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## **The Economics of Corporation Law and Securities Regulation, edited by Posner and Scott**

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# BOOK REVIEW

THE ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION. Edited by Richard A. Posner and Kenneth E. Scott. Boston and Toronto: Little, Brown & Co., 1980. Pp. x, 384.

*Reviewed by Larry E. Ribstein\* and C. Paul Rogers\*\**

*The Economics of Corporate Law and Securities Regulation* represents an ambitious attempt to provide—in a compact, accessible format—a fairly comprehensive sampler of economic thinking about corporations and corporate law. Not surprisingly, questions of economic efficiency permeate most of the book's selections. Wealth maximization appears to raise two related inquiries in the corporate context. First, do corporations generally behave in a wealth maximizing manner and second, does the law encourage or retard efficient corporate conduct? The readings raise these questions and systematically suggest answers by focusing on the various aspects of corporate conduct.

## I.

Organized into four sections, the book begins with an excerpt from Coase's *The Nature of the Firm*,<sup>1</sup> an essay that introduces the corporation in its economic context as a type of "firm." The second chapter provides an introduction to those economic forces that affect corporate managers. The chapter emphasizes that although, as Berle and Means concluded,<sup>2</sup> shareholders may not con-

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This Book Review evolved from an informal discussion group on the economics of corporate law held throughout the spring semester, 1981, at the Southern Methodist University Law School. Group participants included the reviewers, Alan Bromberg, Joseph Norton, and Peter Winship. The reviewers owe a debt of gratitude to the group participants; however all opinions, views, errors, and omissions are attributable to the reviewers alone.

1. THE ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION 3-7 (R. Posner & K. Scott eds. 1980) (quoting Coase, *The Nature of the Firm*, 4 *Economica* (n.s.) 386 (1937)).

2. See A. BERLE & G. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

trol directly corporate managers in public corporations, market forces operate to align management with the profit-maximization goals of shareholders. This theme continues into the third chapter dealing with corporate social responsibility: the same market constraints that unify management and shareholders' interests also limit the extent to which management can and should make decisions that benefit society.

The next section of the book deals with various specific aspects of market restraints on management. Chapter Four presents the debate about whether permitting states to compete in setting corporation management rules harms shareholders or whether market forces operate to produce efficient fiduciary standards. Chapter Five examines insider trading to determine if market forces operate to prevent insiders from realizing gains that may be unfair to investors or to the corporations whose stock is being traded on inside information. The chapter also considers the effect of insider trading regulations.

The last two chapters of the second section examine the market itself. Chapter Six deals with the efficient market hypothesis and its corollary, the portfolio theory of investment. After presenting the theory that the market accurately values corporate stocks, the book in Chapter Seven examines the hypothesis that the corporate control market disciplines inefficient management by permitting firms to retain new controllers who can increase the firm's value. The excerpts in this chapter consider the extent to which gains may be achieved through acquisition, and the extent to which transaction costs and regulations limit these gains and, therefore, inhibit the acquisition market.

The book's third section deals with creditors' interests. Chapter Eight presents the Modigliani and Miller thesis<sup>3</sup> that a firm cannot reap a financial advantage solely because of its decision to adopt a particular capital structure, and Chapter Nine presents the analogous thesis that a firm cannot reap a market advantage solely because of a dividend policy. Other excerpts in the chapter critically analyze and qualify these theories. A central point emerges from the selections: Market forces protect creditors as well as shareholders.

The final section examines federal securities regulation. Chap-

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3. See Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261-97 (1958); Modigliani & Miller, *Dividend Policy, Growth, and the Valuation of Shares*, 34 J. BUS. 411-33 (1961).

ter Ten considers the appropriate role of disclosure regulations in light of market forces that encourage accurate disclosure. Chapter Eleven presents studies by Stigler and Benston on the performance of the Securities and Exchange Commission and critiques of these studies by Irwin Friend and others.

## II.

To evaluate this book as a teaching tool one must consider several questions. First, of what value is an economic analysis of law? Second, should one consider economics in a corporations or securities law course? Third, does this book offer a worthwhile approach to bringing economics into the corporate law curriculum? Last, how well has this approach been executed in the book?

It may be a bit late to ponder the value of an economic analysis of the law. Economic legal theorists are both extending and deepening the thinking about economics' role in facilitating an understanding of law.<sup>4</sup> This new thinking encompasses broad nonmarket areas of the law, including privacy,<sup>5</sup> criminal law,<sup>6</sup> and constitutional law.<sup>7</sup> In addition, scholars now are attempting to transcend the descriptive or "positive" focus of the analysis—arguing that the law develops in accordance with economic principles such as the desire of individuals in society to maximize their wealth—and articulate a "normative" theory of economic legal analysis—arguing that the legal system should be founded upon economic principles such as wealth maximization.<sup>8</sup> Indeed,

4. See, e.g., W. HIRSCH, *LAW AND ECONOMICS* (1979); *Symposium—Change in the Common Law: Legal and Economic Perspectives*, 9 J. LEGAL STUD. 189-427 (1980); *Symposium on Efficiency as a Legal Concern*, 8 HOFSTRA L. REV. 485-770 (1980); *A Response to the Efficiency Symposium*, 8 HOFSTRA L. REV. 811-972 (1980).

5. *The Law and Economics of Privacy*, 9 J. LEGAL STUD. 621-842 (1980); Posner, *The Right of Privacy*, 12 GA. L. REV. 393 (1978); Posner, *Privacy, Secrecy, and Reputation*, 28 BUFFALO L. REV. 1 (1979).

6. See, e.g., W. HIRSCH, *supra* note 4, at 200-12; Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968); Polinsky, *Private Versus Public Enforcement of Fines*, 9 J. LEGAL STUD. 105 (1980); Posner, *Retribution and Related Concepts of Punishment*, 9 J. LEGAL STUD. 71 (1980).

7. See R. POSNER, *ECONOMIC ANALYSIS OF LAW* 497-552 (2d ed. 1977); Coase, *The Market for Goods and the Market for Ideas*, 64 AM. ECON. REV. PAPERS & PROC. 384 (1974); Michelman, *Constitutions, Statutes, and the Theory of Efficient Adjudication*, 9 J. LEGAL STUD. 431 (1980); Posner, *The DeFunis Case and the Constitutionality of Preferential Treatment of Racial Minorities*, 1974 SUP. CT. REV. 1.

8. See, e.g., Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 HOFSTRA L. REV. 487 (1980); Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. LEGAL STUD. 103 (1979). But see Dworkin, *Is Wealth a Value?*, 9 J. LEGAL STUD. 191 (1980); Kronman, *Wealth Maximization as a Normative Principle*, 9 J.

the economic approach to law has taken on the trappings of a new and competing jurisprudential philosophy.<sup>9</sup>

The inherent persuasiveness of an economic analysis of law provides a sound basis for all this scholarly proselytizing. Samuel Butler recognized this persuasiveness more than a century ago when he referred to certain rebels in Erewhon society.

But the main argument on which they rely is that of economy: for they know that they will sooner gain their end by appealing to men's pockets, in which they have generally something of their own, than to their heads, which contain for the most part little but borrowed or stolen property; and also, they believe it to be the readiest test and the one which has most to show for itself. If a course of conduct can be shown to cost a country less, and this by no dishonourable saving and with no indirectly increased expenditure in other ways, they hold that it requires a good deal to upset the arguments in favour of its being adopted.<sup>10</sup>

The value of an economic analysis of law is not, however, universally acknowledged. Legal education traditionally has emphasized the complexity of our legal system. The notion that such an intricate order of rules, obligations, freedoms, limitations, and procedures can be reduced to a central guiding principle is anathema to the way American lawyers have been trained to think about the law.<sup>11</sup> Furthermore, lawyers who are taught not to accept a contention at face value must be shown why the law is efficient before they will believe that it does in fact have that attribute,<sup>12</sup> particularly since wealth maximization as a standard for conflict resolution strikes many as both intuitively unappealing and logically troublesome. It is difficult to accept the idea that judges—who presumably possess noneconomic characteristics of fairness, wisdom, impartiality, compassion, insight, and skill—decide cases simply to achieve the most efficient result even when they have had no training that enables them competently to discern the most efficient re-

LEGAL STUD. 227 (1980); Rizzo, *The Mirage of Efficiency*, 8 HOFSTRA L. REV. 641 (1980).

9. Posner has recently written that "the positive economic theory has the cardinal virtue of being the only positive theory of the common law that is in contention at this time." Posner, *Some Uses and Abuses of Economics in Law*, 46 U. CHI. L. REV. 281, 294 (1979) (footnote omitted). See also Horwitz, *Law and Economics: Science or Politics?*, 8 HOFSTRA L. REV. 905 (1980); Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757 (1975).

10. S. BUTLER, *EREWHON* 147-48 (new ed. 1933).

11. See, e.g., Leff, *Law and*, 87 YALE L.J. 989, 1010-11 (1978); Michelman, *Norms and Normativity in the Economic Theory of Law*, 62 MINN. L. REV. 1015, 1044-47 (1978).

12. For theoretical arguments addressing the *why* proposition, see Goodman, *An Economic Theory of the Evolution of Common Law*, 7 J. LEGAL STUD. 393 (1978); Priest, *The Common Law Process and the Selection of Efficient Rules*, 6 J. LEGAL STUD. 65 (1977); Rubin, *Why Is the Common Law Efficient?*, 6 J. LEGAL STUD. 51 (1977).

sult.<sup>13</sup> The increasing normative bent of some positivistic legal economic writers probably contributes to the antireductionist skepticism.<sup>14</sup>

Legal economists, however, increasingly are responding to the skeptical and the diffident. They are seeking to make their theories more palatable by demonstrating both that efficiency is not inconsistent with other deeply held societal values and that, in an adversary system, wealth maximization for society as a whole may be an appropriate goal in dispute resolution.<sup>15</sup> On the other hand, some scholars are fashioning increasingly sophisticated and convincing arguments to refute the positive notion of efficiency.<sup>16</sup>

### III.

In order to accept the relevance of economics to corporate law, however, one need not view economic theory as the sole guiding principle to understanding our legal system. Just as the law of contracts concerns bargained-for exchanges of economic value,<sup>17</sup> the law of corporations concerns firm transactions, whether conducted internally or externally, that have financial consequences. Corporate law—a specialized form of commercial law—arguably ought to have an economic conscience.

Economic theory is not only a useful tool for analysis of corporation and securities law, but it enhances the corporations curriculum for pedagogical reasons. The judicial opinions students must study in this area often are little more than bundles of facts tied together with metaphorical ribbons. An economic analysis offers the student possible explanations for results in cases that are not adequately justified by the opinions themselves. For example, such explanations are helpful in cases dealing with areas like piercing the corporate veil, subordination, and unintentional partnership.

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13. See, e.g., Michelman, *A Comment on Some Uses and Abuses of Economics and Law*, 46 U. CHI. L. REV. 307, 311 (1979). See generally Baker, *The Ideology of the Economic Analysis of Law*, 5 PHILOSOPHY & PUB. AFF. 3 (1975); Markovits, *Legal Analysis and the Economic Analysis of Allocative Efficiency*, 8 HOFSTRA L. REV. 811 (1980); Schwartz, *Economics, Wealth Distribution, and Justice*, 1979 WIS. L. REV. 799.

14. See authorities cited note 8 *supra*.

15. *Id.*

16. See, e.g., Kennedy, *Cost-Benefit Analysis of Entitlement Problems: A Critique*, 33 STAN. L. REV. 387 (1981); Kennedy & Michelman, *Are Property and Contract Efficient?*, 8 HOFSTRA L. REV. 711 (1980); Rizzo, *supra* note 8. See also Kronman, *Contract Law and Distributive Justice*, 89 YALE L.J. 472 (1980).

17. Exchanges like this have been described as "quintessentially economic." THE ECONOMICS OF CONTRACT LAW 1 (A. Kronman & R. Posner eds. 1979).

Also, the availability of economic analysis as a criterion encourages students to assess critically the results of cases rather than to accept blindly the courts' metaphors. Robert Rabin noted that traditional law school courses treat "rules of law . . . as if they have the same self-contained quality as those governing basketball or chess."<sup>18</sup> Finally, a collection of supplementary readings is particularly appropriate for courses taken by second and third year law students. Little justification exists for immersing these students exclusively in appellate decisions, and a steady diet of cases produces boredom.

Of course, one must not expect too much of economic analysis. The discipline does not provide a neat, clear theory with which to wholly order and concretize corporate law concepts. The Posner and Scott readings show that significant controversy still surrounds the economic consequences of the Berle and Means hypothesis of separation of ownership and control, the causes and effects of corporate growth by acquisition, and the economic underpinnings of perfect capital markets. The effect pure economic incentives have on many facets of corporate conduct simply is not clear.

#### IV.

Although economic analysis may prove a valuable supplement in corporate law courses, some question exists whether the Posner and Scott book presents the proper medium for incorporating this discipline into the curriculum. First, the book's general approach is suspect because the readings are limited to materials from economics literature. The preface explains that "this focus is virtually dictated, in the present instance, by the sheer volume of the relevant economic literature."<sup>19</sup> Even if the materials could not have been presented more succinctly, however, the important question is whether a reader devoted exclusively to economics is a useful supplement to the already-crowded courses on corporations and securities.<sup>20</sup> Moreover, the danger exists that students will be seduced into ignoring the limited degree to which economic theory can provide answers to corporate law questions.<sup>21</sup>

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18. Rabin, *Preface to PERSPECTIVES ON TORT LAW* at x (R. Rabin ed. 1976).

19. Posner & Scott, *Preface to ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION*, *supra* note 1, at ix.

20. The tradeoff of course coverage for additional reading is ultimately a personal choice. But an economic reader may not present the supplementary breadth that many traditionalists seek and may thus, in many instances, color the personal choice negatively.

21. Rabin's *Perspectives on Tort Law* presents an instructive comparison. *PERSPEC-*

Assuming for the moment that one accepts the general value of a reader limited to the economics of corporations and securities, more particular problems exist with the Posner and Scott book. For example, even if the editors choose to exclude a presentation of alternate perspectives, the student should be informed through an introductory chapter of both the existence of these other perspectives and the general nature and limitations of economic theory. The student who opens this book in hopes of answering the question "What is economics?" is confronted only with "The Theory of the Firm." The book therefore disorients the student at a time when it should be spurring interest in the material. And if the theory of the firm must begin the specifically economic-oriented readings (since it is the cornerstone of an economic analysis of corporate law) a general introduction could have preceded the firm material.

Another problem with the book's approach is that the excerpts have been inadequately related to those legal issues dominating the typical corporations course. In general, the book's editors seem more concerned with the economics of corporations and securities than with the economics of corporation law and securities regulation. For example, the readings begin with a debate between Coase and Knight as to the theory of the firm<sup>22</sup> and, specifically, the significance of the pure profit concept. There is not a word to help the student understand how all this bears on corporate law. The same criticism could be made of Chapter Two, "The Economics of the Corporate Firm"; Chapter Six, "Modern Finance Theory and the Efficient Market Hypothesis"; Chapter Eight, "Capital Structures" (with the exception of the excerpt from Posner's *The Rights*

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TIVES ON TORT LAW, *supra* note 18. In that book, economic theory competes with moral and historical perspectives. Although there may not be as wide a selection of such writings from which to choose in the corporate area, there is a sufficient quantity to comprise an interesting reader. A notable example of a noneconomic perspective on corporate law can be found in Clark, *The Duties of the Corporate Debtor to its Creditors*, 90 HARV. L. REV. 505 (1977). It should be pointed out that the economic focus may present a problem with respect to other readers. ECONOMIC ANALYSIS AND ANTITRUST LAW (T. Calvani & J. Siegfried eds. 1979); ECONOMIC FOUNDATIONS OF PROPERTY LAW (B. Ackerman ed. 1975); THE ECONOMICS OF CONTRACT LAW, *supra* note 17. See also Rogers, Book Review, 93 HARV. L. REV. 1039, 1044 (1980) (reviewing THE ECONOMICS OF CONTRACT LAW, *supra* note 17). Of course, antitrust law may not be subject to this criticism, since in that field the economic impact of conduct to a great extent determines the legal norm which is applied. See, e.g., Morgan, Book Review, 33 VAND. L. REV. 1523, 1524 (1980) (reviewing ECONOMIC ANALYSIS AND ANTITRUST LAW, *supra*).

22. ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION, *supra* note 1, at 3-9 (quoting excerpts from Coase, *supra* note 1; Knight, *Profit and Entrepreneurial Functions*, 2 J. ECON. HIST. 126 (1942)).

of *Creditors of Affiliated Corporations*);<sup>23</sup> and Chapter Nine, "Dividend Policy." The law student who is confronting this material for the first time needs some guidance in considering the relevance to the law of corporations of market efficiency or the effect on a firm's value of its capital structure or dividend policy.

This difficulty is noteworthy particularly because it exacerbates the defects that plague many of the casebooks the Posner and Scott book would supplement. Because the average law student lacks a basic understanding of business, the traditional case approach to legal studies tends to make the corporations course more tedious and less valuable than it could be. Students need a bridge from the abstractions of appellate opinions to the real world. This bridge could be provided both by contextual notes describing the business setting and by problems illustrating how the legal problems studied in the course actually arise. The Posner and Scott book does not lend itself to this approach, since it takes the student deeply into the realm of theory instead of helping students connect corporate law to the business world.

One could easily link directly the economic analysis and the legal issues examined in corporations and securities courses. In the Brudney and Chirelstein casebook,<sup>24</sup> for example, materials on the portfolio theory and efficient markets are followed by a section entitled "Legal Implications of Efficient Market Theory."<sup>25</sup> This approach permits the student to use economic analysis in formulating solutions to the practical problems arising in connection with particular legal issues.

Within their present format the editors could have used the notes and questions that follow each chapter to tie more clearly economics to law. Their notes and questions, however, are primarily concerned with further developing the economic issues raised in the selected readings. There are exceptions. For example, the editors ask whether, in view of the writings on dividends, a court should concern itself with a firm's dividend policy.<sup>26</sup> More questions like this would have enhanced the book's worth both contex-

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23. Posner, *The Rights of Creditors of Affiliated Corporations*, 43 U. CHI. L. REV. 499 (1976).

24. V. BRUDNEY & M. CHIRELSTEIN, *CORPORATE FINANCE: CASES AND MATERIALS* (2d ed. 1979).

25. *Id.* at 1143-1235.

26. *ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION*, *supra* note 1, at 314. For other examples, see *id.* at 111-17 (quoting excerpts from Dyer, *An Essay on Federalism in Private Actions Under Rule 10b-5*, 1976 UTAH L. REV. 7; S. Peck & J. Udinsky, *Tender Offers and Two-Step Acquisitions* 342-45 (1978) (unpublished)).

tually and pragmatically.

An additional problem arises from the very nature of the excerpts themselves. Most originally were written for an audience well versed in economics and already familiar with the terminology and the issues addressed. Thus, the law student frequently is confronted with explanations he or she may find unintelligible and, therefore, not particularly enlightening. For example, consider the following excerpt:

1. *The Efficient Markets/Rational Explanations Hypothesis*. . .

Fama formalizes the efficient markets model by stipulating that deviations of returns to asset  $i$ ,  $\hat{R}_{it}$ , from their equilibrium expected values,  $E(\hat{R}_{it} / \Phi_{t-1})$ , conditional on the information set available at time  $t-1$ ,  $\Phi_{t-1}$ , are not systematically different from zero. In other words, the "fair game" variable,

$$\Sigma_{it} = \hat{R}_{it} - E(\hat{R}_{it} / \Phi_{t-1})$$

has a mean of zero. Given some economic model of equilibrium expected returns to assets, which might incorporate risk premia, term premia, or other differences among assets, market efficiency can be tested by examining the statistical properties of the fair game variable,  $\Sigma_{it}$ .<sup>27</sup>

Quantitative material can be made intelligible and interesting to law students by presenting it in textual, summary form and in excerpts from less technical articles. The Brudney and Chirelstein<sup>28</sup> and Klein<sup>29</sup> texts demonstrate this worthwhile approach. Of course, these texts may sacrifice some precision in the presentation of the theories and ideas, but students must be given an opportunity to become familiar with these difficult concepts before they can be expected to manipulate them with technical dexterity.

In fairness one should note that the book does a good job of developing corporate economics. For example, Chapter Two presents an interesting set of variations on the theme of the relationship between the firm's economic structure and management behavior. The first four excerpts in Chapter Eight and the three excerpts in Chapter Nine develop the effects of capital structure and dividend policy on firm value by presenting a progression of papers, beginning with seminal works by Modigliani and Miller<sup>30</sup> and continuing with related and responsive papers. Chapter Eleven

27. *Id.* at 186-87 (quoting Schwert, Working Paper No. GPB78-7, Center for Research in Government Policy and Business, Graduate School of Management, University of Rochester).

28. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 24.

29. W. KLEIN, *BUSINESS ORGANIZATION AND FINANCE* (1980).

30. See Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, *supra* note 3; Modigliani & Miller, *Dividend Policy, Growth, and the Valuation of Shares*, *supra* note 3.

includes lively debates on the Stigler and Benston evaluations of the effects of federal securities regulation.<sup>31</sup> Additionally, each chapter includes an introductory section that clearly and concisely ties together the chapter as well as the entire book.

The Posner and Scott book does not deliver on its promise to provide suitable supplementary reading for a corporations course. Those who wish to bring economics into the course would do better to assign either the Klein<sup>32</sup> or the Brudney and Chirelstein<sup>33</sup> books discussed above. Those who wish to supplement the course with excerpts from the literature would do better to prepare their own balanced set of materials. Yet, since the book does a good job of presenting the economics of corporations and securities, it is, however, a suitable text for a seminar limited to that specific subject.

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31. ECONOMICS OF CORPORATION LAW AND SECURITIES REGULATION, *supra* note 1, at 346-80.

32. W. KLEIN, *supra* note 29.

33. V. BRUDNEY & M. CHIRELSTEIN, *supra* note 24.