Book Review: The Economic Structure of Corporate Law by Frank H. Easterbrook and Daniel R. Fischel

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BOOK REVIEWS


Unlike the courses which are offered in most university departments and faculties, real world social problems do not come to us already carved up into separate disciplines. Instead, every interesting problem is multi-faceted and calls out for the different analyses that can be provided by a broad range of interdisciplinary perspectives.

It should not be surprising, therefore, that the problems of corporate law have attracted non-legal analyses. In their book The Economic Structure of Corporate Law, Frank H. Easterbrook, a judge for the Seventh Circuit of the U.S. Court of Appeals and a former law professor at the University of Chicago, and Daniel R. Fischel, the Lee and Brena Freeman Professor of Law at the University of Chicago, have very effectively brought economic analysis to bear on corporate law problems. The result is another impressive demonstration of the combination of theoretical argument and close attention to supporting data (usually in the form of stock market “event studies”) which has become characteristic of the economic and financial literature on the corporation over the last two decades. One may not always agree with the

1 Event studies measure the average impact of different kinds of corporate events on the stock returns of similarly affected corporations. What is measured are the “residuals” or abnormal returns, that is, the returns after all other effects on stock performance have been subtracted.

2 It is tempting to date the beginnings of the contractual theory of the corporation with Ronald Coase’s article “The Nature of the Firm” (1937), 4 Economica (n.s.) 386. Indeed, Easterbrook and Fischel dedicate their book to Coase (as well as to their parents). However, there is something ironic in this dedication since the point of Coase’s argument was to suggest reasons why resource allocation would sometimes take place through firms by fiat rather than through market contracting according to voluntary agreement. It was not until Armen Alchian and Harold Demsetz suggested in 1972 that there was no special power in firms to allocate resources by fiat that the contractual theory of the firm really became dominant; see A. Alchian and H. Demsetz, “Production, Information Costs and Economic Organization” (1972), 62 A. Economic Rev. 777 at p. 777. Another seminal
arguments, or with the decisiveness of the event studies, but anyone who ignores the Easterbrook and Fischel approach to corporate law does so at his or her peril. There is real insight in their analysis, and their way of arguing the various points is always clear and engaging.

Easterbrook and Fischel identify their task in the book as “explaining the structure of corporate law”\(^3\). In other words, their goal is not to articulate and assess doctrinal details, but rather to provide a basic understanding for the corporate form and the law which governs it. This is only fitting for any theoretical approach to law, since theory must abstract to some extent from the reality which it seeks to explain if it is to be genuine theory and not mere description. Thus, readers of this book (and Canadian readers more particularly) will get the most from it if they come prepared to gloss over those irksome details which do not seem to match the specific contours of the law in their own corporate law jurisdiction. Instead, they should take in the overall insights which are provided by the basic argument.

For Easterbrook and Fischel the “engine” which drives corporate law is contract. In their first chapter, titled “The Corporate Contract”, they articulate the central thesis of the book with characteristic clarity:\(^4\)

The normative thesis of the book is that corporate law should contain the terms the people would have negotiated, were the costs of negotiating at arm’s length for every contingency sufficiently low. The positive thesis is that corporate law almost always conforms to this model.

This may not seem to be a very original understanding of the corporation, especially to anyone used to constructing elaborate “deals” for various corporate investors. Of course, the corporation and corporate law are contractual in nature; what else could they possibly be? But it is what Easterbrook and Fischel do with this basic understanding of the corporation in various areas of corporate law which is the most innovative part of their book. It is as if they have had the courage to take contract seriously in a way that other corporate theorists have not.

\(^3\) P. viii.
\(^4\) P. 15.

For example, the true contractual theorist of the corporation will recognize that the managers at the strategic centre of the firm do not actually have the unfettered discretion which comes from the apparent “separation of ownership from control” which was so emphasized by Adolph Berle and Gardiner Means in their classic account of the corporation.\(^5\) The contractual theorist will know that the costs of inappropriately exercised managerial discretion, what Easterbrook and Fischel call “agency costs”\(^6\) will in large part be borne by the managers themselves in the form of ex ante contractual discounts on their opportunistic behaviour. This means that there will be less need, for example, to mandate specific shareholder protections in corporate law since managers, in their attempt to avoid these ex ante contractual penalties, will be prepared to offer the same protections as contractual guarantees in the articles of incorporation. Thus, Easterbrook and Fischel argue\(^7\) that corporate law is, and should be, at most “enabling” law, not mandatory, providing as a set of standard form default terms what most corporations would otherwise want to contract for anyway, thereby saving on the costs of explicit contracting. However, as non-mandatory law, it would also allow the unusual corporation to opt out of the law completely if some alternative to the standard term could be put to beneficial use.\(^8\)

Once one has seen the most basic implication of the contractual theory of the corporation, viz., that most corporate law is, and should be, merely enabling law, the theory becomes much more controversial, and less plausible, than it first appeared. The critic will suggest that there is very little opportunity for genuine “contracting” between managers and a widely dispersed and unorganized group of shareholders in a corporation and, therefore, very little chance that managers will face a negotiated

\(^5\) The Modern Corporation and Private Property (New York, Harcourt Brace, 1933).
\(^6\) The notion of agency costs would seem to originate with Jensen and Meckling, supra, footnote 2. Easterbrook and Fischel introduce the term explicitly at p. 10 and use the theory of agency costs throughout the book.
\(^7\) P. 34.
\(^8\) For an importantly different characterization of the default provisions of corporate law, see Ayres, “Making a Difference: The Contractual Contributions of Easterbrook and Fischel” (1993), 60 U. Chi. L. Rev. 294. Ayres suggests that default rules in a corporate code may reflect less what a majority of firms might want and more what any one firm may find easiest to contract out of. Thus, even though the majority of firms might want what Ayres calls a “crystalline” rule, a corporate statute might provide a “muddy” rule (e.g., some vague fiduciary standard) because it is relatively easier for firms (however many there might be) to contract out of mud and into crystal than vice versa.
discount on their opportunistic behaviour, at least in the capital market. Thus, there will continue to be the need to protect shareholders in the corporation with mandatory law. Moreover, the critics will say that this is exactly what corporate law does. It is a mistake, for example, to think that the corporate fiduciary obligations are merely a set of default terms which corporations are free to contract out of if they so choose. These obligations, the argument will go, are properly mandatory and not merely enabling. Thus, Easterbrook and Fischel's contractual theory is both false as a positive account of what corporate law is and, because of its excessively "rosy" view of the contracting process, unattractive as a normative guide as to what the law should be.

But Easterbrook and Fischel have good replies to both criticisms. They argue convincingly that it is not important that the terms of corporate governance actually be "negotiated"; it is sufficient that they be properly "priced". This is something which even an uninformed investor can probably count on when participating in a highly competitive stock market which is priced at the margin by the trades of informed market professionals. Moreover, it is another mistake, say Easterbrook and Fischel, to think that, because the language of corporate law statutes appears mandatory, the enabling account of corporate law is false. If one looks closely at the statutory terms used to describe the corporate fiduciary obligation, for example, it is clear that these apparently mandatory standards call for extensive judicial interpretation

ex post as to what they really mean. It is an important part of Easterbrook and Fischel's argument that these judicial interpretations will provide the solution which "the parties would have contracted for had transactions costs been nil". Indeed, it is only when the courts provide, for example, for a fiduciary duty which is distinct from that which the various corporate constituencies would negotiate and be willing to pay for themselves, such as in the burdensome duty of care which was articulated in the notorious case of Smith v. Van Gorkom, that one will observe the legislative providing for an explicit statutory permission allowing the corporation to "contract out" of the law. However, according to Easterbrook and Fischel, the relative scarcity of such legislative provisions, far from showing that the contractual theory of the corporation is unfounded, only evidences that the courts more often than not provide contractual interpretations of these statutory standards on their own, that is, without any need for a legislative correction of their efforts.

Easterbrook and Fischel bring their contractual understanding of the corporation to bear on a wide variety of corporate law problems. For example, when to pierce the corporate veil, how to organize a close corporation, and whether insider trading should be prohibited or other corporate disclosure obligations mandated, are all questions which receive chapter-length analysis. There is also an interesting chapter on "jurisdiction shopping" by corporations, which, under Easterbrook and Fischel's contractual understanding of the corporation, leads to shareholder gains rather than, as in the more managerialist conception of the firm, a "race for the bottom", where self-seeking out-of-control managers seek out those slack corporate codes which most benefit them. Canadian readers will want to read this last chapter in conjunction with some recent Canadian studies on corporate jurisdictional choice.

However, the best chapter in the book is the one entitled "Corporate Control Transactions". Moreover, this is the chapter which shows the special insights of the contractual approach to greatest advantage. Because the contractual theory

9 See, e.g., M. Eisenberg, "The Structure of Corporation Law" (1989), 89 Col. L. Rev. 1461 at p. 1486.
11 P. 35.
12 P. 250.
13 488 A.2d 858 (Del., 1985). In this case, the Supreme Court of Delaware held that it was a breach of a director's duty of care to accept a merger proposal if the director was "uninformed", for example, by outside expertise, even though the merger was to go through at a huge premium on the market price in an arm's length transaction. Easterbrook and Fischel discuss this case at pp. 107-08. Fischel has described the case as "one of the worst decisions in the history of corporate law"; see D. Fischel, "The Business Judgment Rule and the Union Case" (1989), 40 Law and Economics Working Paper No. WPS-18, Law and Economics Programme, Faculty of Law, University of Toronto (1993).
14 See, for example, Del. Gen. Corp. Law, s. 102(b)(7) (Supp. 1986), for the Delaware state legislature's response to the Van Gorkom case. This provision allows shareholders to adopt a corporate charter which limits directors' liability to illegality, breach of the duty of loyalty, or intentional misconduct, i.e., which allows the corporation to contract out of a director's duty of care.
16 Pp. 109-44.
emphasizes the *ex ante* understanding which different investors bring to the corporate enterprise, it has a totally different view of the fairness of certain rules which require an *ex post* sharing of gains which flow from corporate control transactions than other types of corporate theory. This sharing out of the gains, as might occur under a generous use of the appraisal remedy (a topic which Easterbrook and Fischel treat in a separate chapter17), might be more equal *ex post* but it might well be less *fair* if it gives more to investors than they paid for under a corporate contract which they negotiated *ex ante*. Moreover, and this is the much more important point, it might not be to the advantage of any investor (and particularly any *diversified* investor) to have such generous *ex post* sharing rules if the *ex ante* consequence is that the expected cost of beneficial corporate control transactions is higher to those entrepreneurs who initiate them. These higher costs will mean fewer such transactions, to the disadvantage of all, surely something which no investor would contract for. Easterbrook and Fischel illustrate these points effectively with simple numerical examples and with analyses of such well-known American cases as *Perlman v. Feldman*18 and *Jones v. Ahmanson*.19 However, their arguments are clearly relevant to the Canadian legal experience as well. One need only think of s. 97(1) of the Ontario Securities Act,20 which requires all holders of the same securities to receive the same consideration in takeovers or issuer bids. Such an equal sharing rule would preclude the payment of a control premium on some shares and might frustrate certain beneficial transactions in the way which is suggested by Easterbrook and Fischel.

One reviewer of this book has already characterized it as possibly "the best book ever written about corporate law".21 This is lavish praise indeed and one should always be careful in handing out a top ranking, especially in the company of such other candidates as *The Modern Corporation and Private Property* by Adolphe Berle and Gardiner Means22 and Robert Clark's relatively recent *Corporate Law*.23 But it is easy to say that this is a truly excellent book on corporate law which should certainly be placed in the company of these other two. As a clear demonstration of the power of the contractual theory of corporate law, it is without equal.

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18 219 F. 2d 173 (2d Cir., 1955).
22 *Supra*, footnote 5.
23 (Chicago, Little Brown, 1986).