On the Scope of Economic Efficiency in Judicial Reasoning. A Pattern Derived from U.S. Case Law on Corporations

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ABSTRACT

This article examines the scope of efficiency reasoning in judicial argumentation. The subject is analyzed through a series of U.S. law cases on corporations. Judges use economic analysis in the determination of facts when a legal standard points to an economic-oriented evaluation; they also use economic analysis in the proof of facts, like other sciences or techniques, as the technical basis for presumptions. However, in the determination of applicable law, the notion of economic efficiency appears in case law mostly as a perspective from which to *explain* existing rules at a theoretical level, rather than at the practical level of *justifying* the decision. This article argues that this is so because economic efficiency is a policy goal that, unlike a principle, is too generic to serve as the basis for applying or interpreting preexisting law. In this respect, the situation is not different in the civil law tradition. Only when formulating an entirely new rule, can economic efficiency be a basis for adjudication in the common law, but then it competes with other goals as well as with more specific principles.

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I. INTRODUCTION

A. The Significance of a Possible Economic Efficiency Goal in Judicial Reasoning

This article examines how a policy of maximizing economic efficiency may operate in judicial reasoning.[1] The aim is to assess how a possible legal policy of maximizing economic efficiency may justify a court judgment. In the process, this article will identify the possible uses of the economic analysis of law in judicial decision-making. The work is illustrated by a series of U.S. corporate law cases that use economic analysis of law in various degrees.

Economic analysis of law evaluates the effect of legal rules, conceived as prices, on the behavior of private individuals.[2] The concept of economic efficiency provides the principal normative criterion for evaluating the rules.[3] In order to evaluate a judicial decision in terms of efficiency, the judgment itself must be considered as a legal rule affecting the price of behavior for the future. As one of the founding treaties on economic analysis of law stated with regard to a tort case, the case is of interest solely because it will "establish or confirm a rule for the guidance of people engaged in dangerous activities;" that is because the decision is a "warning" that "alters the prices that confront people."[4] Thus, the scope of a policy of economic efficiency on judicial reasoning will depend on the extent to which the justification for the judgment may be guided, not by the effects of the judgment on the parties, but rather by its effects on the future behavior of private individuals in similar situations.[5]

In justifying their decisions, judges use specific methodologies—criteria of interpretation and faithful and coherent application of legal rules.[6] U.S. judges specifically refer to such criteria in their decisions and assign them a binding force.[7] Although such methodologies are not set forth in any statute, as they are in continental European countries, there are common law rules that provide for those criteria.[8] The methodology that a judge uses for interpreting and applying the law will define the scope in which the decision may be possibly guided by its projected consequences.

1. We use the term "policy" here in the sense of a goal-oriented rule. Policies, as opposed to rules of action, imply a commitment to realize goals set in a very generic way. Policies are distinguished from principles in a strict sense by the fact that the latter establish "values considered as categorical reasons *vis-à-vis* any interests." See Manuel Atienza & Juan Ruiz Manero, Las Piezas Del Derecho 27 (4th ed. 2005); Manuel Atienza, El Derecho Como Argumentación 168 (2006).

2. Steven Shavell, Foundations of Economic Analysis of Law 1-2 (Belknap Press, 2004). In its descriptive aspect, economic analysis deals with the effects of specific legal rules, while in its normative aspect it proposes rules that are considered socially desirable.

3. Avery Wiener Katz, Foundations of the Economic Approach to Law (Foundation Press, 1998). Economists use different definitions of economic efficiency, the fundamental ones being Pareto and Kaldor-Hicks. One rule is superior to another in Pareto terms when it makes at least one person better off and no one worse off. The welfare of each individual is measured according to his own preferences. A rule is superior to another in Kaldor-Hicks terms when although some individuals may be worse off, others are better off to the extent that the improvement in the welfare of those who are better off surpasses the loss of those who are worse off. In the Kaldor-Hicks criterion there is a possibility that the winner may compensate the loser, although this compensation does not have to be necessarily produced. This criterion presents a problem of comparison of utilities in which it can be asserted that the utility of the winner is greater than the loss of the losers. A variation of the Kaldor-Hicks criterion is the so-called cost-benefit analysis adopted by Posner, *infra* note 4. To resolve the problem of comparing utilities, they are measured in terms of willingness to pay; utility is greater depending on the willingness of its beneficiary to pay for the good or right in question. The Kaldor-Hicks criterion is the one most often used in economic analysis of law, especially in economic analysis of corporate law. *See* William T. Allen & Reiner Kraakman, Commentaries and Cases on the Law of Business Organizations 4-5 (Wolters Kluwer, 2003).

4. Richard A. Posner, Economic Analysis of Law 22 (Wolters Kluwer, 1986).

5. Frank H. Easterbrook, *The Supreme Court, 1983 Term–Foreword: The Court and the Economic System*, 98 Harv. L. Rev. 4 (1984); Daniel A. Farber, *Economic Efficiency and the Ex Ante Perspective,* The Jurisprudential Foundations of Corporate and Commercial Law 56 (Jody Kraus & Steven Walt eds., 2000).

6. Robert S. Summers, Form and Function in a Legal System 241 (Cambridge Univ. Press, 2006).

7. *See* Robert S. Summers, *Precedent in the United States (New York State)*, in Interpreting Precedents: A Comparative Study 355 (D. Neil MacCormick & Robert S. Summers eds., 1997); Robert S. Summers, *Statutory Interpretation in the United States*, in Interpreting Statutes 412 (D. Neil MacCormick & Robert S. Summers eds., 1991) (the generally accepted fact that judges refer to methodological criteria of interpretation contrasts with the persistent tradition in US legal scholarship which, from a realist perspective, has questioned the workability of criteria or policies of interpretation). *See also* Richard A. Posner,

Statutory Interpretation—in the Classroom and in the Courtroom, 50 U. Chi. L. Rev. 800, 805 (1983). This author recognizes that, despite constant criticism from legal scholars concerning the efficiency of any interpretive methodology, judges still refer to such criteria. For a summary of the realist position on this and other matters *see* Robert S. Summers, *Pragmatic Instrumentalism in Twentieth Century American Legal Thought—A Synthesis and Critique of our Dominant General Theory about Law and its Use*, 66 Cornell. L. Rev. 908-915 (1981).

8. *See* Summers, *Precedent in the United States*, *supra* note 7, at 371.

9. *See* Jerzy Wróblewski, The Judicial Application of Law 316 (Z. Bankowski & N. MacCormick eds., 1992).

10. Those in continental Europe who support the thesis that judges should promote economic efficiency in their judgments have diminished the importance of the differences between common law and civil law systems with respect to the sources of law, statutory or case law. Ugo Mattei, Comparative Law and Economics 77-88 (Univ. of Mich. Press, 1998); José Cándido Paz-Ares, *Principio de Eficiencia y Derecho Privado*, in Estudios de Derecho mercantil en homenaje al Profesor Manuel Broseta Pont 2843 (1995). Contrary to the opinion that the system of sources of law are comparable, *see* José María Gondra, *¿Tiene Sentido Impartir Justicia con Criterios de Economía?*, Revista de Derecho Mercantil 1559-1560 (1997); *also see* Christian Kirchner, *The Difficult Reception of Law and Economics in Germany*, 11 Int'l. Rev. of L. & Econ 277 (1991).

11. Atienza *supra* note 1, at 174. The author maintains that in weighing policies (that is, in their articulation within a legal rule) the starting point is the need to formulate a goal, taking into account that this cannot be done either without regard to how this may affect other useful goals adopted by the legal system or by overstepping principles in the strict sense. We understand principles in the strict sense to be comprehensive rules extracted from a legal regulation. For instance, "creditor protection" could be a principle of corporate law in E.U. law.

12. This theory was initially proposed by Richard A. Posner, *Utilitarianism, Economics, and Legal Theory*, 8 J. Legal Stud. 103 (1979); Richard A. Posner, *The Ethical and Political Basis of the Efficiency Norm in Common Law Adjudication*, 8 Hofstra L. Rev. 487 (1980). In Spain, it has an adherent. *See* Paz-Ares, *supra* note 10, at 2843.

13. As is well known, there is a strand of thought that maintains that common law is in fact efficient, despite the fact that judges do not deliberately adjudicate based on efficiency. Paul H. Rubin, *Why is the Common Law Efficient?*, 6 J. of Legal Stud. 51-63 (1977); George L. Priest & Benjamin Klein, *The Selection of Disputes for Litigation*, 13 J. Legal Stud. 1-97 (1984). These theories have been questioned by Robert Cooter & Lewis Kornhauser, *Can Litigation Improve the Law Without the Help of Judges?*, 9 J. Legal Stud. 139-163 (1980).

14. Ian Ayres, *Judging Close Corporations in the Age of Statutes*, 70 Wash. U. L. Rev. 365, 366-367 (1992). Current or former Judges such as Richard Posner, Guido Calabresi, Frank Easterbrook and Ralph Winter are adherents to the Law and Economics movement.

Methodologies for interpreting and applying the law vary among legal systems and particularly between civil law and common law traditions. In addition, judges' powers to create legal rules differ substantially in the civil law and in the common law.[9] In the common law, legal precedent is considered a source of the law, which is not formally so in continental legal systems. From this perspective, a judge's attention to the future consequences of his/her judgment is more readily justified in the common law than in continental legal systems.[10]

However, the methodologies for interpreting and applying law followed by common law judges preclude a goal such as maximizing efficiency as the only justification for a judicial decision creating a legal rule. As this article attempts to show, a policy goal of economic efficiency is too generic to serve alone for justifying a judicial decision. This goal may serve to justify the formulation of a specific rule or a principle. However, it cannot serve to justify a decision to *apply* a given rule, even when that rule may be explained in terms of economic efficiency, or when it has been initially formulated to serve that goal. Moreover, articulating this goal of economic efficiency in a new specific judicial rule will require weighing or balancing it against other goals, as well as other more specific legal principles.[11] This operation of weighing—which is also methodological in nature—means that, even in the U.S., where economic reasoning has been used in case law, an economic efficiency goal will rarely provide the sole justification for the creation of a new rule.

Hence, it is to be expected that economic efficiency considerations will have limited impact on the justification of judgments, even in legal systems in which the judge enjoys a significant degree of discretion in the creation of law such as the U.S. Thus, the "normative" theory of adjudication, proposed by some law and economics scholars (according to which judges must promote maximization of economic efficiency through their judgments[12]) can hardly be realized in the actual process of judicial reasoning, given that judges are bound by law and that relatively few cases will arise in which there is no, at some level, *applicable law.*[13]

B. U.S. Case Law on Corporations as a Reflection of the Possible Scope of an Efficiency Goal in Judicial Reasoning

The subject of this article is analyzed through a series of U.S. law cases on corporations. Generally, U.S. case law provides a good field test of the scope of an efficiency goal in judicial reasoning. U.S. methodologies for interpreting and applying the law are more analytical than those followed in continental law, due to the broader discretion of U.S. judges.

For our study's purpose, the choice of U.S. case law on the specific matter of corporations is also justified. On the one hand, U.S. case law on corporations contains frequent references to the literature of law and economics. Several judges are or have been prominent representatives of the movement.[14] Other relevant judges in matters of corporate law have training in economics.[15] On the other hand, U.S. corporations case law offers a better view of the possible scope of economic efficiency goals in judicial reasoning than the case law of strictly common law matters, such as torts. U.S. corporate law is part statutory law and part case law.[16] Thus, corporations case law offers examples of how economic notions operate in the application of judicial precedent, in the interpretation of statutes, and in the development of judge-made law. On that basis, this study shall provide some general conclusions that are applicable to both U.S. and continental law.

The goal of our study is not to evaluate the merit of economic theories concerning corporations or the efficiency effects of certain judicial opinions. Our interest lies solely in judicial reasoning. In that regard, it should be underscored that economic analysis has not formulated a theory of interpretation of law.[17]

The discussion is structured as follows. First, we outline the possible uses of economic analysis in determining and proving the facts at stake. Subsequently, we deal with the scope of an efficiency goal in the determination of questions of law. For this purpose, we distinguish between judicial *application* and judicial *creation* of law in the common law. In the first case (application), there is a rule that the judge deems applicable; in the second case (judge-made law), the judge deems no rule to be directly applicable or finds a gap in the applicable rule, and a judge-made rule is thus required to decide the case. Although this is evidently a matter of degree, this distinction is accepted in traditional common law methodology, and is likewise one of the bases, of a positivistic nature, on which economic analysis of law relies (at least in its legal policy strand of studies): the assumption that judges will in fact apply the rules designed to promote efficiency.[18]

15. Judges such as William T. Allen, currently a professor at New York University and a former Chancellor of Delaware. Judge Allen is responsible for significant case law developments in the corporate law of Delaware. *William T. Allen Biography*, New York University, *available at* http://pages.stern.nyu.edu/~wallen/pdfs/Allenvita.pdf (last visited Apr. 2, 2018).

16 E. Merrick Dodd Jr., *Statutory Developments in Business Corporation Law*, 1886-1936, 50 Harv. L. Rev. 27 (1936).

17. *See* Aharon Barak, Purposive Interpretation in Law 229 (Sari Bashi trans., Princeton Univ. Press, 2005). In fact, problems of interpretation lie outside of the scope of Law and Economics. The economic analyst of law adopts an *ex ante* perspective: he/she seeks to evaluate the effects of legal rules on individual behaviors. Problems of interpretation, which are naturally *ex post*, are perceived as "information imperfections" that hinder individual calculations concerning the content of legal rules. *See* Lewis A. Kornhauser, *Symposium on Post-Chicago Law and Economics: An Economic Perspective on Stare Decisis*, 65 Chi.-Kent. L. Rev. 63-66 (1989). In this regard, the positions of the interpreter and the economic analyst are mutually exclusive. The fragmentary proposals on interpretation coming from the economic analysis of law derive from the two main currents in that discipline: public choice studies and legal policy studies. See Lewis A. Kornhauser, *The Economic Analysis of Law, in* The Stan. Encyclopedia of Philosophy, Ch. 5, 1 (Edward N. Zalta ed., 2001), http://plato.stanford.edu/archives/win2001/entries/legal-econanalysis/ (last visited Apr. 2, 2018). The former draws attention to the dynamics of the legislative process (the influence of pressure groups on legislation) to distinguish between public-interest and private-interest legislation and to propose different interpretive criteria for both, restrictive in the first case and extensive in the latter. *See* Posner, *supra* note 7, at 818. Legal policy studies seek to define and limit the scope of interpretation. Thus, for example, they support the use of specific rules rather than standards, which require a deeper interpretative task from the judge (*see* Louis Kaplow, *Rules versus Standards: An Economic Analysis*, 42 Duke L.J 561 (1992)); they discuss the necessity of specifying the difference between judicial application and creation of law; they underscore the maker/creative role of U.S. Supreme Court's case law for analyzing purported tendencies to a better perception of the economic effects of its opinions (*see* Easterbrook, *supra* note 5, at 5); they propose that interpretive criteria be clearly determined to save legislators the costs of having to anticipate possible conflicts of interpretation in the statutes they enact. *See* Frank H. Easterbrook, *Statutes' Domains*, 50 U. Chi. L. Rev. 533-540 (1983).

18. *See* Kornhauser, *The Economic Analysis of Law*, *supra* note 17. In this article we will not deal with the jurisprudential questions relating to judicial reasoning in connection with law and economics. For a full-fledged account of these questions see Péter Cserne, Consequence-Based Arguments in Legal Reasoning: A Jurisprudential Preface to Law and Economics, in Efficiency, Sustainability, and Justice to Future Generations 31-54 (Klaus Mathis ed., 2011).

In regard to judicial application of the law, a subsequent distinction is made between application of judicial precedents and the interpretation of statutes. Although in a broad sense judicial application of precedents is an interpretative activity, in the U.S., the concept of "interpretation" is customarily reserved for statutory interpretation.[19]

These distinctions give rise to the next three sections of the article: (III) the use of economic reasons in the analogical application of judicial precedent; (IV) the use of economic arguments in statutory interpretation; and (V) the limits of economic efficiency reasons in the judicial creation of legal rules in the common law. Section VI is a conclusion.

II. ECONOMIC THEORIES IN THE DETERMINATION AND PROOF OF FACTS

A. The Use of Economic Analysis in the Determination of the Facts in Issue

The facts of a judgment may be determined descriptively or evaluatively.[20] In the second case, the determination or characterization of the facts requires a value judgment.[21] This is frequently the case in connection with the determination of facts covered by various standards such as *reasonable care*, *good faith*, *due diligence*, etc. With regard to a standard that contains an evaluation of an economic nature, the literature on economic analysis of law may offer criteria determining whether a fact is covered by that standard.

For example, *International Insurance Co. v. Johns*,[22] uses economic analysis of law to determine the significance in respect of a legal standard of a "golden parachute" for outgoing executives in the event of a change in corporate control. The issue in this case was to determine whether a given golden parachute fell within the *corporate waste* standard and was as such prohibited. According to the judicial doctrine of the *business judgment rule*, decisions of a board of directors concerning executive compensation cannot be reviewed by the courts unless they constitute *corporate waste*. The courts, thus, had to consider whether the golden parachute could be construed as a corporate waste and was, therefore, susceptible to judicial review.

To apply the *corporate waste* standard with respect to the facts of this particular golden parachute, the court turned to economic literature that considers a system of compensation as a mechanism for reducing the cost of monitoring managers in situations involving a change in corporate control. According to this literature, golden parachutes benefit stockholders because they ensure compensation for managers in the event of dismissal,

19. The role of precedent varies among different branches of the legal system. In traditional common law areas, such as contracts or torts, precedent is the principal source of legal rules. In others, such as corporate law, in which there is significant legislation, the principal source of reference is legal texts. Nevertheless, in this instance, a precedent interpreting a statute becomes binding for the future. See Summers, *Precedent in the United States*, supra note 7, at 356.

20. *See* Wróblewski, *supra* note 9, at 138.

21. *See id.* at 140. It is affirmed that in such cases establishing the facts implies making an existential judgment coupled with a value judgment.

22. International Insurance Co. v. Johns, 874 F.2d 1447 (11th Cir. 1989).

thus reducing their incentive to oppose a takeover bid that may be to the stockholders' advantage. The judgment ultimately concludes that the golden parachute of this case is not a *corporate waste*; it is not a fact covered by this concept.

Therefore, this case does not present a problem of legal interpretation of a standard. The main issue is to determine whether a fact (this particular "golden parachute") is covered by the standard *corporate waste*. This determination requires a value judgment with regard to the meaning (factual, rather than legal) of the "golden parachute." Economic theory provides a basis for the value judgment concerning the factual meaning of the specific golden parachute of the case. The theory says that golden parachutes do not necessarily constitute corporate waste but rather may benefit stockholders, and thus it allows the court to exclude this specific golden parachute from the concept of waste.[23] In fact, the *corporate waste* standard operates more as a criterion for excluding some facts that reasonably fall beyond this concept than as a concept with a specific content of its own; i.e., it acts as an *excluder*.[24]

B. The Use of Economic Analysis in Proving the Facts: Presumptions

An economic theory may likewise be used to prove the facts at stake. An evident area involves presumptions. In a presumption, the judge infers an unknown fact or consequence from an already-known fact. This inference may be based on a legal maxim or on a technical opinion (generally submitted as expert evidence) that enables the judge to determine the probability of the consequence.[25] An economic theory can be the basis of a technical opinion on which to establish a presumption.

For example, in *Basic Inc. v. Levinson*,[26] a case involving liability for fraudulent information on the securities market, the U.S. Supreme Court established a presumption based on the efficient-market hypothesis, according to which the stock prices reflect all publicly available information on the market.[27] Rule 10b-5[28] (the "anti-fraud provision") provides for compensation to investors for injury caused by fraudulent information on which the plaintiff-investor has relied when buying or selling securities based on such information. This reliance, according to the Supreme Court, constitutes the causal connection between the false information and the plaintiff's injury.

Based on the efficient-market hypothesis, the court established the presumption that the plaintiff who bought or sold stock based on fraudulent information *relied* on that fraudulent information. The market

23. *See International Insurance Co.*, 874 F.2d.

24. *See* Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195 (1968).

25. Thomas Buckles, Laws of Evidence 39 (1st ed. 2001); Luis Muñoz Sabaté, Técnica Probatoria 203, 217 (4th ed. 1993).

26. Basic Incorporated v. Max L. Levinson, 485 U.S. 224 (1988).

27. *See* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 Va. L. Rev. 549 (1984).

28. Securities and Exchange Act of 1934, 15 U.S.C. § 78(a).

had presumably discounted that false information. Hence, the plaintiff who bought or sold stock based on this information did so "relying," by hypothesis, on that information. Thus, to determine the causality between the false information and the injury to the plaintiff, the court formulates a presumption based on the efficient-market hypothesis.[29]

Here, economic theory provides a basis for establishing the rule of probability underlying all presumptions. The efficient-market hypothesis enables one to presume with a degree of certainty, *absent proof to the contrary*, that a person who has bought or sold stock based on fraudulent information relied on that information.

III. ECONOMIC REASONS USED IN THE APPLICATION OF PRECEDENT BY ANALOGY

A. Economic Goal Reasons Within the Framework of a Precedent Methodology

According to standard U.S. precedent methodology, judges are bound by prior judicial decisions rendered in similar cases (that is, in the strict sense, by precedents) according to the principle of *stare decisis*.[30] Judicial precedent has a twofold effect: retrospective, to the extent that judicial opinion should be guided by past judgments, and prospective, in the sense that the decision in a new case establishes a rule for the future.[31] The rule arising from a precedent is the holding or *ratio decidendi*; only the holding is formally binding in subsequent cases. A holding is a ruling on a question of law that is necessary for the decision of a case. The holding is determined in relation to certain facts and is supported by a certain reason or reasons.[32] Judges must consider whether the reason supporting the holding justifies applying the precedent to the new case. Within certain limitations, judges may also invoke new or different reasons from those underlying the precedent, provided that they are reasonably imputable to the precedent.[33]

The reasoning by which a precedent is applied to the facts of a new case is often, if not always, analogical reasoning.[34] This type of reasoning requires identifying a similarity at a given level of generality between the facts of the new case and those of the precedent, which would justify applying the rule of the precedent to the new case.[35] The justifying force of the reason must be such that it supports the application of the rule of the precedent to facts which, based on that precedent, are considered sufficiently similar.

29. Leo Herzel & Addison D. Braendel, *Law and Economics in Action*, The New Palgrave Dictionary of Economics and the Law 495-496 (Peter Newman ed., 1st ed. 1998) (the authors consider this presumption as one of the few examples of the influence of the economic analysis of law on Supreme Court case law in matters of corporate governance and securities markets).

30. *See* Summers, *Precedent in the United States*, *supra* note 7, at 364 & 368-370.

31. *Id.* at 355. Different states in the United States use relatively similar methodologies in creating precedent. *Id.* at 365.

32. *See* D. Neil MacCormick & Robert S. Summers, *Introduction*, in Interpreting Precedents, supra note 7.

33. Robert S. Summers, *Two Types of Substantive Reasons: The Core of a Theory of Common-Law Justification*, 63 Cornell L. Rev. 707, 716 (1978).

34. Lloyd L. Weinreb, Legal Reason: The Use of Analogy in Legal Argument 77 (Cambridge Univ. Press, 2005).

35. *See* Weinreb, *supra* note 34, at 98.

The reasons justifying a holding have been classified into several categories: substantive, authority, institutional and factual.[36] One type of substantive reasons is goal reasons. A goal reason justifies applying a rule based on its effects in serving an objective considered socially desirable.[37] In the formulation of goal reasons, the judge must predict the effects of his or her decision not only on the parties to the case, but also with respect to third parties in similar situations in the future.[38] When there are goal reasons justifying the rule applied, the analogy will be drawn with regard to the effects of the decision based on the goal that the precedent seeks to achieve. In consequence, the judge must make a prediction as to whether the effects of the projected judgment will serve the goal of the precedent in order to decide whether the precedent should be applied.

There are corporate law cases that put forward goal reasons formulated in economic terms to justify the application of a precedent. For example, *Fisher v. Council of the Devon*[39] provides a goal reason for the case law rule that enables the judge to order a company to pay the legal fees incurred in a derivative action brought by an individual stockholder ("fee-shifting") when the company has obtained a financial benefit as a result of that lawsuit. According to the opinion, the intent of such case law is

> to advance the public policy of providing incentive for one or more […] stockholders of a corporation to bring class action or derivative suit to enforce the rights of the class or the corporation as a whole under circumstances in which filing suit to enforce only their individual rights would be prohibitively costly or otherwise impracticable.[40]

The reason imputed by *Fisher* to the cited case law is goal-oriented because the rule arising from that case law is based on an objective considered socially desirable. That objective is to provide an incentive to monitor directors through litigation in view of its prohibitive costs for individual stockholders. Such goal is expressed in economic terms as "providing an incentive" for monitoring. Moreover, the reason of the precedent presupposes a prediction of an economic nature as to how that goal is achieved by the rule derived from the precedent. According to this prediction, the rule will promote monitoring because it removes the deterrence inherent in the individual stockholder's bearing the costs of bringing suit.

The issue in *Fisher* was whether the fee-shifting rule developed by a precedent involving publicly-held companies was applicable to a condominium association. A unit owner demanded that the condominium association

36. *See* Summers, *supra* note 33, at 707.

37. *Id.* at 718 & 738.

38. *Id.* at 737.

39. Fisher v. Council of the Devon, WL 1313661, No. 17190 (Del. Ch. 1999).

40. *See Fisher*, WL 1313661.

pay the legal fees he incurred in filing an action against the association, which resulted in financial benefit for the association. The complaint was dismissed. The opinion considered that "the economic situation and the set of incentives" in a condominium association are different from those present in a widely-held corporate enterprise. In condominium associations individual unit owners have a relatively large stake in the property, ease of communication with other unit owners, and inexpensive means of monitoring the decision-making body.[41] For this reason, according to the opinion, "unit owners have a greater incentive to perform monitoring functions than do corporate stockholders and, thus, there is less need for fee-shifting arrangements to encourage individual owners to resort to litigation than is true in the case of corporate stockholders."[42] In consequence, the rule governing corporations should not be extended to condominium associations. Only when the costs to be assumed by the association are necessary "to achieve an important objective" may fee-shifting be justified in the context of condominium associations.

Thus, according to the opinion, the goal reason for the precedent (to monitor directors) does not warrant extending fee-shifting to a condominium association because the "economic situation and set of incentives" present in a condominium association are not analogous to those of a widely-held corporate enterprise. An economic analysis of the facts of the case indicates that those facts are not really similar to the facts of the precedent from the perspective of the goal that the rule in the precedent seeks to achieve (to promote monitoring).

Hence, the opinion draws on economic analysis in the context of, but internalized in, an analogical argument. Economic analysis is used to characterize the facts of the case (economic situation and set of incentives) as they relate to the precedent. However, it is the analogical argument that concludes that the facts of the case under consideration are not similar to those of the precedent. Given that the precedent seeks to achieve a specific goal (to promote monitoring), the analogy argument requires the judge to evaluate the effects of the decision in relation to the effects sought in the precedent. The judge concludes that there is "less need" for fee shifting in a condominium association in order to ensure *a desirable level* of monitoring of its directors. This value judgment presupposes an economic prediction concerning the comparative incentive effect of the rule in one situation and the other. The opinion draws on economic analysis to formulate this prediction, but it does so on the basis of an evaluative (non-economic)

41. *Id.* at 2.

42. *Id.* at 10. As stated in the judgment, "Condominium associations present a different economic situation and a different set of incentives to unit holder monitoring functions. Generally speaking, individual condominium owners have (1) a relatively large economic stake in the property, (2) easy means of communicating with their fellow unit owners and (3) simple and inexpensive ways to access and influence the decision-making body. Moreover, the agency relationship between unit owners and the decision-making body is quite different than in the case of widely held corporate enterprises. A distinct characteristic of the corporate form of enterprise is that it 'offers owners of capital [...] the utility that an investor gains through centralized management. Centralized management allows passive (low cost) ownership and promotes investor diversification.' The situation in the context of condominium associations is quite different, as the facts of this case show."

argument controlled by the precedent applied and the goal reason supporting it. Thus, economic analysis has a purely empirical function in the argument.

Analogical reasoning controls the argument of the opinion also with respect to when fee shifting to the condominium association would be justified—when the costs to be borne by the association are necessary "to achieve an important objective."[43] This is not a cost-benefit analysis either, but rather analogical reasoning.[44] In the case of the precedent, the important objective was to promote monitoring of the directors. This precedent could be extended to the condominium association if there was an "important objective" comparable to the monitoring goal contained in the precedent, which could be justified by analogy, in which the important objective of promoting monitoring of the association directors (in a situation where this would be lacking) would justify applying the fee-shifting rule.

B. Economic Efficiency Explanations of a Rule of a Precedent

As previously noted, *Fisher* explains the fee-shifting rule in terms which refer to economic efficiency considerations as a mechanism for resolving a "collective action" problem involved in the monitoring of directors; i.e. it provides an economic explanation for the precedent. According to the judgment, individual stockholders in publicly-held corporations do not monitor because their monitoring costs exceed their individual benefits. This results in a lower level of monitoring than would be desired by the stockholders as a group. Hence, the fee-shifting rule is efficient from this perspective because it determines the total expense in monitoring to approach the costs to those that will be considered optimum by the stockholders as a whole.[45]

Thus, the rule of a precedent is explained in terms of economic efficiency.[46] However, the reason justifying the rule of that precedent itself is not economic efficiency. The reason of the precedent is the specific goal that the precedent rule seeks to achieve. It is, in this case, the goal to promote stockholders' monitoring of directors, not a goal as general as to promote efficiency.[47] A goal to "promote monitoring" may be explained in terms of efficiency, but it could also be explained in terms other than efficiency (for example, in terms of the institutional or fiduciary model of the corporation).[48]

Thus, in *Fisher*, the reference to the economic efficiency effects of monitoring (or its effects in reducing agency costs) operates at a theoretical level, as a possible perspective from which to explain the reason of the precedent. However, this explanation does not play a role in *justifying* the decision to apply the precedent, which is based on an analogical argument. The

43. *Id.* at 11.

44. *See* Weinreb, *supra* note 34, at 94. The author affirms, in general, that "instrumental" reasons cannot carry any weight in judicial reasoning without the support of analogical argument.

45. The judgment refers to the following "explanation" for the goal reason of the fee-shifting rule set forth in a previous precedent in Bird v. Lida, Inc., 681 A.2d 399 (Del. Ch. 1996): "Chancellor Allen further explicated the underlying economic justification for fee shifting in publicly held corporations in Bird v. Lida, Inc. as follows: 'In a public company with widely distributed shares any particular shareholder has very little incentive to incur... [monitoring] costs himself in pursuit of a collective good, since unless there is some method to force a sharing of costs, he will bear all of the costs and only a (small) *pro rata* share of any gains that the monitoring yields. Thus, it is likely that in a public corporation there will be less shareholder monitoring expenditures than would be optimum from the point of the shareholders as a collectivity.'"

46. In the economic analysis of a corporation, the goal of economic efficiency (or of maximizing welfare) is defined in terms of agency theory: those rules offering optimum solutions to agency conflicts will be efficient rules. *See* John Armour, Henry Hansmann & Reinier Kraakman, *Agency problems and Legal Strategies*, in The Anatomy of Corporate Law: A Comparative and Functional Approach 29-48 (Oxford Univ. Press, 3d ed. 2017). Corporations are conceived as "nexus of contracts" among the holders of productive factors: shareholders, directors, creditors. The relationship between shareholders and managers (as well as the relationship between shareholders and creditors) is conceived as an "agency relationship", that is, a relationship in which an individual (agent) has the power of decision over the interests of another (the principal). To the extent that the interests of the agent may differ from those of the principal a cost will arise ("agency cost"). A rule that reduces agency costs would be considered economically efficient, i.e., beneficial to both principals and agents.

47. To promote stockholders' monitoring is the actual reason supporting the holding of the precedent. *See supra* note 32 and accompanying text.

48. According to this theory, shareholders monitor directors because directors manage another's property as fiduciaries. The explanation here would be in terms on fairness, rather than efficiency.

conclusion of the analogical argument that the facts of the case can be equated to those of the precedent for purposes of applying the precedent rule is based solely on the specific reason supporting the precedent, i.e., to promote monitoring (in the case, the conclusion is that a condominium association is not analogous to a publicly-traded corporation from the perspective of the need to promote monitoring of directors).

Likewise, the decision applying the precedent by analogy (and explaining the precedent in efficiency terms) may, as a new precedent, be explained later on in terms of economic efficiency, although it may also be explained in other terms. Because the reason for applying a precedent is not economic efficiency itself, but always a more specific one, it may be that a decision that applies a precedent purportedly formulated to promote efficiency is not itself, as a new precedent, economically efficient. Or it may not also be explained in terms of economic efficiency in accordance with the same criterion used to explain the rule of precedent.

Bird v. Lida, Inc., cited as precedent in *Fisher*, offers an example. The issue in *Bird* was the scope of the same judicially-created rule that obliges a corporation to pay legal fees in derivative actions, filed against directors, resulting in a financial benefit for the corporation. In this case, a stockholder demanded out-of-court that the directors renegotiate certain leases between the company and other entities in which the directors had personal interests. In view of the pre-complaint demand, the directors renegotiated the leases and, consequently, the company obtained significant economic benefit. The stockholder then sued the company, seeking reimbursement for the legal fees incurred. The stockholder alleged that, given that the company had received financial benefit, it had hypothetically agreed *ex ante* to compensate an individual stockholder whose actions led to such benefit.

The opinion begins by explaining "the important role of the derivative suit and its stockholder reimbursement component in the efficient operation of the corporate form." It describes this function in terms of agency costs and collective action. Individual stockholders "have little incentive to bear the costs associated with activities that monitor board of director (or management) performance."Although the fact of "rationally passive investors" may provide a source of utility—because it facilitates management centralized in a board of directors—it also leads to costs, because directors may have "incentives that are not perfectly aligned" with those of the shareholders. "For that reason, *some* expenditure for shareholder monitoring would be efficient."[49]

49. *Bird*, 681 A.2d. at 405.

Given the above efficiency explanation for the fee-shifting rule, the opinion indicates that perhaps in this case, the most efficient rule would be allowing the plaintiff to recover legal fees.[50] In effect, according to the judgment: 1) the shareholder had expended resources, 2) at a risk of loss, 3) through which excess management costs were uncovered, 4) and had taken action (the demand made on the board), 5) which resulted in a benefit for the corporation.

However, the opinion concluded that plaintiff's claim could not prevail. The judge analyzed the applicable precedents and concluded that the out-of-court demand should have invoked a meritorious claim for the company to be required to pay the shareholder's legal fees, that is, "an action that is prima facie valid in law," just as would be required in a lawsuit.

This requirement makes sense because the reason justifying the judicial precedent to be applied is to promote the monitoring of directors in the exercise of their powers as defined by law, but not economic efficiency as such. In effect, the reason of the precedent is not one as generic as to ensure the efficiency of the corporation or the efficiency of the acts of its directors. As indicated in the opinion, the demand "must involve not simply a claim of business sub-optimization, but a "meritorious" claim of a legal (including equitable) wrong." Such action was not invoked in this case.[51]

Thus, the basis for applying the rule of the precedent to this case is not economic efficiency, despite the fact that the precedent could be *explained* in efficiency terms. The judge does not abstract from the rule of precedent a purported efficiency policy, which he subsequently specifies in a new rule for a new case. Rather, the judge applies the given rule by analogy in the light of the specific reason which justifies it (in the case, to promote monitoring of directors). And this is so even though the specific reason for justifying this rule may be explained, on a theoretical level, from the perspective of economic efficiency, as occurs in the judgment itself.[52]

Precisely because the reason underlying the precedent is not efficiency, but rather a more specific one, the decision that applies an efficient precedent may, considering itself as a precedent for the future, be questioned from the perspective of efficiency. In fact, the judgment in *Bird* has been criticized from an economic perspective.[53]

50. *Id.* at 403. The opinion literally reads: "I suppose that on their face these considerations would support the conclusion that this is the sort of activity that rational shareholders would encourage and would agree to reimburse had they had the relevant information *ex ante*. If one so concludes, that would present a powerful argument in favor of construing corporation law to permit the reimbursement of shareholder costs and fees in this setting."

51. *Id.* at 407. The judgment asks: "But will not the same justification apply to a larger step which would see the court act generally to facilitate solutions to the shareholders collective action disabilities by ordering the payment of reasonable compensation whenever a shareholder risks the expenditure of funds in monitoring corporate management and that expenditure results in board action that confers a substantial financial benefit on the corporation? Perhaps so, but such an innovation is a step that would move courts from their traditional mission, including the settlement of disputed legal questions (and incidentally the awarding of fees for services rendered in litigation), to a rather different administrative task: the ex post pricing of "volunteer" informational services to corporations. While such a result would certainly be rational and quite possibly efficient, the step that it requires cannot sufficiently be supported by existing legal authorities to warrant judicial adoption at this time."

52. *Id.* at 403. In that regard, Judge Allen offered the following declaration of principles: "The law comprises more than the determination of contested facts and the unmediated application of principles of economic efficiency to resolves disputes arising from those facts. This is true even of corporation law, which may be thought to be especially concerned with facilitating the realization of benefits from efficient forms of organization. In determining the rule of decision in a specific case, courts apply law. While notions of economic efficiency will appropriately play a role in the myriad instances in which common-law courts shape the law interstitially, case by case, courts do tend to look first, and often last, not to calculation of (contestable) efficiency effects, but to concerns more directly affecting legal values. Thus, courts are primarily concerned with legal values such procedural fairness; fidelity to authoritative pronouncements of substantive law; the application of a professionally defined canon of construction techniques to produce legal meanings; and the acceptance of an established hierarchy of authority. More generally, in our system courts reflect an institutional commitment to obedience to binding authority, to rationality, to consistency in judgments and to elaborated, reasoned justifications. These institutional values may trump efficiency concerns in a particular case, although quite often they will be consistent with such concerns."

53. *See* Jeffrey M. Smith, T*he Role of the Attorney in Protecting (and Impairing) Shareholder Interests: Incentives and Disincentives to Maximize Corporate Wealth*, 47 Duke L. J.161 (1998), (an efficiency criterion would support extending the fee-shifting rule as long as a benefit has been conferred on the corporation).

54. *See* Summers, *Statutory Interpretation in the United States*, *supra* note 7, at 412. According to William N. Eskridge, Dynamic Statutory Interpretation 276 (1994), formulating a clear system for interpreting legal rules was a constant concern of the Supreme Court during its last stage under Chief Justice Rehnquist.

55. *See* Summers, *Statutory Interpretation in the United States*, *supra* note 7, at 415.

56. *Id.* at 417.

57. *See* D. Neil MacCormick & Robert S. Summers, *Interpretation and Justification*, in Interpreting Statutes, *supra* note 7, at 530.

58. *See* Summers, *Statutory Interpretation in the United States*, *supra* note 7, at 435.

59. *Id.*

60. *Id.* at 441.

IV. ECONOMIC ARGUMENTS IN STATUTORY PURPOSIVE INTERPRETATION

A. Methodological Criteria of Interpretation and Resolution of Conflicts Between Interpretative Arguments

The methodology of statutory interpretation generally followed by U.S. judges uses a series of interpretative criteria which are similar to those followed in civil law systems: linguistic, systematic or contextual, and purposive or teleological criteria.[54]

A linguistic or literal interpretation is the interpretation in accordance with the relevant standard meaning of the words of the statute and, when the law uses technical terms, the interpretation in accordance with the standard technical meaning. Systematic interpretation takes into account the placement of terms in the sentence, the relation of the sentence to the paragraph and the section in the statute, the use of those terms in that same law, and the coherence of the meaning with other provisions. Other systematic interpretive arguments are the argument from precedent, the argument from statutory analogy, and the argument from coherence with a general legal concept. Finally, purposive or teleological interpretation looks at the ultimate purpose of the statute. Purposive arguments may take into account the legislative intent, discernible in the legislative history of the statute (the argument most often used), or may consider the type of statute and the statutory nature of the matter in issue.[55] The interpreter may also appeal to substantive reasons of morality or to reasons based on consequences.[56]

Together with these basic interpretative arguments, judges also invoke certain principles to resolve conflicts between different criteria of interpretation. Such criteria are certainly open-ended, although they are more specific in U.S. case law than in any other legal systems.[57] When a statute is sufficiently clear, the interpretative argument generally applied is the standard ordinary meaning of the words.[58] Only in cases in which legislative intent is clear an ultimate purpose argument will prevail over a literal interpretation.[59]

When a statute is ambiguous or excessively generic, systematic arguments (argument from context, argument from prior judicial or administrative interpretations, etc.) and purposive arguments (both subjective and objective) will prevail.[60] Less frequently, the courts appeal directly to what they consider the best or fairest policy. When several arguments favor different interpretations, judges weigh the various arguments in conflict.

B. Economic Arguments When the Meaning of the Statute is Clear

When a statute is sufficiently clear, most often no interpretative problems will arise, or interpretation will be based on criteria of literal interpretation. Sometimes, opinions make reference to the possible efficiency effects of the rule applied. Such references play, however, an explanatory or theoretical function with respect to the rules, but they do not operate on the practical level of justification of the decision to apply that rule. For example, when applying the corporate rule of limited liability of shareholders, Judge Posner affirmed that this rule is efficient because it promotes investment.[61] Judge Allen said that it is efficient that shares grant voting rights,[62] or that directors' duty of loyalty is better explained in economic rather than moral terms.[63] Here, however, the rule is applied independently of the explanation offered by the judge with regard to its function.

Sometimes, when legislative intention with regard to the purpose of a statute is clear, a goal-oriented argument, characterized in economic terms, may prevail over an argument from the standard meaning of words. *Mohammad Yousefi v. Lockheed Martin Corporation*[64] provides an example. This case involved a problem of interpretation of a statute clause governing class actions under the securities market laws. The *Private Securities Litigation Reform Act*[65] provides that judges may appoint as lead plaintiff "the person or group of persons who have the largest financial interest in relief sought by the class."According to the opinion in *Yousefi*, the purpose of this provision, as expressed in its legislative history, is to eliminate frivolous tactics and settlements by attorneys interested in increasing their fees. To that end, the law provides that the plaintiff or group of plaintiffs having the greatest financial interest in the suit shall represent the group, since they will have the greatest incentive to monitor the attorneys. *Yousefi* quotes economic literature that describes the problem of monitoring attorneys in class actions as a problem of "free-riding," and justifies the legal rule from a perspective of economic efficiency.

In this case, a group comprising over a hundred plaintiffs moved for the court to be appointed as lead plaintiff. Their motion was based on the literal import of the aforementioned legal provision, which provides that the court shall appoint the "person or group of persons that have the largest financial interest in relief sought by the class" as lead plaintiffs. However, the court denied the motion considering that a lead plaintiff composed by such a large number of plaintiffs would result in less incentive to monitor attorneys, precisely the situation the law seeks to prevent.[66]

61. Eastern Trading Co v. Refco, 229 F.3d 617, 625 (7th Cir. 2000).

62. Len v. Fuller, WL 305833, No. 15352 (Del. Ch. 1997).

63. Cinerama Inc. v. Technicolor Inc., 663 A.2d 1134 (1994).

64. Yousefi v. Lockheed Martin Corp., 70 F. Supp. 2d 1061 (C.D. Cal. 1999); *See also Eastern Trading Co.*, 229 F.3d.

65. Private Securities Litigation Reform Act, 15 U.S.C. § 78(u-4);

66. The argument reads as follows: "The Court recognizes a tension between the Act's express purpose and language. Although the legislative history stresses the need to place control of securities class actions in a small and finite number of plaintiffs, the statute's language explicitly provides for more than one lead plaintiff, altogether failing to limit the number of lead plaintiffs a court may employ. [...] This Court finds that an aggregation of class members as large as the Lockheed Plaintiffs Group would frustrate the Act's purposes. One of its primary goals is to enable plaintiffs to seize control of securities fraud class action suits from the plaintiff's bar. In a suit with 137 lead plaintiffs, attorneys would have to assume a leadership role to coordinate and manage this number of lead plaintiffs. In addition, as the number of lead plaintiffs increases, individual plaintiff's incentives to monitor attorney behavior decreases, causing a "free-rider" problem." *See Yousefi*, 70 F. Supp. 2d.

67. *See* Summers, *Statutory Interpretation in the United States*, *supra* note 7, at 436.

68. *See* Atienza, *supra* note 1, at 176.

The judgment in *Yousefi* defined the specific scope of application of a statute on the basis of its ultimate purpose. The ultimate purpose criterion thus undercuts or corrects the literal interpretation criterion, which would enable the court to appoint any number of plaintiffs as lead plaintiffs for the class action. Therefore, this is a case of undercutting the scope of an excessively general text in view of the statute's purpose.[67] It is an example of what on the European continent is called *teleological reduction*.

Indeed, the statutory rule presupposes a theory as to how the goal that the plaintiffs monitor their attorneys will be achieved. The rule assumes that appointing as lead plaintiff the group with the greatest economic interests in the suit will reduce the problem of lack of monitoring of attorneys. This prediction is economic in nature. Correspondingly, in applying this rule, the opinion relies on economic literature to conclude that multiple lead plaintiffs will result in increased free-rider behavior, thus defeating the purpose of the statute. In view of that prediction, the court applies the rule refusing to appoint an excessive number of lead plaintiffs. Here, economic theory is integrated into an ultimate purpose interpretative argument, helping the court to articulate the factual prediction required in order to apply the statute in accordance with its purpose.[68]

As indicated in the opinion, the purpose of the statutory rule is "to enable plaintiffs to seize control of securities fraud class action suits." This purpose determines the interpretative argument justifying the decision. Said purpose may be explained from the perspective of economic efficiency, as it is explained in the literature quoted in the opinion, although it may be explained in other terms (of fairness, for instance). But, once again, that economic explanation in terms of efficiency of the purpose of the statutory rule does not play a role in justifying the decision on the application of the rule. The economic theory is only used at a factual level in the decision, in order to predict how the purpose of the statute would be better served in the case.

C. Cases of Generality or Vagueness in Legal Texts

When a statute is overly general or vague, systematic and teleological arguments usually take precedence over linguistic arguments. This is particularly the case with respect to the interpretation of standards. As previously noted, economic analysis of law can offer criteria to assist in determining whether a given situation is covered under a standard when the standard requires a previous factual evaluation from an economic perspective. The question now is whether an economic efficiency goal can be used to interpret the legal content of a standard.

The U.S. Supreme Court addressed this issue in *Basic Incorporated v. Max L. Levinson,*[69] the same case that accepted the use of economic theory to establish an evidentiary presumption. The Supreme Court rejected an interpretation of a standard that reasoned "backwards from a goal of economic efficiency," i.e., an interpretation drawing on the goal of efficiency to specify the content of the standard.

Here, the Supreme Court made reference to Judge Easterbrook's opinion in *Ann Flamm v. Rudolph Eberstadt.*[70] This case involved interpreting the standard of *materiality* set forth in Rule 10b-5 of the *Securities and Exchange Act of 1934.*[71] According to this rule, it is unlawful "to make any untrue statement of a material fact or to omit to state a material fact" in the disclosure of information required under the securities law. Under this rule, a minority shareholder had sued the company and its directors for failing to disclose negotiations to find an investor (a "white knight") to acquire the company after a tender offer had been announced. Judge Easterbrook maintained that the directors were under no obligation to disclose negotiations concerning merger plans until an agreement on the "price and structure" of the deal had been reached. The reason offered was that investors, considered as a group, will always prefer *ex ante* any solution that may tend to maximize their wealth. Given that the disclosure could have jeopardized the negotiations, investors would have preferred that they not be disclosed until an agreement had been reached with regard to price and basic conditions. The judgment in *Flamm* states that "in selecting a legal rule, a court must consider the effects on all investors in all firms, not just the effects on the plaintiff." [72]

However, in this case there was already an applicable legal rule that established the standard of *materiality* for determining the information that could be disclosed. For this reason, the Supreme Court rejected the rule formulated in *Flamm*. According to the Supreme Court "materiality depends on the facts and is to be determined on a case-by-case basis." "Ease of application alone is not an excuse for ignoring the purposes of the securities statutes and Congress's policy. Any approach that designates a single fact or occurrence as always determinative of an inherently fact-specific finding such as materiality must necessarily be over inclusive or under inclusive."[73] As an advisory committee to the SEC had indicated in an argument quoted in the judgment, the "materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula."

Indeed, *Flamm* did not limit itself to specifying the content of a standard in regard to a single case, but rather it created a new rule, legislating for another

69. *See Basic Incorporated*, 485 U.S.

70. Ann Flamm v. Rudolph Eberstadt, 814 F.2d 1169 (U.S. App. 7th Cir.1987).

71. 15 U.S.C. § 78 (u-4), *supra* note 65.

72. *See Flamm*, 814 F.2d.

73. *See Basic Incorporated*, 485 U.S.

multitude of future cases based on the stated reasons of efficiency. Attributing an economic efficiency goal to the standard of *materiality* in order to formulate a new rule was not possible under statutory interpretation accepted methodology.[74] The specific goal of Rule 10b-5 is to attain "full disclosure" to investors. This specific goal is the only one that can serve to articulate the purposive interpretation of the *materiality* standard embodied in the rule, although, on a theoretical level that specific goal may be explained in terms of economic efficiency.

Therefore, as evidenced by this case, when a goal of economic efficiency is used as the basis on which to justify a judicial decision such decision is no longer applicative or interpretative, but rather legislative.[75]

V. LIMITS TO THE USE OF EFFICIENCY REASONS IN COMMON LAW JUDGE-MADE RULES

A. Cases and Limits on Judge-Created Legal Rules in Common Law Methodology

According to U.S. case law accepted methodology, a judge may formulate new judicial rules in the following instances:[76] a) in cases which involve a new issue not addressed in a legal rule (the so-called "cases of first impression"); b) in cases in which a precedent has become obsolete (including the precedent that interprets a legal rule) due to changes in circumstances in the society in which the rule must be applied, enabling the judge to depart from that precedent; and c) in cases in which, for reasons of justice or morality, a prior precedent should be overruled.

In these instances, precedent methodology determines: 1) the formal requisites of the new rule (the rule must be easily applied to future cases, it must have a certain degree of generality, etc.), 2) the possible "retroactivity" of the new rule with regard to the instant case (in cases of departure and overruling), and 3) the courts that can make such pronouncements (lower courts cannot deviate from the precedents of higher courts, federal courts cannot create rules in areas that fall under the jurisdiction of state law).[77]

An example of how such formal requirements limit the scope of an economic efficiency policy can be found in the case of *Jill S. Kamen v. Kemper Financial Services Inc.*[78] This case deals with the same issue of the goal of derivative actions, and raises the question as to whether a pre-complaint demand on the board of directors of a bank required filing a derivative action against the directors under a federal law, the so-called *Investment Company Act of 1940*[79] ("ICA"). In a judgment subsequently reversed and remanded by the

74. Summers, *supra* note 6, at 241-282. The author characterises statutory interpretative methodologies as *formal*.

75. The new rule formulated in *Flamm* was put to the test in a subsequent case (James S. Jordan v. Duff &Phelps, Inc. et al, 815 F.2d 429 (U.S. App. 7th Cir. 1987)), decided by the same Federal Court comprising Judges Easterbrook (who wrote the opinion), Posner and Cudahy. A shareholder sued a closely-held company for failing to disclose material information concerning a projected merger when the shareholder sought to sell his stock to the company. Precisely because a new rule had been formulated in *Flamm* outside of the securities market legislation (applicable only to publicly-held corporations), in *Jordan* the court reversed the trial court's decision (which had applied the *Flamm* rule) and had to create a new rule for closely-held companies to distinguish it from *Flamm*: close corporations have a fiduciary duty to disclose material facts. However, in his dissenting vote Posner affirmed that "a publicly-held corporation is a fiduciary of its shareholders, too." And in his vote, dissenting with the grounds (but concurring with the decision), Judge Cudahy underscored the underlying methodological question, finally formulated by the Supreme Court: "To go on to lay down general rules applicable to all failure-to-disclose cases—even when the rules have been the subject of considerable debate—is simply not called for."

76. *See* Robert S. Summers & Leigh B. Kelley, *Economists' Reasons for Common Law Decisions*, in Essays in Legal Theory 383-384 (Kluwer Academic Publishers, 2000).

77. *Id. See also* Robert S. Summers, *The Form and Content of a Precedent Methodology*, in Law and Legal Culture in Comparative Perspective 273 (Guenther Doeker-Mach & Klaus A. Ziegert eds., 2004).

78. Jill S. Kamen v. Kemper Financial Services, Inc. et al, 500 U.S. 90 (1991).

79. Investment Company Act of 1940, 15 U.S.C. § 80(a).

Supreme Court, the Court of Appeals announced a new rule: a pre-complaint demand must be made before filing a derivative suit under this law. The court formulated this federal-level rule, despite the fact that the state corporate law governing the banking company in question provides that a previous complaint demand is not necessary when it is futile. The so-called *futility exception* that excuses such a demand was, thus, abolished by the court.

The grounds for the newly created judicial rule were strictly economic. The court deemed that the universal requirement to make a pre-complaint demand on the board of directors would limit the volume of future litigation on that matter. Any other rule other than a universal requirement of a demand or a complete excuse would constitute an incentive to litigation. "When the stakes are high (as they frequently are in cases of this character), even a small disagreement between the parties about the application of a legal rule makes it difficult to resolve agreements amicably."

The Supreme Court reversed this opinion on the grounds that a federal court cannot create a new rule on matters regulated by state law unless the state law is inconsistent with the underlying policies of federal law. According to the Supreme Court, the requisite of a pre-complaint demand is relevant in delimiting the powers of directors and shareholders and, consequently, is a matter for state law, despite the fact that the ICA is a federal statute. The futility exception did not contradict the purpose of federal law. According to the Supreme Court, the rule set forth by the Court of Appeals would have required congressional approval. Thus, the Supreme Court reversed the judgment for methodological reasons. The Court of Appeals had ignored the limits of the federal judge's powers to create legal rules and, therefore, the state statute establishing the futility exception should have been applied.

In that regard, the application of the procedural rule of jurisdiction between federal and state courts also required a prior evaluative judgment concerning the significance of the demand in the overall regulation of corporations. Despite being an issue not resolved under the federal law, it was necessary to provide an interpretation of the substantive principles of corporate law in order to determine whether this was a question in which a federal judge could make a new rule.

B. Weighing Efficiency Policy in the Creation of Law

An evaluation of the substantive and institutional principles informing the relevant regulation is therefore required in cases of judge-made law. As *Kamen*[80] shows, judicial formulation of a new rule specifically requires an operation of balancing or weighing the different principles at stake and, if

80. *See Kamen*, 500 U.S.

warranted, the legal policy goals of the regulation in question.[81] This implies that an economic efficiency policy will rarely serve as the sole justification for a judicial decision that shapes a new legal rule. In the words of Judge Allen:

> When, in absence of authoritative text or precedent, courts are modernly called upon to fashion corporate law rules interstitially, it is appropriate for the court, among other considerations, to consider the future effects generally of alternative rules and, in doing so, to consider especially the efficiency effects of those alternatives, to the extent they can reliably be detected. Thus, reasoning of the foregoing kind is not inappropriate to the institutional role of courts. But while not inappropriate, rarely will such reasoning directly produce an applicable rule or a ruling. To state what I would suppose is obvious, the corporate law, as applied in specific cases by courts, is institutionally a rich stew; the corporation law's underlying efficiency concerns are mediated through a body of authoritative rules, principles and practices to which courts owe loyalty.[82]

NoDak Bancorporation v. Robert L. Clarke[83] provides an example of how considerations of economic efficiency are weighted and balanced against other considerations in the judicial creation of law; it also shows the degree of discretion that U.S. judges have in this task. This case addressed an issue not foreseen in the federal law, the *National Bank Act of 1864*. The issue was whether a bank merger entailing a freeze-out or squeeze-out of the minority shareholders was consistent with that law.[84]

In this case, the court commenced by underscoring that the law was silent on that particular point. However, the court deemed it significant that "the statutory language uses a double negative, allowing any type of merger agreement not inconsistent with this subchapter." There follow a series of systematic considerations, favorable to accepting the freeze-out: the law mentions both cash and stock as acceptable methods of compensating shareholders in the event of a merger. Other arguments of a systematic nature are likewise offered; the law does not have to specifically provide for squeeze-outs for them to be acceptable, as long as they are not inconsistent with the statute "when taken as a whole." In addition, the court underscored that nothing in the legislative history of the statute precludes accepting this type of operation. "The legislative history does, however, reveal Congress' desire to facilitate national bank mergers." Nevertheless, the court also admits that one of the purposes of the statute is also the protection of minority shareholders, but it considers that "the appraisal remedy grants sufficient

81. *See also* Wilson R. Huhn, The Five Types of Legal Argument 68 (Carolina Academic Press, 2002).

82. Ronald S. Haft v. Herbert. Haft, 671 A.2d 413 (Del. Ch. 1995).

83. NoDak Bancorporation v. Robert L. Clarke, 998 F.2d 1416 (U.S. App. 8th Cir. 1993).

84. Concerning this type of operation *see* Robert C. Clark, Corporate Law 499 (2d. ed. 1986).

protections." The court then criticizes a precedent regarding this issue set by another federal court of equal rank that declared that "if owners of the same class of stock are to be treated differently, there should be some specific decision to that effect by Congress." Contrary to that assertion, the judgment argues that "if Congress wished to prohibit this type of merger, it could have done so and may still do so through amendments." Finally, it is argued that the tradition of protecting minority shareholders at all costs has changed, and reference is made to the fact that state corporate law statutes provide for this type of operations, likewise citing economic literature favorable to accepting them based on considerations of economic efficiency.

Hence, as this case shows, economic efficiency alone does not dictate a conclusion, but it is an integral part of the evaluative reasoning.[85] Several interpretative and policy arguments, including economic efficiency, are weighed and balanced in the formulation of a new rule.[86] Still, in a dissenting opinion,[87] one of the judges questioned whether courts had the power to create a new rule in this case.[88]

VI. CONCLUSION

There is substantial academic support for the claim that the goal of corporate law is (or ought to be) to maximize economic efficiency. From this view point, the goal of corporate law would be formulated as to "advance the aggregate welfare of a firm's shareholders, employees, suppliers (including financial ones) and customers without undue sacrifice and, if possible, with benefit to third parties such as local communities and beneficiaries of the natural environment."[89]

This article shows that the consideration of efficiency as a policy goal of corporate law is external to the law. From the perspective of judicial reasoning, the purported goal of economic efficiency may constitute (as long as it is accepted by a legal system) a policy that needs to be first articulated in a rule of a more specific content. As a goal, it cannot be interpreted in judicial reasoning. Economic efficiency is not, nor can it in the strict sense constitute, a legal principle; it is a notion that is too generic. From this standpoint, the positions of common law and continental law do not differ.

An economic efficiency goal cannot function in the justification of a decision *to apply* a rule, not even when the reasoning is goal-oriented and the purpose of the rule can be expressed in economic terms (in terms of "incentives").

In the application of precedent rule by analogy, the judge will have to establish a similarity, on a general level, between the facts of the case at hand and those

85. *See* Summers & Kelley, *supra* note 76, at 246-248. *See also* Horst Eidenmüller, Effizienz als Rechtsprinzip 468-469 (1995). The operation of weighing cannot be reduced in any way to a mere cost-benefit calculation; this operation is evaluative. *See also* Hector Fix-Fierro, Courts, Justice, and Efficiency. A Socio-Legal Study of Economic Rationality in Adjudication 70-76 (Hart Publishing, 2004). According to this author, "economic rationality is not the prevalent value in the legal decision-making, as it is subject to all kinds of constraints, local conditions and concrete negotiations with other values and interests." As shown in this article, at the level of judicial rule-making it is the operation of balancing and weighing that subjects the goal of efficiency to such compromises.

86. For a defense of *NoDak* based on economic arguments *see* Diana R. Ivanovic, Note, *NoDak Bancorporation v. Clarke: Redefining the Rights of Minority Shareholders in a Freeze-Out Merger under the National Bank Act*, 39 Vill. L. Rev. 915 (1994). For a critical perspective on NoDak *see* Lori J. Carlson, Case Comment, *The Case Against Cash-Outs in National Bank Mergers: A Critical Analysis of NoDak Bancorporation v. Clarke*, 79 Minn. L. Rev. 173 (1994). *See also* Marc R. Lisker, Note, *NoDak Bancorporation v. Clarke: The Eighth Circuit's Ruling on Freeze-Out Mergers Sends a Chill to Minority Shareholders*, 89 Nw U. L. Rev. 318 (1994).

87. *See NoDak Bancorporation*, 998 F.2d.

88. This case was complex under U.S. law. It was a case of federal law, while corporate law is governed by state law. The law of some states do provide for squeeze-out or freeze-out mergers. In that regard, acceptance of this merger procedure is rooted in statutory law. However, there has been significant case law development in the area of appraisal of the price of stock.

89. *See* John Armour, Henry Hansmann & Reinier Kraakman, *What is Corporate Law*, in The Anatomy of Corporate Law: A Comparative and Functional Approach 22-23 (Oxford Univ. Press, 3d ed. 2017); *See also* Kornhauser, *Symposium on Post-Chicago Law and Economics*, *supra* note 17, at 87.

of the precedent that will enable the rule to be applied in view of its own reason. This level of generalization is controlled, up to a point, by the rule of precedent and its specific reason. As we have seen, in the cases of fee-shifting in derivative actions, an analogy is drawn between the facts of the precedent (for example, a derivative action against directors in a widely-held corporate enterprise) and those of the case at hand (action against the administrators of a condominium association), but any possible generalization of the facts in order to establish the analogy is subject to the fee-shifting precedent rule, whose reason is *monitoring of directors*. The reason of the rule of the precedent defines the framework within which analogical reasoning operates. However, the generality of a goal of economic efficiency does not permit such analogical reasoning. Its implementation cannot be made by analogy, but only by formulating a new rule. Analogical reasoning always makes reference to a norm (rule or principle) and its specific reason.

The same may be said of the interpretation of a statutory rule, including those containing a legal standard. Economic analysis may be used, within purposive or "teleological" argumentation, in the formulation of the prediction as to how the purpose of the rule will in fact be achieved through the application of the rule to the case. In short, economic analysis can operate within judicial reasoning.

But the goal of the statutory rule cannot be as general as economic efficiency. A rules purpose can be of a consequentialist nature and may be characterized in economic terms, but it will always be more specific than economic efficiency *per se*. This purpose must have already been articulated by the legislature in a specific statutory rule. Thus, the rule will have a more specific purpose, for example, to promote or to encourage the monitoring of attorneys in class actions. Therefore, in judicial interpretation the notion of economic efficiency will correspondingly serve, if at all, as a perspective from which to explain the rule at a theoretical level, but not at the practical level of justifying the interpretative decision.

Of course, as described in the first part of this article, economic analysis can also be used, when warranted, in the determination of facts when a *standard* points to an economic-oriented evaluation. It may also be used in the proof of facts, like other sciences or techniques, as the basis for presumptions.

So far, the situation is not substantially different in European continental law. However, the role of a possible policy goal of economic efficiency in the judicial creation of a new rule may be different in continental and U.S. law, due to the different degree of discretion that judges enjoy in both systems.

In order to serve for justifying the formulation of a new rule, an efficiency goal must in any case be weighed against other principles and policy goals within the system. The goal of efficiency will always operate within the context of this weighing methodological process. But weighing a policy goal so generic as economic efficiency (i.e. articulating a goal in a specific legal rule) requires a high degree of discretion. As noted, in this respect policy goals differ from legal principles.[90] Principles (in the sense of comprehensive rules extracted from a legal regulation) are more specific than policy goals and do not require such discretion in order to be applied. Principles will prevail over policies, such as efficiency, because their legal content will be more specific and, thus, more readily applicable to the case. For example, a legal principle of creditors protection or investors protection in corporate law or securities law may justify a decision without the need to formulate a new general rule. To the contrary, an efficiency goal must first be articulated in a rule that makes a choice of what is efficient.

The new rule itself may be more or less general. For example, the same goal of economic efficiency may justify a fee-shifting rule applied in derivative actions, or a rule of fee-shifting applied anytime a shareholder can prove a claim of sub-optimization of business on the part of its directors. This was the issue raised in *Bird*. Each of these rules would in turn affect a different group of rules and principles of corporate law. The second rule would affect not only the regulation of monitoring of directors in the corporation, but also the very function of judges.

Thus, in the case of a goal as generic as economic efficiency, the need of weighing substantially limits its scope of influence on judicial reasoning. For this reason, in the absence of a binding rule or precedent rarely can an economic efficiency criterion serve alone as the basis for a new judicially-created rule, even in the U.S. Rarely, especially in an area such as corporate law, the judge will not find rules or principles, and perhaps other goals that are more specific in content than efficiency.

However, continental judges do not enjoy the same degree of discretion required to weigh or balance an economic efficiency goal, in the event that it was accepted in the legal system.[91] A case such as *NoDak*, in which a court formulates a new rule accepting squeeze-out or freeze-out mergers not provided for by statute, would hardly be possible in European continental law. This does not mean that judge-made law is not possible to some extent in the civil law tradition. It means that economic efficiency is too generic as a goal to enable civil law judges, given their degree of discretion, to articulate such goal in new general rules.

90. *See* Atienza & Manero, *supra* note 1.

91. Gondra, *supra* note 10, at 1571-1573.