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The Role of Exit Rights: What the Theory Of the Firm Says About the Conduct of Brexit Negotiations

Richard A. Epstein

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INTRODUCTION

The United Kingdom's (U.K.) June 2016 decision to exercise its option to leave the European Union (E.U. or Union) represents one of the great surprises in the complex history of supranational organizations. Most of the discussion in the wake of that decision has tended to stress the particulars of the referendum with regard to the short-term advantages and disadvantages of a decision that has clearly divided class and region within the U.K.[1] Older individuals, and those who did not live and work in the Greater London area, tended to vote in favor of exit. Those who were younger and in professions like finance

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1 For a detailed breakdown on the issue, see *The Brexit Index: A Who's Who of Remain and Leave Supporters*, POPULUS, http://www.populus.co.uk/2016/05/brexit-index-whos-remain-leave-supporters (last visited Dec. 31, 2017).

and banking tended to vote in the opposite direction. It is easy to find general theories of individual or group self-interest that explain both of these voting patterns, even without assuming corrupt motives on the part of those for whom exit was the preferred option. British people who work daily in European markets have far greater incentives to remain in the E.U. than people whose loyalties, though often in support of free trade, have a more diversified portfolio of interests.

The Brexit decision, however, is important in yet another way. It offers a case study on one of the hardest questions of political and legal theory, which is the role of exit rights in the organization of the state. This problem is one that arises, not only in connection with a decision by one nation to exit a larger confederation, but also in a wide variety of other contexts. In particular, three prototypical exit cases are of relevance here. The first of these involves individual exit options from private contractual arrangements, such as the repudiation of private common ownership, the partition of jointly held land, or the dissolution or division of private firms. The second involves the decisions of individuals to exercise their exit rights from states or nations, usually through emigration. The third deals with complex decisions by government entities to engage in either separation or, in some cases, annexation. Understanding these various patterns helps explain the importance of exit rights generally. It also lends a cautious vote of approval for the Brexit decision, notwithstanding the major transactional challenges that will follow, industry by industry, in making good on the British referendum.

I. EXIT RIGHTS IN PRIVATE TRANSACTIONS

When people enter into various kinds of transactions, one of the first questions they commonly ask themselves is whether they have preserved some form of exit right. The question, as posed here, is of great generality, covering not only various kinds of exchange relationships like contracts for the sale and hire of goods, but also the creation of joint tenancies and tenancies in common, and the formation of partnerships or other firms. In the first case, the duties between the parties are normally specified with a good deal of particularity: it is made clear which goods of what quality and quantity should be delivered, at what price, and at what given time and place. The complexities in these deals arise when there is a disruption in the anticipated sequence of performance between the two parties, so that the failure of one side to perform on cue gives rise to a set of options for the other side in deciding whether to continue or end the relationship.

The situation in a joint tenancy is quite different. Here, it is normally understood that none of the joint tenants owes any fiduciary

duties to the others, so that each can move as aggressively as he wants in the use and occupation of common premises so long as the others do not push back. It is also possible for one joint tenant to change the character of some portion of the land without the consent of his co–joint tenants, who then receive a larger issue in other portions of the land.[2] The want of any fiduciary duty tends to limit the use of joint tenancies to highly specialized situations, of which the most common is concurrent ownership between husband and wife; the right of survivorship allows for the transfer of ownership to the surviving spouse without any further legal action. In these two-party situations, the level of trust between parties is usually high, so conflicts of interest will rarely appear; and when they do, it is possible for a joint tenant to unilaterally convert the relationship to a tenancy in common (where the survivorship feature is eliminated) or to unilaterally call for the complete partition of the property either by sale or in-kind division.

The situation inside the partnership or firm is somewhat different. As Ronald Coase wrote years ago in his famous essay, *The Nature of the Firm*, mundane matters of transaction costs often dictate the appropriate form of organization.[3] The price system, which is involved in the sale or hire of goods, is not costless to operate, for someone has to both attach prices to individual services and specify other terms of the ongoing relationship. All of these activities consume resources and are subject to error and breakdown at every stage of a given exchange from formation to execution. The formation of the firm represents the view that individuals should be bound by relational contracts that do not specify particular duties at each juncture in their common venture. In dealing with these relationships, Coase identifies the "person or persons who, in a competitive system, take the place of the price mechanism in the direction of resources."[4] As his phrase "person or persons" indicates, Coase pays very little attention to the difference between the singular and the plural in this formulation and thus does not address the question of why some firms operate with a single head, and others operate with a group of partners (often, but not necessarily, of equal rank) who have divided the entrepreneurial responsibilities among themselves. Unlike the situation with concurrent ownership, the partners owe each other fiduciary duties of both loyalty and care.[5] They

2 *See, e.g.*, Swartzbaugh v. Sampson, 54 P.2d 73 (Cal. Dist. Ct. App. 1936).

3 R. H. Coase, *The Nature of the Firm*, 16 ECONOMICA 386 (1937).

4 *Id.* at 388 n.2.

5 For the most influential formulation, see *Meinhard v. Salmon*, 164 N.E. 545 (N.Y. 1928):

> A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior . . . . the level of conduct for fiduciaries [has] been kept at a level higher than that trodden by the crowd.

Id. at 546. In my view, Judge Cardozo applied this rule incorrectly in the particular case, which

are bound by obligations of mutual good faith, which specify not particular tasks to be done, but a way of approaching their mutual obligations. The particular motivating force is the good faith obligation that each partner shall weigh equally the welfare of his or her fellow partners in making decisions, so that their benefits are treated as if they were his benefits and their costs are treated as if they were his costs. The partnership that achieves this nirvana has overcome all conflicts of interest among its partners and makes good, at least in miniature, on the traditional boast of "all for one and one for all!" But the only reason why this system has a chance to work is that the partners get to select each other in advance and typically pick persons with whom they share some independent and antecedent affinity, such as that which exists between parents and children or among siblings.

While an acceptance of the good faith objective within these select groups goes a long way in forging effective cooperation among partners, it is difficult to operationalize this principle. Further, these business arrangements, in particular, come under massive pressure when one party deviates from this good faith arrangement. At this point, a number of different exit options present themselves. The partners could just go their separate ways and thus abandon any synergies that may have arisen among them. But this is easier said than done because there is no obvious metric for either the separation of partnership assets or for the conduct and timing of a sale of those assets from which the proceeds could be divided. Or it could well be that partners switch the relationship around into a long-term contract between two smaller firms for the provision of particular services. The two or more separate firms that emerge keep the same relational strategies among the smaller group of partners, but revert to a long-term sale or hire relationship under which cooperation takes place through discrete contracts and not through an overall merger of governance over common affairs.

It is not possible to give one comprehensive explanation for the partial disintegration of the firm into a system of "vertical integration by contract," but one obvious explanation is that certain subgroups work more coherently together than others and thus generate higher levels of trust by using more specific price-sensitive arrangements to deal with their former partners.[6] Various kinds of requirements contracts and

asked whether one partner had offered to another a future deal that had come to him alone. In general, there is no good reason to force partners in one deal to join together in a second deal given the serious risk of some imbalance in the initial transaction, which makes it unwise to force the association in a second transaction. For my views, see Richard A. Epstein, *Contract and Trust in Corporate Law: The Case of Corporate Opportunity*, 21 DEL. J. CORP. L. 5 (1996). For a particular application, see *Burg v. Horn*, 380 F.2d 897 (2d Cir. 1967).

6 For an early discussion, see Friedrich Kessler & Richard H. Stern, *Competition, Contract, and Vertical Integration*, 69 YALE L.J. 1 (1959).

output contracts meet this standard.[7] Under the former, a firm agrees to meet all the requirements of its trading partners from its own production. Under the latter, a firm agrees to take all the production output from a second firm. In both of these cases, the requirements taken or the outputs required can be subject to maximum and minimum levels, and the prices for these contracts can be linked to various indices that reflect a change in costs. Indeed, the line between a once-unified firm and the independent operators is always shaded in these cases of partial integration and it is not possible, without some detailed knowledge of a particular industry, to indicate how these relationships will shake out. Nor is it necessary for the economist or lawyer to do so. It is only necessary that the legal system contain methods that allow relationships to morph from one form to another, so that a firm can dissolve into two separate units that in turn enter into some long-term contract for the provision of various services on an exclusive or nonexclusive basis. At this point, it becomes a matter of private choice to determine what kinds of arrangements are sensible or not.

Within this larger mosaic, the exit right is an indispensable tile because it operates as the major protection against abuse in various bilateral-monopoly situations, where the opposite party can push down hard if an exit right is absent. This need for exit rights arises in every type of arrangement, from individual sales to long-term vertical arrangements to the formation of a firm. The requisite exit right, however, does *not* provide the party who holds it with perfect relief. Many transactions promise individuals gain from trade if a particular transaction is properly executed. In the law of contract, these expected gains often give a remedy to one side in the form of lost profits or consequential damages should the other side breach. The exit right, in contrast, allows for the rejection of the goods received and a return of the cash paid, but not for any fraction of the losses incurred because the transaction did not go according to plan. Even so, in many transactions this exit option is the preferred remedy (even though it may provide incomplete relief), as it is a self-help remedy that is cheap to exercise.

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7 *See, e.g.*, U.C.C. § 2-306 (AM. LAW INST. & UNIF. LAW COMM'N 1977):

> (1) A term which measures the quantity by the output of the seller or the requirements of the buyer means such actual output or requirements as may occur in good faith, except that no quantity unreasonably disproportionate to any stated estimate or in the absence of a stated estimate to any normal or otherwise comparable prior output or requirements may be tendered or demanded.
>
> (2) A lawful agreement by either the seller or the buyer for exclusive dealing in the kind of goods concerned imposes unless otherwise agreed an obligation by the seller to use best efforts to supply the goods and by the buyer to use best efforts to promote their sale.

The unilateral action of rejecting goods is sufficient to escape a deal gone wrong. Given this exercise of self-help, the burden is now on the other side to initiate litigation in order to preserve its supposed rights under the contract, which is costly under any circumstances and unwise if, in fact, there was good cause for the rejection of the goods supplied. Whenever litigation costs are high, the more complete damages remedy may be less attractive given the time and money necessary for its enforcement.

The tradeoff here carries over to vertical arrangements and to firms. The dissolution of a firm could result in a sale of assets followed by a division of the proceeds, or it could result in the assignment of specific assets to each of the parties accompanied by a sale of those that neither desire. In these settings, claims for lost profits from the other side's breach of duty are rarely invoked; complete remedies are expensive to implement and, given the complex path toward separation, it is unclear which way the inequality among former partners runs.[8] Exit rights are cheap, which makes them universally attractive. Nonetheless, in some cases, such as when one partner keeps past revenues owed to another, a suit for a recovery of payments owed is pursued for a liquidated sum that is a lot easier to determine than lost profits inflicted by the alleged bad faith of former partners.[9]

II. POLITICAL EXIT RIGHTS

These private analogies go a long way toward explaining how a system of exit rights works in the context of political rights. The first form of this problem involves cases where one individual wishes to leave a given country. This exit right should not be treated as a constitutional given; some states reserve the right to keep their citizens within their territory, which in turn allows them to condition the option to leave on the forfeiture of property held in the jurisdiction. Even if these explicit

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[8] For a critique of the expectation measure of damages, see Richard Craswell, *Against Fuller and Perdue*, 67 U. CHI. L. REV. 99 (2000) (explaining weaknesses of Fuller's tripartite classification of contract damages as expectation, reliance, or restitution); Richard A. Epstein, *Beyond Foreseeability: Consequential Damages in the Law of Contract*, 18 J. LEGAL STUD. 105 (1989) (explaining the weakness of mitigation rules).

[9] For the general case for liquidated damages, see RESTATEMENT (SECOND) OF CONTRACTS § 356 cmt. a (AM. LAW. INST. 1981):

> The parties to a contract may effectively provide in advance the damages that are to be payable in the event of breach as long as the provision does not disregard the principle of compensation. The enforcement of such provisions for liquidated damages saves the time of courts, juries, parties and witnesses and reduces the expense of litigation. This is especially important if the amount in controversy is small.

Id.

burdens are not imposed on the exit right, most individuals understand that they will suffer major losses in general social relations and business opportunities if they leave, either with or without their own state's blessing. Yet in many cases, leave they do, and in droves. The young individuals that fled Eastern Germany before the Berlin Wall are a case in point. At home, their loss of liberty was manifest; their economic opportunities were limited; their ability to draw down state pensions on retirement depended upon contributing to the system for decades before their claims would vest; and even then, it was uncertain that they would be funded; and their social relations were undercut by state surveillance and mutual distrust. They had little of value to leave behind, and so they went until a wall kept them in place.

This exit right is of course valuable even in less draconian circumstances. Inside the United States, for example, there are no legal barriers that prevent any one person from moving to another state. Differences in economic climate between states contribute to major internal migrations that have altered the political landscape over the past seventy-five years. While this exit right has been deservedly celebrated,[10] it would be a mistake to think that the exit right is tantamount to a complete remedy against government intrusions. More specifically, the exit right does not protect individuals whose fixed assets, typically real estate, are immovable.[11] Thus, a land developer can quickly move its plans and capital from one location to another and avoid the brunt of severe zoning restrictions or heavy service obligations to supply, for example, affordable housing. However, there is no easy way out for the owner of land whose capital asset goes down in value once the same obligations are imposed. Indeed, in many business contexts, the exit right is often hampered by statutory limitations, making it difficult for a railroad, for example, to discontinue service without an explicit government permit, or for an insurance company to withdraw from a losing wind-insurance (e.g., hurricanes) market even if it is prepared to throw in all of its other profitable lines of insurance.[12] Therefore, it is critical to ask which conditions, if any, can be attached when any individual or firm seeks to exit a particular market. That inquiry heavily depends on the level of judicial scrutiny, which in most cases of exit obligations is on the low end of the spectrum due to the somewhat dubious view that higher levels of scrutiny only attach in cases where there is a loss of physical property as opposed to loss of

10 *See* Vicki Been, *"Exit" as a Constraint on Land Use Exactions: Rethinking the Unconstitutional Conditions Doctrine*, 91 COLUM. L. REV. 473 (1991).

11 *See* Richard A. Epstein, *Exit Rights Under Federalism*, 55 LAW & CONTEMP. PROBS. 147 (1992).

12 *See* Richard A. Epstein, *Exit Rights and Insurance Regulation: From Federalism to Takings*, 7 GEO. MASON L. REV. 293 (1999) (arguing that rules that require a firm to continue to operate at a loss count as regulatory takings).

ability to enter into certain forms of business. But these restrictions on the ability to recover make it more likely that people will exercise exit rights given that they have no way to preserve their jurisdiction-specific entitlements.

III. BREXIT AND EXIT

The first question to ask about Brexit has to do with the structure and the stability of the E.U. The key point here is that the evolution of the structure of the European market had the consequence of increasing the level of heterogeneity within the organization, making it ever harder to come up with a set of centralized solutions that made sense for all of its members.[13] In all collective activities, the level of dissatisfaction increases exponentially the further a given member's private preferences deviate from that of the overall group. Thus, in an oversimplified version of the basic proposition, assume that the collective solution is set—arbitrarily, but without loss of generality—at zero. If a firm's private evaluation of its ideal position is one unit plus or minus from that collective solution, its level of dissatisfaction is the square of that distance, which is also one. But let the distance move from one to two, application of the same squaring function now yields a level of dissatisfaction of four. Move it to three and it is nine, and so on. The larger the dissatisfaction with the median solution, the higher the gains that the members of the organization have to offer to keep the coalition together. At some point, sooner rather than later, the forces of disintegration start to take over. It seems that even a brief review of the history shows that the expansion of the E.U., both in terms of the scope of its activities and the increase in its membership, has undermined the possibility of the cohesion needed to keep the E.U., like a rational firm, together. At this point the E.U. looks like an ill-designed conglomerate merger that should be unraveled so that a set of more discrete contractual relationships can unite different countries in different ways. The monolithic structure is not stable, in the sense that any collective solution that it generates will create too much net unhappiness for the overall structure to prosper. It is of course possible to keep such a union together by brute force. But it is not possible to do so when exit rights, even controversial exit rights, are preserved.[14] It is, therefore, important

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[13] Alberto Alesina, Guido Tabellini & Francesco Trebbi, *Is Europe an Optimal Political Area?* 2 (CESinfo Working Papers, Paper No. 6469, 2017), https://ssrn.com/abstract=2983690 (asking whether increases in E.U. heterogeneity make the Europe project "too ambitious").

[14] Interestingly enough, there is a suggestion that the drafters of Article 50 never anticipated its actual use. *See, e.g.*, *Planet Money: Episode 743: 50 Ways to Leave Your Union*, NPR (Dec. 21, 2016, 5:53 PM), http://www.npr.org/sections/money/2016/12/21/506502394/episode-743-50-ways-to-leave-your-union. In retrospect, this public-law political

to understand how Brexit, which may be followed by other exit actions, stemmed from the effort to concentrate too much power inside the E.U.

To start at the beginning, European integration began with the 1951 formation of the European Coal and Steel Community, which was comprised of Belgium, France, West Germany, Italy, the Netherlands, and Luxembourg. The limited purpose of this common market was to make use of the wide distribution of coal and steel to forestall another major war. By 1957, those postwar fears had diminished in European politics, but the idea of a common market led to the formation of the European Economic Community (EEC). The EEC went into operation in January 1958 with the explicit purpose of creating a common market with the obvious systematic advantages of a free-trade zone. Its initial members consisted of the same relatively cohesive group of six nations. The point of the original common market was to allow free movement across national borders of people, goods, services, and capital. Even the movement of people within the closed universe did not present serious problems, certainly not on the order associated with the immigration and refugee problems of the last decade that are connected with the war-torn Middle East and other violent crises. A common market with such modest aspirations, therefore, leaves each nation free to organize its internal production as it sees fit, knowing that its comparative advantage lies in keeping those regulations that foster commerce and eliminating those that do not. The common market may require that nationals from other states be allowed to cross borders for purposes of trade, but it does not give them the right to become citizens or permanent residents of other nations.

So as understood, a free-trade zone like the initial EEC has two enormous advantages. First, it is capable of long-term operation among countries that have very different ways of doing business internally because it is unnecessary, indeed impossible, to impose a uniform set of regulations on all nations with their very different histories and institutions. Second, a common market offers better prospects for an orderly expansion to include other nations with divergent traditions, who can also gain the benefits of free trade across national lines without having to agree on matters of collective governance. There is no need to jigger other rules to take into account any set of unique circumstances. The admission of the U.K. into the EEC in 1973, done only with much uneasiness, was in fact possible only because of the then-limited nature of its European commitment. For example, there was no need to develop a common currency. Britain therefore remained on the pound so exchange rates could vary as a rough measure of the relative efficiency of the different national economies.

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miscalculation overlooked the frequent use of exit rights in the realm of private associations.

Within the framework of a common market, it is possible to adhere to the traditional four freedoms that guarantee the free movement of goods, capital, services, and people across state lines. That system, in effect, creates a larger zone of tariff-free activity and should be supported by all free-traders. In each of these cases, moreover, it should be possible to specify the rules that govern this shift. It is not that all goods, capital, services, and people are free from all forms of government regulation. Rather, the central obligation that should be placed on local governments tracks the rules of the dormant commerce clause, as these have developed in the United States, chiefly at the hands of the courts.[15] The initial presumption is that a nondiscrimination rule applies; goods, capital, services, and people that come from elsewhere are subject to the same regulations that are imposed on persons within the home country. The nondiscrimination principle is used precisely because no one, not even the most ardent defender of laissez-faire, believes that all forms of regulation are counterproductive. At the very least, regulations that impose formalities for the completion of certain transactions have to be obeyed by outsiders as well as insiders. Much the same can be said about the limitations that are imposed by antitrust laws, consumer-protection laws, and the like. What the nondiscrimination principle does is to avoid the knock-down-drag-out fights that come from determining which set of rules is better than the other. The home state, as a first approximation, gets to set the rules that are used within its territory, so long as the locals are willing to play by these rules as well.

This presumption can, of course, be overcome in certain cases. The importation of flora and fauna that could endanger wildlife or threaten to transmit disease can of course be stopped.[16] However, these safety exceptions are in general few and far between, as most exported goods are also sold within their country of origin. There is far less concern on this dimension with respect to the movements of capital and service, but the same principles can apply, if necessary, to limit the scope of the nondiscrimination principle. The most obvious difficulty arises with the movement of people across state lines, which poses risks that states do have a right to prevent, most notably regarding terror, crime, and the

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15 *See, e.g.*, H.P. Hood & Sons, Inc. v. Du Mond, 336 U.S. 525 (1949); Wickard v. Filburn, 317 U.S. 111 (1942); NLRB v. Jones & Laughlin Steel Corp., 301 U.S. 1 (1937); Baldwin v. G.A.F. Seelig, Inc., 294 U.S. 511 (1935). For a more recent case, *see Comptroller of Treasury of Md. v. Wynne*, 135 S. Ct. 1787 (2015).

16 For the American version, see *Maine v. Taylor*, 477 U.S. 131 (1986) (protection of local fisheries from parasites and non-native species justify restrictions on importation). For the protection of public health under the World Trade Organization, see WORLD HEALTH ORG. & WORLD TRADE ORG., WTO AGREEMENTS & PUBLIC HEALTH: A JOINT STUDY BY THE WHO AND THE WTO SECRETARIAT (2002), https://www.wto.org/english/res_e/booksp_e/who_wto_e.pdf.

possibility that the new entrants will become charges of the legal system in terms of welfare benefits or have children that might claim rights to remain. A small common market is better able to deal with these questions than a larger one. The movement of people does not (necessarily) scale with the same positive effect as the movement of goods, capital, and services.

On this view, the great blunder of the E.U. was the shift from a free-trade zone to a broader social and economic union under the 1993 Treaty of Maastricht, which placed the Union beneath an all-powerful Brussels bureaucracy. A robust E.U. was created to "harmonize" the laws of the various nations not only on trade but also on agriculture, fisheries, and regional development. At this point, the operation was no longer a free-trade zone, but a centralized planned economy whose purpose was to make substantive demands on its member states that went far beyond the nondiscrimination principle. In such a case, the composition of the rulemaking bodies is critical, because there is no single path down which they can travel. The difficulties grew as the E.U. continued to expand its membership to the present-day number of twenty-eight nations. The greater heterogeneity of the member states points to the need to have more modest objectives like the common trading zone. It is a sign of false optimism to think that the larger body can handle the more delicate task of comprehensive harmonization without opening serious fissures.

This is particularly true of the movement of persons—one of the issues that prompted the Brexit vote. Immigration in every country has never been subject to the same regime of free entry and exit applicable to goods. New entrants are allowed in conditionally, and a state has to decide how much to investigate each entrant prior to admission and how much to monitor them after arrival. This often creates policy difficulties, such as if there is a connection between criminal arrest on the one hand and deportation on the other.[17] Similarly, with the notable exception of the United States, countries do not extend citizenship rights to newborns simply because their parents are present in the country. At this point, the case for free movement is attenuated. One partial fix is to limit the class of individuals who are entitled to enter, as this reduces the pressure on individuated review of each application; and that is much easier within a smaller European Community than a larger one where cultural and language differences matter greatly. So it is easy to have bilateral arrangements that let French citizens work in

17 The applicable American law is the Illegal Immigration Reform and Immigrant Responsibility Act of 1996, Pub. L. No. 104-208, 110 Stat. 3009, 3546 (balances the need for expediency with some notion of due process for those persons brought within the system). For discussion, see Richard A. Epstein, *America's Immigration Quagmire*, HOOVER INST.: DEFINING IDEAS (Dec. 5, 2016), https://www.hoover.org/research/americas-immigration-quagmire.

London and British citizens retire in Southern France. But the same level of confidence does not attach to a larger E.U., where the cultural and economic gaps are larger, and it certainly does not attach if refugees from war-torn locations make their way into one E.U. country and have relatively unrestricted movement through all the rest.

The combined E.U. policies represented a fatal overreach, and the overall trends in economic growth inside the E.U. switched dramatically.[18] In the early post-war era, European growth was robust. There was much catching up to do from the devastation of the Second World War, and the basic strategies inside the smaller EEC were generally pro-growth. It was also a time when the dominant technologies were large-scale activities that often required a top-down approach. But the innovation markets have moved since that time. The overall situation was summarized to me in an email by Jesus Fernandez-Villaverde as follows:

> Again, a more granular description would point out small pro-market reforms here and there (i.e. in Germany in the early 2000s, in Spain in the late 1990s), but making the point that the E.U. is less friendly to markets, innovations, and entrepreneurship now than in 1967 gets 95% of the history right.
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> And this is particularly important because the technology of the 1950s and the technology of today are radically different. In the 1950s the frontier was nuclear power, airplanes, automobiles, etc. These are industries where a top-down approach can handle many of the challenges reasonably well. The government, for instance, can hire a bunch of smart nuclear engineers and get things more or less right. The technology of today (Airbnb, Uber, Amazon) is truly an emergent process in the Hayekian sense, and a bunch of engineers working for the French Ministry of Industry will never get it right. Which bureaucrat will ever come up with [F]acebook? That is why European kids log into their [F]acebook account (US company) in their [i]phone (US company) to tell their friends they just binged watched the new season of Game of Thrones (US company) in Netflix (US company) and that they liked it so much they will order the book for their Amazon kindle (US compa[n]y).[19]

It is also worth noting that, consistent with his data, there is no major company comparable to those mentioned above that has

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[18] For a tabulation of the trends, see Jesus Fernández-Villaverde & Lee Ohanian, Address at the Hoover Institution's Conference on Restoring Prosperity: Contemporary and Historical Perspectives: European Productivity Growth (Feb. 11, 2017) (slide presentation available at http://www.hoover.org/sites/default/files/villaverde_and_ohanian_presentation_post.pdf).

[19] E-mail from Jesus Fernandez-Villaverde, Professor of Econs., Univ. of Pa., to Richard A. Epstein, Laurence A. Tisch Professor of Law, N.Y. Univ. School of Law (Apr. 4, 2017, 08:23:57 CDT) (on file with author).

generated business in the E.U.,[20] which helps explain why that body frequently takes an aggressive attitude on regulation and antitrust matters with large corporations.[21] They do not have their own oxen to gore.

In short, by 1975 pro-growth policies tended to give way to more interventionist policies within the EEC. The consequence of this transformation was that that overall growth lagged both internally and in relationship to the United States (which for the last fifteen years has had its own growth problems). With the expansion of the E.U. to cover nations in different stages of economic development, greater heterogeneity among E.U. members required costly negotiations to achieve any common solution. Yet at the same time, the central government in Brussels sought to do more than it had ever been done before under its dangerous banner of harmonization. There are of course two ways to harmonize—up and down. But the bureaucrats in Brussels displayed strong social-democratic tendencies toward central planning, and thus "harmonized up" on the naive assumption that more regulation of labor and capital markets was better.

It is important to note here that a relatively small Brussels bureaucracy is capable of imposing extensive obligations on E.U. member nations only because the member nations have to bear their own costs for integrating the various commands into their own codes and then enforcing those obligations within their respective territories. That leverage allows the Brussels bureaucracy to expand its reach by conscripting national bureaucracies to implement its general directives. Accordingly, the E.U. has strong employment discrimination directives that address all forms of discrimination in labor markets.[22] To be sure,

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20 For a list of large European firms, see *List of Largest European Companies by Revenue*, WIKIPEDIA, https://en.wikipedia.org/wiki/List_of_largest_European_companies_by_revenue (last visited Dec. 31, 2017), which is dominated by old line firms, with oil and gas companies and automotive companies heading up the list.

21 *See* Eleanor M. Fox, *US and EU Competition Law: A Comparison*, *in* GLOBAL COMPETITION POLICY 339 (Edward M. Graham & J. David Richardson eds., 1997).

22 A sense of the scope of these obligations is apparent from the E.U.'s own celebration of its expanded mission:

> For many years the focus of E.U. action in the field of non-discrimination was on preventing discrimination on the grounds of nationality and gender. A few years ago, however, the E.U. countries approved unanimously new powers to combat discrimination on the grounds of racial or ethnic origin, religion or belief, disability, age or sexual orientation.
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> New legislation thus has been enacted in the area of anti-discrimination, which is the Racial Equality Directive (implementing the principle of equal treatment between persons irrespective of racial or ethnic origin in many areas of social life) and the Employment Equality Directive establishing a general framework for equal treatment in employment and occupation.

Justice: Building a European Area of Justice: Legislation, EUROPEAN COMM'N, http://ec.europa.eu/justice/discrimination/law/index_en.htm (last visited Dec. 31, 2017).

the U.K. and other nations have national policies of their own on these issues, so the choice presented by Brexit is not one between unregulated labor markets (which I have long favored) and heavily regulated ones. It is rather over the scope and rigidity of legislation, where it is highly unlikely that any activity done through Brussels will ever reduce the net obligations on member states, including Britain. The exact relationship between regulation imposed from the center and labor market rigidity in France, Italy, and Spain is not easy to determine, but there is no question that some portion of the stagnation in the E.U. comes from the move away from the pro-growth and pro-market policies of its earlier days.

Matters were not made any easier when by 2002 the Euro had become the single currency for nineteen E.U. member states, while Britain retained the pound. Currency policy poses a particularly interesting problem, given both the absence of a common E.U. fiscal policy and the presence of major differences in the growth rates of member state economies. Clearly a currency has to have a large enough range to be serviceable, but just as the range can be too small, so can it be too large. Putting Germany and Greece under the Euro meant that changes in exchange rates could not buffer the distinct economic differences between them. Centralized control meant that unwise interventions could not be confined to particular countries but took hold across the entire E.U. The uniform Euro also turned out to be an enormous mistake in system design, given that each country could form its own fiscal policy. It is always a question as to the optimal geographical reach of a given currency. It will not do to have a thousand different currencies, each covering some small portion of any given country. But to yoke different countries together with a single currency prevents the sensible adjustments that can otherwise take place through alteration of the exchange rates so that weaker countries can improve their export position by letting their currency float downward in exchange markets. The rigidity of a single currency meant that other steps had to be taken to keep the union together and these, in turn, required some explicit subsidies that had to be paid from stronger nations like Germany to weaker nations like Greece, if only to allow the Greek government to pay back its debt to the German banks that lent it money.

IV. A ROADMAP FOR THE FUTURE?

At one time, there was some genuine doubt whether the British would actually go through with their Brexit option. But as of late March 2017, the Article 50 application to leave the E.U. has been filed and finalized by the British. The framework under Article 50 is sketchy, but

it does contain some points of note. First, under Article 50, there is nothing that the E.U. can do to block the decision of the U.K. to exit. Consistent with the basic theory of the firm, Article 50(1) of the Treaty provides that "[a]ny Member State may decide to withdraw from the Union in accordance with its own constitutional requirements."[23] The withdrawal is triggered by a unilateral notification from the withdrawing nation, which in this case took the form of a letter that Prime Minister Theresa May sent to the E.U. on March 29, 2017.[24] The letter stated that while the decision to leave was irrevocable, the U.K. hoped to preserve "the deep and special partnership" as the E.U.'s "closest friend and neighbour."[25] Beyond this point, the Treaty provides no clear roadmap for agreements, only stating that "the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union."[26] The procedures for negotiation under Article 218(3) call for the E.U. to be represented by a Union representative who sets the basic framework for the negotiations.[27] For Brexit, that party is Michel Barnier. The Treaty also states that it "shall cease to apply to the State in question" once the agreement is completed, with a default term providing that it will cease to apply within two years after the notification letter, or in this case by March 29, 2019.[28]

This framework gives only limited guidance on how the negotiations toward settlement will work. The unconditional exit right under Article 50(1) is valuable, because it allows for the British to extricate themselves from an organization that they do not wish to be bound to, and to forge relationships with other nations unilaterally or (more promisingly) through other organizations, most notably the World Trade Organization, of which it is a member. But in fact, the exit option does not come close to solving all the issues that remain on the table. There remain matters of both principle and politics that have to be solved. The ultimate success of Brexit critically depends on first, working out the separation and then, on selecting some new mode of cooperation that keeps maximum interchange between the U.K. and the E.U. The situation here is exceedingly complex because there is no area of economic and social life in which the Brexit arrangement will be self-

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23 Consolidated Version of the Treaty on European Union art. 50(1), Oct. 26, 2012, 2012 O.J. (C 326) 43 [hereinafter TEU].

24 Letter from Theresa May, Prime Minister, U.K., to Donald Tusk, President, European Council (Mar. 29, 2017), https://www.scribd.com/document/343404076/U-K-Prime-Minister-Theresa-May-s-Letter-to-European-Council-President-Donald-Tusk [hereinafter Letter from Theresa May].

25 *Id.*

26 *See* TEU, *supra* note 23, at art. 50(2).

27 *Id.* at art. 218(3).

28 *Id.* at art. 50(3)–(4).

executing. Someone has to agree to terms, and the question is what those terms should be.

In my view, the proper approach in this particular case relies on the same logic that applies to the firm. In those cases where there are still gains from trade, the objective should be to substitute long-term contractual agreements for the single governance structure that created so much difficulty. Ideally, as often happens with the firm, the sensible arrangement is to put all questions of side payments to one side until the working relationships are established. Negotiations over past debts are at best transfer payments. But politics often takes a different course, and in this instance, Theresa May has announced that Great Britain "has already set aside £27bn to pay E.U. for a three-year transition deal."[29] Her unilateral decision should ease the path toward a stable institutional framework now that it is less likely to be subject to the tug-of-war that is the resolution of financial obligations. There are necessarily difficult transitional schemes, but the grand objective should be to work back to the early common market arrangement between the U.K. and the E.U. The first point is that Brussels no longer has any power over what laws the British pass and why. Obviously, in the transition period, the British then have to decide which of the European directives they wish to incorporate into their domestic law and which they wish to jettison. This inquiry could be complicated if there is some side agreement between Britain and members of the E.U. that may (or may not) survive that separation. There is no question that a lot of digging has to be done on a field-by-field basis.

Nonetheless, it should be possible to keep much of the freedom-oriented agenda associated with the original EEC. The free movement of goods and services in both directions should be encouraged, subject to the same antidiscrimination principles that applied before. That means that British banks, for example, should be allowed to supply the same services inside the E.U. after the breakup as they do now and members of the E.U. should, in exchange, be able to supply the same mix of goods and services to the U.K. The quicker one moves to this model of keeping alive as much trade as possible, the lower the loss of production that will come from the transition. The position here is not different from that of a large firm that enters into complex cooperative agreements upon fragmentation. It should be stressed that the restoration of the free trade model produces gains to both sides and minimizes the disruption on the ground for just about everyone. The E.U. can then continue to, if it chooses, apply its strong harmonization model to its various countries. But in my view, it would be a mistake for it to do so because the

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[29] Ross Logan, *Theresa May 'Has Already Set Aside £27bn to Pay EU for a Three-Year Transition Deal*,' EXPRESS (Sept. 16, 2017, 11:24 AM), http://www.express.co.uk/news/uk/854815/brexit-transition-deal-27bn-theresa-may-pay-eu-three-years.

pressures toward disintegration will remain for the twenty-seven nations (that are widely different from each other) still inside the E.U.

The clear area of difficulty is that of the movement of persons, which, in the form of the refugee problem, was among the levers that helped move the Brexit vote. It would of course be a huge mistake to stop all movement between the U.K. and the E.U. But one obvious fix is that the U.K. need not buy into accepting refugees and certainly not at the same level that has caused complex social problems in nations such as Germany, Sweden, and elsewhere. But more limited movement among a smaller group of nations is possible, and this would separate the refugee problem from work-related movements. Finally, there is the question of entering into free-trade agreements with other nations. Theresa May has made it clear that she wishes to proceed on all fronts simultaneously, in the hopes of sharing the gains of a different cooperative arrangement. That position seems consistent with the language of Article 50(2) that allows the parties to take into account their future relationships as part of the separation agreement.[30]

As a practical matter, moreover, May's position has gained some political support and intellectual respectability from the discussions inside the E.U. about developing a model for a "Multispeed Europe,"[31] which recognizes that the lockstep movement toward further integration may well be counterproductive. Indeed, some versions of this proposal would cede enormous powers back to the individual states, which could "essentially strip the E.U. back to being merely a single market."[32] It was clear, however, that proposals for modest decentralization failed in the negotiations between the U.K. and the E.U. in the run up to the June 2016 referendum.

A change of heart in this direction could well signify a recognition that the E.U. cannot survive in its current form simply because its median member is happy with its ongoing institutional arrangement. What really matters is some version of the domino effect. Let the most dissatisfied country decide to pull out, and each of the other twenty-six countries that are left will have to reevaluate its own loyalty to the E.U. The process here could easily lead to the formation of preferential blocks in which some nations under the E.U. have closer ties to each other than they do to the body as a whole. Yet once this takes place, it is fair to ask: why worry about the changes, and why worry about Brexit? If these changes reduce the stress on governance structures, they should be encouraged. If other nations follow the path of the U.K., so much the

30 *See* TEU, *supra* note 23, at art. 50(2).

31 Valentina Pop, *Once Scorned, 'Multispeed Europe' Is Back*, WALL ST. J. (Mar. 1, 2017, 12:11 PM), https://www.wsj.com/articles/once-scorned-multispeed-europe-is-back-1488388260.

32 *Id.*

better if overall levels of production are higher. If the appropriate common-market adjustments are made, then trade relations can be put into place as quickly as possible under a model that makes as few changes as possible, while transitioning back to something akin to an economic common market.

The reality of the situation, however, undermines this rosy scenario. The trouble is not on the British side. During the run-up to Brexit, the common charge was that the campaign was isolationist and populist and would therefore be against free trade and participation in the global economy. Many rank-and-file Brexiteers were said to be the same kinds of people as the anti-trade Trump faction in the United States. But the exit letter of Theresa May reveals a very different spirit.[33] Britain reasserted its self-determination precisely to ensure its larger participation in the global economy and proclaimed the goal of acquiring a free-trade agreement with the E.U. as soon as possible. May's vision is to have negotiations on withdrawal and negotiations on the future go in parallel, so as to minimize the period of disruption. It ought to be possible to make the program work, because the need for continued trade is as strong for members of the E.U. as it is for the U.K.

Nonetheless, it looks as though this pattern of simultaneous negotiations will not take place. The hardliner is the E.U.'s chief negotiator Michel Barnier, who insists on righting wrongs rather than figuring out how to make the relationships work going forward. As is so often the case, the sequence of negotiation tells the tale.[34] May wants the negotiations to go on in parallel so that new trade relationships can be defined and strengthened quickly. Barnier, along with the European Parliament, takes the position that divorce proceedings must be completed before any negotiations take place about future arrangements on the highly technical grounds that the E.U. cannot negotiate with a still-member state as though it were any outsider.[35] Indeed, in Barnier's view, the parallel negotiations over divorce and subsequent trade talks would be "very risky," despite the lack of clear explanation of what is gained by slowing up the normalization of trade relations.[36] Although the E.U. may wish to conduct side proceedings to determine, among other things, how much money the U.K. owes the E.U. for obligations previously incurred (some of which may be reduced or removed given

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33 *See* Letter from Theresa May, *supra* note 24.

34 *See* Michel Barnier, Chief Negotiator for the Preparation and Conduct of the Negotiations with the U.K., Speech at the Plenary Session of the European Committee of the Regions (Mar. 22, 2017) (transcript available at http://europa.eu/rapid/press-release_SPEECH-17-723_en.htm).

35 *See* Daniel Boffey, *European Parliament Backs Red Lines Resolution for Brexit Negotiations*, GUARDIAN (Apr. 5, 2017, 10:57 AM), https://www.theguardian.com/politics/2017/apr/05/european-parliament-red-lines-resolution-brexit-negotiations.

36 *Id.*

the separation), this is no reason to hamper forward-looking arrangements. The E.U. claims the tidy sum of €60bn (£51bn) to settle the key items of account: budget commitments, pension liabilities, loan guarantees, and E.U. spending on U.K. projects. Each of these figures can be contested along with countless other issues. But there is no reason why the financial questions cannot be bracketed so that the restoration of trade arrangements can take place swiftly.

By the same logic, there is no reason why the E.U. should take the hard line that all four freedoms are so intertwined that it constitutes illicit "cherry-picking" to take one without the others, given that the pros and cons differ widely for each. All of the proposed freedoms that survive could be reciprocal and if, as seems likely, that some separation of the freedoms makes sense, why have the blanket rule requiring a tie-in that does not work economically? Right now, the E.U. has arrangements with other nations that are *sui generis*, and the same can be done here so long as there is a willingness to make the best bargain.

Indeed, the entire stance of the E.U. has a deeply protectionist tone, which will have the same consequences as all forms of protectionism. The powerbrokers who negotiate the deal will profit from the exclusion. The bureaucrats of Brussels will thrive as well because the hard line is intended to make sure that their discretion is preserved over their now-smaller dominion. But protectionist approaches trap everyone in the crosshairs. If British banking services are kept out of the E.U., the E.U. customers of British banks will suffer along with the British themselves. Indeed, in one sense, the position could be riskier for the E.U. given its bulky processes than it is for the U.K., which at least is free to enter into other trade arrangements with the United States and its Commonwealth trading partners. There is no magic way to proceed in bilateral negotiations in high-stakes games. But the same principles that guide the dissolution of the firm should carry over to the dissolution of the E.U., and it becomes a matter of the greatest urgency that the E.U. switch to a more constructive bargaining position that puts mutual gains ahead of factional discord.