The Influence of *The Nature of the Firm* on the Theory of Corporate Law*

Jason Scott Johnston**

I. INTRODUCTION .............................................. 213


III. THE COASEAN REVOLUTION AND BEYOND ...................... 232

IV. THE NEXT FRONTIER: CORPORATE LAW IN A WORLD OF EVOLVING STRATEGIC RATIONALITY .................................... 241

I. INTRODUCTION

To read and re-read Ronald Coase's *The Nature of the Firm*, some fifty-five years after its original publication date, is to encounter a curious mix of perceptions. The article is not especially long. It sets out neither an elegant mathematical formulation of its central behavioral conjectures, nor empirical or institutional evidence in their support. The bulk of the piece is in fact concerned with the comparison between Coase's theory of the firm, and other contemporaneous theories which (with the notable exception of Frank Knight's) have long since disappeared from discussions of the topic. And it is this—the survival and expanding influence of Coase's theory—that is in the end the perception most in need of explanation. Of particular interest to corporate law are the remarkably divergent lifetimes of Coase's work on the firm and that undertaken by Adolf Berle and Gardiner Means in *The Modern Corporation and Private Property*. The revolution in corporate law scholarship that has occurred over the last fifteen years marks the passage from an era dominated by Berle and Means's work to one dominated by economic theories of the firm, of which Coase's was perhaps the first. Thus, to explain the survivability and influence

* Copyright 1993 by Jason Scott Johnston.
** Professor of Law, Vanderbilt University Law School. I am grateful to Donald Langevoort and Robert Rasmussen for helpful comments. The views expressed below remain mine alone, however, as does the responsibility for any errors or omissions.


HeinOnline -- 18 J. Corp. L. 213 1992-1993
of Coase's theory is to do more than just account for a piece of the history of economic or law and economic thought. It is to gain insight into both the structure of social science theorizing and into the relationship between social science and law. It is to gain insight into why some theories are productive and progressive, while others are not, and to understand in particular both the revolution in corporate law scholarship to which Coase's little article has led, and the next frontier in the economic analysis of corporate law.


Coase's article on the firm begins by setting out the gap in economic theorizing which Coase sought to fill: While economists had thought long and hard about how the price mechanism might organize and direct production and distribution decisions, they had merely noted the coordinating function of firms and entrepreneurs, and had failed entirely to explain how these "islands of conscious power" might come to exist within the atomless market economy. What economists had by and large treated as a matter of assumption—that for some purposes one might assume that resources were allocated via the price mechanism, while for other purposes one might assume that the "entrepreneur-co-ordinator" allocated resources—Coase treated instead as a problem requiring explanation. In Coase's view, "[o]ur task is to discover why a firm emerges at all in a specialized exchange economy." Having set out the issue, Coase quickly and directly addressed it. For transactions to be organized within a firm rather than across or within the market, there must be "a cost of using the price mechanism," and because it is always possible to revert to the open market, firms (or, in Coase's terms, "entrepreneurs") will be in charge of directing resources if (and only if) they can lower "marketing" or "transaction" costs. Coase then mentioned several types of "marketing" costs incurred in market exchange. Viewed in hindsight, perhaps the most important of the costs Coase considered are the costs of contracting. Short-term market contracts, said Coase, involve the direct costs of "negotiating and concluding a separate contract for each exchange transaction . . . ." While some of these costs might be avoided by entering into long-term rather than short-term contracts, "the longer the period of the contract . . . , the less possible and, indeed, the less desirable it is for the person purchasing to specify what the other contracting party is expected to do." Thus,
Coase conjectured that long-term contracts would specify only the "limits" to what a "supplier" should do, while leaving the "details" to be determined at a later date by the "buyer." Similarly, within a firm, a series of short-term market contracts are replaced by a single contract—in Coase’s generic, between a factor of production and an entrepreneur—"whereby the factor, for a certain remuneration (which may be fixed or fluctuating), agrees to obey the directions of an entrepreneur within certain limits. The essence of the contract is that it should only state the limits to the powers of the entrepreneur." Coase thus identified contracting costs as one reason why transactions are organized either under long-term contracts or within the firm, rather than in a series of short-term market contracts. He went somewhat further, and in fact at one point defined the firm as consisting of "the system of relationships which comes into existence when the direction of resources is dependent on an entrepreneur," so that the size of the firm would increase "as additional transactions (which could be exchange transactions co-ordinated through the price mechanism) are organized by the entrepreneur . . . ." Limits on the size of the firm answered the question why "there are any market transactions at all." Coase conjectured that the size of the firm was limited by the demands made by increased firm size on the limited capability of entrepreneurs to efficiently organize and use resources and factors of production. Firm size was also limited by the rather vague possibility that a large firm might need to pay its employees more to compensate them for the disutility of working for a large and impersonal organization. Regardless of the precise cause of increasing marginal cost to firm size, however, Coase’s general approach to firm size was strongly marginalist. Coase conjectured “that a firm will tend to expand until the costs of organizing an extra transaction within the firm become equal to the costs of carrying out the same transaction by means of an exchange on the open market or the costs of organizing another firm.” While brief, this description of Coase’s analysis suffices to indicate the keys to its lasting influence. What Coase did was to open up the “black box” of the “firm” as a subject worthy of economic inquiry. He did this not merely by noting the need for an explanation of the determinants of firm existence and size, but also by going beyond this general suggestion to provide the outline of a marginalist approach based on the comparative costs of transacting within the firm and transacting outside the firm. While the question Coase posed was new to economics, the general sort of approach to its pursuit which he set out perfectly matched the methodological predilections that would come to characterize contemporary economic theory: marginalist theorizing designed to explain observed patterns of economic behavior.
The particular sort of marginalist analysis proposed by Coase did, however, take quite some time to catch on. This delay in influence was primarily because Coase was interested in marginal analysis of a sort of cost—the cost of conducting transactions in alternative institutional settings—that was long considered to be outside the realm of formal (i.e., mathematical) economic theory. It was not until the recent institutionalist revival led by Oliver Williamson that economists began to look closely enough at institutional detail—the form and pattern of contracts, both within and outside the firm—to be able to discern transaction cost variables, such as asset specificity, that were sufficiently precise and measurable to be thought of as independent variables in formal theoretical or econometric analysis. Indeed, not only has Coase's work inspired an entire field of economics—"transaction cost economics"—but several quite distinct approaches now compete for dominance within that field.

The quite sharply contrasting implications of the various brands of transaction cost economics now available in the intellectual marketplace is a topic to which I shall return, for these contrasts have much to say about the likely future direction of the economic analysis of corporate law. That there quite clearly is an economic analysis of corporate law, and that this economic analysis has at least fair claim to being the dominant contemporary approach to corporate law is, however, traceable quite directly to the Coasean root of contemporary transaction cost economics. For while the kind of close comparative institutional analysis which Coase called for in The Nature of the Firm was once completely outside the universe of mainstream economists, and remains still a foreign, if potentially productive enterprise for many, close comparative analysis of institutions is home turf for law professors. At least, that is, for post-Realist law professors who have found inspiration and guidance in either the empirical or policy strains of realism. As legal realism urged upon law professors the importance of understanding what courts actually do, as well as the need for evidence regarding the world governed by law and law's various effects on that world, so too did Coase direct inquiry to the institutional details of firm struc-


20. Coase has recently observed that, while there were occasional citations to his article during the 40s, 50s, and 60s, it was not until the 1970s that the article was not only cited, but also seemed to have an effect on the way economists were thinking about the firm. R.H. Coase, The Nature of the Firm: Meaning, in The Nature of the Firm: Origins, Evolution and Development 48, 51 (Oliver E. Williamson & Sidney G. Winter eds., 1991) [hereinafter Meaning].


22. See id.


24. See Oliver E. Williamson, Economic Institutions: Spontaneous and Intentional Governance, 7 J.L. Econ. & Organization 159 (1991 Supp.).


ture and contractual design—the question of who controls whom and with what limits on discretionary control. It is unsurprising, therefore, that we often find post-Realist legal scholars and transaction cost economists pursuing very closely related lines of inquiry. Stewart Macaulay's classic post-Realist empirical study, showing that many businesspeople chose to rely for contractual assurance on the discipline of market reputational effects rather than the technicalities of contract law, parallels Klein and Leffler's classic transaction cost analysis of market reputation and contractual assurance. Ian MacNeil's "discovery" of the long-term, relational contract, and his analysis of both what is specific and what is left to discretion in such contracts, parallels Oliver Williamson's more detailed identification of the factors—asset specificity, opportunism, and bounded rationality—which dictate both the choice and form of such contracts.

Yet, notwithstanding these striking similarities between post-Realist legal analysis and Coasean transaction cost analysis, a fundamental methodological difference between the two forms of analysis remains. What legal Realists share is a conviction that announced legal rules may differ from what courts actually do, and that embedded presuppositions regarding the law's effects and relevance to social behavior are quite often wrong, and at the very least, worthy of serious empirical testing. What Realists lack is any commitment to a general theory of human behavior that would allow them to systematically explain and predict the law's effect on behavior. Rather than a single shared theory, Realists get their theory of human behavior from one or more of a variety of disciplines—chiefly sociology and social psychology—which themselves are characterized by a great variety of behavioral theories, which while insightful, are often times starkly conflicting. For this reason, there cannot be a single "Realist" explanation of either the law, or the behavior and institutions regulated by law. However persuasive any particular Realist account may be, it can always be countered by a competing Realist account which draws its underlying theory from a completely foreign discipline. Also lacking is any external source for a normative basis upon which to evaluate law, so that Legal Realism itself in the end merely presents data about the world to legal policymakers, who inevitably turn to the norms already embodied in the law for

31. See Grey, supra note 25; Schlegel, supra note 26.
prescriptive guidance.\footnote{33}

It is in this inability of Legal Realism to offer a \textit{progressive research program}\footnote{34} that we find the clue to the expanding influence of Ronald Coase's economic theory of the firm within both economics and law. Coase's theory innovated by extending the application of economic analysis. Its fruitfulness as the basis for an entire research program, however, may be attributed to Coase's stolid retention of the economic paradigm of \textit{rational choice}. In viewing the choice between the firm (or long-term contracts) and the market as a matter of the comparative transaction costs of these alternative methods of resource allocation, Coase implicitly assumed that the actors making the choice were rational. This assumption was made at least in the weak sense that no one would organize through a firm rather than the market unless the cost of organizing transactions within a firm was at least no greater than the cost of organizing those transactions in the market. More specifically, since Coase recognized that an inevitable aspect of organizing through either a firm or a long-term contract would be to vest contractual discretion in one of the parties, Coase's theory explained discretion and control within the firm and in long-term contracts as an aspect of the rational and purposeful adoption of those institutions over the market. The \textit{progressivity} of the research program stimulated by Coase's application of the rational choice paradigm to this set of decisions is to be found precisely in the coincidence of complexity and rationality. Given the great and ever-changing variety of organizational and contractual forms, the rational choice model poses the continuing puzzle of how to explain this enormous variety as the product of rational and purposeful economic agents.

To understand the challenge of this puzzle, one must be quite clear about one further thing: that supposedly rational agents are constrained to pursue the logic of transaction cost minimization. This constraint is more or less assumed in \textit{The Nature of the Firm}, and indeed, Coase did not provide its full defense until almost thirty years later, in \textit{The Problem of Social Cost}.\footnote{35} Without this assumption, one might well end up with a story of rational and purposeful agents putting themselves into control positions within firms and then simply rigging the rules of the game—the limits on their discretion—such that they may use their control to benefit themselves at the expense of others, such as laborers, within the firm. For organizational choice to be based upon the principle of transaction cost minimization, and yet be consistent with the self-interest of rational actors, an individual exercising discretionary control in a firm or long-term contract must find it in his or her own self-interest to minimize transaction costs. In other words, someone must benefit from discovering a cheaper form of organizing transactions, if one exists, so

\begin{itemize}
\item \text{33. See David M. Trubek \& John P. Esser, "Critical Empiricism" in American Legal Studies: Paradox, Program or Pandora's Box, in Critical Legal Thought: An American-German Debate 105 (Christian Joerges \& David M. Trubek eds., 1989).}
\item \text{35. Problem, supra note 23.}
\end{itemize}
that only those organizations which are in fact transaction cost minimizing survive.

In The Problem of Social Cost, Coase provided a theory of how this might occur. For example, consider two entrepreneurs (to use Coase's earlier term), one of whom will organize a certain set of transactions across the market (hire outside consultants to do the job) while the other will organize a certain set of transactions within a firm (do the job internally at corporate headquarters). According to the Coase Theorem, if there are no costs of bargaining over the right to control the enterprise, the entrepreneur who values the enterprise most highly will acquire the right to control. Furthermore, other things being equal, if the entrepreneur whose organizational form generates the lowest transaction costs will value the right to control most highly, the Coase Theorem implies that the entrepreneur with the transaction-cost minimizing organizational form will acquire the right to control and implement that form. According to the Coase Theorem, if bargaining works, then rights will be acquired by those who value them most highly, and the incentive to discover and implement transaction cost minimizing organizational forms will exist. Without this incentive, there is no reason to expect Coase's explanation in The Nature of the Firm to have any power whatsoever.

The conjunction of rationality with constraint underlying Coase's explanation of alternative organizational forms not only provided the basis for modern transaction cost economics, but also caused a revolution in corporate law scholarship. What was, at least until the 1960s, considered to be among the sleepiest of legal fields, was revitalized during the 1970s and 1980s. Even those whose work began squarely within the post-Berle and Means tradition have been heavily influenced by the new economic approach to corporate law—an influence apparent even in their criticism of it.36 This reawakening was due in large part to the dramatic contrast between the Coasean approach to organizational form as the product of rational and constrained choice, and the Realist approach, epitomized by Berle and Means's The Modern Corporation and Private Property. Although Berle and Means portrayed in great empirical detail what has indeed been viewed as the fundamental organizational feature of the modern publicly held corporation—the separation of stock ownership from managerial control—they failed to provide any systematic explanation of how this form arose and succeeded in gaining dominance. And yet, Berle and Means's book was for decades the starting point for serious corporate law scholarship. To understand its influence is to gain insight into both the strengths and weaknesses of the normative tradition of corporate law scholarship which preceded the contemporary economic approach.

The strong point of Berle and Means's analysis was their claim to have identified a profoundly important empirical phenomenon: beneath the widespread diffusion of ownership effected by public markets in the stocks and bonds of corporate enterprises, they said:

[There] lies a more fundamental shift. Physical control over the instruments of production has been surrendered in ever growing degree to centralized groups who manage property in bulk, supposedly, but by no means necessarily, for the benefit of the security holders. Power over industrial property has been cut off from the beneficial ownership of this property—or, in less technical language, from the legal right to enjoy its fruits. . . . We see, in fact, the surrender and regrouping of the incidence of ownership, which formerly bracketed full power of manual disposition with complete right to enjoy the use, the fruits, and the proceeds of physical assets. There has resulted the dissolution of the old atom of ownership into its component parts, control and beneficial ownership.\textsuperscript{37}

In this passage, as throughout the book, Berle and Means describe the separation of ownership from control effected by the publicly held corporation in terms of the "surrender" of control, the transformation of the owner from an "active" agent with discretion over the property to a state of passivity in which the owner "is practically powerless through his own efforts to affect the underlying property."\textsuperscript{38} They summarize the current "condition" of the "modern corporation" as one in which the individual interest of the shareholder is definitely made subservient to the will of a controlling group of managers even though the capital of the enterprise is made up out of the aggregated contributions of perhaps many thousands of individuals.\textsuperscript{39} Berle and Means did not merely describe an empirical phenomenon in the cold, value-free terminology economics has come to expect as a sign of its practitioners' commitment to economics as science.\textsuperscript{40} Rather, they decried in strongly normative terms the abuse and exploitation of the shareholding public by a small number of controlling managers.

This quite overt blurring of normative judgment with positive description meant that the influence of Berle and Means's work on economic thought would be limited at best.\textsuperscript{41} For the modern economist, Berle and Means's book contains some interesting, although for the most part overly general data, and a good deal of "soft" opinion that fails to even attempt to deduce theoretical results that might be subject to empirical testing. Unlike Coase, Berle and Means set out no theory that might account for the developments they had catalogued, let alone a theory based upon the marginalist constrained rationality congenial to the methods of formal economic analysis.\textsuperscript{42} They made hardly any reference at all to the economist's talisman—the

\begin{itemize}
  \item 37. \textit{BERLE} \& \textit{MEANS, supra} note 3, at 8.
  \item 38. \textit{Id.} at 64.
  \item 39. \textit{Id.} at 244.
  \item 40. On whether the language of economics is in fact as value-free as might be supposed or desired, see \textit{DONALD N. McCLOSKEY, THE RHETORIC OF ECONOMICS} (1985).
  \item 41. \textit{See HERBERT HOVENKAMP, Enterprise and the American Law 1836-1937,} 359 (1991) ("This was a book written for lawyers. Correspondingly, most economists ignored Berle and Means's.").
  \item 42. \textit{See, e.g.,} Harold Demsetz, \textit{The Theory of the Firm Revisited, in THE NATURE OF THE FIRM: ORIGINS, EVOLUTION AND DEVELOPMENT} 159, 167 (Oliver E. Williamson \& Sidney G. Winter eds., 1991) (explaining that during the 1970s, economists turned their interest toward the problem identified
\end{itemize}
Influence of Corporate Law

free market. They noted only that while the need to go back to the securities market to raise new capital would "set a very definite limit on the extent to which those in control can abuse the suppliers of capital," the adequacy of the protection afforded by the market constraint "depends on factors that are wholly beyond the investor's control: the state of the industry; the position of the particular corporation; and the attitude of the management." Completely unmentioned, of course, is the public shareholder's power to buy, sell and diversify across firms, a power which to a large extent is the mechanism underlying all of modern financial theory.

Yet, if unsuited to the methods and requirements that have come to characterize economics, Berle and Means's approach mirrored perfectly the dominant scholarly method adopted by law professors of their own generation and generations to come. By not only identifying the separation of ownership from control as the characteristic feature of the modern corporation, but by putting the description of this phenomenon in strongly normative terms such as "surrender," "subjection," and "abuse," Berle and Means presented a problem to legal scholars in precisely the way they would find it most interesting and worthy of pursuit. It is a characteristic of "traditional legal scholarship" generally, and corporate legal scholarship in particular, that it considers a question to be worth exploring only insofar as the analysis and solution of the problem lead necessarily to a proposal for doctrinal reform, even if this reform is but the correction of a recent doctrinal deviance. The perceived value of such scholarship is perhaps at its zenith when its analysis holds out the promise of correcting a doctrinal error that has not only weakened the law's integrity, but encouraged the very societal ills the law is designed to alleviate.

It was precisely such a prospect for corporate law which Berle and Means's treatise raised. Berle and Means did not just describe and bemoan the separation of ownership from control. They spent considerable effort in tracing the problem to laxity in the corporate laws, particularly corporate statutory law. The central chapters of their book discuss a series of changes in the statutes regulating corporations which they viewed as at least "recognizing" the underlying economic fact that shareholders no longer managed the businesses they owned. Among the developments noted by Berle and Means were the innovation of vote by proxy (which they asserted had become "one of the principal instruments not by which a stockholder exercises power over the management of the enterprise, but by which his power is separated from him"); the elimination of the shareholders' right to remove the directors at will; the great liberalization in the extent to which the corporate charter

by Berle and Means, "with the important difference that, unlike Berle and Means, the task became one of understanding how firms organize to resolve the problem").

43. Id. at 247.
44. Id.
47. Berle & Means, supra note 3, at 131.
48. Id. at 129.
could be amended at the directors' initiative;\textsuperscript{49} the transformation of par value from a literal obligation of stock issuers to a formalism backed only by restrictions against fraud in issuance;\textsuperscript{50} and related changes which disempowered shareholders by greatly increasing managers and directors' discretion to alter the financial position of shareholders in the overall corporate structure.\textsuperscript{51}

Against the laxity of corporate statutory law, Berle and Means placed tremendous emphasis on the importance of common law fiduciary limitations on management discretion:

The law holds the management to certain standards of conduct. This is the legal link between ownership and management. As separation of ownership from management becomes factually greater, or is more thoroughly accomplished by legal devices, it becomes increasingly the only reason why expectations that corporate securities are worth having, can be enforced by the shareholders. If the situation ever arises that a management is, in fact, not chosen by its security holders, and has no duties towards the security holders recognized at law or enforceable through legal means, then the security holder has a piece of paper representing a capital contribution, which is valuable only as the good nature or good faith or the economic advantage of the men actually in charge of the corporate affairs lead them to make it so. \textit{We are thus led to conclude the strength of law in this regard is the only enforceable safeguard which a security owner really has.}\textsuperscript{52}

Berle and Means saw the common law development of the fiduciary limits to management discretion as "more healthy" than corresponding changes in statutory corporate law. They noted that these developments were "perhaps the only section of corporate jurisprudence which has not undergone a sustained weakening process."\textsuperscript{53}

Berle and Means thus provided an extensive and highly critical description of the vast and ever-widening gap between management control and shareholder subjugation. They declared that it was only the common law fiduciary duty that gave shareholders any ability whatsoever to prevent management from using its control to steal the entire value of their securities. It is hard to imagine words sweeter to the ears of the traditional corporate law scholar than these. Berle and Means raised the design and reform of corporate case law—the specialty of traditional corporate law scholars—to new heights, and made it the only thing preventing corporate America from entirely swallowing the shareholders.

Any sample of corporate law scholarship during the period from 1940 to 1970 will include examples illustrating the influence of Berle and Means's approach. For concreteness, consider two areas of application: the regulation of proxy voting, and

\begin{itemize}
\item \textsuperscript{49} \textit{Id.} at 132.
\item \textsuperscript{50} \textit{Id.}
\item \textsuperscript{51} \textit{Id.} at 131-40.
\item \textsuperscript{52} \textit{BERLE \\& MEANS, supra note 3, at 196-97 (emphasis supplied).}
\item \textsuperscript{53} \textit{Id.} at 197.
\end{itemize}
the scope and content of the directors’ fiduciary duties in corporate control transactions. Virtually every major law review article dealing with the regulation of proxy voting written during this period viewed voting by proxy as a major factor contributing to the separation of ownership from control. Writing in 1940, Sheldon Bernstein and Henry Fischer began by citing Berle and Means for the proposition that proxy regulation could be understood only by appreciating the separation of ownership from control. Despite the developing federal securities laws, thirteen years later Professor Mortimer Caplin charged that:

[A]s presently employed . . . the proxy machinery is completely dominated by the managers of industry, with the nominations of directors being made by the managers themselves, and with the shareholders being denied the opportunity of making independent nominations in management’s proxy statement—the proxy system of voting has become an anti-democratic device, destructive of any real system of checks and balances against possible managerial abuse, and operating in contravention of our fundamental notions of fair play.

In 1970, Professor Melvin Eisenberg identified as the fundamental problem with proxy voting the fact that “in any number of publicly held corporations de facto control over election of directors and fundamental corporate actions does reside with management rather than with shareholders” poses a fundamental empirical phenomenon which needs to be redressed.

If for thirty years legal commentators on proxy regulation began with the same perceived problem, it was in large part because their analysis never attempted to explain the survival of management-dominated proxy machinery, but rather saw that domination as a problem to be redressed by the courts and/or the Securities and Exchange Commission. Proposed solutions necessarily became progressively more complex as the problem seemed to persist despite the at least partial adoption of earlier proposals. As proposals for increased disclosure and greater shareholder access to the proxy machinery found expression in federal regulatory policy, the

57. Bernstein & Fischer, supra note 54.
58. Caplin, supra note 55, at 152.
59. Expression, that is, to an extent strictly limited to somewhat expanded disclosure obligations. Given authority to regulate corporate proxy elections by Section 14 of the 1934 Exchange Act, the Securities and Exchange Commission adopted strengthened proxy rules in 1942, but even these did not allow non-controlling shareholders to use the corporate proxy machinery to nominate directors. JOEL SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 238 (1982). Despite judicial willingness to enforce these rules strongly to broaden shareholder rights in proxy elections, see, e.g., SEC v. Transamerica Corp., 163 F.2d 511 (2d Cir. 1947), the SEC amended its proxy rules in 1954 to allow a corporation to
focus shifted to state law, and to the possibility that the problem—"management control over elections and fundamental actions"—might be due not only to "economic realities," but to the fact that "legal rules governing the proxy system help insulate management control by giving management virtually exclusive and practically unlimited access to the corporate proxy machinery." With the aim of "delineating the legal rules by which such questions [of management access to the proxy machinery] should be governed," Professor Eisenberg began his project in the normative engineering of corporate law by describing the doctrinal test for when board members would have access to the proxy machinery in a contested election and criticizing it as "fundamentally defective." Eisenberg found the doctrine's defect to lie mostly in its ignorance of a "crucial fact" about human nature and self-interest:

As to policy issues in dispute between incumbents and insurgents, the director is not a decisionmaker but a proponent who is vitally self-interested in the acceptance of his proposals. A director cannot be left to determine whether the future good of the shareholders requires spending corporate money to elect him to a new term. How many officeholders can resist the temptation of deeming themselves indispensable, particularly if the alternative includes not only being dispensable but being dispensed with?

From this basic "fact," Eisenberg drew the doctrinal conclusion that "the presence of a policy issue in a proxy fight should not in itself justify board access to the corporate proxy machinery," and on this ground, among others, criticized the "policy-information-reasonability" test then (and still) in effect.

General analyses of the directors' fiduciary obligations written during this period omitted from proxy materials any shareholder proposal "which impinges upon the duties and functions of management." SELIGMAN, supra, at 271 (quoting Securities Exchange Act Release No. 34-4979 (1954)). The new rule's effect was to significantly restrict the range of matters that shareholders had a right to include in proxy materials. See Thomas M. Cluserath, The Amended Stockholder Proposal Rule: A Decade Later, 40 NOTRE DAME LAW. 13 (1964). By the 1970s:

[T]he SEC's authority to regulate corporate proxy elections long had been treated by the agency as tangential to the Commission's primary responsibilities . . . . Historically, the SEC had approached the regulation of proxy elections largely as a matter of adequate disclosure in required proxy literature, regarding other aspects of corporate governance as matters for state law.

SELIGMAN, supra, at 534. As Eisenberg summarized the state of affairs in 1970, "the Proxy Rules deal elaborately with the information that must accompany a proxy solicitation, but only tangentially with access to the corporate proxy machinery." Eisenberg, supra note 56, at 1493.

60. Eisenberg, supra note 56, at 1490.
61. Id.
62. Id. (emphasis added).
63. Id. at 1496.
64. Id. at 1497.
period display a strikingly similar pattern. In one of the more influential of such efforts, Professor Victor Brudney's analysis of the application of fiduciary duty protections to control transactions begins with the following statement of the problem:

At the heart of the matter is the lack of identity between the economic interests of those who control corporations while owning only a portion, or none, of the equity and the economic interests of the owners of the equity. This lack of identity of interest permits the controlling group to obtain for itself two distinct kinds of rewards from its direction of corporate affairs. One results from the economically successful operation of the corporation's business and takes the form of a derivative benefit—a return on the investment and an increment in the value of both the enterprise's assets and the stockholders' equity. This reward is enjoyed by all stockholders, including, but not in any disproportionate measure, those of the controlling group of stockholders. The other reward is a direct benefit to the insiders stemming from the use of the corporation's assets or facilities in such a way as to compensate disproportionately those in control. These direct benefits consist not merely of private payments or uses which are readily found to be unlawful, but also of emoluments which either are lawful or whose lawfulness is not policed or readily determinable.67

The problem, in short, is that control transactions present an especially attractive opportunity for those in control to exploit their independence from the owners of the firm. Brudney's general solution to this problem was the same solution proposed many years earlier by Berle and Means: "[E]fforts by insiders unilaterally to preserve or alter control arrangement for their own benefit and to the possible disad-
vantage of the other stockholders call in to play the insiders' fiduciary role."68 As in the analysis of proxy regulation, Brudney had no difficulty in identifying either the source of the problem under study—the separation of ownership from control—or its solution—strict regulation under the common law fiduciary duty doctrine.

With both the problem and its solution in general so easily discoverable, the remaining task for Brudney was to expose in detail the failure of existing doctrine to adequately protect shareholders and produce a recommendation for doctrinal reform. Brudney first identified current doctrine on the application of fiduciary duties to control transactions as concerned mainly with discerning whether the insiders' "purpose" or motive was to preserve or obtain control for their own good or instead for the collective good of all the shareholders.69 He went on to criticize the cases for "eroding" this general test by placing on the "challengers the burden of establishing the primacy of the self-serving purpose rather than requiring the

68. Id. at 262.
69. Id. at 269.
insiders to negate such a purpose.” 70 Brudney recommended instead that because “[i]nsiders are in a better position than are the challengers to produce all the facts and to explain the significance of the various factors considered in deciding upon the transaction,” 71 the application of “fiduciary considerations would deny insiders the personal benefits they seek unless they can demonstrate the primacy of external business purposes.” 72 To the rather immediate charge that such a legal burden of proof might well deter insiders from undertaking transactions that effected both control and the general direction of the corporation’s business, Brudney responded that:

The short answer is that, in the vast bulk of cases, management can recognize, and therefore act, when external business purposes are plainly predominant or when control-preservation purposes are plainly not material to a stock issuance or repurchase. It is only in the doubtful case that the problem exists. There is no way of knowing how extensive such cases may be, although it is worth noting that a comparable uncertainty with respect to the “fairness” of many types of self-dealing transactions has not prevented management from acting on them. In the absence of empirical evidence to the contrary, there is little reason to doubt that the risk of harm from institutionally perpetuating the incumbents’ grip on control outweighs any risk that economically desirable transactions will be discouraged by placing the burden of proof where it traditionally belongs—on the self-serving fiduciary. 73

Just as Eisenberg’s recommendations for proxy regulation reform were based on some taken-for-granted intuition regarding the motives and incentives of directors involved in proxy fights, so too did Brudney’s approach to fiduciary duties in control transactions reflect solely his own common sense about the corporate world. Of course, as often is the case, Brudney’s common sense was in no way either based upon, or constrained by, logical consistency. Without wishing to make more of this particular example than is appropriate to my more general point, it is perhaps worth noting that, in a few short sentences, Brudney manages to say: a) that in the “vast bulk of cases,” business purposes predominate clearly over control purposes; b) yet there is “no way of knowing” how many cases there might be when the two purposes are not so clearly distinct; and c) while until there is “empirical evidence to the contrary,” we can comfortably suppose that the category of mixed purpose cases is small enough that putting the burden of proof where traditional fiduciary principles would put it has small adverse incentive effects. If there is “no way of knowing” how many mixed purpose cases exist, then one cannot be sure that “the vast bulk of cases” do not involve a mixed purpose. Then again, if there is “no way of knowing” how many mixed purpose cases exist, there can never be empirical evidence refuting Brudney’s belief that there aren’t very many cases of this sort.

70. Id. at 271.
71. Id.
72. Brudney, supra note 66, at 271 (emphasis supplied).
73. Id. at 272
Thus, Brudney's proposal for doctrinal reform can be seen to have been based entirely upon a strongly held, but empirically irrefutable, belief about the reality of the corporate world.

The patterns visible in these few examples of post-Berle and Means corporate law scholarship are representative of the genre. Indeed, Brudney and Eisenberg have been among its premier practitioners. My claim is not that this sort of scholarship has been without influence on the law. The Delaware Supreme Court's contortionate dance with the burden of proof in fiduciary duty challenges to takeover defenses may indeed be seen as the apogee of the "fiduciary ideology" approach to the law of public corporations. ¹⁴ There are, moreover, many other interesting examples of post-Berle and Means corporate law scholarship. These examples range from the very broad—Cary's condemnation of the gradual weakening of state statutory limits on directors' discretion as a "race to the bottom" ¹⁵—to the more doctrinally focused. ⁷ The questions raised by post-Berle and Means corporate scholarship are in many instances fundamental. The potential conflict between a manager's self-interest and her obligation to the shareholders must be addressed by any systematic theory of the corporation. Nevertheless, I believe that the influence of the post-Berle and Means style of analysis will be limited relative to the continuing influence of the Coasean approach.

It may seem that I have not yet said nearly enough to defend this argument, for while the ideas and influence of Berle and Means have been set out already, I have described only the ideas of Coase, and not their subsequent expression in economics and law. Yet it is central to the methodological distinction I wish to draw between Coase's little article and Berle and Means's big book that Coase's theory may be usefully studied and understood apart from its application in corporate law scholarship, while Berle and Means's views may not. For Berle and Means did not generate a theory, or even a conjecture, regarding the phenomenon they had observed. The structure of their approach was to: 1) identify the separation of ownership from control in explicitly normative terms that condemned it as an abusive structure involving too much discretionary control by managers and direc-

---

74. Compare Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1990) with Revlon v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986). I do not mean to imply that post-Berle and Means style analysis has been completely driven from the marketplace of corporate law thinking about control transactions. As observed recently in Einer Elhauge, The Triggering Function of Sale of Control Doctrine, 59 U. CHI. L. REV. 1465, 1482 (1992), Berle may have "started the ball rolling," Adolf A. Berle, Jr., Control in Corporate Law, 58 COLUM. L. REV. 1212 (1958), but many corporate law scholars "use arguments based on intuition or formal categorization to reach conclusions about sale of control doctrine." This is not to say that an argument supporting equal sharing of gains from control transactions might not be fashioned along less intuitive and more systematic lines. For such an approach, see William D. Andrews, The Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 HARV. L. REV. 505 (1965).


tors; and 2) immediately identify state statutory corporate law as contributing to, or at least facilitating, this abusive structure, and state common law fiduciary duties as the only thing limiting the extent of the abuse. While there is a great deal of empirical data in Berle and Means and much of it at the level of the individual corporation, the data is presented merely to demonstrate the existence of the general phenomenon—the separation of ownership from control—rather than to explain its development over time or cross-sectional variations in its manifestation. Aside from this empirical evidence (necessary to present only once, to prove the existence of the general phenomenon), what Berle and Means did in their book is what corporate law scholarship did for decades. Methodologically, the examples of corporate scholarship discussed above are identical to Berle and Means's approach, and thus the examples have served to further clarify precisely what this methodology presupposes. It is at this level—of general methodological presupposition—that the contrast between the Coasean and post-Berle and Means scholarly worlds is most stark.

In the Berle and Means approach to corporate scholarship, the general problem for analysis, and its solution, are taken as a given. As a consequence of the separation of ownership from control, managers and directors have too much discretion. The solution is to use the law, especially common law fiduciary duties, to discipline this discretion and force managers to act in the interest of shareholders. There is, crucially, no need to explain why a structural form having these characteristics of separation and discretion might have come to exist and flourish for decades. These things are simply taken as facts. Equally important, the analysis of the proper legal response is based solely upon common sense regarding management's motives and incentives in particular settings—such as proxy contests or other control disputes or both—and upon the unassailable faith that increasing the scope of legal regulation will not create adverse behavioral incentives and is thus presumptively required. On this approach, corporate law scholars generate whatever scanty data they might need—since most of the “data” is simply common sense intuition—and find in the common law and legal commentary all they require in the way of policy guidance.

Although lawyers as a group are frequently inattentive to developments in allied social sciences, the field of corporation law presents an egregious

77. Such as data on the concentration of share ownership in the 200 largest corporations. BERLE & MEANS, supra note 3, at 86-107.

78. In this regard, it is instructive to compare the Berle and Means presentation of data on the concentration of share ownership with the dramatically different analysis of the same empirical question in Harold Demsetz & Kenneth Lehn, The Structure of Corporate Ownership: Causes and Consequences, 93 J. POL. ECON. 1155 (1985).

79. Although proposals for new SEC rules, and the SEC regulatory process itself, might seem to be exceptions to this pattern, during the period 1940-1970, SEC rules were more often than not themselves the product of precisely this sort of analysis. As Seligman observed, as recently as the 1970s, the SEC proceeded “as if much of the postwar generation of economics, business school, and psychology literature bearing on the governance of the giant corporation did not exist.” SELIGMAN, supra note 58, at 535.
example of cultural lag. Dominated by centuries-old fiduciary concepts borrowed from the law of agency and the law of trusts, corporate law has not considered to any significant degree the relevance of the social sciences. 80

Free to thus determine on the basis of unguided intuition both the existence of problems with the corporate structure as well as the effect of proposed legal remedies, only post-Berle and Means corporate law scholars would seem to have had a degree of discretion approaching that which they presumed managers to possess.

Coase started not only with a different and more general perception of the problem, but a dramatically different approach to its analysis. The problem for Coase was to explain why firms exist, and it was only in approaching this general problem that he identified the discretionary control of managers as a phenomenon of interest. Because Coase's goal was to explain rather than normatively describe and prescribe, he could see that discretionary control was an important feature in many settings besides that of the publicly traded corporation—such as in long-term contracts—and see also market allocation as an option to discretionary control. Under the Coasean view, discretionary control was both an ubiquitous organizational form and a form to which there existed always the ready alternative of market control—its description as an abusive form of shareholder "subjection" would be nonsensical.

Coase's statement of the problem was inextricably linked to his approach to its solution. For Coase, discretionary control arrangements, such as firms, were an organizational choice made by rational and constrained economic actors. A choice, moreover, made interesting by Coase's perception that neither the firm nor the market was nirvana; each involved costs. Calling these costs "transaction costs" had the great virtue of directing attention to the microanalytical level of institutional detail. His perception suggested the value of examining how the mix of institutional arrangements—short-term contracts, long-term contracts and internal firm allocation—might be affected by a range of structural features, limited only by the analyst's ability to tell a concrete and persuasive story regarding how the structural features differentially effected the costs of the alternative institutional arrangements. The persuasiveness of these stories would hinge necessarily on their ability to explain institutional choice as constrained by the Coase Theorem, reflecting not only the competitive pressure for efficiency in frictionless environments, but more importantly, reflecting the competitive pressure to minimize the costs or frictions of transacting itself. And what of the influence of the law? The law is mentioned by Coase only briefly, in remarking that a look at the legal concept of master and servant might be of some value in understanding the economic concept of the firm. 81

Ironies abound in the comparison between Coase and Berle and Means. Coase's theory seems to tightly limit the scope of analysis. The Coasean story assumes that self-interested, rational economic actors choose those organizational forms that

81. FIRM, supra note 1, at 54 n.48.
minimize transaction costs. The analytical play is only in the range of factors that may be identified as effecting these costs. To the extent these factors are measurable, the story is fully susceptible to empirical refutation. The role of the law in supplementing the constraint on organizational form provided by the market is barely mentioned. By contrast, Berle and Means's account assumes that the problem is precisely the lack of any constraint over corporate management other than the law, and gives to the legal scholar the authority to ground legal constraints in the scholar's own untested and perhaps untestable intuitions regarding both the reality of current corporate behavior and the effect of proposed legal regulation of that behavior.

Figure 1
Comparative Law Review Citations:
Berle and Means vs. Coase (and Jensen and Meckling)

![Chart showing comparative law review citations for Berle & Means, Coase, and Jensen & Meckling from 1970 to 1993. The chart displays the number of citations for each author and period.]

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Coase</td>
<td>17</td>
<td>92</td>
<td>48</td>
</tr>
<tr>
<td>Jensen &amp; Meckling</td>
<td>7</td>
<td>207</td>
<td>115</td>
</tr>
<tr>
<td>Berle &amp; Means</td>
<td>168</td>
<td>170</td>
<td>86</td>
</tr>
</tbody>
</table>
The constraint of economic theory and the recognition of alternatives to legal regulation provided by Coase have led to a revolution in corporate law scholarship since the 1970s. This revolution is evidenced in part by the data on law review citations displayed in Figure 1. The number of law review articles citing Berle and Means’s *The Modern Corporation and Private Property* remain constant from the 1970s to the 1980s. The number of law review articles citing Coase’s *The Nature of the Firm*, by contrast, increase by over 500%. Moreover, citations to Jensen and Meckling’s *Theory of the Firm*, which explored the cost of corporate discretion from an economic, Coasean point of view, were significantly more frequent during the 1980s than were citations to Berle and Means. These trends have continued into the 1990s.

The explanation for the relative ascendancy of the economic approach lies in the inability of post-Berle and Means corporate scholarship to progress in an intellectually meaningful sense. Not only did the questions addressed by that scholarship remain roughly the same for over four decades, so did its fundamental assumptions about the world. Assumptions regarding the abuses due to the separation of ownership from control were not completely unfounded. There was, after all, a respectable Realist base both in Berle and Means’s empirical data on the structural phenomenon and continual anecdotal evidence of abuse. Post-Berle and Means corporate scholars rarely, if ever, tried to explain why those phenomena might exist or not exist under various circumstances. Nor did they regard their predictions of the effect of various legal reforms on corporate behavior as even potentially amenable to empirical refutation. As Realists, they could not, for there were so many possible theories of behavior relevant to the problems occasioned by the separation of ownership from control that there could be no conceivable basis for choosing a set of theories to develop and test. One need not claim, as did Popper, that empirical refutation is the death-knell for a theory, nor insist on the strict logico-deductive nature of theoretical explanation, as did Hempel, to recognize the progressive possibilities in the economic paradigm of analysis exemplified by Coase’s theory of the firm. The process of a) clearly specifying one’s underlying assumptions regarding both individual objectives and the underlying environment; b) logically deriving the effect of changing environmental variables on individual behavior; and c) testing, where possible, those predictions against the available evidence, at least holds out the possibility of progressive inquiry.

These claims for the progressivity of the Coasean program remain both vague and unrelated to concrete corporate law scholarship. Happily enough, however, the recent publication of Judge Frank Easterbrook and Professor Daniel Fischel’s, *The Economic Structure of Corporate Law*, provides in a single source a masterful and general application of the Coasean approach to corporate law. I now turn to that book, as evidence both of the dominance and progressivity of the economic

---

approach, and as the foreshadow of future economically-inspired approaches.

III. THE COASEAN REVOLUTION AND BEYOND

The revolution in corporate law scholarship brought about by a Coasean economic view of the subject is apparent on the very first page of Judge Frank Easterbrook and Professor Daniel Fischel's book. The first two questions they ask are:

Why are managers free to decide what the firm will produce, whether it will pay dividends, and how much to pay themselves as salaries and bonuses? [and] Why are almost all of the important decisions the firm will make committed to private actors' discretion, while statutes prescribe such trivia as the maximum duration of voting trusts?88

These questions take as their object the same facts—managerial discretion and (state) statutory permissiveness—that were of interest to Berle and Means. But while Berle and Means then immediately jumped to the norm-laden question, "What can be done to curb the exercise of this discretion?," Easterbrook and Fischel instead pursue a different question, that of explanation and understanding. Their explanatory framework is an elaboration of Coase's view that competitive forces will constrain rational economic actors to choose those organizational forms that minimize the cost of transacting. Like Coase, they are concerned with the competitively constrained choice of form, rather than with isolated instances of behavior under alternative forms, arguing that because "[g]overnance structures are open and notorious, unlike the conduct they seek to control . . . there is no substantial impediment to the operation of the competitive process at the level of structure."86 It is these long-run, competitive forces that shape governance structure. Because the choice of governance structure does not impose costs on those not a party to the corporate contracts constituting the structure,87 "what is optimal for the firms and investors is optimal for society."88 In explaining corporate structure as the result of competitively constrained choice among alternative general contractual structures—the "corporate contract" approach—Easterbrook and Fischel can be seen to directly carry forward Coase's early and sketchy ideas.

Easterbrook and Fischel's great and indeed revolutionary accomplishment, however, has been to use the transaction cost approach inspired by Coase as a tool of detailed doctrinal analysis. The key to this accomplishment is Easterbrook and Fischel's perception of corporate law itself as an element of corporate contractual structure. This view makes it possible to analyze corporate law as the product of the same long-term process of competition—induced adaptation that constrained private

86. Id. at 7.
87. Id. at 14.
88. Id.
actors to minimize transaction costs. In this analysis, corporate law determines the participation rights of the various participants in the corporate enterprise. The fundamental economic question regarding corporate law then becomes how alternative allocations of legal rights to participate in corporate decisionmaking affect the comparative cost of alternative methods of corporate operation and governance.

The apparent extremity of this equation—that corporate law is itself part of the contractual structure subject to competitive selection pressure—is indeed only apparent. By "corporate law" Easterbrook and Fischel mean primarily a set of rules—such as the fiduciary obligation—which are both imprecise and suppletory rather than mandatory. These terms operate in default of explicit terms to the contrary, and, in a world of rational actors and market security prices, are "contractual in the sense that they are fully priced in transactions among interested parties." Coase's theory of the firm as an alternative to the market was a theory of the long run, in which observed organizational choices were assumed to reflect competitive pressures that forced private actors to choose transaction cost minimizing organizational forms. In the spirit of Coase, Easterbrook and Fischel's theory of corporate law is also a theory of the long run. In this model, corporate law supplies the "rules that investors would select if it were easy to contract more fully," and it is the observed rules of corporate law—including those that are merely suppletory or default terms—which are assumed to reflect the pressure of the market's imperative for value maximization. Easterbrook and Fischel have subsumed the content of corporate law as an aspect of organizational form. Thus, just as Coase viewed the observed patterns of contractual form as reflecting the cost-minimization imperative of market selection, so do Easterbrook and Fischel see the patterns of corporate law as "adaptations with substantial value in the evolutionary struggle for corporate survival." In their interest more in explanation than normative critique, Easterbrook and Fischel may be seen to follow closely Coase's lead. They go well beyond Coase, however, in the strength of their commitment to an evolutionary, functional explanation of corporate law and structure. Indeed, a reader unacquainted with what is


90. EASTERBROOK & FISCHEL, supra note 85, at 14.
91. Id. at 15-22.
92. Id. at 17.
93. Id. at vii.
94. Id.
95. Good general discussions of functional explanation may be found in JON ELSTER, EXPLAINING TECHNICAL CHANGE 49-68 (1983); DANIEL LITTLE, VARIETIES OF SOCIAL EXPLANATION: AN INTRODUC-
to come in the body of Easterbrook and Fischel's book might conclude from its first chapter that the book is about evolutionary theory rather than corporate law. They go so far in their commitment to the adaptive model of corporate law as to state that "[t]o say that a complex relation among many voluntary participants is adaptive is to say that it is contractual." The power of this adaptive approach lies in the general persuasiveness of a functional explanation as an explanatory model. Just as evolutionary theory in biology relies upon competitive natural selection to "make sense" of a bewildering variety of species' characteristics, so too does Easterbrook and Fischel's evolutionary approach to corporate law "make sense" of the observed patterns of corporate law and organization as the product of market competition among alternative governance types. Post-Berle and Means corporate law scholarship viewed essentially every feature of the modern corporation and modern corporate law as a simple reflection of the untrammeled whims of powerful managers. If the structure of the corporation and state corporate law was as abusive to shareholders and socially inefficient as post-Berle and Means scholars assumed, then one might have at least wondered how the rather amorphous manager group could have somehow succeeded in fooling, or simply overpowering, generations of investors and market analysts, as well as preventing entrepreneurs from innovating new legal forms that would be more attractive to investors. Such a theory, however, was entirely lacking in post-Berle and Means corporate scholarship.

Into this void, Easterbrook and Fischel put forward their evolutionary approach. In the sort of long-run evolutionary equilibrium they suppose, existing corporate law rules and governance forms are taken to reflect the operation of competitive selection. The presumption, therefore, is that governance forms are neither abusive nor inefficient, but rather efficient responses to the various factors that determine the relative costs and benefits of alternative organizational forms. The common charge against any functional, evolutionary theory is that it is tautological—in the form of "whatever is, is best; therefore x, which is, is best"—or untestable. While it certainly is possible to concoct a functional explanation of almost any phenomenon that is in fact guilty of these charges, their prosecution seems more often to reflect ignorance of the details of the functional explanation rather than knowledge of its weaknesses. As a conceptual matter, a non-empty,
interesting functional explanation is fully possible. Such an explanation not only relies upon market forces to select optimal adaptations, but theorizes in considerable detail regarding which adaptations will arise in which circumstances, and how changes in circumstances will lead to changes in adaptive makeup. Such a detailed, functional explanation generates precise hypotheses which are, at least in principle, subject to statistical testing.

A detailed, functional economic theory of corporate law and governance would specify how competitive conditions in the relevant markets for managers, securities, firms, and products affect and interact with other influences on the costs and benefits of alternative contractual governance structures. It would generate predictions regarding which governance forms would be dominant (i.e., efficient) under which circumstances. And providing that the relevant governance forms and relevant circumstances are somehow measurable and in fact measured, such a theory could be subject to empirical refutation. Even together with The Problem of Social Cost, however, Coase’s theory of the firm falls far short of providing sufficient detail to generate empirically testable, in-principle refutable hypotheses regarding the determinants of optimal governance structures or, for that matter, corporate law viewed (ala Easterbrook and Fischel) as an aspect of such structures. Coase simply said very little about the concrete costs and benefits of alternative contractual forms.

Coase’s great virtue (a virtue, incidentally, unique among Nobel Prize winners) has been to say just enough to formulate a general framework for inquiry, while leaving the development of that framework to others. His career has been marked by its wonderful, eye-opening beginnings rather than its mountainous completions. Of all his beginnings, no other proved more fruitful of further developments than his The Nature of the Firm. It is upon these developments that Easterbrook and Fischel have based their economic theory of corporate law. Where Coase failed quite clearly to identify the costs of organizing transactions within a firm,99 others have developed an elaborate and detailed theory of the “agency costs” that are incurred when one person is placed in control of assets that are owned by another person.100 This work identifies in a more rigorous way the general sort of incentive problem discussed by Berle and Means, but goes much further in discussing a broad range of market and contractual constraints on the exercise of managerial discretion. Closely related is the school of transaction cost economics associated most prominently with Oliver Williamson.101 Transaction cost economics identifies the potential incentive

Gould, Impeaching a Self-Appointed Judge, SCIENTIFIC AM. 188 (July 1992) (reviewing PHILLP E. JOHNSON, DARWIN ON TRIAL (1991)).


101. For expositions of the transaction cost approach, see WILLIAMSON, supra note 21; Oliver E. Williamson, Transaction Cost Economics: The Governance of Contractual Relations, 22 J.L. & ECON.
problems that arise when investments—as in highly firm-specific skills and knowledge—are relationship specific (and thus will be lost at least in part if the relationship ends prematurely), and private actors are opportunistic and will take advantage of asset specificity to "hold up" the other party to a contract by demanding a greater than agreed-upon share of the gains from cooperation. It stresses the inability—due to bounded or limited human rationality—of contracting parties to fully specify contractual expectations ahead of time to protect against such ex post opportunism. This approach then explains a number of observed features of such relationships—such as lifetime executive salary profiles that pay executives much less than their marginal products during their early training years and much more than their marginal products in their twilight years—as an effort by rational agents to provide a "bond" or "credible commitment" against future opportunistic behavior. Transaction cost economics thus complements the economic theory of agency by explaining how a variety of contractual and other institutional devices has arisen to lessen the incentive problems characteristic of long-term, asset-specific relationships such as that between corporate managers and the corporations who employ them.

These are by no means the only interesting economic theories of the firm, or of contractual structure, and yet they are at least among the most important to


106. An excellent survey of this field is found in Oliver Hart & Bengt R. Holmstrom, The Theory of Contracts, in ADVANCES IN ECONOMIC THEORY (Truman Bewley ed., 1987). A very accessible and current introduction to the principal-agent branch of the theory of contracts is available in David E.M. Sappington, Incentives in Principal-Agent Relationships, 5 J. ECON. PERSP. 45 (1991). A somewhat dated, but helpful, discussion of the technical nuts and bolts of principal-agent analysis can be found in Glenn M. MacDonald, New Directions in the Economic Theory of Agency, 17 CAN. J. ECON. 415 (1984). It should be noted that the predictions of principal-agent theory regarding internal corporate incentive structures have not been generally confirmed. George P. Baker et al., Compensation and Incentives: Practice Versus Theory, 63 J. FIN. 593 (1988). This may be due to difficulty in determining when monitoring is cheap and substitutes for contractual control. See John M. Abowd, Does Performance-Based Managerial Compensation Affect Corporate Performance?, in DO COMPENSATION POLICIES MATTER? 52, 54 (Ronald G. Ehrenberg ed., 1990). It may in part have been due also to the failure, until very recently, see Benjamin E. Hermalin, The Effects of Competition on Executive Behavior, 23 RAND J. ECON. 350 (1992), to formally incorporate shifting market constraints into the principal-agent analysis.
the revolution in corporate legal scholarship.\textsuperscript{107} Indeed, within the general rubric of transaction cost economics, there are by now a number of quite general but quite different approaches.\textsuperscript{108} I shall conclude by briefly mentioning the as-yet-unrealized potential applicability to corporate law of some of these theories.\textsuperscript{109} However, a full application of any of these theories is beyond the scope of the present essay. My goal is merely to indicate that Coase's somewhat sketchy theory has been given substantial detailed explanatory content.

It is in Easterbrook and Fischel's application of this developing theory to the analysis of corporate law, rather than in a survey of the economics of the firm, that my concern in this article lies. For Easterbrook and Fischel have produced a theory which is far from an untestable, functionalistic equating of whatever is with what is best. Instead, they have provided an economic theory of corporate law which is both general and yet sufficiently detailed in its explanatory conjectures to provide the basis for a long line of progressive inquiry in the economic analysis of corporate law. In this, they have achieved what decades of post-Berle and Means scholarship failed to achieve and paid an enormous tribute to the original insights of Coase. It is possible to look almost anywhere in Easterbrook and Fischel's book and find support for this opinion, but one of the sharpest differences between Easterbrook and Fischel and post-Berle and Means scholarship is to be found in Easterbrook and Fischel's treatment of the application of the fiduciary principle to corporate control transactions. It is not that Easterbrook and Fischel are oblivious to the possibility that managers may benefit greatly from using their structural, de facto control to determine changes in legal control and ownership. Indeed, they are quite straightforward in stating:

Managers do not always maximize the wealth of investors. We have


\textsuperscript{108} For some inkling of the current theoretical menu, see Oliver E. Williamson, A Comparison of Alternative Approaches to Economic Organization, 146 J. Institutional & Theoretical Econ. 146 (1990); Oliver E. Williamson, Economic Institutions: Spontaneous and Intentional Governance, 7 J.L. Econ. & Organization 159 (1991); Paul Milgrom & John Roberts, Economics, Organization and Management (1992); Symposium, Organizations and Economics, 5 J. Econ. Persp. 1 (1991).
already discussed the costs of principal-agent relationships. Because managers have only a small stake in the fortunes of the firm, these costs may be quite high. Managers may not work as hard as they would if they could claim a higher share of the proceeds—they may consume excessive perquisites, and they may select inferior projects for the firm without bearing the consequences of their action.\footnote{EASTERBROOK \& FISCHEL, supra note 85, at 112.}

But this recognition of the inevitable conflict between the self-interest of managers and investors leads not to immediate condemnation of the managerial role in control transactions, as in Brudney's analysis cited earlier, but to a more optimistic and yet more complex approach.

Easterbrook and Fischel assume explicitly that premiums for control paid in control transactions reflect an anticipated increase in firm value due ordinarily to the replacement of inefficient with efficient management, or the move toward greater structural efficiency.\footnote{Id. This idea, which is fundamental to the economic theory of control transactions, was first set out in an amazingly prescient and original article by Henry Manne, \textit{Mergers and the Market for Corporate Control}, 73 J. POL. ECON. 110 (1965).} As this is the assumed source of the control premium, the Coase Theorem kicks in to imply that "[s]elf-interest thus assures us that changes of corporate control, like other voluntary exchanges, move assets to higher valued uses."\footnote{EASTERBROOK \& FISCHEL, supra note 85, at 113.} They find opportunities for value-increasing changes in control in the whole gamut of control transactions. In minority freezeouts, the "elimination of minority shareholders in a subsidiary produces gains if the combined entity can achieve economies of scale, centralized management and corporate planning, or economies of information."\footnote{Id.} Easterbrook and Fischel also find value increasing opportunities in mergers of subsidiaries, which give the parents' investors a proportionate share of both the gains and losses on subsidiary projects, and therefore eliminate the structural disincentive to shift risky projects guaranteed by the parent away from the subsidiary.\footnote{Id.} Other control transactions, they argue, such as going private arrangements, "attack agency costs directly" by eliminating or substantially reducing the separation of ownership and control that "creates the clash of interest between principal and agent."\footnote{EASTERBROOK \& FISCHEL, supra note 85, at 113-14.} Even the massive debt burdens attendant upon leveraged buyouts (LBOs) and management buyouts (MBOs) may have strong efficiency effects, as lenders continually monitor management performance and huge compulsory payment obligations drive managers forward from the constant fear of bankruptcy.\footnote{Id.} And even the allocation of corporate opportunities generally to a corporate insider may often be efficient, because "[m]anagers who assign opportunities to themselves can appropriate a greater portion of marginal gains from their efforts, and thus have greater incentive to produce such gains. The manager can compensate the firm by taking a lower salary and bonus, and the
reduction in agency costs may be mutually beneficial."\textsuperscript{117}

The balance in Easterbrook and Fischel's examination of control transactions is their recognition that not only may some intendedly efficient control changes simply fail, as may any innovation, but also that "[s]ome changes in control may be attributable to self-aggrandizement rather than to gains in the use of the acquired firms' assets."\textsuperscript{118} They also recognize that the market price mechanism may not be able to penalize all such attempts to use control changes for personal aggrandizement at the expense of firm value, because the market simply is unaware of the information that is necessary to properly evaluate the likely effect of the change, as when a going private transaction is motivated by inside information.\textsuperscript{119} While recognizing the possibility of inefficient redistributive control transactions, Easterbrook and Fischel are nonetheless reasonably confident that the vast majority of such transactions generate increases in value because "price data speak clearly. Prices paid for shares acquired in control transactions exceed the market price by substantial amounts, in the range of 30 to 70 per cent."\textsuperscript{120} This is a small excerpt from a small portion of Easterbrook and Fischel's book, yet it is fully representative of the book's general explanatory methodology. What it illustrates is not the application of a tautology of the form, "Whatever managers have arranged for themselves must be efficient," but rather the presentation of detailed and ingenious arguments regarding the possible efficiency of the exercise of discretionary control by management and other corporate insiders. In addition, the central assumption underlying the analysis—that control transactions usually generate increases in firm value—is supported with a reference to empirical studies of market prices. My point is most decidedly not that Easterbrook and Fischel's efficiency claims are correct—either in this or any other particular instance. It is instead that the methodology they have adopted makes possible a progressive increase in our understanding of corporate structure and behavior. Their assumptions about law and behavior are clear and straightforward. We may challenge their assumptions at any number of discrete points: 1) the assumption that premium prices paid to gain control necessarily imply that the control transfer will increase firm value;\textsuperscript{121} 2) the assumed incentive effects of stock ownership and debt burden

\textsuperscript{117} Id. at 115.
\textsuperscript{118} Id.
\textsuperscript{119} Id. at 115-16.
\textsuperscript{120} EASTERBROOK & FISCHEL, supra note 85, at 116.
on managerial performance after an LBO or MBO;\footnote{122} 3) the supposedly distorted incentives of parent shareholders in deciding whether to allocate projects to a subsidiary; and 4) the quite testable assertion that in otherwise identical firms, the firm which allows managers more freedom in appropriating opportunities for their own investment and gain should also pay managers lower salaries and bonuses. None of these questions necessarily has a ready and obvious answer. Easterbrook and Fischel have given us their answers. However, their larger contribution is not in the answers they have provided, but in the way they have put the questions. The title of their book should not be allowed to mislead. They have provided an economic theory of corporate law, not the economic theory of that field.\footnote{123} There has never been, and will never be, a final economic theory of anything.\footnote{124} Economics provides not answers but a framework of inquiry. This framework includes assumptions about general behavioral motives or objectives, deduction of specific behavioral predictions, and testing of these predictions against empirical or anecdotal evidence. This framework succeeds most by explicitly revealing the limits of any particular application, and thereby suggesting the next inquiry, the next model, the next story to tell. And as I sketch below, the future of the economic approach to corporate law.
may well be in extending the analysis to question the fundamental assumptions of constrained rationality first applied to analysis of the firm by Ronald Coase.

IV. THE NEXT FRONTIER: CORPORATE LAW IN A WORLD OF EVOLVING STRATEGIC RATIONALITY

I have argued that the explanatory power of the economic approach to corporate law inspired by Coase derives very largely from the fact that this approach is a theory of what competitive forces should eventually, in the long run, constrain rational economic actors to do. Under such an approach, the pattern of corporate governance structures which we observe at any point in time—whether corporate charters generally or explicitly forbid insider trading, the extent to which Delaware shareholders have voted to opt out of the directors’ duty of care, the extent to which corporations indemnify or insure directors against such liability—are presumed to be efficient, equilibrium choices, because in the long run, only such choices will survive. As Easterbrook and Fischel argue, “even hard-to-value terms” may be treated as “contractual” in this sense, because “[t]he long run will arrive eventually, and terms that are not beneficial for investors will stand revealed; the firm will lose out in competition for investors’ money.” In other words, people are rational and well informed, and the general pattern of observed corporate contracts corresponds to a long run, rational expectations equilibrium.

As discussed earlier, this theory is neither tautologous nor untestable, and it quite clearly survives these naive criticisms of functional explanation. But there is another, deeper criticism which Easterbrook and Fischel’s model cannot so easily brush aside. They have provided no account of the mechanism that would lead to long-run efficiency, but instead merely assume that markets, and particularly securities markets, at all times reflect such an equilibrium. In this, they neglect at least three increasingly important areas of economic research: 1) the game-theoretic analysis of rational bargaining behavior, 2) the analysis of the dynamics of economic evolution, and 3) a large body of empirical work indicating that the fundamental empirical assumption underlying Easterbrook and Fischel’s work—that securities markets are efficient—is quite probably false.

126. Easterbrook & Fischel, supra note 85, at 21.
128. The study of evolution and learning in repeated games is one of the most important areas of contemporary economic research. For an indication of the direction this research is taking, see George J. Mailath, Introduction to Symposium on Evolutionary Game Theory and Economics, 57 J. Econ. Theory 257 (1992); Lawrence Blume & David Easley, Evolution and Market Behavior, 58 J. Econ. Theory 9 (1992); Alan Kirman & Mark Salmon, Learning and Equilibrium in Economics (forthcoming 1993). For an application to the theory of legal evolution, see Jason S. Johnston, Notes on the Economic Approach to Legal Evolution (April, 1993) (on file with Vanderbilt University).
129. For a general approach to the estimation of the fraction of unrejected (point) economic hypotheses which are in fact false, see J. Bradford De Long & Kevin Lang, Are All Economic Hypotheses False?, 100 J. Pol. Econ. 1257 (1992). For an illuminating survey and legal application of the
Each of these areas of economic research has great potential relevance for the economic analysis of corporate law. To the extent that innovation in corporate law rules may be analogized to product innovation, an extremely interesting body of economic work on technological evolution may be applied to analyze evolution in corporate law. While Easterbrook and Fischel often seem to assume away the role of chance, historical events in influencing the evolution of corporate law, the great likelihood of increasing returns in the adoption of new legal innovations strongly suggests that legal evolution will be both potentially inefficient and unpredictable. On this theory, an initial advantage in terms of the numbers of firms "adopting" a new legal innovation might then generate advantages for that innovation. An example of this is the refinement of legal rules due to increased frequency of litigation which has nothing to do with inherent advantages or disadvantages of those rules relative to other competing innovations. Legal innovations may exhibit "lock-in" for a variety of other reasons, including the externalities generated by cases establishing new precedents, and the costs incurred by consumers—such as corporate counsel—in switching from one legal "product" to another. A detailed application of ideas such as these may succeed in explaining what Easterbrook and Fischel's theory of long-run equilibrium cannot, which is a continuing pattern of both inefficient and efficient corporate law rules and statutes. Somewhat differently, game theoretic analysis of the evolution of conventions might be applied to look at many corporate statutory provisions as both reflecting and affecting conventions which have evolved in a repeated game of coordination.

Recent economic research into the noise trader phenomenon has shown that there are many plausible circumstances under which rational arbitrage will not in fact eliminate irrational traders from the market—that they may in fact persist and

“noise trader” literature—which has demonstrated the general conditions under which "irrational" traders are not driven from securities markets by rational arbitrage, but in fact proliferate—see Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 U. Pa. L. Rev. 851 (1992).


even dominate. At least, this work suggests that securities markets may provide a much looser constraint on the survival of inefficient managerial discretion than is supposed by Easterbrook and Fischel. And with insulation from market constraint, the terms of the corporate contract become a matter for negotiation rather than market determination. In particular, the hierarchical structure of corporate decision-making, and the presence of very real but unpriced benefits to moving up in the hierarchy, makes the problem of influence costs central to the corporate incentive structure.\textsuperscript{138} Influence costs are the costs expended by managers in efforts that do not increase firm profitability, but, instead, improve managerial qualifications for promotion. Milgrom and Roberts, the economists who have developed the influence cost paradigm, recognize that subjecting various managerial decisions to legal scrutiny will tend to generate inefficiencies in the attempt to influence courts and juries to attach liability to \textit{ex post} mistaken managerial decisions.\textsuperscript{138} To date, very little consideration has been given to the alternative possibility that external influence activities directed at courts and juries might in some circumstances lower the cost of internal influence activities and be part of an efficient response to the influence cost problem. More generally, by emphasizing "bargaining costs" as an important element of "transactions costs,"\textsuperscript{137} Milgrom and Roberts point to the possible role of corporate law as an important determinant of the efficiency of bargaining in corporate settings. Such a role is likely to be especially important insofar as default rules in corporate law systematically influence both what sorts of private information are valuable, and what sorts of private information must be disclosed in the process of bargaining around the default rules supplied by corporate statutes.\textsuperscript{138} Easterbrook and Fischel rarely recognize these possible economic effects of


\textsuperscript{136} MILGROM & ROBERTS, supra note 135, at 277-80.

\textsuperscript{137} Id. at 130-60.

corporate law.\textsuperscript{139} They emphasize the constraint of the market as a substitute for legal regulation rather than the effect of legal rules on influencing the cost and nature of private bargaining.\textsuperscript{140} Yet, a bargaining analysis builds directly upon their work and its own Coasean inspiration. For what is most lasting in that work is not its assumption that the world is always in long-run equilibrium, and that the market eliminates all but efficient exercises of managerial discretion, but rather its emphasis on corporate structure as the product of rational choice. Allowing that rationality may be imperfect and adaptive, and that the expression of rationality may be enormously varied depending upon the strategic nature of the environment, does not return us to the post-Berle and Means world of unconstrained power. Neither does it give us the quick and direct answers provided by the assumption of long-run, cost-minimizing equilibrium. Rather, it sets a research agenda in which the role of corporate law is both more varied and more creative than either Berle and Means or Easterbrook and Fischel presume, as neither the only check on managerial discretion nor a mere convenience to mimic the check automatically provided by the market, but instead a fundamental determinant of strategic bargaining over the terms of the corporate contract.

\textsuperscript{139} For one of the few examples, see Easterbrook and Fischel's observation that since it is very difficult to actually enforce a contractual provision preventing insider trading, then it will be difficult for firms that gain from such restrictions to "distinguish themselves (in investors' eyes) because other firms will disingenuously claim to be similarly restrictive." \cite{Easterbrook85} at 263. They seem here to recognize the general sort of "mimicry" behavior that is an important constraint on private contracting under asymmetric information. On this more generally, see Kathryn E. Spier, \textit{Incomplete Contracts and Signalling}, 23 \textit{Rand J. Econ.} 432 (1992); Philippe Aghion & Benjamin Herermalin, \textit{Legal Restrictions on Contracts Can Enhance Efficiency}, 6 \textit{J.L. Econ. & Organizations} 381 (1990).

\textsuperscript{140} See, \textit{e.g.}, Easterbrook \& Fischel, \textit{supra} note 85, at 125 (discussing how the fiduciary rule against looting mimics the contract term which market competition would dictate even without the law).