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COMPANY LAW REFORM AND ECONOMIC ANALYSIS: ESTABLISHING BOUNDARIES

STEPHEN COPP*

The recent process of company law reform has highlighted the absence of consensus over what should be the appropriate methodological basis for it. The adoption of economic analysis by the Law Commissions, and the prominence given to economic issues by the Company Law Review Steering Group, have focused attention on economic analysis. Although such analysis is well-established in other jurisdictions, notably the United States, it has proven controversial in the United Kingdom, and such controversy has, perhaps, deflected attention away from consideration of its detailed application and limitations. The articles in this issue are derived from papers originally given at an SPTL Workshop on "Company Law Reform and Economic Analysis: Establishing Boundaries". The themes that emerge are the limitations of company law reform and the limitations of economic analysis. The limitations of company law reform are shown to result from the beneficial role that social norms consistent with economic efficiency may play, the harmful role that legal rules inconsistent with economic efficiency may play, and the difficulties that can arise in the wholesale importation of legal rules from one jurisdiction to another. The limitations of economic analysis are shown where the application of economic theory is tested against historic events, in the adoption of over-simplistic conceptual language in economic literature and the difficulties in seeking to utilise economic analysis as a detailed guide for the development of specific rules. This article concludes by setting out the implications of these conclusions for both future "law and economics" research in the field of company law and for the company law reform process itself.

* Director, European Centre for Corporate Governance, Bournemouth University.

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A. Company law reform

Company law has been in a state of almost constant "reform" since its inception in the mid-nineteenth century. Company law has traditionally been said to have two main functions: enabling and regulatory.[1] The enabling function is seen as limited to incorporation, being that which parties could not otherwise have achieved, whereas the regulatory function is seen as prescribing the conditions which have to be complied with, and the rules which have to be observed to protect members, creditors and the public against the dangers thought to be inherent in such a body.[2] Whilst this distinction is inadequate, in the sense that, narrowly defined in this way, many important aspects of company law fall into neither function,[3] it is useful in that it can be seen that it is from the regulatory function that much of the imperative for company law reform is derived. It provides a dynamic for what might otherwise be seen as essentially a limited and fairly static technical function. What are perceived as the dangers inherent in such a body may change over time in the light of changing commercial practices and social expectations, as may the categories of person entitled to protection and the standard of that protection.

The methodology for company law reform until recently has rarely, if ever, been articulated.[4] There was much criticism of this state of affairs and the resulting perceptions as to the quality of company law in the United Kingdom.[5] However, it became rapidly apparent that many of the arguments advanced for company law reform were not merely technical issues but involved challenges to the ideological orthodoxy of company law or the need to respond to changes in the environment in which companies operated. Traditional "doctrinal" legal methodology was unsuited to the task of providing an evaluative framework for this.[6] The involvement of the Law Commissions in the United Kingdom in company law

1 PL Davies, *Gower's Principles of Modern Company Law* (London, Sweet & Maxwell, 1997), 7.

2 *Ibid.*

3 For example, how might the statutory contract or governance by directors be categorised?

4 See, e.g. *Report of the Company Law Amendment Committee*, Cmd 2657 (1926), 3–5; *Report of the Committee on Company Law Amendment*, Cmnd 6659 (1945), paras 1–10; *Report of the Review Committee on Insolvency Law and Practice*, Cmnd 8858 (1982), ch. 4; Report by LCB Gower, in *Review of Investor Protection*, Cmnd 9125 (1984), 5–9.

5 Notably LS Sealy, *Company Law and Commercial Reality* (London, Sweet & Maxwell, 1984); and Law Society Company Law Committee, *The Reform of Company Law* (London, Law Society, 1991). However, calls for reform in academic circles can be traced at the least to E Manson, "The Reform of Company Law" (1889) *LQR* 61; E Manson, "Tinkering with Company Law" (1890) *LQR* 428; and E Manson, "The Reform of Company Law" (1895) *LQR* 346.

6 As BR Cheffins, *Company Law, Theory, Structure and Operation* (Oxford, Clarendon Press, 1997), xlv, has argued, most company law texts seek to classify, categorise and define legal rules rather than provide a conceptual framework for companies' inner workings, the legal system's impact on corporate activities or the evaluation of governmental regulatory strategies and possible legal reforms. See, further, BR Cheffins, "Using Theory to Study Law: A Company Law Perspective" (1999) 58 *CLJ* 197.

reform represented a major change in emphasis at a policy level. In the consultation paper and subsequent report *Shareholder Remedies*, a serious attempt was made to establish "guiding principles" for the process, and a range of methodologies was employed, including an empirical survey and the use of comparative law. Nonetheless, the methodology remained the subject of serious criticism.[7] In a further exercise, the Law Commissions' consultation paper[8] and subsequent report,[9] *Company Directors: Regulating Conflicts of Interests and Formulating a Statement of Duties*, was a strong attempt to deal with these criticisms. In particular, Part 3 of the consultation paper contained a report on "Economic Considerations".[10] This proved to be controversial in academic circles,[11] although the use of economic analysis of law in academic discourse—and beyond—was well-established in other jurisdictions[12] and hardly novel in the United Kingdom itself.[13] Nonetheless, there has been

[7] See, e.g. D Sugarman, "Reconceptualising Company Law—Reflections on the Law Commission's Consultation Paper on Shareholder Remedies", in B Rider (ed.), *The Corporate Dimension* (Bristol, Jordans, 1998), 180, 182, who criticised the Law Commissions' remit as too narrow, observing that it had been accentuated by the dearth of empirical work on corporate business organisations, corporate law and markets and the conceptual confines of the legacy of classical company law. Sugarman argued that the "essential process of reconceptualising company law" required a broader approach, drawing upon economic and socio-legal studies of business, contracting and civil justice, and engagement with the problems of regulation, voluntariness, power, legitimate expectations and trust.

[8] Law Commission Consultation Paper No. 152; Scottish Law Commission Discussion Paper No. 105 (1998).

[9] Law Commission Report No. 261; Scottish Law Commission Report No. 173 (1999).

[10] See, further, S Deakin, and A Hughes, "Economic Efficiency and the Proceduralisation of Company Law" (1999) 3 *Company Financial and Insolvency Law Review* 169.

[11] See, e.g. D Sugarman, "Is company law founded on contract or public regulation? The Law Commission's paper on company directors" (1999) 20 *Company Lawyer* 162, 178, who commented that "a lot of the law and economics scholarship has consisted of neo-liberal economic assumptions to legal ideas and institutions", and later argued that "the assumptions that Part 3 makes about economic actors, the operation of markets, the behaviour of shareholders and directors, and the provisional conclusions that can be drawn from the analysis, are open to challenge" (*ibid.*, 179). AJ Boyle commented, in "Economic considerations in Part 3 of the Law Commissions' paper on company directors" (1999) 20 *Company Lawyer* 210, 212, that "I remain unhappy that the 'economic considerations' in Part 3 might become permanently the sole theoretical compass of company law reform". J Dine, in "Fiduciary duties as default rules, European influences and the need for caution in the use of economic analysis" (1999) 20 *Company Lawyer* 190, 193 observed that "the use of economic analysis in the consultation paper is to be welcomed but it should not be forgotten that economic analysis is a tool and not an ideology". It is interesting to contrast the approach of the Law Society Committee on Company Law, in Memorandum No. 366, which made little comment on the use of economic analysis in the consultation paper.

[12] For reviews of the development of "law and economics", see N Duxbury, *Patterns in American Jurisprudence* (Oxford, Clarendon Press, 1995); C Veljanovski, "The Economics of Law" (London, Institute of Economic Affairs, Hobart Paper 114); RA Epstein, "Law and Economics: Its Glorious Past and Cloudy Future" (1999) 64 *University of Chicago Law Review* 1167.

[13] See, e.g. W Bishop and DD Prentice, "Some Legal and Economic Aspects of Fiduciary Remuneration" (1983) 46 *MLR* 289; J McCahery, S Picciotto and C Scott, "Introduction: Corporate Control: Changing Concepts and Practices of the Firm", in J McCahery, S Picciotto and C Scott (eds), *Corporate Control and Accountability* (Oxford, Clarendon Press, 1992), 1, which claimed that the papers in the volume, which had resulted from a conference at Warwick University in July 1991, offered the first sustained attempt to transcend the new institutionalist and contractarian visions which had become the mainstream perspectives on the corporation. See also A Ogus, *Regulation: Legal Form and Economic Theory* (Oxford, Clarendon Press, 1994).

much discussion at a high level of generality and less at the level of the detailed application of economic analysis to particular problems.

The articles in this issue are based on an SPTL Workshop held under the auspices of the European Centre for Corporate Governance in May 2000, entitled "Company Law Reform and Economic Analysis: Establishing Boundaries". This article gives an overview of the issues explored and analyses how some of the boundaries of economic analysis—including the role of economic efficiency, social norms, history and comparative law—are dealt with. Two main themes emerge from the contributions: the limitations of company law reform and the limitations of the use of economic analysis. Perhaps surprisingly, the use of historical and comparative methodologies are dominant in suggesting these limitations, and this article will conclude with appropriate recommendations for future research and policy agendas suggested by this. The limitations of company law reform are shown to result from: the beneficial role that social norms, consistent with economic efficiency, may play by reference to the "London Approach" to corporate rescue; the harmful role that legal rules inconsistent with economic efficiency may play, for example the potential impact of directors' disqualification on entrepreneurial activity; and the difficulties that might arise in the wholesale importation of legal rules from one jurisdiction to another, such as between the United Kingdom and Germany. The limitations of economic analysis are shown: where the application of economic theory is tested against historic events, for example the emergence of the "Berle-Means corporation"; in the adoption of oversimplistic conceptual language in economic literature, such as "the firm"; and by the difficulties in seeking to utilise economic analysis as a detailed guide for the development of specific rules, for example in the context of pre-emption rights.

B. The boundaries of company law reform

1. The role of company law and company law reform

The Company Law Review Steering Group appears to have had few illusions as to the limits on what might be achieved with the Company Law Review, as demonstrated in the objectives and guiding principles adopted early in the process.[14] This was particularly noticeable in the predominant "competitive economy" objective which stated that:[15]

> "It is not for the law to substitute for the business judgements involved, but to provide optimal conditions for their optimal exercise. The importance of the law should be kept in perspective—companies should not, and typically do not, operate at the legal boundary but adopt a wide range of non-legal standards, including best practice. A

[14] See Company Law Review Steering Group, *The Strategic Framework* (London, DTI, 1999), ch. 2.

[15] *Ibid.*, para. 2.4.

> competitive economy will rely as little as possible on costly and inflexible legal mechanisms. The most efficient law will often derive from well-tried best practice or provide the best conditions for its development."

Mixed up within this statement are a number of important issues. Of note is the explicit recognition of the limitations of the law, even though this is not a new concept.[16] In particular, state regulation is seen as less desirable than private ordering because of its inflexibility and cost, raising, by implication, issues such as enforcement problems.[17] The role of law in reflecting social norms or facilitating their development is also recognised.[18]

Further constraints on the role of law were also emphasised by the Company Law Review Steering Group in its identification of key trends characterising contemporary markets and businesses. These are crucial since, in effect, they provide a potential justification for changes in the rules and open up the possibility that the existing rules provided by company law may have become sub-optimal (assuming that they were at some stage optimal). The factors identified are: globalisation; Europe; changing patterns of regulation; information technologies; changing patterns of ownership; the modern asset mix; and the importance of small and closely held companies.[19] A detailed critique of these is outside the scope of this article. Suffice it to say that important questions are raised as to the extent to which these factors impose limits on the legislative discretion of the United Kingdom in the field of company law and the extent to which they can be considered social constructs. The force of these factors is reflected in a number of the articles discussed in detail below: globalisation, by Bradley[20] and Wilson and Wilson;[21] the modern asset mix and small and closely held companies, by Wilson and Wilson;[22] changing patterns of regulation, by MacNeil;[23] and changing patterns of ownership, by Cheffins[24] and Esen.[25]

[16] See, e.g. A Allott, *The Limits of the Law* (London, Butterworth, 1980), v, who put forward what perhaps should have been a self-evident notion—but one which had not previously received much attention, namely the usefulness, uselessness and limits of the law. The issues on which he focused included limits on the effectiveness of law; perceived causes were the different issues applying to permissive and mandatory norms, the lack of monitoring, the lack of awareness of the law, and the lack of fit between laws and their social context.

[17] For further consideration of such problems, see Cheffins, *supra* at n. 6, 199–211.

[18] This limitation on the role of law forms the subject of the article by Armour and Deakin, considered *infra* at p. 21.

[19] See Company Law Review Steering Group, *supra* at n. 14, paras 2.10–2.19.

[20] *Infra* at p. 53.

[21] *Infra* at p. 211.

[22] *Ibid.*

[23] See *infra* at pp. 125–7.

[24] *Infra* at p. 71.

[25] *Infra* at p. 91.

2. Where law may be unnecessary: the role of social norms

The study of norms has long contributed to understandings of jurisprudence: hence, for Kelsen, the law consisted of norms[26] and it was necessary to seek to find the basic norm to which legal norms could be traced.[27] Other norms existed in so far as the state did not prohibit them.[28] The study of these other norms—social norms—has been valuable in areas such as the law of contract where it has demonstrated divergences in parties' behaviour from that which might be expected from legal analysis. In economic analysis, social norms may be consistent (or inconsistent) with the achievement of economic efficiency. They can be seen as evolving towards efficiency when they co-ordinate the behaviour of parties in long-term relationships and when the effects of the norms do not spill over to other people.[29] In fact, formal rules may make up a small (though very important) part of the constraints that shape economic choices,[30] and both social norms and formal rules make up the *institutions* that shape human interaction.[31] Yet there has been little research into the way in which social norms arise and their stability. A number of the articles in this issue comment on the importance of social norms.

Armour and Deakin, in their article "Norms in Private Insolvency: The 'London Approach' to the Resolution of Financial Distress", show how the traditional view of law as possessing a price-like character has been supplemented by two alternative views: that social norms may bypass or substitute for the effect of law on behaviour; and that the effect of law may be indirect at best, depending on subtle interactions with embedded norms.[32] They argue that the debate on corporate insolvency has been deficient in the assumption that parties' incentives will be shaped by legal enforcement mechanisms and that, in contrast, the role of social norms in regulating insolvency processes should be incorporated. They test their argument by an analysis of the "London Approach", an informal framework to enable the rescue of companies in financial difficulties, which has attracted much recent academic interest. The methodology adopted involved 14 open-ended interviews with practitioners with experience in large, public company debt restructuring. They find that private norms may substitute for publicly supplied legal rules in this context. However, there are some interesting *caveats* to these

26 See H Kelsen, "The Pure Theory of Law" (1934–35), cited in MDA Freeman (ed.), *Lloyd's Introduction to Jurisprudence* (London, Sweet & Maxwell, 1994), 291–2.

27 *Ibid.*, 301.

28 *Ibid.*, 290.

29 See, e.g. R Cooter and T Ulen, *Law and Economics* (Reading, MA, Addison-Wesley, 1999), 422.

30 DC North, *Institutions, Institutional Change and Economic Performance* (Cambridge, Cambridge University Press, 1990), 36.

31 *Ibid.*, 4. See also JC Coffee, "Do Norms Matter?: A Cross-Country Examination of the Private Benefits of Control", Columbia Law School Center for Law and Economic Studies Working Paper No. 183 (January 2000); available online at <http://papers.ssrn.com/paper.taf?abstract_id=257613>.

32 *Infra* at p. 21.

conclusions. First, it appears that the existence of legal procedures in the shadows plays an important role in underpinning the stability of the observed norms. Secondly, the private norms in question came into being through a seeding process whereby a state institution, here the Bank of England, led their generation in a small, relatively homogenous group of actors. Thirdly, there is a risk that a reverse process might take place. Shifts in the composition of a population of agents could destabilise a body of norms which had previously been widespread and generally adhered to.

Cheffins' article, "Law, Economics and the UK's System of Corporate Governance: Lessons from History",[33] additionally provides some support for the concept that social norms may matter. He examines the historical development of corporate governance in the United Kingdom as a way to evaluate the theoretical basis advanced for corporate governance in the United States: what is often referred to as the "Berle-Means corporation". One of three theories for the development of such corporations in the United States he traces is the "law matters" thesis, according to which such corporations evolved because common law jurisdictions were more supportive of minority shareholders. The "law matters" thesis is discounted because, at the time when such corporations were becoming established, the legal regime had yet to be made more "comfortable" for minority shareholders, although extra-legal factors, notably the role of the Stock Exchange and financial intermediaries, might well have performed this role.

Contrasting perspectives on the role, and significance, of social norms are provided by other articles in this issue. Wilson and Wilson argue that social norms theory will struggle to balance the complexities of the world against the need to provide a rigorous analytical framework, so that the possibility of a third way between neo-classical economics and social norms theory may remain elusive.[34] MacNeil observes that norms which at some point in the past emerged as efficient solutions to particular problems may have retained their normative quality, but may no longer be efficient because of changed circumstances, suggesting, as an explanation, the problem of path dependency.[35]

3. When law may be harmful: its impact on entrepreneurialism

In so far as reliance is placed upon the generation and maintenance of social norms, the law is seen as benign and, perhaps actually or potentially, unnecessary. However, the law may be positively harmful in efficiency terms if it serves to undermine the incentives of the economic actors concerned.[36] This question has become of considerable importance in the debate over how entrepreneurship

33 Which is considered further *infra* at p. 13.
34 See *infra* at p. 232.
35 See *infra* at p. 135.
36 See Cheffins, *supra* at n. 6, 171–4.

should be encouraged and how the law should respond to business failure.[37] From an economic perspective, problem-solving in society may be encouraged by the law encouraging the maximum number of experimental trials: since it is inevitable that in such a trial situation there will be some failures, attention must turn to how the law responds to those failures.

In their article, "Responsible Risk-takers: Notions of Directorial Responsibility—Past, Present and Future", Wilson and Wilson focus on "New Labour" claims that economic efficiency in the United Kingdom is being hindered by a failure to innovate which is, in turn, linked to a widespread fear of risk-taking and business failure.[38] Accordingly, they conduct an historical investigation into how these cultural attitudes may have emerged. In particular, they identify the fraud trials of the mid-to-late-nineteenth century as especially significant. The reason for this is the way in which the parties' personal repute, social standing and honour were treated in the courtroom. In doing so, they demonstrate how the fear of failure which these trials generated, instead of being difficult to reconcile with a social culture which greeted success with unease, shared common origins. Law reform which sought to distinguish moral culpability for business failure was received with little enthusiasm, not just in criminal trials but also in the bankruptcy regime which sought to introduce three classes of certificate of conformity on this basis. Wilson and Wilson conclude that these failed because of the complexity of the issues, the lack of clear benchmarks and the sheer difficulty of mapping morality, law and commerce.[39]

Bradley, in her article "Enterprise and Entrepreneurship: The Impact of Director Disqualification", employs a comparison of US and UK legal mechanisms with very similar conclusions.[40] She compares how both jurisdictions have public systems for prohibiting directors from acting with a view to protecting the public. However, in the United States the power derives from federal securities regulation, applies only to investors and is intended to protect investors, whereas in the United Kingdom it derives from company and insolvency law, applies to all companies, and additionally serves to protect creditors. Accordingly, in the United States it is usually the market which will decide whether an entrepreneur can start a new venture, whereas in the United Kingdom less faith is placed in the market, even though both approaches may have similar effects. However, attitudes to risk are not static and, in the United States, bankruptcy law tends to be moving in a less pro-debtor direction, whereas in the United Kingdom the limitation of

[37] See, e.g. the speech by the Rt Hon Stephen Byers MP, Secretary of State for Trade and Industry, to the Mansion House (2 February 1999), available at <http://www.dti.gov.uk/Minspeech/byers 020299.htm>, and Foreword by the Rt Hon Gordon Brown MP, Chancellor of the Exchequer, and the Rt Hon Stephen Byers MP, Secretary of State for Trade and Industry, in "Fostering Enterprise: the American Experience", Report of the UK–US Conference on Entrepeneurship (2 July 1999).

[38] *Infra* at p. 211.

[39] See *infra* at pp. 230–31.

[40] See *infra* at pp. 68–9.

liability is being encouraged. Nonetheless, Bradley urges caution in encouraging courts to distinguish between honest and respectable business people and rogues, as otherwise this may discourage innovation and entrepreneurship.

4. When law may be inappropriate: its importation to other jurisdictions

The value of the comparative analysis of law has long been recognised in legal scholarship, albeit subject to some substantial qualifications.[41] Similarly, it has been recognised in economic analysis, not least as assumptions in relation to legal rules bear directly on the economic models adopted for both positive and normative purposes.[42] Differences between legal systems play an important role in shaping the institutional constraints which may or may not be consistent with the attainment of economic efficiency and therefore impact on comparative economic performance. This is particularly important in ensuring that economic analysis has a dynamic and not static quality, and has resulted in the extension of concepts such as path dependency. However, there are inherent limitations in this approach, not least that to attempt to conduct such an analysis involves taking into account such a wide range of historical, political, social and other variables that the scope for empirical analysis may be lost in the welter of available data. Nonetheless, the benefits of such an approach are clear, as a number of recent and significant studies by La Porta and others demonstrate.[43] Their work sought explicitly to move away from a focus on one or a few wealthy economies, and instead focus on 49 countries from Europe, North and South America, Africa, Asia and Australia and, in particular, on the rules designed to protect shareholders and creditors, their origins and the quality of their enforcement.

The importance of comparative law is demonstrated in a number of the articles in this issue. Cheffins uses a comparison of the US and UK development of the "Berle-Means corporation" to show how economic theories rooted in an analysis of historical events may be evaluated by applying those same theories to a jurisdiction which is similar as to key variables.[44] MacNeil compares shareholders' pre-emption rights in the United Kingdom and United States.[45] He finds that such rights in the United Kingdom have long been a default rule, despite EU harmonisation elevating them to a statutory status, whereas in the United States

[41] See, e.g. M Van Hoecke and M Warrington, "Legal Cultures and Legal Doctrine: Towards a New Model for Comparative Law" (1998) 47 *ICLQ* 495; and G Samuel, "Comparative Law and Jurisprudence" (1998) 47 *ICLQ* 817.

[42] See, generally, North, *supra* at n. 30, ch. 12.

[43] See R La Porta, F Lopez-de-Silanes, A Scheifer and A Vishny, "Law and Finance" (1998) 106 *Journal of Political Economy* 1113: as a consequence the study was able to demonstrate how common law countries generally have the strongest level of protection and French civil law countries the weakest.

[44] *Infra* at p. 71.

[45] See *infra* at pp. 127–34.

such rights have long been a mandatory rule of common law, but have been downgraded to a default rule because they were no longer regarded as optimal: they limited access to new sources of capital.[46] Bradley contrasts the impact of the UK's regime for disciplining directors of failed companies with the absence of a comparable US regime on the culture of enterprise and entrepreneurship in those countries.

Esen, in her article "Internal Control Within the Legal Structure of UK and German Companies: Prospects for Change", contrasts the way in which UK and German companies' laws have responded to the problems arising out of the principal–agent relationship.[47] She observes the differing concentrations of ownership in UK and German companies, how German companies have been insulated from the pressures of hostile takeovers by a combination of institutional factors, such as extensive cross-shareholding, and how recent changes in German law promise significant change.[48] The legal reforms she discusses were far-reaching, including: the abolition of certain limited voting rights; the introduction of restrictions on bank voting rights where a bank holds shares as a custodian; providing more transparent financial reporting; and enhancing the ability of shareholders to enforce board liability. She argues that these reforms may bring about radical changes in the structure and control of German companies and make investment in German listed companies more attractive both to indigenous and foreign investors. Nevertheless, she cautions that wholesale importation of one system of governance into the other is neither likely nor justified.

C. The boundaries of economic analysis

1. The role of economic efficiency

Central to the economic analysis of law is the controversial concept of economic efficiency. This controversy is primarily ideological in nature,[49] and the approach adopted in a number of the articles in this issue is cautious. Villiers generally argues that economic considerations are relevant, but should not be overestimated because there are other valid considerations.[50] In particular, in analysing disclosure requirements in terms of the efficient capital markets hypothesis, she argues that efficiency-based arguments leave gaps: mandatory disclosure might be necessary, seen through this lens, but it cannot indicate what, when or how relevant information might be disclosed. Wilson and Wilson criticise the way in which neo-classical economic models remove ethical and cultural frameworks

[46] See *infra* at pp. 53–4.
[47] *Infra* at p. 91.
[48] These are the Control and Transparency in Corporate Field Act, the Facilitation of Raising Capital Act and the Shares Without a Nominal Value Act, all of which came into force in 1998.
[49] See, e.g. *supra* at n. 11.
[50] See *infra* at pp. 182–3.

from consideration in the evaluation and reform of corporate law (or indeed any other branch of law). They turn to a brief consideration of the social norms school, considered above, as a possible alternative.[51] However, as MacNeil observes, "The premise is not that efficiency is the only or even necessarily the primary objective which should be pursued in formulating company law, but that it is inevitably an important consideration in any system in which private ordering through the mechanism of contract has a prominent role",[52] later concluding that "the pursuit of objectives other than efficiency will narrow the extent to which company law will be efficient. This is a question of prioritisation of values—it is not possible to have the penny and the bun at the same time".[53]

The ideological concerns as to economic analysis have perhaps served to obscure the need for closer consideration of the limitations of economic analysis. The economic model at its core is an abstract concept and the boundaries of economic analysis therefore tend to be drawn along the lines of the assumptions in that model, with extended models being required. The assumptions, however, clarify the conditions with which such models predict with reasonable accuracy.[54]Three themes emerge from the articles in this issue as to the potential limitations of economic analysis: the role of history in testing economic theory; the oversimplistic nature of some of the language of economic analysis; and the difficulties in applying economic analysis, whether because of the inherent nature of the economic concepts concerned, or because the application of economic concepts leaves gaps.

2. When economic theory is unproven: the role of history

Mark has gone as far as to claim that:[55]

> "While the economistic perspective has altered traditional interpretations of many areas of corporate historiography, nowhere has its effect been both more and, paradoxically, less profound than in our understanding of corporation theory . . . The scholarship is largely ahistorical, both because it seeks to explain contemporary phenomena and because it sees itself as a new development in the history of corporate theory."

The thesis that "history matters" is, however, a significant theme of new institutional economists, such as Williamson, who states, "The entire institutional environment (laws, rules, conventions, norms, etc.) within which the institutions of governance are embedded is the product of history".[56] However, there is little

[51] See *infra* at p. 232.
[52] See *infra* at p. 110.
[53] See *infra* at p. 125.
[54] See M Friedman, "The Methodology of Positive Economics" (reprinted from *Essays in Positive Economics* (Chicago, University of Chicago Press, 1953), 3–43), in Brett, Hochman and Saueracker (eds), *Readings in Micro-economics* (St Louis, MI, Times Mirror/ Mosby, 1986).
[55] GA Mark, "Some Observations on Writing the Legal History of the Corporation in the Age of Theory", in LE Mitchell (ed.), *Progressive Corporate Law* (Boulder, CO, Westview, 1995), 67, 72.
[56] OE Williamson, *The Mechanisms of Governance* (Oxford University Press, 1996), 240.

consensus as to the appropriate basis for the interaction between economic and historical analysis. On the one hand, some attempts to apply economic analysis to law have paid relatively scant attention to the difficult methodological issues presented. Posner, for example, when applying economic theories to primitive societies, pays relatively brief attention to the significant methodological problems this poses.[57] Yet, on the other hand, North has developed the theory of institutional change and sought to apply this across a wide sweep of history.[58] Butler has applied a model of legal-institutional change to company incorporation in the nineteenth century, identifying economic and legal events tending to alter legislators' costs and benefits, and then determining whether the predicted changes occurred.[59] More recent work by Bebchuk and Roe has refined the concept of path dependence, distinguishing between structure-driven and rule-driven sources for path dependence.[60] Such work, however, remains the subject of criticism. The interaction can be questioned on the ground of instrumentality: Mark has recently argued that the rise in the use of historical evidence to support economic theories mirrors the demise in its use to justify political explanations of the company.[61] Mark takes up the methodological issues presented in applying economic analysis to the history of law, arguing for caution as regards its "deeper analytical techniques and assumptions", identifying a number of conflicts relating to: the behavioural assumptions made in economic analysis; the extent to which economic theory relies upon the existence of capital markets given the lack of historic evidence as to the efficiency of those markets; and the extent to which economic theory contradicted other historical explanations.[62] Drawing attention to these factors does not, however, invalidate the application of economic analysis: it simply means that it must be rigorous. One significant problem is that, in a sense, economic efficiency is part of the historical environment: it was observation of particular environments that, in part, led to the development of efficiency concepts. Economic efficiency could itself be seen to be path dependent, until it was

[57] RA Posner, *The Economics of Justice* (Cambridge, MA, Harvard University Press, 1981), 151. He simply anticipated the objection that his analytical categories were drawn from modern economic theory and were therefore ethnocentric, doing violence to the ways in which primitive people thought about their activities and institutions, and responded that the objection could equally be made to economic studies of modern society. Similarly, GM Anderson and RD Tollison, "The Myth of the Corporation as a Creation of the State" (1983) *International Review of Law and Economics* 107, in examining the historical development of the company in England and presenting an efficiency-based argument as to the significance or otherwise of limited liability, did not consider the methodological issues to which this gave rise.

[58] DC North, *Structure and Change in Economic History* (New York, WW Norton & Co., 1981).

[59] HN Butler, "General Incorporation in Nineteenth Century England: Interaction of Common Law and Legislative Processes" (1986) *International Review of Law and Economics* 169.

[60] LA Bebchuk and MJ Roe, "A Theory of Path Dependence in Corporate Ownership and Governance" (1999) 52 *Stanford Law Review* 127.

[61] GA Mark, "The Role of the State in Corporate Law Formation", in F Macmillan (ed.), *International Corporate Law Annual* (Oxford, Hart Publishing, 2000), Vol. 1, ch. 1.

[62] *Ibid.*

defined; thereafter it has, to some extent, been used to shape the institutional framework itself.

A number of the articles in this issue rely, to some extent, on historical analysis. MacNeil traces the historical development of the legal rules governing shareholder pre-emption rights both in the United Kingdom and in the United States from the early nineteenth century onwards.[63] As a consequence, he is able to demonstrate how, in the United Kingdom, the fundamental principles governing such rights remained the same, whilst in the United States a more restrictive approach was rejected, leaving pre-emption rights to be subject to default provisions in both jurisdictions. Villiers uses historical evidence to explain the rationale for the principle of disclosure in company law, citing the famous report of the Gladstone Committee in 1844, and contrasts this with the move to explain disclosure in efficiency terms.[64] She argues that communication theory provides a differing approach to disclosure from the original historic standpoint by seeking to nurture trust and co-operation, rather than emphasise conflict or suspicion.[65]

Cheffins' article criticises the tendency to ignore the historical context of economic analysis.[66] It proceeds to examine the historical development of corporate governance in the United Kingdom as a way of evaluating the theoretical basis advanced for corporate governance in the United States: what is often referred to as the "Berle-Means corporation". Two of the theories (which are by no means mutually exclusive) for the development of such corporations in the United States traced are: (i) the "economic" argument according to which such corporations were inevitable; and (ii) the "historical" argument according to which such corporations were an adaptation reflecting political forces which sought to avoid institutional dominance. The significance of these insights arises from path dependency: if the historical interpretation is correct, then convergence along US lines will not progress substantially in countries which retain political and historical traditions different to the United States. UK companies share a sufficiently common structure to enable a meaningful comparison to be made. Cheffins shows that the economic argument must be treated with caution because it is not clear that companies ever *needed* to adopt US-style governance, or that UK companies suffered from their delay in doing so. He also shows that the historical argument could be discounted because the political conditions for the development of such corporations arguably existed many decades before they were established.

63 See *infra* at pp. 128–33.
64 See *infra* at pp. 181–2.
65 See *infra* at p. 194.
66 See *infra* at pp. 74–5, 78–9, 90.

3. When economic language is too simplistic: the case of the firm

Economic language and, as a consequence, the underlying analysis, can be too simplistic in the way in which it deals with complex concepts. As Veljanovski put it:[67]

> "Economists do, however, have a serious problem of communication. Their treatment of law appears strained because it uses the metaphors and prose of the market-place. Many articles applying economics to law, model by analogy with the market. For example, the economist will talk about the 'supply of and demand for' crime, the penalty as a 'price' to engage in crime, thereby conveying the impression he believes that if criminals are willing to 'pay' an appropriate 'price' they can rape and pillage at will."

The use of the terminology "the firm" in economic literature is one common example of a source of a barrier to interaction. In economic literature the term has been traditionally used at a high level of abstraction to refer generically to production, with apparently scant regard for the real-life distinctions between legally different forms of organisation and their differing economic consequences, which are of critical importance in legal discourse. This should, by now, be perhaps a caricature: as long ago as 1937 Coase acknowledged that "the use of the word 'firm' in economics may be different from the use of the term by the 'plain man' ".[68]

Maughan and McGuinness, in their article "Towards an Economic Theory of the Corporation", examine the nature of the economic firm and the relationship between that concept and the real-life forms of business organisation, primarily proprietorships, partnerships and corporations.[69] They criticise the way in which much economic literature focuses on the generic concept of the firm: not least, they argue, that the implied increase in size from proprietorship to corporation gives a false illusion of a continuum of firms of increasing size when, in reality, the distinction between the various forms is not a function of size but rather of their fundamental legal character.[70] This, in turn, leads to an overly simplistic transaction-cost economics explanation reliant on a generic transaction-cost variable.[71] Maughan and McGuinness see the solution to this problem in the construction of a model which more rigorously links the relevant economic and legal arguments. They argue that a primary economic explanation of the use of corporations is that they are a mechanism for reducing endogenous costs, such as those relating to frequency in transacting. Corporations with limited liability further contribute to the reduction of costs, by ensuring that risks associated with particular types of investment can be quantified and priced into contracts, so that credit markets can operate with greater technical efficiency.

[67] Veljanovski, *supra* at n. 12, 37.
[68] RH Coase, "The Nature of the Firm" (1937) 4 *Economica, New Series* 386.
[69] *Infra* at p. 141.
[70] See *infra* at p. 143.
[71] See *infra* at pp. 144–5.

4. When economic concepts cannot readily be applied: the case of pre-emption rights

The structure of law, in the sense of the functional categorisation of legal rules, falls within the province of jurisprudence. Sadly, perhaps, it is difficult to discern within the traditional approach to the study of jurisprudence the development of a coherent body of principles to analyse and govern this categorisation. Nonetheless, much work has been done towards the categorisation of legal rules.[72] Economic analysis seemingly presents a significant challenge to this work by broadly providing a straightforward categorisation of legal rules and seeking to state which categories may be appropriate in which circumstances and what the consequences of adoption/non-adoption of any particular category might be, through the lens of economic efficiency. For example, Eisenberg categorised the legal rules affecting corporations as "enabling", "suppletory or default", or "mandatory", and sought to develop normative principles to determine which should apply.[73] He concluded his exercise, however, warning that the balance between such rules would, in effect, be difficult to determine since it required the exercise of prudential judgment, informed by economic analysis as well as other factors—not least the limitations of the concepts of market failure and regulatory failure.[74]

MacNeil, in his article "Company Law Rules: An Assessment from the Perspective of Incomplete Contract Theory", reviews the arguments in favour of and against the use of mandatory and default provisions in efficiency terms.[75] He concludes that the balance in company law cannot be determined exclusively by reference to efficiency, or limited to examples of market failure. The test he applies is whether the loss of efficiency is counterbalanced by other considerations ranked above efficiency by society, such as the allocation of power (and therefore wealth) to employees. He identifies a number of difficulties in categorising the complex web of UK company law regulation as mandatory or default provisions and, instead of a comprehensive categorisation, selects the issue of pre-emption rights on the issue of shares in the United Kingdom and United States for detailed scrutiny. Accordingly, economic analysis was problematic when it came to formulating detailed rules, and there were few examples of its practical application. Applying this to the question of pre-emption rights, MacNeil argues that the categorisation of a pre-emption right as mandatory or default might not be of significance because of the way in which the rule was formulated or because the rule might, in effect, operate as mandatory, and, in any event, listing rules were developing into the primary source of mandatory rules as states reallocated rules

72 For a useful summary of the relevant literature on the nature of rules, see W Twining and D Miers, *How To Do Things With Rules* (London, Butterworths, 1991), 439–40.

73 MA Eisenberg, "The Structure of Corporation Law" (1989) 89 *Columbia Law Review* 1461.

74 *Ibid.*, 1524–5.

75 See *infra* at pp. 125, 133–7.

from being mandatory to default. Even if the appropriate boundary could be set between mandatory and default rules, MacNeil argues that there would be difficulties in formulating an efficient default rule. The first (and simplest) would be a "majoritarian default" which represented what most contracting parties would have agreed. The second would be a "penalty default" designed to force parties to disclose information or bear a penalty. In either case the rule could be "strong" or "weak" depending on the extent to which there were obstacles to contracting around the rule. However, there is no simple way of determining which would be appropriate.

5. When economic analysis leaves gaps: the case of disclosure obligations

The Law Commissions' consultation paper, which provided the impetus for the conference from which these articles derive, was concerned with the accountability of company directors. Legal analysis has tended to focus on the contrast between seeking to influence management behaviour by requiring much disclosure, and direct regulation of specific forms of behaviour, even though the theoretical justification for this has been little articulated.[76] Economic analysis has played an important role in providing a theoretical perspective with its analysis by reference to concepts of principal–agent, moral hazard and opportunism, and the evaluation of solutions in terms of categorising incentives, constraints and their costs. Economic analysis, however, is limited by its reference point of economic efficiency. It has little to say on many other issues which are often of considerable importance and therefore may need to be supplemented in such areas.

Villiers, in her article "Disclosure Obligations in Company Law: Bringing Communication Theory into the Fold", focuses on the methodology underpinning disclosure obligations in company law.[77] Criticisms identified of the present system include: the failure of annual reports to address the needs of their users, with information often being excessive in volume, yet weak on environmental or social issues; the emphasis on numbers rather than words; and overly flexible accounting procedures. In economic terms the regime addresses problems such as self-dealing by directors. By redressing the information asymmetry between shareholders and directors, shareholders are encouraged to monitor and participate in management decision-making. Disclosure can be seen as an efficient alternative to substantive regulation. In contrast, Villiers turns to communication theory to provide a way of filling the gaps argued to exist in an efficiency-based approach, observing that assumptions are made about communication by relevant bodies without theoretical justification. Communication theory was developed in a range

[76] See, generally, LS Sealy, *Company Law and Commercial Reality* (London, Sweet & Maxwell, 1984), ch. 2; JH Farrar and BM Hannigan, *Farrar's Company Law* (London, Butterworths, 1998), ch. 29.

[77] *Infra* at p. 181.

of contexts such as mathematics and engineering to advertising and management systems. Key aspects of communication are argued to be the existence of a relationship between sender and receiver which enables messages to be understood, and appropriate or meaningful responses to be made; there is also a normative aspect to communication, whereby communication can be seen as a legitimating mechanism in which affected parties are entitled to participate in the decision-making process. Accordingly, it can be linked to ideas of stakeholder theory, outside the scope of this particular article. Villiers puts forward a number of suggestions that bear on company law reform, based on communication. These include: questioning the current practice of one-to-one meetings for privileged investors; identifying non-shareholder groups with whom there should be communication; giving new investors more background information than long-established investors; accompanying accounts with an explanation of the accounting methods used; use of graphs and other images; repeating information in different ways; and so on. Nonetheless, she recognises the danger that directors may abuse their powers where information can be presented in an alternative way.

D. Conclusions

The nature of company law means that there is an inherent dynamic towards its continual reform to reflect changing commercial practices and social expectations. The basis for such reform is, however, unclear, and there are strong arguments that economic analysis should play an important role. The conference from which the articles in this issue are derived sought to explore the boundaries both of company law reform and of economic analysis. What this highlighted were the difficulties of weighting various theories, the tensions between which can readily be seen from the labels attached to them: economic analysis as an "imperial" discipline; the "institutions matter" thesis; the "law matters" thesis; the "history matters" thesis; and the "social norms school". If everything "matters", is it possible to produce any meaningful abstract theoretical perspective? The answer suggested by the articles in this issue is that it is indeed possible. Instead of law and economics being a discrete form of perspective analysis, we find that there are complex interactions between the law, economics, institutions, politics, history, social norms and other theoretical perspectives, rather than these merely being, to paraphrase Calabresi, different views of the same cathedral. They provide a fruitful source of insight on the ways in which company law might be reformed.

The boundaries of company law reform explored demonstrate the importance of company law in shaping the social norms which might be consistent or inconsistent with the attainment of economic efficiency. Accordingly, Armour and Deakin's analysis of the informal "London Approach" to corporate rescue, demonstrates that it is the existence of legal procedures in the shadows which perform an important role in underpinning the stability of the observed norms, which are consistent with economic efficiency. However, in contrast, Cheffins casts doubt on the role of law in protecting minority shareholders in the development of the "Berle-Means corporation" in the United Kingdom, emphasising instead extra-legal factors. Wilson and Wilson, and Bradley, go further and show how the law can provide a framework which is positively inconsistent with the attainment of economic efficiency by undermining the incentives of potential entrepreneurs with ill-thought-out (but well-meaning) bankruptcy and disqualification regimes. The importance of the law in shaping social norms which are consistent or inconsistent with economic efficiency could result in the importation of inappropriate examples of law from other jurisdictions. Esen, based on a comparison of recent reforms in UK and German regulation bearing on corporate governance, sounds a note of caution, arguing that the mechanics of the different corporate governance systems were shaped by local economic, financial and social factors, and therefore wholesale importation of one system into another was inappropriate. This, in turn, points to the need for research to be focused on these complex points of interaction.

The boundaries of economic analysis demonstrate the limitations of its abstract theoretical base. Academic debate in the United Kingdom has tended to be directed towards the ideological roots of economic analysis, rather than exploring the limitations inherent in the nature of any such theory and how the theory might be refined. These limitations can be seen from the problems in testing the application of economic theory to historic events, the oversimplistic conceptual language adopted in economic literature, and the difficulties inherent in seeking to utilise economic analysis as a detailed guide for the development of specific rules. Accordingly, Cheffins questions the economic arguments for the inevitability of the "Berle-Means corporation" in the United States, pointing to the significance of political factors. Maughan and McGuinness demonstrate the inadequacies of the use of the economic concept of "the firm", and the need for the construction of a more refined economic model to explain the corporation. MacNeil and Villiers both show the problems of applying economic analysis in particular situations—in the case of shareholders' pre-emption rights because of the difficulties in formulating an efficient default rule—and in the case of disclosure because of the difficulties in formulating a practical model for good communication based on efficiency criteria. In each case, it is important to establish exactly what may be expected from economic analysis, and when and how it is necessary to go beyond it.

These conclusions have important ramifications for research into company law and the company law reform process itself. The article by Maughan and McGuinness presents an important challenge for legal policy making in the area of company law. If their argument is correct, and if economic efficiency is to be an important goal of company law reform, then the role of legislation in this area should be to ensure that the role of the limited liability corporation in reducing the costs of multiple contracting and in credit markets should be strengthened by company law. Furthermore, the implications of this argument are wider than company law since they extend to the general legal environment in which corporations function, which should, in turn, be free from laws which would undermine the reduction of costs in multiple contracting and force businesses into technically inefficient alternative structures. The article by Armour and Deakin should demonstrate to legislators the power that regulation has to provide the support for the generation of social norms which are valuable in efficiency terms and therefore to broader issues of economic performance. However, the articles by Bradley, and Wilson and Wilson, should caution legislators on the dangers of well-meaning legislation seeking to foster social norms, which might nonetheless have unpredicted and adverse effects, such as upon entrepreneurship. However, these conclusions also show the need for legislators to be aware of the limitations of economic analysis. As the contributions by MacNeil, Villiers, and Wilson and Wilson demonstrate, economic efficiency need not be the only factor to motivate the efforts of legislators in this area, so long as they are aware of the costs in paying regard to alternative goals. MacNeil and Villiers also demonstrate the difficulties posed in seeking to apply the abstract theoretical model of economic analysis to the detailed drafting of legislation.

Finally, it is perhaps worthwhile reflecting on the recent question posed by Epstein:[78]

> "Our discipline is no longer nourished by huge advances outside its own field. Familiar doctrinal issues are exhausted . . . So where do we go? . . . There are vast areas of historical and social activity that would repay close study . . . How this programme will play out is anyone's guess, which is why the future of the field is so hard to predict . . . But given the vast array of social experiments, both past and future left to analyse, perhaps such a modest program will yield larger dividends than we sceptics may have guessed."

[78] RA Epstein, "Law and Economics: Its Glorious Past and Cloudy Future" (1999) 64 *University of Chicago Law Review* 1167, 1174.