

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INTRODUCTION

In his book *Siberia Bound*, Minnesota-native Alexander Blakely details his five years living and working in Siberia in the mid-1990s.¹ Blakely claimed that Minnesota wasn't cold enough,² but the more important motivation for his move to Siberia was his desire to bring capitalism to post-communist Russia. During Blakely's time in Siberia, he and his Siberian business partner "Sasha" engaged in numerous entrepreneurial ventures that included selling cocoa beans, chocolate, latex gloves, potatoes, and whatever else they could get their hands on. Blakely's experiences living and working in Siberia were a mixed bag. Some days he felt like anything was possible; other days he wondered what change had wrought.

Entrepreneurship in Siberia was certainly different than entrepreneurship in America. Contrary to Blakely's academic training as an economist, business arrangements did not proceed in accordance with sound economic theory.³ Instead, friendships cultivated by bribes were the key to obtaining and sustaining business, even if profits suffered. Blakely details bribes to business partners, the local mafia, and bureaucrats. Sometimes these bribes were paid in cash, sometimes in vodka, and sometimes in trips to America.

Blakely's rich account of entrepreneurship in post-communist Siberia strikingly conveys the absence of the rule of law. While routine bribery may be the most telling indicia of the law's absence, it is also interesting that Blakely engages in numerous

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¹ ALEXANDER BLAKELY, *SIBERIA BOUND: CHASING THE AMERICAN DREAM ON RUSSIA'S WILD FRONTIER* (2002).

² *Id.* at 19 ("On the coldest days of the year [in Minnesota], I'd go outside to test whether it was that cold. It never was.").

³ For instance, the economist in Blakely could not understand why the chocolate factories that he and Sasha were supplying with cocoa beans did not simply cut out the middleman and buy the beans directly. As Blakely explains to Sasha, "[w]e're not adding anything to the equation. If anything, we are in the way of a more efficient means of getting things done." *Id.* at 286.

business ventures yet never mentions the law or lawyers. In one anecdote, Blakely tells of borrowing \$20,000 from a local lender. Sasha presents the lender with a contract, which the lender slides back across the table to Sasha. Blakely describes what came next:

Sasha, still grinning, ripped the paper lengthwise in two, then ripped the two halves into quarters, then into eighths....I felt drunk with emotion. In two days, we had sold six tons of chocolate and borrowed twenty thousand dollars without a single lawyer charging two hundred dollars an hour to put words on paper to protect us from any and every eventuality. Even better, there would be no lawyers to siphon thousands of dollars from us when an unforeseen eventuality did occur and a dispute arose, a dispute that only lawyers profited from.⁴

Despite the exuberance that Blakely feels in keeping the law out of entrepreneurship, he fails to see that the absence of the law is one main reason he ends up leaving Siberia after five years. Blakely is particularly troubled by the mutated strain of capitalism he sees, where making a profit comes from stealing wealth rather than creating it. In the end, although he and Sasha are making money, Blakely admits that their business model boils down to an unappealing proposition: bribing the directors of chocolate factories.⁵ What Blakely fails to realize is that this mutation is present because the rule of law is not.

Blakely is by no means alone in taking a dim view of the law's importance to entrepreneurship. Many entrepreneurs here in the United States, the land of the rule of law, also consider the law and lawyers an impediment to business rather than an aid.⁶ And while entrepreneurship scholars have not been so hostile to the law, they have treated it equally unfortunately. They have ignored it.

This article makes the claim that law matters to entrepreneurship. Law induces, enables, shapes, constricts, and in all these ways affects entrepreneurial activity. The entrepreneurship literature does not sufficiently account for this. This article will begin to. The article explores the way in which law affects the creation and discovery of entrepreneurial *opportunities*, which are the lifeblood of entrepreneurial activity.⁷ Thus, while the existing literature has focused on how isolated laws impact entrepreneurship,⁸ we begin to think more systematically about law-entrepreneurship connections.

Our thesis is that law allocates the right to exploit opportunities between competing, would-be entrepreneurs through the granting of property rights, which in turn causes entrepreneurs to frame the opportunities they create or discover to obtain a

⁴ *Id.* at 7.

⁵ *Id.* at 301.

⁶ Mark Suchman argues that Silicon Valley lawyers, at least, are aware of this perception and actively work to combat it. Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 LAW & SOC. INQUIRY 679, 697 (1996) ("Silicon Valley attorneys see themselves as facilitators rather than voices of caution in the venture financing process.").

⁷ See *infra* notes ___ and accompanying text.

⁸ See *infra* notes ___ and accompanying text.

favorable allocation. Some entrepreneurship scholars have recognized that factors such as an entrepreneur's prior experience influence the framing of entrepreneurial opportunities, but we argue that law also serves a framing function. We illustrate the framing of entrepreneurial opportunities through an examination of intellectual property law, contract law, business organizations law, and fiduciary law. All of these areas of law, and others, affect whether and how entrepreneurial opportunities are created, discovered, and exploited.

This article proceeds as follows. Part I discusses the existing literature on entrepreneurial opportunities, concluding that while the entrepreneurship literature offers several critical insights, it is deficient in one key respect: it fails to consider the relevance of law to the topics under discussion. In Part II we summarize the economic theory of property rights, which is foundational to our understanding of the importance of law to the creation, discovery, and exploitation of entrepreneurial opportunities. Property rights allow the rights-holder to exclude others from certain opportunities. This basic insight sets up our discussion of the effect of law in Part III. We contend that the law's primary functions with respect to entrepreneurial opportunities are to allocate and frame them. The law allocates opportunities between competing, would-be entrepreneurs through the granting of "property rights," which allows the grantee to exclude competitors. This, in turn, motivates entrepreneurial framing of opportunities in a certain way to obtain a favorable legal allocation. Entrepreneurial framing might be important to avoid infringing another's established property rights, or it might be important because it allows the entrepreneur to obtain new property rights and exclude others. We illustrate the framing effect of intellectual property law, contract law, business organizations law, and fiduciary law.

I

ENTREPRENEURIAL OPPORTUNITIES: CREATION, DISCOVERY, AND EXPLOITATION

A. The Nature and Importance of Entrepreneurial Opportunities

Entrepreneurship is often defined as the creation, discovery, and exploitation of *opportunities*.⁹ Therefore, the concept of "opportunity" plays a central role in the study of entrepreneurship.¹⁰ Those opportunities that we considered entrepreneurial in nature are

⁹ The precise formulation of the definition may vary. *See, e.g.*, SCOTT SHANE, A GENERAL THEORY OF ENTREPRENEURSHIP: THE INDIVIDUAL-OPPORTUNITY NEXUS 4 (2003) ("Entrepreneurship is an activity that involves the discovery, evaluation, and exploitation of opportunities to introduce new goods and services, ways of organizing, markets, processes, and raw materials through organizing efforts that previously had not existed."); S. Venkataraman, *The Distinctive Domain of Entrepreneurship Research: An Editor's Perspective*, in *ADVANCES IN ENTREPRENEURSHIP, FIRM EMERGENCE AND GROWTH* (J. Katz & R. Brockhaus eds.) 3:119 (1997).

¹⁰ Jonathan T. Eckhardt & Scott A. Shane, *Opportunities and Entrepreneurship*, 29 J. MGMT. 333, 336 (2003) ("[W]e define entrepreneurship as the discovery, evaluation, and exploitation of future goods and services. This definition suggests that, as a scholarly field, entrepreneurship involves the study of opportunities.").

at least the subset of market opportunities that involve some form of novelty or innovation.¹¹

Entrepreneurship commonly brings to mind innovation in the *strong sense*, including the technological breakthroughs associated with Silicon Valley and backed by venture capital. Although he wrote several decades before the emergence of Silicon Valley, Joseph Schumpeter described such innovations. He defined an entrepreneur as someone who carries out “new combinations”¹² – or, famously, as an agent of “creative destruction.”¹³ Schumpeter’s entrepreneur is an agitator who mixes things up by introducing new information into a complacent market.¹⁴ Schumpeter also offered a typology of five forms that entrepreneurial opportunities may take – 1) new goods; 2) new methods of production; 3) new geographical markets; 4) new raw materials; and 5) new ways of organizing.¹⁵

In our modern economy, opportunities that are innovative in the strong or Schumpeterian sense are particularly valuable. A recent study found that firms backed by venture capital, which are typically innovative firms in the strong sense, directly employed over 12.5 million people¹⁶ and in the year 2000 accounted for 11% of the U.S. Gross Domestic Product.¹⁷ At a time when globalization has resulted in the outsourcing of traditional manufacturing and service jobs¹⁸ and our financial markets are

¹¹ See Scott Shane & S. Venkataraman, *The Promise of Entrepreneurship as a Field of Research*, ACAD. MGMT. REV. 217, 220 (2000) (“Entrepreneurial opportunities differ from the larger set of all opportunities for profit, particularly opportunities to enhance the efficiency of *existing* goods, services, raw materials, and organizing methods, because [entrepreneurial opportunities] require the discovery of new means-ends relationships.”) (emphasis in original); see also Eckhardt & Shane, *supra* note __, at 336 (the entrepreneur constructs a new means-ends relationship or provides either the new means or the new ends). For more discussion on entrepreneurial opportunities versus market opportunities, see SHANE, *supra* note __, at 39-41.

¹² JOSEPH A. SCHUMPETER, *THE THEORY OF ECONOMIC DEVELOPMENT: AN INQUIRY INTO PROFITS, CAPITAL, CREDIT, INTEREST, AND THE BUSINESS CYCLE* 74 (Redvers Opie trans., 3d prtg., Harvard Univ. Press 1949) (1934).

¹³ JOSEPH A. SCHUMPETER, *CAPITALISM, SOCIALISM, AND DEMOCRACY* 83 (3d ed. 1950).

¹⁴ SHANE, *supra* note __, at 21 (“Schumpeterian opportunities are innovative and break away from existing knowledge”).

¹⁵ SCHUMPETER, *supra* note __, at 66; see also Eckhardt & Shane, *supra* note __, at 340 (illustrating Schumpeter’s typology with examples); SHANE, *supra* note __, at 34 (observing that there has been a lack of research on the forms that entrepreneurial opportunities may take, and that only one empirical study has employed Schumpeter’s typology of opportunity).

¹⁶ Testimony of Robert E. Grady Before the U.S. House Committee on Education and the Work Force, March 11, 2004, at 2 (citing study conducted by _____).

¹⁷ *Id.*

¹⁸ See generally THOMAS L. FRIEDMAN, *THE WORLD IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY* (2005).

experiencing strong competition from foreign rivals,¹⁹ this sort of innovation may well be America's competitive advantage moving forward.²⁰

Still other entrepreneurial opportunities involve innovation or novelty in the *weak sense*. Ask the average person whether the typical small business owner is an entrepreneur, and many would reply that she is. Some scholars have likewise suggested that opportunities exploited by small business owners count as entrepreneurial opportunities. Scott Shane has stated that “the entrepreneurial process can involve a type of innovation that is much milder, such as placing a restaurant on a different corner of an intersection from existing restaurants, or using different recipes or employees in a new restaurant in the same location as the old one.”²¹ Israel Kirzner's writings on entrepreneurial opportunities are well known and also invoke innovation in the weak sense.²² Kirzner's notion of an entrepreneurial opportunity is one found by an alert entrepreneur without an active search – for instance, when the entrepreneur discovers an underpriced commodity in one market that he can sell for more in another market.²³ If opportunities involving innovation in the weak sense are also counted as entrepreneurial, the importance of entrepreneurial opportunities to our society and economy is multiplied many times over.

B. Entrepreneurial Opportunities: Creation, Discovery, Exploitation

Entrepreneurial opportunities have a life cycle consisting of three stages: 1) creation; 2) discovery; and 3) exploitation. First, an opportunity must be created – that is, it must come to exist. Second, it must be discovered by an entrepreneur and recognized as

¹⁹ [cites to number of IPOs on foreign exchange on recent years compared to previous years]

²⁰ This is the main thrust of a recent book from the president of the Kauffman Foundation. See generally CARL J. SCHRAMM, *THE ENTREPRENEURIAL IMPERATIVE* (2006).

²¹ SHANE, *supra* note __, at 8; but see Robert A. Baron, *Opportunity Recognition as Pattern Recognition: How Entrepreneurs “Connect the Dots” to Identify New Business Opportunities*, __ ACAD. MGMT. REV. 104, 107 (2006) (“the focus here is on what have been described as innovative opportunities – ones that truly break new ground rather than merely expand or repeat existing business models, such as, for instance, opening a new Italian restaurant in a neighborhood that does not currently have one”).

²² A good amount of the opportunities literature is devoted to comparing and contrasting Kirznerian and Schumpeterian opportunities. See, e.g., ISRAEL M. KIRZNER, PERCEPTION, OPPORTUNITY, AND PROFIT 111 (1979) (“In Schumpeter it appears that the entrepreneur acts to disturb an existing equilibrium situation....in our discussion, the entrepreneur is seen as the equilibrating force.”); SHANE, *supra* note __, at 21 (observing at least five important differences between Kirznerian and Schumpeterian opportunities); Guido Buenstorf, *Creation and Pursuit of Entrepreneurial Opportunities: An Evolutionary Economics Perspective*, 28 SMALL BUS. ECON. 323, 325 (2007).

²³ See Israel M. Kirzner, *Entrepreneurial Discovery and the Competitive Market Process: An Austrian Approach*, 35 J. ECON. LIT. 60, 70 (1997) (the entrepreneur “buys where prices are too ‘low’ and sells where prices are too ‘high’”); Kirzner's view of opportunities as arbitrage rather than production has been dismissed by some as unrealistic. See, e.g., Mark Casson & Nigel Wadson, *The Discovery of Opportunities: Extending the Economic Theory of the Entrepreneur*, 28 SMALL BUS. ECON. 285, 285-86 (2007) (describing Kirznerian opportunities “like dollars bills blowing around on the sidewalk, waiting for an alert entrepreneur to pick them up,” and arguing that there “are few opportunities that simply lie around for people to stumble across by chance”).

an opportunity. Third, the entrepreneur must go about exploiting the opportunity in the hopes of making a profit.²⁴ Much of the entrepreneurship literature focuses on the final step, exploitation. This literature assumes that an entrepreneur has an idea, has *legal rights* to the idea, and is seeking to exploit it for profit. The literature on exploitation breaks down into two main strains. The first strain focuses on the traits of individuals who choose to exploit opportunities when others do not, such as an appetite for risk-taking.²⁵ The second strain focuses on the means of exploiting an opportunity, typically through the creation of a new firm but also possibly within an established firm (intrapreneurship) or through market transactions.²⁶

However, some recent literature reminds us that there are important steps that come before an opportunity is ready to be exploited.²⁷ Rather than simply assume away these prior steps, this literature asks how we get to the exploitation stage – what are its logical antecedents?²⁸ Questions here focus on the first two steps of entrepreneurial life cycle: How do opportunities come to exist, and how are they discovered by entrepreneurs? In this paper, we too are primarily concerned with what happens *before* exploitation, for it is here that the law has an important and non-obvious impact on the opportunities that end up being exploited.

Although there are several possible ways to look at opportunity creation and discovery, one useful distinction comes from separating *endogenous* and *exogenous* opportunities. Endogenous opportunities are those opportunities that the entrepreneur creates, by extension “discovers,” and then proceeds to exploit in the hopes of profit. These sorts of opportunities, because they are created by entrepreneurs from whole cloth, tend to be innovative in the strong sense. They do not rely on preexisting information so much as they inject new information into the economic stream, and therefore fit within

²⁴ This is not to imply that all entrepreneurs are driven by profit, or profit alone. Schumpeter, for instance, identifies other factors that may induce entrepreneurial behavior including the will to conquer, the desire to succeed, and the joy of creating. SCHUMPETER, *supra* note __, at 93.

²⁵ See R. H. Brockhaus, Sr., *Risk Taking Propensity of Entrepreneurs*, 23 ACAD. MGMT. REV. 509 (1980) (risk-taking propensity); R. Kirchoff & J. Laffont, *A General Equilibrium Entrepreneurship Theory of Firm Formation Based on Risk Aversion*, 87 J. POL. ECON. 719 (risk-taking propensity); D.C. MCCLELLAND, THE ACHIEVING SOCIETY (1961) (need for achievement).

²⁶ See William B. Gartner, *A Conceptual Framework for Describing the Phenomena of New Venture Creation*, 10 ACAD. MGMT. REV. 696 (1985).

²⁷ A recent conference at the Max Planck Institute of Economics in Jena, Germany was devoted to an exploration of entrepreneurial opportunities prior to exploitation. See, e.g., Jeffery S. McMullen et al., *What is Entrepreneurial Opportunity?*, 28 SMALL BUS. ECON. 273, 274 (2007) (introductory paper); Yosen E. Company and Jeffery S. McMullen, *Strategic Entrepreneurs at Work: The Nature, Discovery, and Exploitation of Entrepreneurial Opportunities*, 28 SMALL BUS. ECON. 301, 302 (2007) (a research framework that takes into account the origins of entrepreneurial opportunities is necessary but currently limited). Scott Shane, S. Vankataraman, and Jonathan Eckhardt have also argued that the existing literature is too focused on exploitation. See Shane & S. Venkataraman, *supra* note __, at 219 (“[W]e argue that entrepreneurship does not require, but can include, the creation of new organizations.”); Eckhardt & Shane, *supra* note __, 336 (“in contrast to [existing] theories, which assume away the existence of entrepreneurial opportunities, we view entrepreneurship as requiring those opportunities”).

²⁸ See Shane, *supra* note __, at 448 (“Unfortunately, most research on entrepreneurship investigates the entrepreneurial process after opportunities have been discovered.”).

the Schumpeterian mold. Referring back to Schumpeter's typology of opportunity, endogenous creations often take the form of new products and services. Ready illustrations of these opportunities include technological innovations which the innovator then proceeds to exploit, such as Larry Page and Sergey Brin's creation and exploitation of the Google search engine.

But endogenous opportunities need not be high-tech. For instance, Starbucks is a low-tech yet highly innovative company.²⁹ Nor are endogenous opportunities limited to new products and services. Following Schumpeter, new ways of organizing would also count. Pierre Omidyar's creation of eBay to leverage the power of the Internet for e-commerce was a new way of organizing the "flea market" business, much as Sam Walton's creation of Wal-Mart was a new way of organizing the retail business. Endogenous opportunities, whatever their particular form, are particularly important to our economy and to entrepreneurship because they in turn beget more opportunities, including opportunities for complementary products and services and related innovations.³⁰

The other main type of entrepreneurial opportunity is that which is exogenous to the entrepreneur; i.e., opportunities created by someone or something else. These opportunities can be created in three ways: by another person (or firm), by an external shock to the system, or by a prior entrepreneur's error. The first category, and the first thing to note about exogenous opportunities, is that they can also be inventions or innovations in the strong or Schumpeterian sense. The only difference is the person who discovers and exploits them is someone other than the creator.³¹ Schumpeter did not make the mistake of conflating invention with entrepreneurship, but instead recognized that the inventor who does not exploit his invention is not an entrepreneur at all.³² Guido Buenstorf argues that most entrepreneurial opportunities result from human creation of some sort, but that does not imply that all are endogenous opportunities.³³ He gives the

²⁹ Starbucks was initially backed by venture capital. [cite]

³⁰ Buenstorf, *supra* note __, at 327 ("innovations frequently create opportunities for (potential) producers of complementary and vertically related goods and services"); Holcombe, *supra* note __, at 33 ("the most important source of entrepreneurial opportunities is the activity of other entrepreneurs").

³¹ This is why the entrepreneurship literature sometimes refers to technological changes as *exogenous* shocks to the system. See Shane, *supra* note __, at __; see also Jonathan T. Eckhardt & Michael P. Ciuchta, *From Fee to Fee: An Examination of Factors Influencing the Switch from Public Innovator to Commercial Entrepreneur*, FRONTIERS OF ENTREPRENEURSHIP RESEARCH (on why "public" innovators such as academic and government scientists will choose to commercialize their innovations).

³² Schumpeter did not conflate entrepreneurship with invention. He observed: "Although entrepreneurs of course *may* be inventors just as they may be capitalists, they are inventors not by nature of their function but by coincidence and vice versa." SCHUMPETER, *supra* note __, at 88-89 (emphasis in original).

³³ Buenstorf, *supra* note __, at 330 ("[O]pportunities are almost invariably created by human activity, in part by activity outside the market sphere, in part by economic activity within markets. However, the agent who pursues the opportunity need not be the one who created it."); see also Saras D. Sarasvathy et al., *Three Views of Entrepreneurial Opportunity*, in HANDBOOK OF ENTREPRENEURSHIP RESEARCH 141, 145 (2003) (If neither supply nor demand exist in an obvious manner, one or both have to be 'created', and several economic inventions in marketing, financing, etc. have to be made, for the opportunity to come into existence.") (emphasis removed).

example of the special bikes designed by a group of California “hippies” to suit their downhill races, which were only later commercialized as “mountain bikes” by an entrepreneur who was not part of the original group.³⁴ Of course, if the creator has established property rights in the opportunity, the entrepreneur must license or acquire those rights before exploiting the opportunity.

The second way in which exogenous opportunities are created is by political, regulatory, or legal changes.³⁵ These external “shocks” to the system may open up new markets and therefore give rise to opportunities for profit. For example, deregulation of the U.S. airline industry in the 1970s created opportunities for aviation entrepreneurs.³⁶ Socio-demographic changes, such as urbanization, are another type of exogenous shock that gives rise to entrepreneurial opportunities.³⁷ These sorts of opportunities usually entail the weak form of innovation.

Finally, Kirzner posited that entrepreneurial opportunities come from errors made by prior entrepreneurs. Prices are sometimes too low and sometimes too high because “a market setting requires the participants to guess each other’s expectations about a wide variety of things,” and they may guess incorrectly for any number of reasons.³⁸ This creates errors in the form of “shortages, surpluses, and misallocated resources” that the entrepreneur may then “correct” for profit.³⁹ These opportunities may be less important because they are innovative in the weak sense and have a very different effect on the market than do Schumpeterian opportunities. That is, while Schumpeterian entrepreneurs add to the pool of available opportunities by permitting complimentary products and services and related innovations, Kirznerian entrepreneurs actually subtract from the pool of undiscovered opportunities that are then available for future exploitation.⁴⁰

The main benefit of separating endogenous and exogenous opportunities is that it allows us to isolate and focus on the extra step – discovery – that is required before an exogenous opportunity can be exploited.⁴¹ Unlike endogenous opportunities, exogenous

³⁴ Buenstorf, *supra* note __, at 330. Randall Holcombe gives another example: Xerox developed the use of on-screen windows and the computer mouse, but its lack of “entrepreneurial insight” allowed Apple and Microsoft to exploit these opportunities. Randall G. Holcombe, *The Origins of Entrepreneurial Opportunities*, 16 REV. AUSTRIAN ECON. 25, 28 (2003).

³⁵ SHANE, *supra* note __, at 25-28.

³⁶ SHANE, *supra* note __, at 25.

³⁷ *Id.* at 28-33.

³⁸ Shane & Venkatamaran, *supra* note __, at 220-21 (discussing Kirznerian opportunities).

³⁹ See Kirzner, *supra* note __, at 70 (“opportunities are created by earlier entrepreneurial errors which have resulted in shortages, surplus, and misallocated resources”); KIRZNER, *supra* note __, at 132 (“error exists...[and] the market process is a process of systematic discovery and correction of true error”).

⁴⁰ *But see* Holcombe, *supra* note __, at 33 (Kirzner could be read as suggesting that there is a stock of opportunities which are depleted as entrepreneurs act and the market moves toward equilibrium, but the better reading is that Kirzner’s entrepreneurs breed more opportunities for entrepreneurship).

⁴¹ See Eckhardt & Shane, *supra* note __, at 338 (defining discovery as “the perception of a new means-end framework to incorporate information, incompletely or partially neglected by prices, that has the potential to be incorporated in prices and thereby efficiently guide the resource allocation decisions of others”).

opportunities are not known to the entrepreneur and therefore must be discovered and recognized as such. Scholars have offered various explanations for how entrepreneurs discover opportunities. These explanations generally fall into one of two categories: information asymmetry or belief asymmetry.⁴²

Information asymmetry is present when the entrepreneur possesses information that others do not, which provides an obvious advantage in discovering opportunities that stem from this information.⁴³ Entrepreneurs might have superior information due to their current jobs, prior experiences, or social networks.⁴⁴ They may also gain informational advantages through an active search for information.⁴⁵ Viewing discovery as an ongoing process that begins with an active search reveals the opportunity costs and sunk costs that entrepreneurial activity may entail.⁴⁶ A second line of thought emphasizes “belief asymmetry,” or the idea that entrepreneurs hold different beliefs about the viability of shared information due to traits such as intelligence, creativity, and alertness.⁴⁷ Unlike market actors who can rely on “mathematical rules of optimization” to find profit opportunities within existing means-end frameworks, entrepreneurs must engage in conjecture about uncertain future markets.⁴⁸ Therefore, entrepreneurs must be able to look at information differently and see profit potential where others do not.

None of the foregoing is meant to imply that all, or even most, opportunities exist as objective realities that are waiting to be plucked from thin air by the alert entrepreneur. Entrepreneurs may be distinguished from *non-entrepreneurs* by their ability to look at shared information and see an opportunity for profit, but they are further distinguished from *each other* by what precise opportunity each sees in that information. It is probably the rare case where an entrepreneur discovers a fully formed opportunity and exploits it as is. Quite the contrary, what “opportunity” is actually discovered is determined by the entrepreneur based on several factors. Two important factors are the law, which we

⁴² See SHANE, *supra* note __, at 45 (“people discover opportunities that others do not identify for two reasons: first, they have better access to information about the existence of the opportunity. Second, they are better able than others to recognize opportunities, given the same amount of information about it, because they have superior cognitive capabilities”).

⁴³ See Shane & Venkataraman, *supra* note __, at 221 (“If economic actors obtain new information before others, they can purchase resources at below their equilibrium value and earn an entrepreneurial profit by recombining the resources and then selling them”); Eckahardt & Shane, *supra* note __, at 337 (price system does not incorporate all relevant information to make decisions about the most efficient use of resources).

⁴⁴ See SHANE, *supra* note __, at 46-50 (detailing the reasons why entrepreneurs may enjoy information advantages over others).

⁴⁵ See *id.* at 48-49.

⁴⁶ See Casson & Wadeson, *supra* note __, at 288 (viewing opportunities as projects that involve time and expense to develop). *But see* KIRZNER, *supra* note __, at 155 & Kirzner, *supra* note __, at 72 (discovery does not require an active search, nor is it pure luck; instead, it relies on the entrepreneur’s “unique talent” and “attitude of receptiveness”).

⁴⁷ See Shane & Venkataraman, *supra* note __, at 220-21.

⁴⁸ See SHANE, *supra* note __, at 39, *citing* M. CASSON, *THE ENTREPRENEUR: AN ECONOMIC THEORY* (1982).

discuss later, and the entrepreneur’s prior knowledge and training. Both of these factors shape and frame the opportunity that is discovered.

An important paper by Scott Shane illustrates the impact of an entrepreneur’s prior knowledge on discovery.⁴⁹ Shane tracked eight entrepreneurial teams who sought to license and exploit a single MIT technology for a three-dimensional printing process.⁵⁰ Each of the eight teams saw a different opportunity in the same technology, ranging from architectural models based on CAD drawings to a new drug delivery system to ceramic filters for power generation.⁵¹ Shane found that each iteration of the “opportunity” was based on that particular team’s prior knowledge and training. Thus, prior knowledge can provide an advantage in allowing discovery of opportunities that other entrepreneurs cannot see. It might, however, also be a limitation – for instance, where the prior knowledge confines the entrepreneur’s vision to a market that is too small to make the opportunity worth pursuing.⁵² Either way, Shane’s study demonstrates the importance of entrepreneurial framing during discovery.

C. *The Interdisciplinary Nature of Entrepreneurship Research*

The preceding summary of the entrepreneurship literature on opportunities allows us to glean an important point about entrepreneurship more generally: its study is inherently interdisciplinary in nature. We talk about this in more depth in another paper,⁵³ but our general claim is that entrepreneurship is different from the social sciences of economics, sociology, and psychology because it does not offer its own casual theories for human behavior, but rather explores an important and interesting phenomenon.⁵⁴

For this reason, entrepreneurship scholars must necessarily look to other fields for guidance.⁵⁵ Indeed, the literature discussed above reveals this interdisciplinary focus. Entrepreneurship scholars attribute the discovery of exogenous opportunities to information and belief asymmetries. The former is an important concept in the economics

⁴⁹ Scott Shane, *Prior Knowledge and the Discovery of Entrepreneurial Opportunities*, 11 *ORG. SCI.* 448 (2000).

⁵⁰ Four of the teams actually started new firms to exploit the technology, while four did not. *Id.* at 454.

⁵¹ *Id.* at 455 tbl. 1.

⁵² *Id.* at 459 (for example, the team that discovered an opportunity for architectural models based on CAD drawings abandoned their idea because “the architectural model making industry nationwide is only \$10 million, [and] that’s too small to build a company”).

⁵³ Darian M. Ibrahim & D. Gordon Smith, *Entrepreneurs on Horseback: Reflections on the Organization of Law*, 50 *ARIZ. L. REV.* 71 (2008).

⁵⁴ *See id.* at __.

⁵⁵ *See* McMullen et al., *supra* note __, at 276 (“Opportunity is an inherently interdisciplinary topic. Human action is studied by economists, psychologists, sociologists, and a range of more applied fields including strategic management, organizational psychology, and entrepreneurship, to name only a few.”); SHANE, *supra* note __, at 40 (“any effort to provide a conceptual framework for entrepreneurship seems to require an interdisciplinary approach. The domains of psychology, sociology and economics all seem to provide insight into a piece of the puzzle, but none seem to explain the phenomenon completely”).

literature, while the latter implicates the psychology literature. Economics and psychology also play an important role in the exploitation literature. Inquiries into the means of exploitation – the choice between start-ups, established firms, and market transactions – implicate the economics literature on vertical integration and the boundaries of the firm,⁵⁶ while the notion of entrepreneurs as risk-takers draw from the psychology literature and peer into “the entrepreneurial mind.”⁵⁷

Despite the need for external guidance, scholars who study entrepreneurship fail to draw, or draw sufficiently, on the law. This is a surprising and significant omission that provided the impetus for this paper. This is not to discount the work that *has* been done on how law affects entrepreneurship, particularly in the area of exploitation. An important example comes from law professor Ronald Gilson and his explanation for Silicon Valley’s comparative entrepreneurial advantage over Boston’s Route 128. While AnnaLee Saxenian first explored the issue and attributed Silicon Valley’s advantage to its progressive cultural norms,⁵⁸ Gilson offered a legal explanation: that California refused to enforce non-compete agreements but Massachusetts did not. California’s law allowed for robust start-up activity and knowledge spillover in Silicon Valley, while Massachusetts’ law did not.⁵⁹

Gilson’s contribution and others like it help us understand law-entrepreneurship connections. However, they come to us as bits and pieces of the larger puzzle. Such contributions tend to focus on single laws, like non-compete laws, rather than offer systematic attempts to think about law’s impact on entrepreneurship.⁶⁰ For the remainder of this paper, we attempt a broader exploration of how law affects entrepreneurial opportunities in their pre-exploitation stages. We argue that law allocates the right to exploit opportunities between competing, would-be entrepreneurs, and in doing so ends up shaping their very form. We illustrate this effect with a detailed examination of intellectual property law, contract law, business organizations law, and fiduciary law.

Importantly, while we attempt a more systematic exploration of influence of law on the development of entrepreneurial opportunities relationships than has been offered in the

⁵⁶ See Ronald H. Coase, *The Nature of The Firm*, 4 *ECONOMICA* 386 (1937); OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES* (1975); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985)

⁵⁷ [cite relevant psychology literature]

⁵⁸ See generally ANNALEE SAXENIAN, *REGIONAL ADVANTAGE: CULTURE AND COMPETITION IN SILICON VALLEY AND ROUTE 128* (1994).

⁵⁹ See generally Ronald Gilson, *The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete*, 74 *NYU L. REV.* 575 (1999).

⁶⁰ There have been some attempts, most of them very recent, to think about law and entrepreneurship on a broader level. See, e.g., Steven H. Hobbs, *Toward a Theory of Law & Entrepreneurship*, 26 *CAP. U. L. REV.* 241, 243 (1997) (focusing on the “study of law as it affects the entrepreneurial activities of small businesses”); Amir N. Licht, *The Entrepreneurial Spirit and What the Law Can Do About It*, 28 *COMP. LAB. L & POL’Y J.* ___ (2007); Viktor Mayer-Schoenberger, *Entrepreneurial Law*, draft available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=984311 (April 2007); John Armour & Douglas Cumming, *Bankruptcy Law and Entrepreneurship*, draft available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=762144 (October 2007); Simon C. Parker, *Law and the Economics of Entrepreneurship*, 28 *COMP. LAB. L & POL’Y J.* ___ (2007).

past, we also recognize the inherent limitations of such a task, at least for a single paper.

The potential breadth of the law-entrepreneurship connections is staggering, which is why we confine this paper to entrepreneurial opportunities, and in their pre-exploitation stages only, leaving the exploitation of entrepreneurial opportunities for another time.

Finally, we concede that our framework will not capture all connections in the limited area of our analysis. Despite these limitations, however, we think our paper offers a good starting point for more systematic attempts to think about the emerging field of “law and entrepreneurship.” II

PROPERTY RIGHTS THEORY

Property theorists are quick to observe that “property” is not a *thing*,⁶¹ but rather a “bundle of rights” with respect to a thing.⁶² The tricky part of defining “property” is that the bundle of rights is not the same for all things.⁶³ As a result, the designation of something as “property” does not say anything about the associated rights.⁶⁴ Thus, the label “property” has come to be seen by some as “almost meaningless.”⁶⁵ Fortunately, we are not interested in the legal definition of property, but rather in the economic understanding of property rights. For many economists (and lawyers, as it turns out), the essence of “property” is the right to exclude.⁶⁶ We use “property rights” in this sense to motivate our discussion of law and entrepreneurial opportunities.

Rights to exclude are pervasive. As Shyamkrishna Balganesh recently observed, “The idea of exclusion, in one form or the other, tends to inform almost *any* understanding of property, whether private, public, or community.”⁶⁷ The right to exclude from a resource implies the correlative duty not to interfere with the resource.⁶⁸

⁶¹ Thomas W. Merrill & Henry E. Smith, *What Happened to Property in Law and Economics?*, 111 YALE L.J. 357, 358 (2001) (stating, tongue-in-cheek, that “[s]omeone who believes that property is a right to a thing is assumed to suffer from a childlike lack of sophistication—or worse”).

⁶² See, e.g., Felix S. Cohen, *Dialogue on Private Property*, 9 RUTGERS L. REV. 357, 361 (1954); Morris R. Cohen, *Property and Sovereignty*, 13 CORNELL L.Q. 8, 12 (1927) [hereinafter Cohen, *Sovereignty*]; Jeremy Waldron, *What is Private Property?*, 5 OXFORD J. LEGAL STUD. 313, 314-15 (1985).

⁶³ See Waldron, *supra* note __, at 315 (noting that if the bundle of rights “remained constant for all or most of the cases that we want to describe as private property, the bundle as a whole could be defined in terms of its contents. But, of course, it does not remain constant, and that is where the difficulties begin.”).

⁶⁴ See Joan Williams, *The Rhetoric of Property*, 83 IOWA L. REV. 277, 297 (1998) (“Labeling something as property does not predetermine what rights an owner does or does not have in it.”).

⁶⁵ Merrill & Smith, *supra* note __, at 357.

⁶⁶ See J.E. PENNER, *THE IDEA OF PROPERTY IN LAW* (1997); 2 WILLIAM BLACKSTONE, *COMMENTARIES ON THE LAWS OF ENGLAND* 2 (Univ. of Chicago Press 1979) (1766) (defining property as “that sole and despotic dominion ... exercise[d] over the external things ... in total *exclusion* of the right of any other”); see also Cohen, *Sovereignty*, *supra* note __, at 12 (noting that “the essence of private property is always the right to exclude others”); Merrill, *Right to Exclude*, *supra* note __, at 730 (stating that “the right to exclude others is more than just ‘one of the most essential’ constituents of property—it is the *sine qua non*”).

⁶⁷ Shyamkrishna Balganesh, *Demystifying The Right To Exclude: Of Property, Inviolability, And Automatic Injunctions*, 31 Harv. J.L. & Pub. Pol’y 593, 595 (2008).

⁶⁸ Wesley Newcomb Hohfeld, *Some Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 23 YALE L.J. 16 (1913); Wesley Newcomb Hohfeld, *Fundamental Legal Conceptions as Applied in Judicial Reasoning*, 26 YALE L.J. 710 (1917).

Thus, the right to exclude becomes the touchstone for describing a broad swath of legal rules that protect one person's resources from infringement by another. This expansive understanding of the right to exclude also undergirds our thesis: a fundamental purpose of law is to define rights to exclude, and rights to exclude are inextricably linked to entrepreneurial opportunities.⁶⁹ [expand]

III

HOW LAW ALLOCATES AND FRAMES ENTREPRENEURIAL OPPORTUNITIES

The crux of our argument proceeds as follows. Multiple entrepreneurs might be interested in commercializing similar opportunities, but not all of them have the legal right to do so. Faced with competing claims to opportunities, the law's primary function is to *allocate* them between competing, would-be entrepreneurs. It does so through the granting of property rights, which, as outlined in Part II, allows the grantee to exploit the opportunity while at the same time excluding others from doing so. Some of the entrepreneurship literature recognizes that property rights are indeed important to opportunities,⁷⁰ but here we open the black box to explain *why*.

We consider the practical effect of the law's allocative function. Because the law allocates opportunities between competing entrepreneurs, it motivates entrepreneurs to frame their opportunities in a certain way to obtain a favorable allocation. In other words, an entrepreneur may want to do X, but because of legal constraints, he may have to do Y, which is closely related to X but not the same. This is an example of *ex ante* framing.

Alternatively, an entrepreneur may have pursued an opportunity only to be confronted by claims of infringement by another putative owner of the opportunity. In the resulting process to resolve this dispute, the parties will frame their respective opportunities in a manner designed to achieve strategic advantage. We call this *ex post* framing.

Entrepreneurial framing might be important to avoid infringing another's established property rights, or it might be important because it allows the entrepreneur to obtain new property rights and exclude others. In this way, the law promotes innovation, rather than the sort of pirate capitalism that Blakely encountered in Siberia.

A. Intellectual Property Law

Intellectual property law – including rules governing patents, trademarks, copyrights, and trade secrets – is the most obvious example of law allocating

⁶⁹ We do not intend to suggest that all entitlements are potential opportunities, but rather than all opportunities depend on legal entitlements.

⁷⁰ See Kirsten Foss & Nicholai Foss, *Entrepreneurship, Transaction Costs, and Resource Attributes*, draft available at <http://ssrn.com/abstract=982103> (“Property rights steer the entrepreneurial discovery process. If the entrepreneur cannot hold (sufficiently) secure property rights to certain resource attributes, he will not explore these and certain resource attributes may therefore never be discovered and explored.”).

opportunities through the granting of property rights, even though intellectual property has traditionally been classified as outside the realm of “property.”⁷¹ For example, the Patent Act provides patent holders with a “right to exclude others from making, using, offering for sale, or selling the invention throughout the United States or importing the invention into the United States.”⁷² Entrepreneurs who wish to avoid claims of infringement are required to develop intellectual property that is distinctive. In this way, intellectual property rules encourage innovation. Also, by specifying the types of information that qualify for various forms of protection, intellectual property rules influence the framing of entrepreneurial opportunities. We focus our attention in the remainder of this section on the framing effect of patent law.

The creation of a patent occurs at the conclusion of the complex process of patent prosecution, and the requirements of that process shape the resulting patent. The process begins with preparation and filing of a written application.⁷³

The Patent Act describes the possible subject matter of a patent as “any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof.”⁷⁴ When this language was drafted in 1952, Congress seemed to have an expansive view of the scope of patent protection. The Committee Reports accompanying the Act state that Congress intended the subject matter to include “anything under the sun that is made by man.”⁷⁵ Nevertheless, the Supreme Court has recognized limits on the subject matter of patents: “a new mineral discovered in the earth or a new plant found in the wild is not patentable subject matter. Likewise, Einstein could not patent his celebrated law that $E = mc^2$; nor could Newton have patented the law of gravity. Such discoveries are ‘manifestations of ... nature, free to all men and reserved exclusively to none.’”⁷⁶ Thus, the Supreme Court has excluded from patentable subject matter, “laws of nature, natural phenomena, and abstract ideas.”⁷⁷

As a result of this subject-matter limitation, an entrepreneur may exploit an opportunity that relies on the law of gravity – a bungee-jumping business, for example, or, more exotically, a space tourism company – but the opportunity would not be defensible on the ground that other companies were not allowed to work with gravity. Instead, such companies must find other bases for strategic advantage.

A second foundational requirement in the Patent Act is “utility,”⁷⁸ which means simply that the invention have some beneficial use. Though the threshold for utility is

⁷¹ Pamela Samuelson, *Information as Property: Do Ruckelshaus and Carpenter Signal a Changing Direction in Intellectual Property Law?*, 38 CATH. U. L. REV. 365 (1989).

⁷² 35 U.S.C. § 154(a)(1). Balganesch calls this a “claim-right.” Balganesch, *supra* note ___, at 608.

⁷³ 35 U.S.C. § 112 (2000).

⁷⁴ 35 U.S.C. § 101 (2000).

⁷⁵ *Diamond v. Chakrabarty*, 447 U.S. 303, 309 (1980).

⁷⁶ *Id.* (quoting *Funk Bros. Seed Co. v. Kalo Inoculant Co.*, 333 U.S. 127, 130 (1948)).

⁷⁷ *Diamond v. Diehr*, 450 U.S. 175, 185 (1981).

⁷⁸ 35 U.S.C. § 101 (2000).

often said to be low, the Supreme Court has held against patentability for “a process which either has no known use or is useful only in the sense that it may be an object of scientific research,” as well as “the product produced by the process.”⁷⁹

If an invention is not useful, it may seem hard to imagine how it would become the basis for an entrepreneurial opportunity. On the other hand, the issue is not whether an invention *might become useful*, but rather whether the invention has a *demonstrated utility*.⁸⁰ New technologies seem particularly susceptible to rejection on this ground.⁸¹

A third foundational requirement in the Patent Act is “novelty,”⁸² which is designed to ensure that the invention is not already publicly available and that the true inventor is awarded the patent.

A fourth foundational requirement in the Patent Act is “non-obviousness,”⁸³ which requires that the invention not be obvious to a “person having ordinary skill in the art to which said subject matter pertains.”⁸⁴ The standard for evaluating the obviousness of an invention has generated substantial controversy. In 1966 the Supreme Court articulated a flexible test:

[T]he scope and content of the prior art are ... determined; differences between the prior art and the claims at issue are ... ascertained; and the level of ordinary skill in the pertinent art resolved. Against this background the obviousness or nonobviousness of the subject matter is determined. Such secondary considerations as commercial success, long felt but unsolved needs, failure of others, etc., might be utilized to give light to the circumstances surrounding the origin of the subject matter sought to be patented.⁸⁵

The Federal Circuit attempted to bring more certainty to the determination of obviousness by employing a “teaching, suggestion, or motivation” (TSM) test, “under which a patent claim is only proved obvious if the prior art, the problem’s nature, or the knowledge of a person having ordinary skill in the art reveals some motivation or suggestion to combine the prior art teachings.”⁸⁶ In 2007 the Supreme Court reviewed the TSM test, concluding that it “captured a helpful insight[, namely,] a patent composed of

⁷⁹ See *Brenner v. Manson*, 383 U.S. 519, 535 (1966).

⁸⁰ See *In re Novak*, 306 F.2d 924 (C.C.P.A. 1962).

⁸¹ William J. Simmons, *Nanotechnology as a Nascent Technological Model For Immediate Substantive United States and Japan Patent Law Harmonization*, 17 ALB. L.J. SCI. & TECH. 753, 787-88 (2007) (“if a scientific field is emerging, a rejection based on a lack of utility might be issued more frequently (i.e., in the field of nanotechnology) versus other complex technological fields such as biotechnology, where examiners can and do make certain functional assumptions even though the discipline is per se unpredictable”).

⁸² 35 U.S.C. § 102 (2000).

⁸³ 35 U.S.C. § 103 (2000).

⁸⁴ *Id.*

⁸⁵ *Graham v. John Deere Co. of Kansas City*, 383 U.S. 1, 17-18 (1966).

⁸⁶ *KSR International Co. v. Teleflex Inc.*, 127 S. Ct. 1727, 1730 (2007).

several elements is not proved obvious merely by demonstrating that each of its elements was, independently, known in the prior art.”⁸⁷ Nevertheless, the Court concluded that the Federal Circuit applied the test too rigidly: “the analysis need not seek out precise teachings directed to the specific subject matter of the challenged claim, for a court can take account of the inferences and creative steps that a person of ordinary skill in the art would employ.”⁸⁸

Each of these requirements in the Patent Act helps to define the patents that are issued (to the extent that the requirements are enforced by patent examiners) or used (to the extent that issued patents are challenged). A large majority of patent applications are approved by the Patent and Trademark Office,⁸⁹ but many applications are denied.⁹⁰ And some of the patents that are granted are subsequently invalidated.⁹¹ The threat of denial or invalidation provides an incentive for putative patent holders to frame their claims in accord with the foregoing requirements. To the extent that the content of patents define entrepreneurial opportunities, those opportunities have been shaped by patent law.

[expand]

B. Contract Law

Contract law comprises a set of technical rules that, among other things, prescribe the requirements of contract formation,⁹² provide certain bases for avoiding performance of contracts,⁹³ and describe various legal and equitable remedies for breach of contract.⁹⁴ The purpose of contract law is generally said to be the promotion of allocative efficiency through the facilitation of trade and the mitigation of advantage taking. Contract law allows private parties to secure access to resources, thus promoting the creation of entrepreneurial opportunities.

While it may seem odd to apply property rights theory to contracts, this is, in fact, a fairly common move. As Balganesch observes, “the right to exclude perform[s] a function in our understanding of property almost identical to the one played by that of promising and the duty of performance in the area of contract law.”⁹⁵

⁸⁷ *Id.* at 1741.

⁸⁸ *Id.* The PTO issued new examination guidelines in the wake of *KSR*. See Examination Guidelines for Determining Obviousness Under 35 U.S.C. § 103 in View of the Supreme Court Decision in *KSR International Co. v. Teleflex Inc.*, 72 FED. REG. 57526 (Oct. 10, 2007).

⁸⁹ NAT'L RESEARCH COUNCIL OF THE NAT'L ACADS., A PATENT SYSTEM FOR THE 21ST CENTURY 52-53 (Stephen A. Merrill et al. eds., 2004) (estimating patent approval rates of 66% to 97%, depending on methodology).

⁹⁰ [numbers]

⁹¹ [data?]

⁹² RESTATEMENT (SECOND) OF CONTRACTS chs. 2-5 (1979).

⁹³ RESTATEMENT (SECOND) OF CONTRACTS chs. 6-8, 11-12 (1979).

⁹⁴ RESTATEMENT (SECOND) OF CONTRACTS ch. 16 (1979).

⁹⁵ Balganesch, *supra* note ___, at 619.

[expand]

C. Business Organizations Law

Business organization law erects borders around entrepreneurial opportunities. Formal business organizations, such as corporations or limited liability companies, require those who establish the organizations to segregate the assets belonging to a particular opportunity, thus protecting those assets – and, by extension, the opportunity – from expropriation by outsiders. Informal business organizations – such as “joint ventures” or general partnerships – impose borders around certain entrepreneurial opportunities. In addition to protecting opportunities from outsiders, these formation rules also protect insiders from each other.

[expand]

D. Fiduciary Law

Fiduciary law is a broad category, encompassing many substantive areas of law. For purposes of this discussion, we will illustrate the allocative and framing functions of law through examination of one subspecies of fiduciary law, the corporate opportunities doctrine, which is a subset of corporate law’s duty of loyalty.

While patent law generally deals with endogenous opportunities, the corporate opportunities doctrine (COD) usually deals with exogenous opportunities, or those opportunities created by someone or something else and then discovered by the entrepreneur. When an entrepreneur discovers an exogenous opportunity, the existing literature assumes that he has the right to exploit it through the creation of a new firm or market transactions. Whether he will do so is limited only by his imagination as to its profit potential and his willingness to take risks. However, the law serves an important function in allocating the right to exploit these exogenously created opportunities, just as it allocates the right to exploit endogenous opportunities in the case of patent law. This is particularly true when the would-be entrepreneur has entered into a fiduciary relationship. The COD provides a vivid and non-obvious illustration.

The COD allows fiduciaries of corporations – the corporation’s officers and directors – to exploit only those opportunities that courts do not deem to be “corporate” opportunities.⁹⁶ In the typical case, a third party might approach the fiduciary with an opportunity for profit. In one leading case, *Guth v. Loft*,⁹⁷ it was the opportunity to buy the Pepsi trademark and secret formula out of bankruptcy in the early 1930s; in another

⁹⁶ See D. GORDON SMITH & CYNTHIA A. WILLIAMS, BUSINESS ORGANIZATIONS: CASES, PROBLEMS, AND CASE STUDIES 515 (2004) (stating that the question of “whose opportunity is it?” is the “most difficult aspect of the corporate opportunity doctrine”); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1483 n.359 (“The most difficult issue in [the COD] area is deciding which opportunities belong to the corporation.”); ROBERT CHARLES CLARK, CORPORATE LAW 224-25 (1986) (“the difficult issue is to determine what should be deemed, as between the corporation and fiduciary, to belong to the corporation, and why”).

⁹⁷ 5 A.2d 503 (Del. 1939).

leading case, *Broz v. Cellular Information Systems, Inc.*,⁹⁸ it was an opportunity to buy a regional cell phone license for an area in Michigan. The fiduciary is presented with a dilemma: Can he simply purchase and exploit the opportunity through a separate company, perhaps a start-up, and reap all of the profits, or does his status as a fiduciary mean that he must offer the corporation the right of first refusal on the opportunity?

The COD answers this question, and in doing so allocates exogenous opportunities between competing, would-be entrepreneurs – in this case corporations and fiduciaries.⁹⁹ There are a number of alternative COD tests that courts may choose from, each drawing the allocative line in a different place. Consider two leading tests that draw the line in very different places. A test favored in Delaware, the state of incorporation for over half of public companies, is the *line of business test*. This test asks whether the opportunity is part of a business in which the corporation currently engages or which is a logical and natural adaptation of that business.¹⁰⁰ If so, it is deemed to be a corporate opportunity and is allocated to the corporation. This test, if interpreted broadly, allocates a large number of opportunities to the corporation, as large, public corporations engage in or could logically adapt to almost any opportunity if attractive enough.¹⁰¹ It is also reasonable to assume that most opportunities offered to a corporate fiduciary will have something to do with the corporation’s business, as this is where the fiduciary’s expertise lies. Conversely, the *interest or expectancy test* draws the line in a very different place. This test allocates to the corporation only those opportunities in which it has a recognizable interest or expectancy – for instance, those opportunities on which the corporation has a contractual option.¹⁰² Because there will be many opportunities related to a corporation’s business that it does not have a contract on, the interest or expectancy test draws the allocative line in favor of fiduciaries.¹⁰³

Other tests include the “fairness” test, which asks whether it is fair, all things considered, to allow the fiduciary to exploit the opportunity individually,¹⁰⁴ and the

⁹⁸ 673 A.2d 148 (Del. 1996).

⁹⁹ We assume that corporate exploitation of an entrepreneurial opportunity, sometimes referred to as “intrapreneurship,” counts as entrepreneurial behavior. See GIFFORT PINCHOT, *INTRAPRENEURING* (1986).

¹⁰⁰ See *Guth*, 5 A.2d at 514; see also Talley, *supra* note __, at 289 (“the line-of-business test (or a close variant) has now become preeminent).

¹⁰¹ See Pat K. Chew, *Competing Interests in the Corporate Opportunity Doctrine*, 67 N.C. L. REV. 435, 458 (1989) (“under the *Guth* court’s adaptability test, virtually all opportunities presumptively belong to the corporation”). Of course, depending on the court, “the line of business formula could be interpreted very narrowly or very broadly.” CLARK, *supra* note __, at 228.

¹⁰² The classic case is *Lagarde v. Anniton Lime & Stone Co.*, 28 So. 199 (Ala. 1900).

¹⁰³ Talley, *supra* note __, at 292 (the interest or expectancy test “has been criticized as under-inclusive because it reaches only those projects over which the corporation’s proprietary claim is relatively mature”).

¹⁰⁴ *Durfee v. Durfee & Canning, Inc.*, 80 NE2d 522 (Mass. 1948). Needless to say, this has not proved the easiest test for courts to apply. See Talley, *supra* note __, at 293 (“Jurisdictions adopting [the fairness] test have had little success in articulating – beyond recapitulations of circular rhetoric – the substantive contours of a fairness approach.”).

“Miller two-step” test (named after the case that created it¹⁰⁵), which layers the fairness test on top of the line of business test. Under the Miller two-step test, if an opportunity is within the corporation’s line of business, the fiduciary might still be permitted to exploit it if fair for him to do so. The American Law Institute (ALI) has developed yet another test: one that requires fiduciaries to disclose corporate opportunities in advance, but then allows fiduciaries to the opportunity should the corporation reject it.¹⁰⁶ (It should be noted that corporate rejection will allow fiduciary exploitation in most cases regardless of the test.) Under the ALI test, corporate opportunities are those that are “closely related to a business in which the corporation is engaged or expects to engage”¹⁰⁷ – which appears similar to the line of business test.

In addition to the basic tests, COD cases are also decided by looking at certain factors, including whether: the fiduciary learned of the opportunity in his individual or corporate capacity;¹⁰⁸ the corporation was financially able to exploit the opportunity;¹⁰⁹ or the third party refused to deal with the corporation.¹¹⁰ The plethora of tests and factors, and their inconsistent use across and even within jurisdictions, has led one prominent legal scholar to refer to the COD as a “doctrinal quagmire.”¹¹¹ These factors can be as important or more important than the formal tests in the outcome of COD litigation.

We have now seen many of the tests and factors that the COD uses to allocate opportunities among competing, would-be entrepreneurs. But how does the COD accomplish this allocation? As in the case of patent law, the COD fulfills its allocative function through the granting of property rights, although in the case of corporate opportunities there are a couple of refinements. First, the COD does not grant property rights in the strong sense, or property rights that allow the grantee to exclude the rest of the world from the opportunity. Instead, it only allocates opportunities between corporation and fiduciary, with third parties still free to exploit until either the corporation or fiduciary establishes property rights that allow it to exclude more broadly. As Dean Robert Clark explains, “the opportunity need not be corporate property in the strong sense that the corporation could legally object to its being taken and developed by independent third parties. The point is only that, as between the corporation and its fiduciary, the opportunity belongs to the corporation.”¹¹² Second, the limited allocation that the COD makes runs only one direction – that is, it serves to exclude fiduciaries from corporate opportunities. But, should the corporation discover the same opportunity through another channel – i.e., if another agent of the corporation brings the opportunity to the corporation’s board of directors – the corporation owes no corresponding duty to

¹⁰⁵ *Miller v. Miller*, 222 NW 2d 71 (Minn. 1974).

¹⁰⁶ ALI PRINCIPLES OF CORPORATE GOVERNANCE § 5.05 (Year).

¹⁰⁷ *Id.* at § 5.05(b)(2).

¹⁰⁸ *See infra* notes ___ and accompanying text.

¹⁰⁹ *See* CLARK, *supra* note ___, at 224.

¹¹⁰ *Energy Resources Corp., Inc. v. Porter*, 438 NE 2d 391 (1982).

¹¹¹ Talley, *supra* note ___, at 280.

¹¹² *See* CLARK, *supra* note ___, at 224.

the fiduciary not to exploit. Therefore, to be precise, the COD is serving its allocative function through the granting of quasi-property rights to corporations that allows them to exclude fiduciaries from exploiting entrepreneurial opportunities. On the other hand, the fiduciary may be able to exclude the corporation, for all practical purposes, if the COD does not require him to disclose the opportunity, unless another corporate agent also learns of the opportunity and shares it with the board. Despite these refinements, the COD fits within our broad allocative framework because of the right to exclude granted to the corporation over its fiduciaries.

Finally, the COD's legal allocation of entrepreneurial opportunities through the granting of (quasi-)property rights has an important effect on entrepreneurial behavior: it motivates entrepreneurs to frame opportunities in a certain way to obtain a favorable legal allocation. Shane's study of the MIT printing press technology revealed that opportunities do not present themselves in fixed form, but rather are often shaped by entrepreneurs.¹¹³ Entrepreneurial framing might be important to avoid infringing another's established property rights, or it might be important because it allows the entrepreneur to obtain new property rights and exclude others. Shane's study of the MIT printing press technology revealed that an entrepreneur's prior knowledge framed opportunities stemming from that technology. We argue that the law's allocative function also affects entrepreneurial framing. Under Shane's argument, entrepreneurs may exploit opportunity X instead of Y because their prior knowledge leads them to see X but not Y. Under our argument, fiduciaries may see both X and Y, but the law will only allocate them the right to exploit X, and hence it is that opportunity they end up exploiting. Whether it is prior knowledge or law that drives framing, the result is the same: a determination of the very shape of the opportunities we see today and will see in the future.

Entrepreneurial framing of opportunities in COD scenarios can occur at two different times. First, fiduciaries who are aware of the COD in advance (perhaps they consulted a lawyer!) can frame their opportunities during the planning phase. For instance, in the case of Delaware corporations, the fiduciary would learn that she can only exploit opportunities that fall outside of the corporation's line of business. Armed with this knowledge, she can shape the opportunity accordingly: she can re-craft the opportunity to fall outside of the corporation's line of business. For instance, a fiduciary who works for the LA Fitness corporation might come across a vacant building and wish to start a new business there. Because his expertise lies in health clubs, he may wish to open that sort of a business there. However, because the COD (and also perhaps a non-compete agreement) would allocate *that* opportunity to LA Fitness, he may decide to open a sporting goods store instead. Thus, the law has shaped the very opportunity that results from the vacant building.

Second, when fiduciaries are not aware of the COD until after exploitation has occurred and the corporation brings a usurpation claim,¹¹⁴ framing can occur only during litigation. The fiduciary and his lawyer, on the one side, and the corporation and its lawyer, on the other side, will each present the opportunity in such a way as to fall

¹¹³ See discussion at *supra* notes ___ and accompanying text.

¹¹⁴ [mechanics of claim as derivative suit brought by shareholder on behalf of corporation]

outside of or within the corporation's line of business. COD cases often turn on the characterization of the facts. [Add examples from the case law illustrating attempts to frame during litigation.]

CONCLUSION

Law determines *who* is entitled to pursue and opportunity (the allocative function) and *what* that opportunity is (the framing effect). [expand]