Book Reviews
Comptes rendus

Company Law: Theory, Structure and Operation.

By B.R. CHEFFINS.
Oxford: Clarendon Press, 1997. Pp. 727.

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Using the principles and concepts of economics to explain legal rules has become increasingly common in the discourse of legal academics but in no area has it achieved the dominant position it has as in corporate law.[1] This approach is most developed in the United States and, after more than a decade of extensive academic writing, it is beginning to be used as an analytical tool by American courts.[2] In Canada, an economic perspective is commonly used in law review articles on corporate law[3] and in the most popular case books used for teaching the subject.[4] To date, however, there has been no Canadian textbook on corporate law which uses economics as its primary analytical model.[5]

In this context, one may be somewhat disappointed that Brian Cheffins, a leading Canadian corporate law academic, has chosen to write a text based on this approach which is directed to an English audience. To be sure he draws on his expertise in Canadian law and Canadian references are featured prominently in the footnotes but his book seeks to explain the English model corporate statute, which is now significantly different from the corporate statutes in most Canadian jurisdictions. Having said that, there is much to be learned by Canadian lawyers from Professor Cheffins's work.

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[1] S. Bainbridge, "Community and Statism: A Conservative Critique of Progressive Corporate Law Scholarship" (1997) 42 Cornell L.R. 856. In this essay reviewing a collection of papers written by progressive corporate law academics critical of much law and economics scholarship, Professor Bainbridge states that the academic war over the most effective analytical approach to the analysis of corporate law is over, noting that even the opponents of main stream economic analysis use its methodology and insights in their critiques.

[2] *E.g. Credit Lyonnais Bank Nederland N.V.* v. *Pathe Communications Corp.* (1992), 17 Del. J. of Corp. L.1049 (Ch.).

[3] *E.g.* R. J. Daniels, J. G. MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime" (1991) 29 Osgoode Hall L.J. 863.

[4] J.S. Ziegel, *et al.*, *Cases and Materials on Partnerships and Canadian Business Corporations*, 3d ed, (Toronto: Carswell, 1994); F.H. Buckley, *et al.*, *Corporations: Principles and Policies*, 3d ed., (Toronto: Emond Montgomery, 1995).

[5] There are several American books which do so. One of the leading examples is F.H. Easterbrook, D.R. Fischel, *The Economic Structure of Corporate Law* (Boston: Harvard University Press, 1991).

In part this is because Professor Cheffins's purpose is not to provide a comprehensive presentation of corporate law rules in the manner of most conventional corporate law texts. Instead, he provides an accessible overview of what economic theory has to say about the nature of the corporation and the relationships between those with a stake in it: shareholders, directors, managers, creditors, employees. He then applies this conceptual framework to discuss two sorts of issues. First, he examines the structure of corporate law itself, looking at the nature of corporate law rules and the institutions which are involved in their operation including courts and regulators. Second, he turns his attention to selected topical problems, such as the role of independent directors in corporate governance.

In his overview, Cheffins outlines the basic features of law and economics analysis in a manner which will be easily accessible to lawyers and business people without any background in economics. The initial premise is that people act in a rational way to maximize their self interest. If this is so, people can improve their welfare by exchanging what they have for something that they prefer. Indeed, rational actors will only enter into transactions in which both sides are made better off in this way. Private exchanges of this kind are efficient in the language of economists because through such exchanges resources in society will be transferred to persons who value them most highly. In other words, they will lead to an allocation of resources which is efficient. Government intervention in the form of legal rules is needed only where some constraint, such as inadequate information or excessive costs associated with negotiation, prevent such free market exchanges. The goal of any intervention should be to impose the outcome that bargaining would have reached unencumbered by such constraints.[6] From this analytical starting point, Cheffins develops a searching reconsideration of corporate law rules.

Legal economists characterize all relationships between corporate stakeholders as the outcome of bargaining. Even though some of these relationships are not contractual in a legal sense, such as those between shareholders and managers, they are all voluntary. All stakeholders, including shareholders and managers, make decisions to participate and to cease to participate in the corporation and have more or less scope to negotiate the terms of their participation.[7] The law and economics approach focuses on this aspect of stakeholder relationships in assessing the impact and desirability of corporate law rules governing stakeholder participation. In essence, it asks whether a corporate law rule is needed to arrive at an economically efficient result or whether the stakeholders affected are likely to negotiate such a result themselves. Answering this question involves a close examination of the incentives encouraging stakeholders to negotiate for what will make them better off in particular circumstances and the barriers which prevent them doing so.

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[6] This is referred to by Cheffins and other legal economists as the "hypothetical bargaining" model. See 264-307.

[7] Legal economists refer to this as the "nexus of contracts" conception of the corporation (at 31-46).

The law and economics approach is concerned as well with the impact of market exchanges on third party stakeholders. If, for example, the market place threat that shareholders will sell their shares to a takeover bidder hostile to management is an effective inducement to managers to ensure that they will manage the corporation effectively, the need for corporate law rules designed to achieve the same objective will be reduced. A key element of this approach is testing hypotheses regarding the operation of markets against the available empirical evidence.

Cheffins is an advocate of the law and economics approach and does not rehearse the many criticisms which have been levelled at it. Nevertheless, a strength of his book, as compared to other law and economics works, is the attention he pays to the limits of economic analysis and the care he takes to acknowledge non-economic justifications for corporate law rules such as values like fairness, the protection of community ideals and so on.[8] Also he has also taken pains to avoid the abstruse theoretical discussions characteristic of some economic analysis. Throughout he illustrates his analysis with useful practical examples of corporate law doctrine and current events in the business world.[9]

In considering the structure of corporate law from an economic perspective, the author examines both the nature of corporate law rules and the institutional setting in which corporate law operates. Consistent with most law and economics scholarship, he characterizes corporate rules as mandatory, meaning imposing requirements for behaviour, presumptive, meaning the participants may waive them, and permissive, meaning they enable participants to do something, such as incorporate. As might be suspected, like most law and economics scholars, Cheffins favours presumptive and permissive rules over mandatory ones because they allow parties to decide for themselves what corporate structure they want. Nevertheless he thoroughly canvasses the advantages and disadvantages of all three types. The debate on the relative merits of mandatory versus presumptive and permissive rules is highly relevant to how Canadian corporate law is evolving and so Cheffins's analysis of these issues should be of substantial interest to a Canadian audience.[10]

With respect to institutions, Cheffins tackles the role of the judiciary and the litigation process in the development of corporate law, the regulatory structures of corporate law in the United Kingdom and the relationship between United Kingdom company law and the European Union, each in separate chapters. In a marked departure from most other works, Cheffins does not simply describe these institutions but analyses the dynamics of how they operate with a view to ascertaining what role they really play in the operation of corporate law. In this

[8] At 142-62.

[9] *E.g.* at 140, 181, 558.

[10] One of the major reforms of the Canada Business Corporations Act, R.S.C. 1985, c. C-44, was to move away from mandatory rules in favour of presumptive and permissive rules in many areas. The desirability of further movements in this direction is an issue in the current reform of that legislation.

section of the book, for example, Cheffins argues that businesses should be able to choose freely the jurisdiction in which they will incorporate because such freedom creates incentives for officials to keep the corporate laws in their jurisdictions up to date and attractive to business. Only by doing so will they receive the incorporation fee and tax revenues payable by locally incorporated corporations. Cheffins also considers the prospects for the United Kingdom to compete for incorporation business against other European Union jurisdictions.

It has been suggested that there is evidence of such competition between Canadian jurisdictions and some have argued in favour of competition, rejecting the traditional goal of national corporate law uniformity.[11] In the context of the current reform process, Industry Canada has expressed a desire to ensure that the CBCA is designed to be competitive with other jurisdictions.[12] In the United States, critics have suggested that competition for incorporation business will lead to a "race to the bottom" as jurisdictions seek to enact legislation which is attractive to the managers who effectively make decisions about incorporation and changes in jurisdiction at the expense of all other corporate stakeholders.[13] Cheffins's work provides some useful insights into the controversy over such competition.

In the final section of the book, Professor Cheffins discusses several critical operational issues, including, the appropriateness of shareholder remedies rules, the manner in which corporate law rules should deal with creditors and employees and the need for new rules governing the role of independent directors and executive compensation. In dealing with each of these areas, Cheffins provides an overview of the issues, describes the existing legal rules and then evaluates them, looking at both the desirability and practical prospects of changing them.

Some of these issues are more directly relevant to a Canadian audience than others. While the extensive discussion of worker ownership may be thought to be a European preoccupation, his discussions of the need for independent directors and excessive management compensation speak directly to current Canadian concerns and on these issues Professor Cheffins' analysis is provocative. For example, he is very sceptical regarding the need for legal requirements for independent directors to ensure that the board of directors is a more effective monitor of management. He casts doubt on the need for more effective monitoring, referring to the various market based mechanisms which ensure

[11] R.J. Daniels, "Should Provinces Compete? The Case for a Competitive Corporate Law Market" (1991) 36 McGill L.J. 130. J.G. MacIntosh expresses some concerns regarding Professor Daniel's analysis in "The Role of Interjurisdictional Competition in Shaping Canadian Corporate Law: A Second Look", (1996) University of Toronto Law and Economics Working Paper No. 49. National corporate law uniformity is an express goal of the Canada Business Corporations Act (s. 4).

[12] *E.g.* Industry Canada, "Financial Assistance and Related Provisions" (Canada Business Corporations Act Discussion Paper) (Ottawa: Industry Canada, 1996) at 22-24.

[13] R.S. Karmel, "Is it Time for a Federal Corporation Law?" (1991) 57 Brooklyn L. Rev. 55; L.A. Bebchuk, "Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law" (1992) 105 Harvard L.Rev. 1437.

that management will be accountable. He argues that management's fear of losing its reputation, the threat of takeover bids and other market mechanisms are likely to be more effective in ensuring that management acts to maximize shareholder value than requiring more independent directors on the board.[14] This analysis challenges directly the need for legal reform to enhance the independence of directors from management, a key recommendation in recent reform initiatives.[15]

Regarding management compensation, Professor Cheffins presents a thoughtful critique of currently popular schemes to align management interests with those of shareholders by tying management compensation to share price.[16] He points to the inadequacy of share price as a proxy for management performance. He also suggests many reasons to doubt the efficacy of proposals to control excessive management compensation.[17]

Overall, Professor Cheffins has produced a useful contribution to the study of corporate law which speaks to many Canadian concerns, notwithstanding that is, essentially, a book about English company law. Although the Canadian corporate law in most jurisdictions now is based on the American rather than the English model, many of the older English cases discussed by Cheffins continue to be cited frequently in Canadian courts and Cheffins treatment of them is instructive. Of course, many of the issues arising in corporate law are the same in both countries. Indeed, one of the most interesting features of the book from a Canadian point of view is the discussion of how similar problems have been addressed in different ways in the United Kingdom.[18] In this regard, Cheffins's work is a useful counterpoint to United States economic analysis based on features of American capital markets which do not exist in Canada.[19]

Of greatest utility to the Canadian reader, however, is his introduction to law and economics and its application to corporate law issues. In his Preface, Professor Cheffins suggests that if the economic analysis of corporate law may analogized to a chess game, his book is not definitive but provides the first 50 moves. Undoubtedly, he is too modest. While other academic writing in the area does more fully analyse some of the issues he addresses, this book is not just an introductory work. It is an accessible and engaging account of corporate law in the United Kingdom which delivers a range of penetrating insights into the broader context in which corporate law and policy is made and the impact which law has on corporate activity.

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[14] At 651.

[15] The role played by independent directors in Canada was criticized in the *Report of the Toronto Stock Exchange Committee on Corporate Governance in Canada: Where Were the Directors?* (Toronto: Toronto Stock Exchange, 1994) and new policies were recommended to enhance the independence of the board from management.

[16] At 680-85.

[17] At 678-708.

[18] *E.g.* the Company Directors Disqualification Act 1986 (U.K.), 1986, c. 46, sets standards for the fitness of directors. There is no analogous legislation in Canada.

[19] Daniels, *supra* note 3.

A Legal History of Scotland. The Eighteenth Century.

By DAVID M. WALKER.

Edinburgh: T. & T. Clark, 1998. Pp. xxi, 878 (£ 105.00).

Reviewed by M.H. Ogilvie*

Whether the fact that Scotland, like England, ceased to exist as an independent, sovereign country, recognized as such in international law, at the beginning of the eighteenth century, was significant for the future course of its peoples and their law, is a matter on which Professor David M. Walker, in the newly published fifth volume of his *A Legal History of Scotland*, expresses no doubt. It did. In his view, it was drawn too close to England but whether and why this was for the worst, or would have happened had sovereignty been retained, is not stated. However, Professor Walker is too learned a scholar and too good a lawyer to allow his evident nationalism to overtake or undermine his narrative account and analysis of the law and legal system in eighteenth century Scotland in the fifth volume of this prodigious series. Like the predecessor four volumes — published in 1988, 1990, 1995 and 1996 — this volume of close to 1,000 pages is yet further testimony to its author's industry and comprehension of Scots law and the production of five large volumes in a decade is all the more remarkable in light of Professor Walker's production of new editions of several of his other books during the same period. Volume five matches the previous volumes in scholarship, observation and utility as the definitive historical study of the history of Scots law to date, and, undoubtedly, for some time to come.

In organization and structure, this volume replicates the pattern and sequence of topics in the previous four volumes, largely chapter by chapter: general historical introduction to the period; government, both central and local; the church; sources of law and legal literature; legal profession; and substantive law and procedure (criminal and private).

The defining event of the century for law and the defining event in the life of the Scottish nation was the Treaty of Union with England which took effect on May 1, 1707, whereby both countries ceased to exist and the new, sovereign state of the United Kingdom came into existence. In chapter four, Professor Walker carefully sets out the negotiations which preceded the Treaty and equally carefully analyzes the true legal nature of the Union, emphasizing how legally erroneous is the widely-held belief that Scotland merged to become an inferior part of England. Rather, the course of the negotiations, the terms of the Treaty and the pre-Treaty legislation of both the Scots and the English Parliaments, respectively, clearly demonstrate that the Union was the product

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of a freely negotiated international treaty of two sovereign states. How the English then proceeded to undermine the legal significance of how the Treaty was framed constitutes the principle theme of much of the rest of the book and of Professor Walker's ire.

Chapter four is the most succinct and (for Canadian readers) accessible account of the legal nature of the Union in 1707 known to this reviewer and for these reasons constitutes a counterpoint for Canadian legal readers to the largely inaccurate reports in the Canadian press about the legal nature of the pending constitutional reforms in the United Kingdom. It is also the pivotal chapter in the volume. The succeeding twenty-six chapters are to a greater or lesser extent about the impact of the Union on the public and private law of Scotland in the eighteenth century.

The removal of the central government from Edinburgh to London had a negative impact on the public law of the nation but a positive impact on the evolution of the private law, the Scots law, which was entrenched together with the two church establishments (English and Scottish) and the Scottish university system as part of the fundamental law of the Union and for which no amending formula was negotiated. Within a few years of the Union, the new Westminster Parliament, acting in accordance with the Parliamentary practices of the old English Parliament, had enacted legislation extending the barbaric English Treasons Act to Scotland; infringing the monopoly of the established church over the Scottish people; and, infringing upon the internal polity of that church by restoring lay patronage of church livings which had been abolished by the Scottish Reformation legislation. The House of Lords ruled on appeals from the Court of Session concerning points of Scots law completely foreign to that body and in complete disregard of the Treaty. It would make for an interesting exercise in "virtual history" to imagine what might have happened had the motion in the House of Lords in 1713 to bring in a bill to dissolve the Union brought by the chief negotiator of the Treaty for Scotland, not failed to pass by only four votes! Clearly, neither party was happy!

Nevertheless, while Westminster legislation after 1707 had a propensity to undermine traditional Scottish constitutional norms, the removal of government to London and the departure of the political class to the metropolis to grovel for patronage freed the very Scottish institutions, the law, the established church and the universities protected by the Treaty to flourish and flower. The role of the established church in nurturing education, social welfare and morality is well-documented as is the role of the universities as centres of the "Scottish Enlightenment". A strength of Professor Walker's volume is his synthetic documentation of how Scots law also flourished and evolved as an indigenous system of law. Textbook writing proceeded at a high volume in almost all areas of law and a number of classical texts which long shaped the evolution of Scots law in the following centuries were written, and in several editions. Law libraries were organized by the various societies of lawyers and law reporting became systematic. At Edinburgh and Glasgow Universities the teaching of law was formalized as an academic study and, as an academic study, law and legal

systems attracted the interest of some of the great thinkers of the age: Adam Smith, John Millar, Francis Hutcheson and David Hume.

Particularly important in this regard, is Professor Walker's discussion of the substantive principles of Scots law in this century to determine whether as a body of law, it could really be considered a civilian or Roman system or, quite simply, an indigenous and unique system of laws. In previous centuries, Scots law had borrowed from canon and feudal law, and to a lesser extent, from Roman law, which Scottish law students had studied in the Netherlands, another Calvinist country, prior to the establishment of law teaching in the Scottish universities and when religious difference barred matriculation at the two English universities. Professor Walker's analysis of the 18th century legal literature suggests that over the course of that century Roman law influences declined considerably as Scottish judges (also a distinguished group at this time) boldly developed new principles influenced by local text writers and local conditions rather than external legal sources. By the end of the century, he suggests, when counsel cited Roman law principles it was more because of a casting around for an appropriate authority for the argument they wished to make than involuntary submission to a higher authority. Nor was there any movement for codification in Scotland in contrast to the continental codification drive in the latter decades of the century. Largely freed by the removal of central government to London at the start of the century, Scots lawyers acquired confidence in their own abilities to develop a legal system suitable to local needs, borrowing where appropriate and otherwise devising indigenous solutions. Professor Walker makes the case for Scots law being a *sui generis* legal system by the end of the 18th century.

As with the previous four volumes of *A Legal History of Scotland*, this fifth volume is a veritable encyclopedia of facts, cases, principles, names, books, statutes and ideas. It is a mine for information in addition to being an interpretation of the evolving legal system of Scotland in the eighteenth century. It is also, as the title of the series suggests, a legal history of the country: a history of a country as seen through its laws and lawyers. It is to be hoped that Professor Walker, now nearing his ninth decade, will be granted the health and strength to complete this fine work.