

CONTRACTARIANISM WITHOUT CONTRACTS: A RESPONSE TO PROFESSOR McCHESNEY

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Even the most casual inspection of the rules of corporation law reveals that these rules take three forms—enabling, suppletory, and mandatory. Enabling rules give legal effect to private rules that corporate actors adopt in a specified manner. Suppletory (or default) rules govern defined issues unless corporate actors adopt other rules in a specified manner. Mandatory rules govern defined issues in a manner that cannot be varied by corporate actors.

In an article entitled *The Structure of Corporation Law*, which appeared in a recent symposium issue of the *Columbia Law Review*,¹ I addressed the issue, what accounts for the partly enabling, partly suppletory, and partly mandatory structure of corporation law? To this end, I distinguished between various kinds of corporation-law rules according to not only their form, but also their subject matter. *Structural* rules govern the allocation of decisionmaking power and control within the corporation, and the flow of corporate information. *Distributional* rules govern the distribution of assets (including earnings) to shareholders. *Fiduciary* rules govern the duties of managers and controlling shareholders. By the use of economic principles, I showed that in the case of closely held corporations, structural and distributional rules should be and largely are enabling or suppletory, while fiduciary rules should be and largely are mandatory.² In contrast, in corporations that are publicly held or are about to go public, mandatory legal rules should and largely do govern both those core fiduciary and those core structural areas in which the interests of shareholders and top managers may materially diverge.³

Professor Fred McChesney was asked to comment on my symposium article. In fact, however, much of Professor McChesney's comment was addressed not to my symposium article, but to another article that I wrote six years ago,⁴ to a book that I wrote fourteen years ago,⁵ and even to my preliminary drafts. More important, throughout his comment Professor McChesney seriously misstated the positions taken in both my symposium article and my earlier work.

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1. Eisenberg, *The Structure of Corporation Law*, 89 Colum. L. Rev. 1461 (1989) [hereinafter *Structure of Corporation Law*].

2. *Id.* at 1463-70.

3. *Id.* at 1471-1515.

4. Eisenberg, *New Modes of Discourse in the Corporate Law Literature*, 52 Geo. Wash. L. Rev. 582 (1984) [hereinafter *New Modes of Discourse*].

5. M. Eisenberg, *The Structure of the Corporation: A Legal Analysis* (1976).

I will not attempt to respond to all of Professor McChesney's points, most of which the reader can evaluate. Rather, I will focus here on only three areas. First, Part I will identify some basic assumptions that underlie Professor McChesney's piece but lack any empirical support. Next, Part II will set the factual record straight by pointing out some of the ways in which Professor McChesney seriously misstated my positions. Finally, Part III will address Professor McChesney's criticisms of my position that corporate law should have not only enabling and suppletory but also mandatory elements. Since Professor McChesney restricted himself to the issues raised by publicly held corporations (as opposed to closely held corporations or corporations that are about to go public), I will do the same.

I.

Professor McChesney considers himself a "contractarian." His interest is almost exclusively with the normative. Of course, there is nothing wrong with that, in itself. At least in corporate law, however, normative prescriptions must be grounded in the teachings of experience about the corporate institution. Unfortunately, Professor McChesney mistakes his own normative views on that question for positive facts. For example, Professor McChesney thinks that the corporation-in-fact is a "'nexus of contracts.'"⁶ That is a lovely intellectual construction, but it has no contact with experience. In the real world of fact, a publicly held corporation is an enterprise of persons and assets organized by *rules*, the great bulk of which are noncontractual. Most of the rules by which a corporation is constituted are determined by the unilateral action of corporate organs or officials. Some of these rules are determined by market forces. Some are determined by law. Some, but only a fraction, are determined by contract. Moreover, the constitutive rules of the corporation would remain largely noncontractual even if all legal rules were enabling or suppletory, because the unilaterally determined nature of most constitutive rules does not stem so much from law as from the sociology of complex organizations in general, and the economic characteristics of publicly held corporations in particular.⁷

Professor McChesney is also a radical reformer. In the real world, publicly held corporations are governed by a mix of enabling, suppletory, and mandatory rules. In Professor McChesney's normative world, however, mandatory rules would be abolished. He tells us that corporate law should do no more than provide standard-form, off-the-shelf language that the parties are free to vary.

6. McChesney, *Economics, Law, and Science in the Corporate Field: A Critique of Eisenberg*, 89 *Colum. L. Rev.* 1530, 1534 n.13 (1989).

7. On the latter issue, see Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1471-1505.

Under the contractarian view, the law should never override the preferences of the parties stated affirmatively in their contracts (absent fraud, duress, or some other common-law defense). Any standard-form term supplied by the law must be an option that parties can use if they want, but which they are free to contract around if they prefer.⁸

In short, Professor McChesney would replace the current law of corporate governance with a radical new approach that has no basis in experience. Ironically, Professor McChesney criticizes me on the ground that I "compare[] imperfect contractual arrangements as they actually exist with a governmental regime that is assumed to be perfect and costless. This is the familiar 'nirvana fallacy' often used by academic lawyers."⁹ In fact, however, it is Professor McChesney (an academic lawyer) who seeks to jettison the present regime of corporate law and replace it with his own nirvana. For example, Professor McChesney quotes my symposium article for the structural rules that I believe should be mandatory in publicly held corporations:

One set of mandatory structural rules should provide for the appointment and monitoring of senior executives by a governing organ (that is, a board of directors) that is elected by shareholders for a limited term of office, a majority of which is composed of members who are independent of the senior executives. A second set should require periodic disclosure of detailed financial data and information concerning material business and legal developments and should provide for institutional mechanisms to ensure that the financial data is reliable. A third set should concern the approval of, and dissent from, transactions that tend to raise positional conflicts. . . . A final set of mandatory structural rules should protect the integrity of shareholder voting.

. . . .
... [T]he core structural rules should require mechanisms for accountability and disclosure for top executives, shareholder approval of certain transactions, and appraisal rights for certain transactions, but they should not regulate the content of corporate transactions.¹⁰

Because most of these mandatory rules are now in place, it is hardly the case that I am comparing "imperfect contractual arrangements as they actually exist with a governmental regime that is assumed to be perfect and costless."¹¹ Rather, I am, for the most part, explaining why the legal regime that now exists does exist. It is Professor McChesney who argues for a nirvana of a wholly contractual corporation that has no roots in reality, and a wholly contractarian legal regime that has no em-

8. McChesney, *supra* note 6, at 1536.

9. *Id.* at 1531.

10. *Id.* at 1534 (quoting Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1480-81).

11. *Id.* at 1531.

pirical support, and who does not even begin to justify this radical program by a detailed comparison of the costs and benefits of his novel and untested contractarian regime with the costs and benefits of the present and relatively successful mixed regime.

One who proposes wholly to overthrow a complex existing and relatively successful regime of law, and replace it with a radically different regime, is under an obligation to demonstrate the advantages of the new regime by an appeal to experience. Professor McChesney never fulfills this obligation, apparently because he has so internalized his own norms that he believes them to be not simply norms but self-evident facts. In particular, he so confidently believes that market regimes are invariably better than mandatory legal rules that he makes no attempt to provide experiential support for that conclusion. As Harold Demsetz has pointed out, however, the "nirvana fallacy" is committed not only by those who argue for mandatory legal rules by comparing ideal rules with real markets, but also by those who argue against mandatory legal rules by comparing real rules with ideal markets.¹² Pure contractarians do not even do that much: Their assumption of the invariable superiority of markets is so deeply rooted that they do not even realize it is only an assumption.

II.

Professor McChesney not only mistakes his own norms for self-evident facts; he also mistakes his own economic views for the entire field of economics. Professor McChesney believes there is only one legitimate kind of economic analysis in corporate law—the analysis he thinks of as contractarianism. Any competing economic analysis is not simply wrong; it is simply not economics. So, for example, Professor McChesney states that "Eisenberg squarely opposes the *economic* or 'contractarian' notion of the role of corporate law."¹³ And again: "*Professing* himself willing in principle to accept a role for economics in analyzing corporate law, [Eisenberg] nevertheless has consistently criticized contractarians whose economic models lead to conclusions opposed to his . . ."¹⁴

It is perhaps this vision of the one path that prevented Professor McChesney from reading what I have actually written and led him to misstate a number of my positions. For example, Professor McChesney refers to an article I wrote in 1984, *New Modes of Discourse in the Corporate Law Literature*,¹⁵ and says that in this article, and in *The Structure of Corporation Law* itself, I object "to what [Eisenberg] has called the 'new mode of discourse' that economic analysis brings to the study of corporate

12. Demsetz, *Information and Efficiency: Another Viewpoint*, 12 J.L. & Econ. 1, 1 (1969).

13. McChesney, *supra* note 6, at 1534 (emphasis added).

14. *Id.* at 1530 (emphasis added).

15. Eisenberg, *New Modes of Discourse*, *supra* note 4.

law.”¹⁶ In fact, however, I have never criticized the use of economic analysis in law, and have often used it in my own scholarship. I did criticize two new modes of discourse in my 1984 article, but neither could be confused with economics. Rather, I criticized discourse that took the form of attacks based on either *ad hominem* criticism or shoddy methodology:

Within the last ten years or so . . . a newer style of discourse has emerged in response to proposals to modernize corporate law. This new style has two modes. Both employ the form of scholarly discourse, but the techniques of political debate. The first mode criticizes proposals on the basis of their supposed provenance, rather than addressing the merits of the proposal itself. The second mode offers criticism that purports to be based on data generated by rigorous quantitative analysis, but in fact is based on conclusory statements that are unsupported by any reliable data.¹⁷

Indeed, since *The Structure of Corporation Law* is based very largely on economic principles,¹⁸ when Professor McChesney states that I object to economic analysis it can only be because in his view nothing except contractarianism constitutes economic analysis.

In a similar vein, Professor McChesney says that in *New Modes of Discourse* I criticized the use of econometric methodologies in corporate law: “Eisenberg has criticized this methodological aspect of the economic mode of discourse. He claims that it ‘purports to be based on data generated by rigorous quantitative analysis, but in fact is based on conclusory statements that are unsupported by any reliable data.’”¹⁹ Here too Professor McChesney misstates my position, by coupling an incomplete quotation and an inaccurate paraphrase. What I actually called into question was not the use of econometric methodology in corporate law, but “criticism that *purports* to be based on data generated by rigorous quantitative analysis, but in fact is based on conclusory statements that are unsupported by any reliable data.”²⁰ I have never criticized the use of econometric methodology in corporate law, and indeed both *The Structure of the Corporation* and *The Structure of Corporation Law* rely heavily on statistical data.²¹ What I criticized in *New Modes of Discourse* was not econometric methodology, but shoddy methodology.

A parallel and equally serious misstatement of my position is that “[l]egal rules, [Eisenberg] says, should be based not on ‘quantitative data’ but on ‘traditional empirical sources of law, such as practical ob-

16. McChesney, *supra* note 6, at 1530.

17. Eisenberg, *New Modes of Discourse*, *supra* note 4, at 582.

18. See Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1471–80, 1488–1524.

19. McChesney, *supra* note 6, at 1539 (quoting Eisenberg, *New Modes of Discourse*, *supra* note 4, at 582).

20. Eisenberg, *New Modes of Discourse*, *supra* note 4, at 582 (emphasis added).

21. See Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1489–97, 1518.

servation of corporate operations.' ”²² Here too the reference is to *New Modes of Discourse*, and here too I have never taken the position Professor McChesney attributes to me. Again, Professor McChesney couples an inaccurate paraphrase with an incomplete quote. Here is what I actually said:

The proposals in the ALI Project draw on traditional empirical sources of law, such as practical observation of corporate operations, data collected by various institutions concerning corporate practice . . . and widespread (although not universal) perceptions concerning the reasonable expectations of investors, the way to preserve public confidence in corporate governance, and what constitutes fairness. The burden is not on the ALI to justify drawing on these traditional sources of empirical evidence, but on those who claim that statistically significant quantitative data is not simply a useful tool but an indispensable condition to the justification of law.²³

In short, what I said in *New Modes* was not that quantitative data should be ignored, but that in the absence of dispositive quantitative data that meets the test of statistical significance—which is the best data we can get, but which is seldom available—other empirical sources can and must be taken into account.

Another misstatement of my views concerns the structure of the legal rules that should govern publicly held corporations. According to Professor McChesney, my position is that these rules should be mandatory whenever the interests of top managers and shareholders “‘may diverge.’ ”²⁴ He then criticizes this position:

[S]hareholder and senior managerial interests “may diverge” in every realm of corporate governance. As a strictly logical matter, therefore, the seemingly circumscribed general principle actually leaves no area in which mandatory rules would not strip from shareholders the ability to control their own relations with top management.²⁵

Any position on what elements of corporation law should be mandatory for publicly held corporations must necessarily be general, and it is therefore correct that the principle I develop is general. What is not correct is Professor McChesney’s statement of that position—that rules should be mandatory whenever the interests of top managers and shareholders “may diverge.” Rather, my position is that “in publicly held corporations, mandatory legal rules should govern those core fiduciary and structural areas in which the interests of shareholders and top managers may materially diverge.”²⁶ Note the deliberate omission

22. McChesney, *supra* note 6, at 1540 (quoting Eisenberg, *New Modes of Discourse*, *supra* note 4, at 593).

23. Eisenberg, *New Modes of Discourse*, *supra* note 4, at 593.

24. McChesney, *supra* note 6, at 1533.

25. *Id.*

26. Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1480.

of distributional rules,²⁷ and the important qualifiers "core" and "materially." Furthermore, the meaning of those terms, as I use them in *The Structure of Corporation Law*, is fleshed out in that article by an enumeration of specific core areas and a discussion of some of the principles that should determine when even in those areas a mandatory rule should be subject to variation.²⁸

Professor McChesney also misstates my views on managerial motivation. At one point, Professor McChesney quotes the following passage in my article:

In the real world, positional conflicts are much more important than either shirking or traditional conflicts of interest. Most top managers will probably refrain from shirking simply because their self-esteem is tied to hard work and accomplishment. Most top managers will probably refrain from unfair self-dealing simply because they have internalized the rules of social morality.²⁹

He then criticizes this passage on the ground that these statements are not empirically supported.³⁰ But only a few pages before criticizing me for saying most top managers will probably refrain from shirking and unfair self-dealing, he claims I say that managers will indulge heavily in such activities:

At the same time, Eisenberg says, "[t]op managers have both the self-interest and the power to install constitutive rules that will efficiently determine the roles, coordination, supervision, and monitoring of lower corporate agents and constrain those agents from giving expression to their own interests in preference to the interests of the shareholders." But why? Monitoring lower management that otherwise would shirk is not costless to a top manager, since (in Eisenberg's world) he could be using that time to cheat shareholders at personal profit to himself. Time spent monitoring is time not spent on the golf course or running one's own business on the side,

27. Correspondingly, in quoting the passage in which I set out the rules that should be mandatory for publicly held corporations, see *supra* text accompanying note 10, Professor McChesney omits the sentence that immediately follows the material he quotes: "Because mandatory rules generally should not regulate the content of transactions, distributional rules should generally be enabling, except as required to protect the interests of creditors." *Id.* at 1481.

28. The principal core fiduciary rules are those that require directors, officers and controlling shareholders to act in good faith, to deal fairly when they transact with the corporation, and not to make improper use of their positions or of corporate property, information or opportunities. The structural areas that should be governed by mandatory rules are set out in *Structure of Corporation Law*, *supra* note 1, at 1480-81, and recapitulated in this Reponse, *supra* text accompanying note 10.

Some principles concerning when variations in core rules should be permissible, together with examples, are set out in *Structure of Corporation Law*, *supra*, at 1470.

29. McChesney, *supra* note 6, at 1539.

30. *Id.*

rather than making money for shareholders.³¹

And again: "In [Eisenberg's] world, corporate managers are venal people" ³²

In still another misstatement of my position, Professor McChesney says, "Eisenberg has at the last minute appended a paragraph accusing contractarians . . . of believing markets are perfect ('heavenly')." ³³ Actually, however, I said just the opposite:

Commentators who stress the Nirvana Fallacy are almost invariably themselves guilty of a mirror-image mistake which might be called the Heavenly Market Fallacy. This is the erroneous belief that because regulation is imperfect, any market, *no matter how terribly flawed*, is heavenly, and therefore to be preferred to a mandatory legal rule. ³⁴

I could go on with this list, but the point should by now be clear. Professor McChesney says near the beginning of his piece that "[i]t is possible that I am misunderstanding Eisenberg's arguments." ³⁵ The supposition is well founded.

III.

The heart of my position in *The Structure of Corporation Law*, as concerns publicly held corporations, is based on two principles. The first principle is that because top managers of publicly held corporations have an inadequate incentive to adopt rules that put constraints on their own positions, the core fiduciary and structural rules that govern material divergences of interest of top managers in publicly held corporations should be neither determined nor subject to material variation by the action of managers or managerial organs. ³⁶

The second principle is that normally these rules also should not be subject to determination or material variation even with shareholder approval. Allowing these rules to be determined or materially varied on the basis of shareholder approval would effectively undercut the first principle because, under current law and practice, shareholder consent to rules proposed by top managers in publicly held corporations may be either nominal, tainted by a conflict of interest, coerced or impoverished. ³⁷

These two principles are not anticontractarian. No one could reasonably call a rule set by top managers a contract, and given the limits on shareholder consent, no one could reasonably call every rule to

31. *Id.* at 1533.

32. *Id.* at 1545.

33. *Id.*

34. Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1525 (emphasis added).

35. McChesney, *supra* note 6, at 1531.

36. Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1473-74.

37. *Id.* at 1474.

which shareholders consent a contract. As concerns publicly held corporations, Professor McChesney's position consists of contractarianism without contracts.

There is, however, a noncontractarian argument that can be made against my position: that even though top managers and shareholders may have a material conflict of interest concerning the core fiduciary and structural rules that might be made for a corporation by its managers after it has gone public, and even though those rules are not contracts, market forces other than contract so adequately align the interests of top managers and shareholders, and so adequately address the problem of managerial inefficiency, that mandatory legal rules to address these issues are unnecessary and indeed undesirable. In Part II.E of my article, I review each of the market forces that might be argued to do this job, and show in detail why none will do so adequately.³⁸ (I do not argue that market forces are unimportant; only that taken alone they are inadequate to do the job, just as, taken alone, mandatory legal rules would be inadequate to do the job.) Professor McChesney does not come out flatly to explain why, despite their severe limitations, these markets are adequate to do the job. Rather, he makes several arguments that nibble around the edges of my position.

One argument is that I do not define what constitutes an "adequate" market. However, I did not, as this criticism suggests, use the term "adequate" as an absolute status, like perfection or imperfection. Rather, I used the term in connection with the question whether a given market is likely to achieve the end claimed to be served. The question, I said, is whether "market forces so adequately align the interests of top managers and shareholders and so adequately address the problem of managerial inefficiency that mandatory legal rules to address these issues are unnecessary and indeed undesirable."³⁹ Given this use of the term, its definition is of course the same as in such standard contexts as whether a tool or a technique is adequate to the purpose at hand, and the complaint that a definition is lacking is wholly inapt. Of course, a case-by-case evaluation of the limits of each market and the limits of each mandatory rule is required, but that is a matter of examination of the relevant facts, not a matter of further definition.

Another argument made by Professor McChesney is that I am selective in drawing upon quantitative data to show that the relevant markets are inadequate to the task:

Eisenberg's readers should also be alerted to his selectivity in reviewing the empirical evidence. He cites only a smattering of the many studies done, the relatively few that favor his position. Readers genuinely interested in a complete picture of the evidence would do better to consult a full review of the

38. McChesney, *supra* note 6, at 1542.

39. Eisenberg, *Structure of Corporation Law*, *supra* note 1, at 1488.

relevant literature.⁴⁰

Of course, any citation to the literature of corporate finance must necessarily be "selective" in the sense that it is not global. In fact, however, I do cite many studies on both sides of the issues. Even more important, a primary source of the quantitative data that I rely on is a paper by Jensen and Murphy that does contain "a full review of the relevant literature";⁴¹ and anyone who knows the work of Jensen and Murphy knows that they are not predisposed to mandatory legal rules.

Finally, Professor McChesney argues that:

An important part of the contractarian position relies on the so-called economic theory of regulation. That theory observes that politicians and regulators ordinarily have less incentive to do what is in the public interest than to work as brokers for special interests seeking to profit at the expense of the public as a whole. In other words, political bodies make politically motivated decisions, not the altruistic ones that Eisenberg promises.⁴²

Although Professor McChesney states that "the economic model of regulation" has been "corroborated" by "hundreds of empirical studies,"⁴³ this statement must be seriously qualified. Many empirical studies have indeed shown that particular statutes have the effect of creating quasi-monopolies that yield rents to interest groups. However, it is widely recognized that the model explains only certain kinds of legislation, not all legislation: the empirical studies of agencies and legislation have shown a wide variety of behavior, both cross-sectionally among different lawmakers and over time for the same lawmakers.⁴⁴

I shall, however, put this aside, because the essential point is that Professor McChesney's argument here is virtually irrelevant to my position. Professor McChesney's argument on this point can be paraphrased as follows: Eisenberg's position is that corporation law should be thrown to the legislature. However, legislatures work on behalf of special interests, not the public as a whole. Throwing corporation law to the legislature, would therefore produce bad results.

That, however, is not my position. My position is that, for economic reasons, certain specific kinds of legal rules, which I identify, should be, and for the most part are, mandatory. That position is not addressed by a theory about what a hypothetical legislature would hypothetically do if given the hypothetical chance. Rather, that position can be addressed only by showing in detail why the specific rules I have

40. McChesney, *supra* note 6, at 1540 n.38.

41. *Id.*

42. *Id.* at 1544.

43. *Id.* at 1545.

44. See, e.g., Wilson, *The Politics of Regulation*, in *Social Responsibility and the Business Predicament* 185 (J. McKie ed. 1974); Farber & Frickey, *The Jurisprudence of Public Choice*, 65 *Tex. L. Rev.* 873, 873-901 (1987).

identified should not be mandatory; why the mandatory rules that have already been adopted should be abolished; why severely limited markets would nevertheless somehow be adequate to do the job now done at least in part by mandatory rules; and why the obvious cost of giving managers the power to determine the rules that govern material positional and traditional conflicts would somehow be exceeded by the benefits of a legal regime that did just that.

This is a task the pure contractarians refuse to undertake. No matter how much quantitative data and other empirical support is advanced to show that a market would be inadequate to achieve a given end, the pure contractarian's answer is always the same: the existing mandatory rule is worse. That may be so in any given case. It may be so even if a market is very defective. But whether or not it is so can only be determined on the facts of each case. In *The Structure of Corporation Law* I showed, on the basis of empirical evidence, that positional conflicts—conflicts based on the manager's interest in maintaining and enhancing his position even at the shareholders' expense—are not adequately constrained by either shareholder consent or relevant markets. If contractarians could show by empirical evidence that in any given area an existing mandatory legal rule is, nevertheless, a more costly way to control divergencies of interest than is leaving the matter to managerial self-interest and the relevant market, then of course the mandatory rule should be either abolished or converted to a default rule. Rather than making such fact-based arguments, however, the pure contractarians, like law school teachers of another era, "pursue an inspirational combined with a logical method, that is, the postulates are taken for granted upon authority without inquiry into their worth, and then logic is used as the only tool to develop the results."⁴⁵ The brute fact is that contractarian theory can have no meaningful application to an institution, like the publicly held corporation, that is essentially non-contractual in nature.

45. O.W. Holmes, *Law in Science and Science in Law*, in *Collected Legal Papers* 238 (1920).