15. An Austrian analysis of contemporary American business law

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I. INTRODUCTION

Economic analyses of law have typically relied on models from mainstream, neoclassical economics. This approach assumes that individuals act "rationally," that they are fully informed, and that all-important phenomena can be described in formal equilibrium models. In the last couple of decades, a number of legal scholars have attempted to incorporate "behavioral" economic analyses of legal rules, jettisoning the assumption of *homo economicus* and considering how welfare calculations change if individuals are not rational, self-interested maximizers but instead exhibit predictable irrationalities (e.g., the endowment effect) or tendencies toward non-self-interested behavior (e.g., the "fairness" tendencies exhibited in the Ultimatum Game). Indeed, some scholars have referred to behavioral law and economics as the "growth stock" of legal academia (Choi and Pritchard, 2003).

Whereas behavioral economics has made significant inroads into legal analysis, another group of heterodox theories, those associated with Austrian economics, have rarely been explicitly invoked in economic analyses of law.[1] This chapter begins to fill that gap in one area: American business law. We begin by setting forth some Austrian insights that are particularly relevant to an analysis of business law. We then examine a number of business law doctrines—some from corporate law, others from business-related fields such as agency and antitrust—and demonstrate how they cohere or conflict with Austrian insights.

[1] Exceptions include the essays collected in Rizzo (2011), along with important papers by Block (1977), Kirzner (1979), Rothbard (1982), Hoppe (2004), and Hülsmann (2004).

II. RELEVANT CONCEPTS IN AUSTRIAN ECONOMIC AND LEGAL THEORY

Austrian thinking on the nature of the firm is the obvious starting point for an Austrian analysis of business law. But Austrian insights on business cycles and on the nature of law itself also shed light on the propriety of the rules governing business structures and operations. We therefore begin with a brief summary of Austrian thought on the nature of the firm, business cycle theory, and the propriety of different types of legal rules.

a. An Austrian Theory of the Firm?

The early Austrians did not develop an explicit theory of the business firm, though their works are rife with insights on the organization of production (Foss and Klein, 2010). More recently, a number of distinct Austrian theories of the firm have emerged, emphasizing characteristically Austrian ideas about property, entrepreneurship, economic calculation, tacit knowledge, and the temporal structure of capital.[2]

i. Insights from the socialist calculation debate

Austrian economists are perhaps best known for their role in the early 20th Century "socialist calculation" debate. Pointing to instances of crushing poverty and severe wealth inequality during and following the Industrial Revolution, socialists, Marxists, and other critics of *laissez faire* contended that free markets had effectively failed and that wise and benevolent governments could allocate resources in a more efficient and equitable manner. A number of theorists now associated with the Austrian school took up the cause of *laissez faire*, contending that markets allocate resources better, or at least no worse, than even the best-run governments could do.

Ludwig von Mises (1920) launched the debate with his argument that rational economic planning requires private property in factors (the "means of production"). Economists had already recognized the role of the price mechanism in allocating resources to high-valued uses, but had not spelled out the legal foundations for this procedure. Mises pointed out that if all factors are owned collectively—by a socialist dictator, or even a voluntary collective with democratic voting—then there can be no exchange markets for factors, and thus no market prices for these

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[2] See, for example, the papers collected in Foss and Klein (2002) and the references cited therein, along with more recent works by Adelstein (2005), Casson (2005), Langlois (2007), Pongracic (2009), and Foss and Klein (2012).

factors. Central planners can assign their own "prices," but these are just meaningless, arbitrary numbers. Without real markets and real prices, it is impossible for entrepreneurs to form judgments about the relative scarcities of various factors and the expected profitability of combining them in various combinations in their attempts to produce goods and services consumers want (and are willing to pay for). Because factors are heterogeneous, it is impossible to quantify, add up, and compare them without prices (bushels of wheat cannot be added to tons of steel or man-hours of labor to see which combinations are the least costly for producing particular outputs). Mises's argument was essentially about the need for cost accounting with numbers that accurately reflect real-world economic conditions (Klein, 1996).

Mises (1951) also emphasized the role of factor markets, and the profit-and-loss mechanism more generally, in selecting among more and less able entrepreneurs. Without markets for inputs and outputs, there can be no economically meaningful profits and losses, and no way for the competitive process to shift resources from less to more valuable uses (i.e., from less to more able entrepreneurs).

F.A. Hayek interpreted Mises's argument in terms of the "knowledge problem"—the fact that the information required to allocate productive resources to their highest and best ends is not readily available to any individual or central authority, because it is widely dispersed among individuals throughout society and frequently idiosyncratic, tacit, and otherwise unarticulable (e.g., Hayek, 1945). Socialist planners, Hayek emphasized, lack access to value-relevant information (including information about individuals' subjective preferences for different uses of productive resources) and could not effectively process all those frequently conflicting bits of information even if they were accessible—hence the failure of centralized economic planning.[3]

Austrian thinkers further emphasized that the factors affecting the value any allocation of resources will generate are constantly changing. Mises, for example, insisted that "the problem of economic calculation is of economic dynamics; it is no problem of economic statics" (Mises, 1922, p. 121). Hayek later added that "economic problems arise always and only in consequence of change" (Hayek, 1945, p. 82). To allocate resources efficiently, socialist planners would have to keep abreast of a multitude

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[3] There is a lively debate within and outside the Austrian school about whether Mises's and Hayek's arguments are slight variations on a common theme, or reflect important differences about value, prices, and equilibrium. This variety of perspectives and interpretations is reflected in the applied Austrian literature on the business firm.

of changing facts, many of which (such as individuals' changing preferences for products and services) cannot be directly observed. In a market economy, by contrast, value-relevant changes continually affect prices, which in turn motivate the "man on the spot" to alter his behavior in a salutary direction. Thus, in Salerno's (1994, p. 121) words, Mises "makes it crystal clear that the static prices mathematically imputed from perfect knowledge of the economic data would not lead to a dynamically efficient allocation of resources. The latter can only be achieved by the entrepreneurially appraised prices that are generated by the historical market process."

Austrian defenders of *laissez faire* also noted the incentive problems besetting socialism. A right to at least a portion of the residual value occasioned by their superior allocation decisions, even the most highly competent socialist planners with complete knowledge about the relative value of competing resource allocations would have little incentive to allocate resources to their highest and best ends, especially if they could attain personal benefits from suboptimal resource allocations. Actual and proposed socialist systems generally did not, however, grant planners any ownership stake in the value they generated. Moreover, such systems generally conferred tremendous power and discretion on planners, so much so that they could easily enrich themselves by personally usurping resources or channeling them so as to earn kickbacks or other perquisites. Accordingly, socialist planning faced an incentive problem as well as a knowledge problem.

As explained below, these three insights from the socialist calculation debate—the knowledge problem, the ubiquity and significance of change, and the importance of incentives in economic planning—contribute to a distinctly Austrian theory of the firm.

ii. Entrepreneurship

The ubiquity of change, Austrian thinkers recognized, creates a constant need for resources to be reallocated (i.e., redirected in their use) in a manner that will unlock greater value. A key figure in any capitalist system, then, is the entrepreneur—an agent who, in the face of uncertainty and widely dispersed knowledge, seeks to discover and take advantage of opportunities to create value and profit by moving capital and resources from less valuable to more valuable uses. Entrepreneurs are constantly alert to opportunities to discover and exploit maladjustments in resource allocation. By engaging in the activities Kirzner termed arbitrage (instantaneous exploitation of price differentials), speculation (arbitrage through time), and innovation (the creation of a new product, productive method, resource use, or organization different from the usual one), entrepreneurs

constantly reallocate resources toward higher and better ends, creating value and earning personal profit in the process (Kirzner, 1985, pp. 84–5).

One way entrepreneurs create value is by experimenting with capital assets. As Barzel (1997) observed, capital assets are distinguished by their "attributes," which are the assets' characteristics, functions, and possible uses, as perceived by an entrepreneur. Asset attributes exist not objectively, but subjectively in the minds of entrepreneurs who employ the assets in various lines of production. This implies that asset attributes are manifested in production decisions and are realized only *ex post*, after those decisions have generated profits or losses. Entrepreneurship is thus not merely a matter of deploying, in a "risky" manner, assets with *given* attributes; it involves experimentation to discover those attributes under conditions of uncertainty.

Because an entrepreneur is a speculator who operates under conditions of true "uncertainty," where not even the probability of success may be determined,[4] he cannot easily be hired. Entrepreneurial judgment cannot be assessed in terms of its marginal product and therefore cannot be valued *ex ante* for purposes of ascertaining a wage. Accordingly, there is no market for the judgment that entrepreneurs rely on, and exercising such judgment may require the person possessing it to start a firm. Klein (2008) therefore asserts that "[f]irms exist not only to economize on transaction costs, but also as a means for the exercise of entrepreneurial judgment, and as a low-cost mechanism for entrepreneurs to experiment with various combinations of heterogeneous capital goods."

iii. Institutions

A final concept that should be included in any Austrian theory of the firm is the notion that social order tends to emerge from the voluntary, decentralized interactions of individuals pursuing their own interests without necessarily trying to create any sort of social order. While very much a feature of Scottish Enlightenment thinking, as exemplified by Adam Smith's "invisible hand" (Smith, 1776, Book IV, Ch. II, para. IX) and Adam Ferguson's reference to establishments that "are indeed the result of human action, but not the execution of any human design" (Ferguson, 1767, Part III, Section II), this concept was embraced by Hayek, building on Menger's distinction between "pragmatic" and "organic" institutions,

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[4] *See* Knight (1921), pp. 19–20, distinguishing "risk," which is quantifiable, from "uncertainty," which is not, and Foss and Klein (2012, Ch. 4) on the implications of the Knightian distinction for the theory of the firm. Mises (1949) emphasized a similar distinction between "class probability" and "case probability" (Klein, 2009).

in which the former are the result of "socially teleological causes" while the latter are "the unintended result of innumerable efforts of economic subjects pursuing individual interests" (Menger, 1883, p. 158). Menger's (1892) famous analysis of the origin of money is the best-known example of such a process. Hayek similarly focused on this distinction between "planned" and "spontaneous" orders, going so far as to distinguish between the rules giving rise to a spontaneous order and those supporting a planned order (Hayek, 1973). (His distinction between types of rules is considered below.)

iv. Synthesis

At first glance, many of the hallmarks of Austrian thought—the impossibility of centralized economic planning, the central role of prices created through decentralized exchange, the general superiority of organic institutions over those resulting from conscious design—seem inconsistent with the notion of planned, structured business firms. Consider, for example, Coase's (1937, p. 389) famous observation that "the distinguishing mark of the firm is the supersession of the price mechanism" and his attempt to define the firm by pointing to its opposite, the unplanned allocation of resources in a free market:

> Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. Within a firm, these market transactions are eliminated and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-coordinator, who directs production. (Coase, 1937, p. 388)

In light of these observations, one may query whether Austrian thought can accommodate a view that recognizes business firms as instances of central planning—"islands of conscious power," as Coase called them—yet regards them as salutary components of a market economy. It can and does.

As an initial matter, the notion of economic planning itself is not inconsistent with Austrian thought. Austrian economists have long recognized that such planning must exist in any economic system. Hayek, for example, emphasized that "all the dispute about 'economic planning'" in the socialist calculation debate was "not a dispute about whether planning is to be done or not"; rather, it was "a dispute as to whether planning is to be done centrally, by one authority for the whole economic system, or is to be divided among many individuals" (Hayek, 1945, pp. 519–20).

While planning and conscious power will appear in any economic system, there is a difference between *state* planning and that which occurs within organizations that are created voluntarily via contract in a system of private ownership. State planners possess presumptively legitimate

power to coerce using force, and are often far-removed (both geographically and temporally) from the situations they govern, and usually face little competition. The "planners" within a contractually created business entity, by contrast, cannot forcefully coerce their subjects (they must procure consent from resource providers), are typically "closer to the action" than state planners, face significant competition from other individuals and contractual entities, and hold residual control rights over the resources they own and manage. Planning within a voluntary association, then, is not the same as state economic planning.

Business entities that allocate resources via managerial fiat regularly emerge in free societies and should thus be regarded as instances of spontaneous order. The Coasian explanation of why they emerge—i.e., because "there is a cost of using the price mechanism" to allocate productive resources—is consistent with Austrian thinking. But Austrian ideas may helpfully supplement the Coasian account. Thus, as Foss and Klein have explained, one may develop a "uniquely 'Austrian' approach to the firm" by "start[ing] with the basic contractual approach, and the Coasian *explananda* of the firm's existence, boundaries, and internal organization, and add[ing] concepts of entrepreneurship, economic calculation, the time-structure of production, and other elements of the Austrian tradition" (Foss and Klein, 2010, p. 287).

In this approach, the firm is a manifestation of entrepreneurial judgment, a nexus of contracts voluntarily entered into by resource owners and suppliers of labor seeking to reduce various costs (e.g., transaction costs, costs stemming from "hold-ups" occasioned by asset-specific investments, agency costs, etc.). In addition, however, firms tend to emerge as the means by which entrepreneurs may secure compensation for their judgments. Because entrepreneurs operate under conditions of true uncertainty (as opposed to predictable risk), the value of their efforts cannot be predicted *ex ante*, and they therefore cannot easily be hired at pre-determined wages. They will often prefer to structure arrangements so that their compensation comes in the form of the residual income stream occasioned by their entrepreneurial judgments, and this will require them to establish a firm.

Austrian insights from the socialist calculation debate, then, shed light on the internal characteristics of the nexus of contracts that constitutes a firm. While resource-owning entrepreneurs hold residual decision rights over the use of the firm's assets, these entrepreneurs will typically delegate specified decision rights to subordinates to take advantage of local knowledge and high-powered incentives (i.e., moving some day-to-day decision-making away from far-removed capital providers and toward hands-on managers, who more closely resemble Hayek's "man on the spot"). Given the need to align the incentives of managers and suppliers of capital,

Austrian thought predicts that the parties to firms will recognize duties from managers to residual claimants and will impose liability on managers who benefit themselves at the expense of those claimants. Because change is both ubiquitous and important, the posited duties should be somewhat flexible, perhaps conceived of as "standards" of care whose contours are fleshed out ex post, rather than "rules" of behavior, which are specified *ex ante.* (In Foss, Foss, and Klein's (2007) terminology, these managers exercise a subordinate form of judgment that is "derived" from the "original" judgment rights of owners.)

In Part III, we consider the degree to which American business law coheres with this somewhat general Austrian theory of the firm. First, though, we consider two other concepts that are relevant to an Austrian analysis of business law principles.

b. Business Cycle Theory

Although an in-depth consideration of Austrian business cycle theory is beyond the scope of this chapter, Austrian insights on the causes of recessions and depressions are useful in analyzing some key securities law doctrines, and we therefore provide a cursory overview of Austrian thinking on business cycles.[5]

The Austrian theory differs from mainstream accounts of business cycles in its emphasis on resource heterogeneity (Foss et al., 2007; Agarwal et al., 2009). In a modern, industrial economy, consumer goods result from complex, multi-stage production processes. Entrepreneurs purchase capital and labor in the present, in anticipation of the receipts from selling products (to consumers or to entrepreneurs at the next production stage) in the future. Entrepreneurs are continually adjusting the economy's inter-temporal production structure, or capital structure, based on their knowledge of past and present technology and resource availability and their expectations about future market conditions. Because production takes time, interest rates are essential for coordinating activities across production stages.

In an economy with a central bank (such as the US Federal Reserve System), interest rates are affected not only by the rates at which individuals save (by deferring current consumption in favor of future consumption) and at which entrepreneurs borrow (to invest in production), but also by the government's monetary policy. If the central bank increases the supply

[5] For more detailed treatments see Hayek (1931), Rothbard (1963), and Garrison (2001). For practical implications see Klein (2014).

of loanable funds (e.g., by purchasing bonds), market interest rates fall, and entrepreneurs borrow to finance new projects that would not have been profitable at higher interest rates. Because time-consuming and temporally remote projects tend to be most sensitive to interest rate changes, those newly funded projects are often "higher-order" projects that are somewhat far-removed from finished consumer goods—e.g., construction projects, mining, new capital equipment, or purchases of raw materials.

This process is appropriate where the growth in funds available for borrowing occurs because of increased saving. Members of the public, by their savings decisions, have indicated a willingness to forego current consumption in favor of future consumption. The public's saved resources provide the wherewithal to see the long-term investment projects through to completion, so the long time horizon of the newly funded projects presents no problem. Market-determined interest rates therefore send appropriate signals, encouraging entrepreneurs to undertake long-term projects only when the public has set aside the funds necessary to finance them.

The situation is different, though, when interest rates drop because the central bank has increased the money supply. In those circumstances, the public has not set aside the resources necessary to make possible the newly initiated projects, and those resources do not magically appear as a result of the central bank's creation of new fiat money. Thus, the lower interest rates resulting from the central bank's actions encourage entrepreneurs to invest in long-term projects and discourages saving by individuals, when the public has not actually set aside the resources required for long-term investment projects. The result is malinvestment—i.e., the allocation of productive resources *away* from their highest and best ends. As Mises (1949, p. 549) puts it, credit expansion by the central bank "falsifies economic calculation." When it becomes clear that the factors do not exist in sufficient quantities to make all the newly initiated projects profitable, the low interest rate-fueled boom turns into a bust, during which malinvestments are liquidated, resources are re-directed to more value-productive ends, and the economy readjusts itself. Government efforts to interfere with this painful process of readjustment—e.g., propping up malinvestments rather than allowing their liquidation—only prolong the economic hardship or sow the seeds for a future boom-bust cycle.

As explained below, Austrian thinking on business cycles is relevant to an analysis of securities regulation, for some aspects of the securities laws encourage the overvaluation of equity and impede price correction, leading corporate managers to make analogous value-destructive malinvestments.

c. The Nature of Law: *Nomos vs. Thesis*

A final concept that is relevant to an Austrian analysis of business law is Hayek's distinction between the types of legal rules (Hayek, 1973). Some legal rules are general in their application, are "purpose-independent" (meaning that the law-giver is not seeking to achieve some specific social outcome but is instead endeavoring to posit the means for resolving disputes in accordance with the parties' settled expectations), and have the effect of setting clear expectations so that parties may confidently predict outcomes in structuring their affairs. Hayek referred to these sorts of rules as *nomos*. Other legal rules are more akin to specific orders from a central authority seeking to achieve some specific purpose. Such "teleological" rules Hayek labeled *thesis*.

In light of his emphasis on the knowledge problem and the impossibility of effective central planning, Hayek contended that the rules that legitimately constrain individuals in their interactions with each other are *nomos*. *Thesis* should be (but often is not) limited to the context of intragovernmental administration. The common law, rendered by judges resolving specific disputes among parties and looking to precedent for guidance, is generally *nomos*. Most (but not all) legislation is *thesis*. The characterization of any piece of legislation will depend on whether it amounts to specific orders aimed at achieving a set purpose (e.g., the recently enacted federal health care law), in which case it is *thesis*, or is instead simply seeking to codify purpose-independent rules that settle parties' expectations and enable them to order their affairs in light of the information to which they alone are privy (e.g., the Uniform Commercial Code), in which case it is *nomos*. As explained below, some business law doctrines are *nomos*-like; others are plainly *thesis*.

III. AN AUSTRIAN ANALYSIS OF SELECTED BUSINESS LAW FEATURES AND DOCTRINES

Having set forth some key insights from Austrian thought, we turn now to an analysis of some specific aspects of American business law. We first consider features that cohere with Austrian thinking on the limits of centralized economic planning and the entrepreneurial function of firms. We then consider various features that conflict with Austrian insights on those matters. (Our lists of coherent and conflicting features are, of course, far from complete. Our goal is not to provide an exhaustive Austrian analysis of business law, but instead to highlight doctrines and features that appear to be particularly coherent or in conflict with Austrian thinking.)

a. Coherent Features

i. Acknowledging the limits of centralized economic planning

A number of features of contemporary business law display a sensitivity to Hayekian thinking on the difficulty of centralized economic planning in light of dispersed knowledge and constant change. Most notably, the very structure of most business organizations' statutes (e.g., state corporation statutes, the Uniform Partnership Act, state limited liability company acts) reflects skepticism about central economic planning. In general, those statutes simply posit sets of tailorable default rules that will determine relations among the participants in a business organization *if those participants do not specify otherwise*. Section 18 of the Uniform Partnership Act (1914), for example, sets the rules that govern how general partners will share profits, losses, and management authority, but it expressly makes those rules "subject to any agreement between [the partners]." By providing rules on a number matters, the state business organization statutes settle expectations among the parties, permitting them to arrange their affairs with some confidence about outcomes. By allowing parties to alter those rules, the statutes enable parties to craft their relationships in light of their private knowledge (including knowledge about parties' subjective values), information to which legislators and regulators could never be privy. State business organization statutes are thus *nomos*-like, purpose-independent rules that eschew central planning and facilitate the emergence of spontaneous orders that reflect local conditions and participants' subjective values.

A similar solicitude for private ordering is evident in the legal doctrines employed to control agency costs, the inevitable losses that occur when a self-interested agent purports to act on a principal's behalf.[6] The law has generally sought to constrain agency costs by saddling agents with fiduciary duties—broad, amorphous obligations whose specific contours are fleshed out *ex post*. Many of these fiduciary duties are tailorable so that they are, in effect, default contract terms between principal and agent. For example, a number of fiduciary duties preclude an agent from earning any "secret profits" from his agency (i.e., any compensation other than that specifically agreed upon with the principal). For the most part, though, those duties apply "except as otherwise agreed" (see, for example,

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[6] The agent, who does not capture all the benefit of his diligent service to the principal, has an incentive to shirk and/or act opportunistically. The principal, knowing her agent's tendencies, has an incentive to expend resources monitoring the agent. The combined losses from the agent's shirking and opportunism and the principal's monitoring constitute agency costs.

Restatement (Second) of Agency Sections 1958, 387–398). Thus, we again see *nomos*-like rules that facilitate planning but permit parties to tailor relationships in light of their private information.[7]

A particularly interesting aspect of fiduciary duties is the remedy provided for breach. When an agent somehow profits from his breach of fiduciary duty to his principal, the law requires that he "disgorge" his gain, *even if* the breach of duty did not injure the principal and the principal could not have earned the profits herself. This is a somewhat curious doctrine. Most breaches of fiduciary duty could alternatively be analyzed as breaches of contract (either express or implied contracts), and a punitive disgorgement remedy would never be allowed if the breach were so analyzed.[8] It might seem odd to permit the principal to collect what are effectively punitive damages by pleading her claim as a breach of fiduciary duty rather than a breach of contract. The disgorgement remedy for breach of fiduciary duty makes sense, though, as an information-forcing "penalty" default. The idea is that the law should encourage agents who know of potential side businesses in which they could earn additional profit to disclose those opportunities to their principals, bargain over them, and strike mutually beneficial deals in which the opportunities are exploited and the profits shared in whatever proportion makes most sense, given the information to which only the principals and agents themselves are privy. If the default rule "punishes" agents who have private information about potential business opportunities by requiring them to disgorge any profits they earn exploiting such opportunities, it encourages agents to share that information and tailor mutually beneficial arrangements. Because the disgorgement remedy (1) recognizes and seeks to harness the value of private information and (2) facilitates private ordering, it appears to cohere with Austrian insights.

Recent developments in antitrust law also seem to recognize the value of allowing business persons to structure their relations as best they see fit given their private information. Until the mid-1970s, antitrust doctrine was quite hostile to "vertical intra-brand restraints"—i.e., manufacturer/distributor agreements under which the distributors promise not to sell the manufacturers' goods on certain terms. Both vertical price restraints

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[7] Note that the law has deemed some fiduciary duties to be non-waivable. Corporate directors, for instance, may not contract out of their duties to shareholders in a way that would permit the directors to engage in insider trading. Mandatory, "tort-like" fiduciary duties would seem to be inconsistent with Austrian thought.

[8] Contract doctrine rejects punitive damages for breach of contract because they deter efficient breaches.

(e.g., resale price maintenance agreements under which a retailer may not sell a manufacturer's product below a certain price) and vertical non-price restraints (e.g., agreements under which a retailer is forbidden to sell a manufacturer's product outside a specified geographic region) were per se illegal. Manufacturers were therefore limited in their ability to distribute their products through dealers while simultaneously exercising control over how those dealers distributed their products. Instead, manufacturers generally confronted a stark "make or buy" decision with respect to product distribution: They could either "make" product distribution by distributing their products themselves (i.e., by vertically integrating) or "buy" it by selling through distributors, over whom they could assert little control. Limiting manufacturers' freedom to engage in partial vertical integration by outsourcing distribution but then contractually controlling their distributors' conduct conflicted with the Austrian notion that decisions about distribution arrangements are best left to the "man on the spot," who should be free to tailor his distributor arrangements in whatever way he believes, based on his private information, will maximize total sales of his product.

In the last few decades, antitrust doctrine has become far less hostile to vertical intra-brand restraints. All such restraints—both non-price and price—are now judged under a rule of reason that recognizes that contractual arrangements achieving a partial vertical integration are generally output-enhancing and should be permitted. Of course, the ability of the courts to decide which vertical restraints promote efficiency (and thus should be permitted) and which are aimed at building, protecting, or extending market power (and thus should be forbidden) violates the idea that business arrangements are best left up to market participants. More generally, Austrians reject the neoclassical economics notion of "perfect competition" that underlies conventional antitrust analysis, tending to view a market as competitive as long as there are no governmental restrictions on entry (Armentano, 1996; Salerno, 2003). Still, contemporary antitrust permits more of the sort of private ordering favored by Austrian thinkers than was the case before the 1980s.

ii. Furthering the entrepreneurial function of the firm

As explained above, Austrians recognize that firms not only economize on various costs, they also provide a vehicle for the exercise of entrepreneurial judgment, which involves experimentation with novel asset allocations in an attempt to create value (and profits).[9] A chief function of the Austrian

[9] Given that value is subjective and change ubiquitous, wealth may be created (and profit earned) by deploying assets differently over time. Entrepreneurs

firm, then, is to foster entrepreneurial uncertainty-bearing. This understanding of the firm provides theoretical support for two central features of corporate law: limited liability and the business judgment rule.

Austrian writers such as Israel Kirzner have distinguished sharply between the "pure entrepreneur" who owns no capital and the "entrepreneur-capitalist" who does, while others have insisted that the exercise of entrepreneurial judgment involves ownership.[10] In either case, entrepreneurs typically rely on outside investors for additional capital. Limited liability—the legal doctrine that, for some types of firms (e.g., corporations), limits an individual investor's liability for firm debts and obligations to the amount of his investment in the firm—facilitates capital formation by entrepreneurs. The business judgment rule—the doctrine that precludes courts from second-guessing business decisions by managers who acted loyally, in good faith, and on a reasonably informed basis—encourages firm managers to take significant business risks. Collectively, limited liability and the business judgment rule enable firms to act as vehicles for entrepreneurial judgment.

The most obvious way limited liability encourages capital formation is by permitting investors to externalize some of the cost of their firms' activities.[11] This somewhat troubling "externalization of cost" effect, though, does not fully account for limited liability's role in facilitating capital formation[12] (Bainbridge, 2002). Limited liability enables passive investment because investors need not monitor firm managers as closely as they would if their entire fortunes were at stake. The possibility of passive investment, then, permits investors to diversify their investment portfolios, thereby reducing unsystematic investment risk. Limited liability also renders equity investments "fungible," because investors need not adjust

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continually experiment with asset allocations, hoping to discover new allocations to which consumers will attach a high value. Because entrepreneurs accomplish this task under conditions of true uncertainty, it is impossible to evaluate and provide compensation for their entrepreneurial judgments *ex ante*, and their best option for compensation is to establish firms in which they are residual claimants.

[10] Compare, e.g., Kirzner (2009) and Foss and Klein (2012).

[11] If, for example, a firm creates tort liability of $2 million but has assets of only $1 million, the investors effectively foist $1 million of the cost of the firm's activities onto the tort claimants.

[12] Limited liability's externalization of cost effect is likely less significant than it initially appears. Contract creditors dealing with limited liability firms can and usually do bargain for protection from externalization (e.g., a higher interest rate, a guaranty from investors). Reputational considerations and, for closely held limited liability entities, the possibility that courts will "pierce the corporate veil" provide a good deal of protection for potential tort victims.

their valuation of an investment to account for the risk that a creditor will pursue their personal assets. This fungibility permits equity investments to be traded on highly liquid markets, which in turn makes those investments particularly attractive to suppliers of capital. By encouraging passive investment, enabling diversification, and facilitating the creation of highly liquid equities markets, limited liability assists entrepreneurs in raising capital for their risk-taking ventures.

The business judgment rule, then, assures that firm managers—who may not themselves hold equity stakes—are willing to bear uncertainty, making them act more like entrepreneur-owners. The rule holds that absent fraud, self-dealing, bad faith, or gross negligence in becoming informed, courts will abstain from assessing the merits of business decisions that lose money for investors. Oft-stated rationales for the rule are that judges are not business experts and that the rule encourages individuals to serve as corporate managers by insulating them from liability for decisions that turn out badly. Those explanations, though, are incomplete. In other contexts, courts routinely assess the merits of complicated decisions, even when they lack expertise and might dissuade qualified individuals from serving in high-risk roles. In medical malpractice cases, for example, courts regularly review treatment decisions, despite the facts that judges and jurors lack medical training and that potential malpractice liability discourages qualified individuals from becoming doctors.

The business judgment rule is thus better understood as a doctrine aimed at encouraging managerial risk-taking. In larger, more mature business organizations, most business decisions are made by professional managers (e.g., corporate directors and officers), who tend to be more risk averse than equity investors. Professional managers are usually fully compensated when a firm breaks even (i.e., earns no economic profit) but stand to lose their career if the firm fails or suffers a large loss. Equity investors, by contrast, receive no payout at all if the firm merely breaks even and lose only the value of their investment, which is typically held as part of a diversified portfolio, if the firm fails. Relative to managers, then, equity investors have a much stronger preference for high-risk, high-reward decisions. By assuring managers that their loyal, good faith, and reasonably informed business decisions cannot create legal liability even if they turn out miserably, the business judgment rule encourages managers to take greater business risks and thereby facilitates the firm's role as a vehicle for entrepreneurial uncertainty-bearing.[13]

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[13] Delaware courts have explicitly acknowledged how the business judgment rule's leniency enables corporations to embrace risk and thereby fulfill their

b. Conflicting Features

While the business law features discussed above seem consistent with Austrian insights on the limits of centralized planning and the entrepreneurial function of the firm, other features of contemporary American business law conflict with those ideas.

i. Discounting the limits of centralized economic planning and the crucial role of prices in allocating resources appropriately

Unlike state business organization statutes and many fiduciary duties, which largely consist of *nomos*-like, purpose independent rules that facilitate private ordering, numerous aspects of contemporary business law ostensibly seek to achieve some pre-determined end state and therefore resemble Hayek's *thesis*. Among the many examples of such "purposive" legal features are federal laws and regulations on shareholder voting rights, rules mandating particular firm structures, attempts to regulate executive compensation, and efforts to assure a level playing field among investors by restricting insider trading. These and similar purposive legal features, often adopted as a political response to some sort of business crisis, are generally insensitive to Austrian insights on the knowledge problem, the ubiquity of change, the limits of centralized economic planning, and the importance of prices.

If they were free to structure their relations as best they saw fit, investors and corporate managers might well decide that broad investor voting rights are not cost-justified. Shareholder voting, after all, is quite

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entrepreneurial function. Consider, for example, the following discussion from the 1996 *Caremark* decision of the Delaware Court of Chancery:

> Where review of board functioning is involved, courts leave behind as a relevant point of reference the decisions of the hypothetical "reasonable person", who typically supplies the test for negligence liability. It is doubtful that we want business men and women to be encouraged to make decisions as hypothetical persons of *ordinary* judgment and prudence might. The corporate form gets its utility in large part from its ability to allow diversified investors to accept greater investment risk. If those in charge of the corporation are to be adjudged personally liable for losses on the basis of a substantive judgment based upon what persons of ordinary or average judgment and average risk assessment talent regard as "prudent" "sensible" or even "rational", such persons will have a strong incentive at the margin to authorize less risky investment projects.

In re Caremark International Inc. Derivative Litigation, 689 A.2d 959, __ n. 16 (1996).

costly, and shareholders tend to be rationally ignorant about a great many issues facing the corporate enterprise. Shareholders might thus prefer to have only a cheap "exit" option, foregoing a relatively costly "voice" option in order to preserve corporate resources. Several aspects of federal law, though, limit the ability of investors and corporate managers to order their relations in a manner limiting the investors' abilities to vote on certain matters. Securities Exchange Act Rule 14a-7, for example, requires corporations to assist certain shareholders seeking to mount proxy contests by either distributing the shareholders' proxy materials or providing them with a list of the names and addresses of shareholders of record. Rule 14a-8 requires corporate managers to go further with respect to some voting matters, actually including on the company's own proxy form certain shareholder proposals. The newly enacted Dodd-Frank law will require corporations to permit some shareholders to nominate directors to be included in the company's proxy solicitation materials and to give shareholders a nonbinding "say on pay" made to certain executive officers. These and similar voting rules, ostensibly designed to give shareholders more say in corporate governance, conflict with the Austrian notion that investors and managers should be free to arrange their relationships as best they see fit given their private information and subjective values.

So do a number of recently enacted "reactive" rules on corporate governance and executive compensation. In the wake of massive financial frauds at Enron and Worldcom, for example, Congress enacted legislation and the securities exchanges (with congressional encouragement) adopted listing standards that mandate certain governance structures for public corporations and dictate who may serve in certain capacities (e.g., only independent directors may serve on audit committees).[14] These and similar mandatory governance rules, which ostensibly aim to reduce financial fraud, limit the ability of business planners to set up governance structures in light of the information to which they alone are privy.

In recent months, Congress has embarked on an effort to combat excessive corporate risk-taking by regulating executive compensation. Section 956 of the new Dodd-Frank law requires "appropriate federal regulators" to require disclosure by financial institutions of the structures of

[14] The Sarbanes-Oxley law requires that public corporations establish audit committees comprised exclusively of independent directors and empower those committees with direct and unfettered responsibility for the hiring, firing, and compensation of auditors. Listing standards for the New York Stock Exchange and NASDAQ go even further: a majority of members of the board itself must meet independence standards, and all members of the audit, compensation, and newly mandated nominating committees must be independent.

all incentive-based compensation, so that the regulators can determine whether such compensation is "excessive," or could lead to a material financial loss by the financial institution. These and similar mandatory governance rules, which ostensibly aim to reduce financial fraud, limit the ability of business planners to set up governance structures in light of the information to which they alone are privy.

Perhaps no feature of American business law conflicts more starkly with Austrian thinking on the desirability of private ordering and the importance of prices than the federal ban on insider trading. Imposed out of a desire to ensure some sort of level playing field among investors, the insider-trading ban precludes corporate managers from trading in their own companies' stock on the basis of material, non-public information. Absent the ban, some firm planners might opt to allow managers to trade on the basis of inside information. As Henry Manne first observed, such trading could constitute an efficient compensation mechanism for managers and would also tend to make the corporation's stock price, influenced by highly informative insider trades, more reflective of the corporation's true business prospects (i.e., more efficient) and thus a less risky prospect for investors (Manne, 1966). As corporations experimented with different insider trading policies, capital markets would tend to punish those that were value-destructive and reward those that were value-enhancing. By imposing a uniform insider trading policy in a quixotic attempt to assure a level playing field among investors, the federal securities laws likely preclude the sort of value-enhancing private ordering favored by Austrian thinkers.[15]

The insider-trading ban is also inconsistent with the Austrian emphasis on the crucial role of prices in assuring efficient resource allocation. When corporate insiders purchase or sell their own company's stock, thereby betting their own money that the stock is mispriced, they convey valuable information to the marketplace. Assuming their trades somehow become public, other rational investors will likely follow their lead, which will cause stock prices to reflect more accurately the underlying value of the firm. More efficient stock prices, then, will lead to a more appropriate allocation of investment capital throughout the economy. The insider-trading ban thwarts this process.

Finally, the insider-trading ban, as implemented in concert with the rest of securities regulation, is inconsistent with the Austrian concern that an

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[15] The insider trading ban conflicts with Austrian thought even if one construes the ban as a means of protecting the corporation's property rights in information (see, e.g., Bainbridge, 2002). While the Austrians would certainly support policies that clarify who owns corporate information, they would oppose policies mandating that the ownership right be non-transferable from corporation to managers.

excess of fiat money will generate value destruction. Under the prevailing regulatory regime, the groups primarily responsible for identifying and correcting instances of stock mispricing are corporate managers and sell-side stock analysts. Both groups are substantially more likely to take steps to correct undervaluation than overvaluation—corporate managers because their jobs depend on maintaining a high stock price, and analysts because they usually work for investment banks that make most of their money advising corporations on deals and thus have an incentive not to "talk down" a potential client's stock. Equity mispricing, then, tends to be more in the direction of over- than undervaluation (Finn, 1999). This means that corporate managers, who can issue stock of overvalued firms at unduly high prices or use overvalued stock to fund acquisitions and other projects, frequently have access to an artificially high level of capital for corporate investments. As Michael Jensen has observed (Jensen, 2005), this dynamic can create significant "agency costs of overvalued equity" as corporate managers use their overvalued equity to make value-destructive acquisitions (Moeller et al., 2005) and pursue investment projects with a negative net present value (Polk and Sapienza, 2004). Eventually, managers of overvalued firms, hoping to delay the day of reckoning on their firm's stock price, will tend to engage in earnings management, delay investments with a positive net present value in order to meet analysts' earnings expectations (Graham et al., 2005), and eventually resort to accounting fraud (Jensen, 2005). This spiral of value destruction resulting from malinvestments occasioned by inflated stock prices should look familiar: it is closely analogous to Austrian business cycle theory's predictions about inflated money supplies. And it is facilitated by the prohibition on insider trading, perhaps the most effective means of correcting equity overvaluation (Lambert, 2006).

ii. Hindering the entrepreneurial function of the firm

As explained, Austrian thought ascribes a key role to the entrepreneur. Often operating through firms, entrepreneurs constantly look for ways to earn supra-competitive returns by allocating resources in novel ways that consumers value. Much of modern antitrust doctrine, however, focuses solely on static efficiency, attempting to eliminate supra-competitive pricing even though such pricing likely enhances dynamic efficiency by spurring innovation. The relentless pursuit of static efficiency at the expense of dynamic efficiency through enhanced innovation conflicts with Austrian thinking on the importance of entrepreneurship.

Take, for example, antitrust's treatment of price discrimination. By varying consumer prices according to consumers' willingness to pay for the product at issue (i.e., charging higher prices to consumers who value a

product more, less to those who value it less), producers can enhance their gain from selling a product. And with certain types of price discrimination ("third-degree" price discrimination, in which the seller divides consumers into groups according to likely willingness to pay and then charges a different uniform price per group), neoclassical price theory predicts that this reallocation of surplus may actually cause a static efficiency loss. In dynamic terms, though, the freedom to price discriminate enhances overall well-being by encouraging firms to innovate. By allowing the entrepreneur to capture more of the surplus her innovation creates, price discrimination encourages innovation by increasing the reward for developing a unique product or service for which consumers are willing to pay above-cost prices (Klein and Wiley, 2003; Semeraro, 2009). Innovation, a central determinant of economic growth, tends to be retarded by the fact that innovators generally capture only a fraction of the surplus their efforts produce (Baker, 2007; Bresnahan, 2003; Griliches, 1992). Price discrimination helps alleviate this wealth-reducing positive externality. Antitrust, though, has frequently been hostile to price discrimination. The Robinson-Patman Act prohibits much price discrimination outright, and antitrust courts have often pointed to price discrimination effects as grounds for restricting business practices such as tying. Such hostility to price discrimination, a consequence of focusing on static efficiency without regard to dynamic considerations, conflicts with Austrian thinking on entrepreneurship and innovation.

In recent years, the Supreme Court has suggested a willingness to take a more dynamic point of view in evaluating antitrust challenges. In its 2004 *Trinko* decision,[16] the Court conceded that monopoly pricing, which occasions static efficiency losses, is key to motivating the sort of entrepreneurial innovation that creates dynamic efficiencies. The Court observed: "The opportunity to charge monopoly prices—at least for a short period—is what attracts 'business acumen' in the first place; it induces risk taking that produces innovation and economic growth."[17] Then, in its 2007 *Independent Ink* decision,[18] the Court suggested that price discrimination is consistent with competitive markets and is not, in itself, enough to warrant antitrust's ire.[19] These developments suggest a move toward an antitrust policy that is more consistent with Austrian thought.

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[16] *Verizon Communications Inc. v. Law Offices of Curtis v. Trinko*, LLP, 540 U.S. 398 (2007).

[17] Ibid. at 407.

[18] *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006).

[19] Ibid. at 45 (observing that "it is generally recognized that [price discrimination] also occurs in fully competitive markets").

IV. CONCLUSION

It would be impossible, in a short book chapter, even to set forth the principles of Austrian thought that would be relevant to an Austrian analysis of business law, much less to conduct such an analysis in any but a cursory fashion. We therefore view this chapter not as a final word, but as a conversation starter. By setting forth the aspects of Austrian thought we believe to be most relevant to an analysis of American business law and analyzing some key business law features in light of those insights, we have shown that this rich body of thought that has proven so useful in analyses of institutions (e.g., the socialist calculation debate) and monetary and fiscal policies (e.g., Austrian business cycle theory) has much to offer the economic analysis of discrete legal rules. We hope the conversation continues.

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